The Power of Dividends

Learn about an investment strategy that can:

- **Enhance investment growth**
- **Increase investment income**
- **Reduce portfolio volatility**
- **Provide special tax savings**

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Reach your financial goals

Choose the right combination of growth, income and capital preservation.

I follow a defined process to help my clients reach their financial goals. This process helps me to:

- Understand their current situation
- Set realistic financial objectives
- Identify investment opportunities
- Seek opportunities for tax efficiency
- Keep them on track to their objectives

One of the investment opportunities I frequently recommend is dividend-paying stocks. Stocks that pay dividends can be a valuable addition to many portfolios because they have the potential to:

- Enhance your rate of growth
- Increase your level of income
- Reduce the volatility of your portfolio
- Provide special tax savings

Please read on to learn more about The Power of Dividends, and how they can help you reach your financial goals.

Understanding the current environment

Why now is an excellent time to consider dividends for your portfolio.

Until the end of the 1990's, the Dow and TSX indices were in a long-term bull market that saw consistent returns above 8%, year after year. Given the current economy, the illusion of easy, low-risk returns has been broken by experience. It's now clear that we need to take sensible precautions to earn solid returns without inviting excess volatility.

Meanwhile, the landscape for earning investment income has also changed with interest rates at historic lows. That means we're living in a challenging time for investors seeking investment income.

Dividends are particularly timely because they address several needs in today's economic environment. They can enhance returns without adding undue risk to a portfolio. They can provide a cushion against market volatility. And they can generate a stream of reliable, tax-advantaged income.

The Rule of 72

How important is your rate of return?

Everyone knows that a higher rate of return is preferable to a lower one. But *The Rule of 72* is a great way to illustrate just how much of a difference it can make. Simply divide the number 72 by a given rate of return to find out how many years it will take to double your money.

Using a target rate of return of 8% and *The Rule of 72,* we can calculate that:

- It will take nine years to double your money
- In nine years, $100,000 will become $200,000
- In 18 years, $100,000 will become $400,000

If you were to lower your target return to 5%, the outcome would be dramatically different. It will take almost 14 and a half years to double your money, and after nine years, your $100,000 will only have grown to $155,133. So there's no doubt that returns are very important.

Time to double your money	
Return %	Years
5	14.4
6	12.0
7	10.3
8	9.0
9	8.0
10	7.2

Looking back over the history of the market, and considering the investment strategies currently available to savvy investors, 8% is not an unreasonable target return. However, you may need to tap into the power of dividends to get there.

Dividends for growth & income

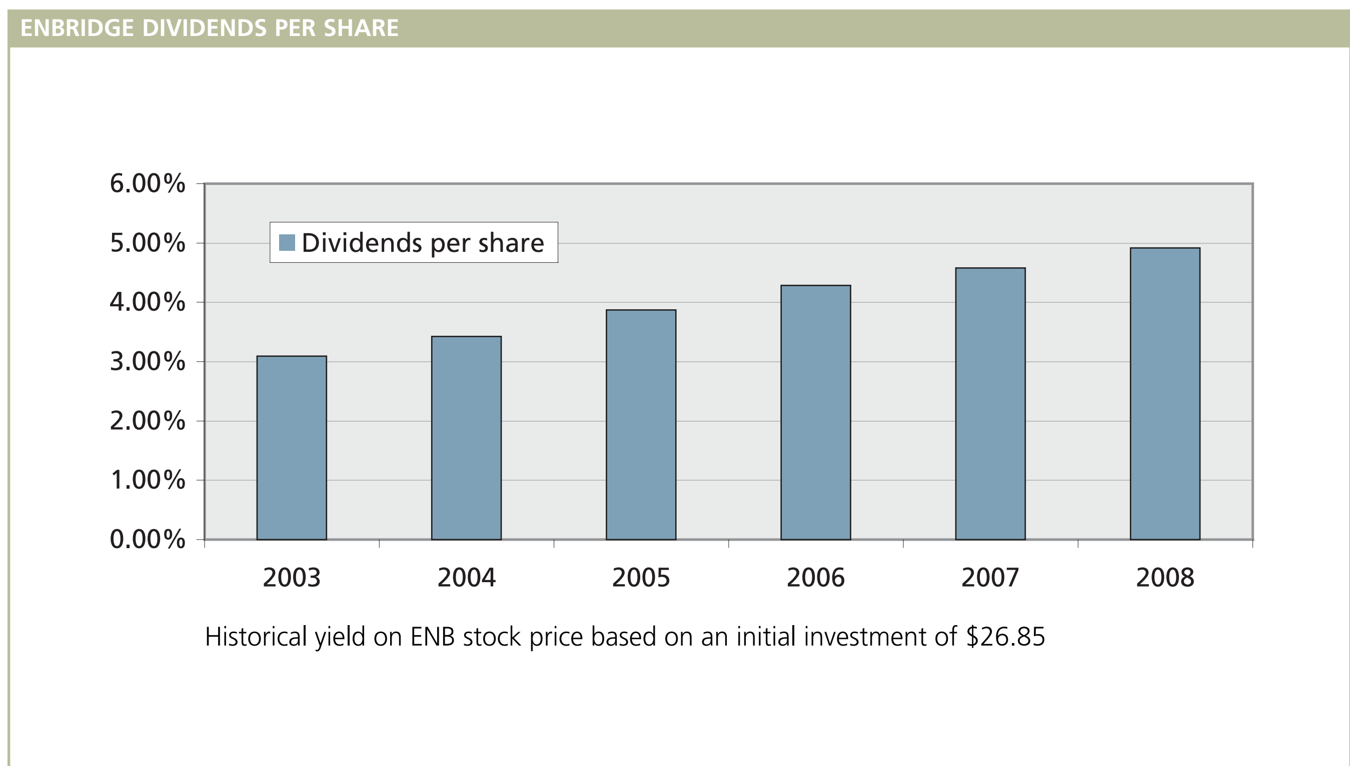
How can you achieve an 8% return?

Most investments are categorized as either growth-oriented or income-oriented. But dividend-paying stocks offer both growth and income to help you achieve your target return. Enbridge (ENB) is a great example. Let's look at how Enbridge helped investors make money during the five-year period from the last trading day of 2003 to the last trading day of 2008.

- At the end of 2003, Enbridge stock traded at $26.85 per share and paid an annualized dividend of $0.83. That equals a rate of income (or "yield") of 3.09%. Therefore, to reach a target return of 8% in 2004, Enbridge only had to appreciate by 4.91%.
- During the five year period from 2003 to 2008, Enbridge consistently increased its dividends. An investor who paid $26.85 per share would now be receiving an annual yield of 4.92% at the end of 2008 based on their original investment. In other words, Enbridge shares only need to appreciate by $0.83 to generate a return of 8% in 2009 based on the original purchase price.

This goes to show how the combination of dividends and growth can put an 8% overall return well within reach.

ENBRIDGE DIVIDENDS PER SHARE



Historical yield on ENB stock price based on an initial investment of $26.85

Dividends to manage risk

Dividends can provide a cushion against volatility, but you must be selective.

Dividend-paying stocks have a distinct advantage during periods of market volatility. Whereas non-dividend-paying stocks need earnings growth and investor optimism to support their price, the income from dividend-paying stocks gives them intrinsic value, even in volatile markets.

All else being equal, if the price of a dividend-paying equity falls, its dividend yield rises, making it more attractive to income-seeking investors. This phenomenon tends to reduce the volatility of dividend paying stocks.

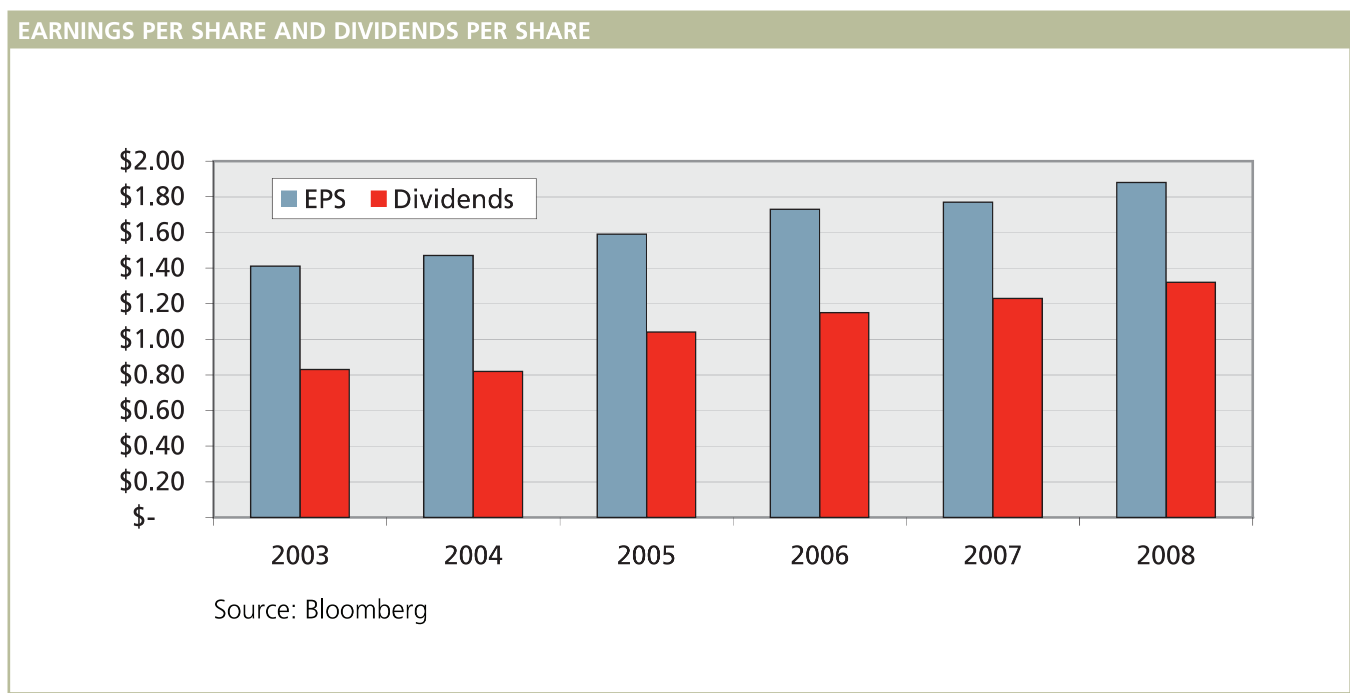
Nonetheless, it takes careful research to benefit from the risk-management aspect of dividend-paying stocks. You need to select companies with attractive dividend records and strong underlying fundamentals. Enbridge once again provides a good example:

- **Dividend Growth.** Enbridge has a long history of increasing dividends. Since 1995, the annual dividend has risen from $0.50 to $1.48 per share.
- **Earnings growth.** The price of Enbridge shares are underpinned by solid earnings growth. Since 2000, earnings per share have increased from $1.27 to $1.88 at the end of 2008.
- **Regulated assets.** Many of the company's assets are regulated which means that regulatory boards determine how much money the company can make. This process adds transparency to Enbridge's earnings and, thus, the sustainability of the dividend.

A company that lacks these characteristics could be vulnerable. For example, a drop in operating income could result in a dividend cut and a share price decline. Further, if interest rates rise, a company that can't afford to raise its dividend won't be able to maintain a competitive yield.

In summary, dividend-paying stocks can help moderate the volatility of many portfolios. The key is to select shares that are issued by conservatively managed companies with a proven history of earnings growth and rising dividends.

EARNINGS PER SHARE AND DIVIDENDS PER SHARE



Source: Bloomberg

Dividends for tax savings

The tax treatment of dividend income offers unique opportunities.

Interest income is like employment income — every dollar is taxed at your full marginal rate. Dividend income, on the other hand, is eligible for a Dividend Tax Credit that can result in a preferential after-tax return. Here's a look at how the three main types of investment income are taxed:

Investment Taxation by Province			
Province	**Interest**	**Capital gains**	**Dividends**[1]
British Columbia	43.7%	21.9%	18.47%
Alberta[2]	39.0%	19.5%	17.45%
Saskatchewan	44.0%	22.0%	20.35%
Manitoba	46.4%	23.2%	23.83%
Ontario	46.4%	23.2%	24.64%[3]
Quebec	48.2%	24.1%	29.7%[4]
New Brunswick	46.95%	23.4%	23.18%
Nova Scotia	48.3%	24.2%	23.35%
Prince Edward Island	47.4%	23.7%	24.44%
Newfoundland & Labrador	47.04%	23.52%	30.63%
Yukon	42.4%	21.2%	17.23%
Northwest Territories	43.1%	21.6%	18.3%
Nunavut	40.5%	20.3%	22.2%

As an investor, the implications are clear. An interest payment and a dividend payment of the same amount before tax will produce two very different outcomes after tax. Based on the above table, an investor who earns $10,000 in interest will keep only $5,630, while an investor who earns $10,000 in dividends will keep $8,153. It's not hard to see how the tax advantages of dividends can have a significant impact, especially if you rely on your investments for retirement income.

Taking into account your specific investment goals and risk tolerance, it can be a wise tax decision to hold Canadian dividend-paying companies in your portfolio.

[1] The combined federal and provincial tax rate on eligible dividends is based on the proposed federal rate reduction and the current provincial dividend tax credit rates. For Newfoundland, Quebec, Ontario, Manitoba, Saskatchewan, Alberta, British Columbia, and Northwest Territories, the dividend tax credit rates contained in the respective provincial proposals have been used.

[2] The combined Alberta tax rate on ineligible dividends will be gradually increased to 27.71% by 2009; for eligible dividends, the combined rate will be gradually reduced to 14.55% by 2009.

[3] The combined Ontario tax rate on eligible dividends will be gradually decreased to 22.38% in 2010.

[4] The combined Quebec tax rate on eligible dividends received between January 1, 2006, and March 23, 2006, is 28.61%.

Call to learn more

As a ScotiaMcLeod wealth advisor, my job is to recommend investment opportunities with the right combination of growth, income, risk management, and tax efficiency for my clients. Dividend-paying stocks offer a unique opportunity to benefit from all of these characteristics in a single investment solution.

Call today to find out how The Power of Dividends can help you reach your financial goals.

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