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RE-DISCOVERING DIVIDENDS

Why dividend investing is making a comeback in these challenging market conditions

Prepared by the Investment Products Research Team

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Historically, participating in the stock market has meant investing in high-quality, blue-chip companies that paid a steady stream of dividends, once considered a fundamental source of returns. However, technology has enabled us to get information faster and trade securities at low cost. Investors, as a result, have exhibited hubris in their quest to beat the market by chasing higher-risk stocks. This strategy has ultimately hurt them during market corrections — for example, when the tech bubble burst more than 10 years ago and once again throughout the credit crisis only a few years back. Not surprisingly, the investor response has been swift and strong: a structural decrease in their *willingness* to take on risk.

The paradigm shift toward risk reduction has also come from another front. Given an aging population, particularly in developed nations, investor time horizons have effectively decreased over time. This trend should continue. For investors, this represents a structural decrease in their *ability* to take on risk.

A dividend-oriented strategy is critical...once again

In today's ultra-low interest rate environment, investors who seek capital preservation through government bonds would do well to merely keep pace with inflation. To benefit from more attractive yields and the potential for modest capital growth, investors are once again considering the advantages of investing in high-quality companies with a solid track record of paying dividends.

Seeking dividends, an old idea, has been made new again by market forces.

Let's examine the advantages of a dividend-oriented investment strategy.

Proof point #1

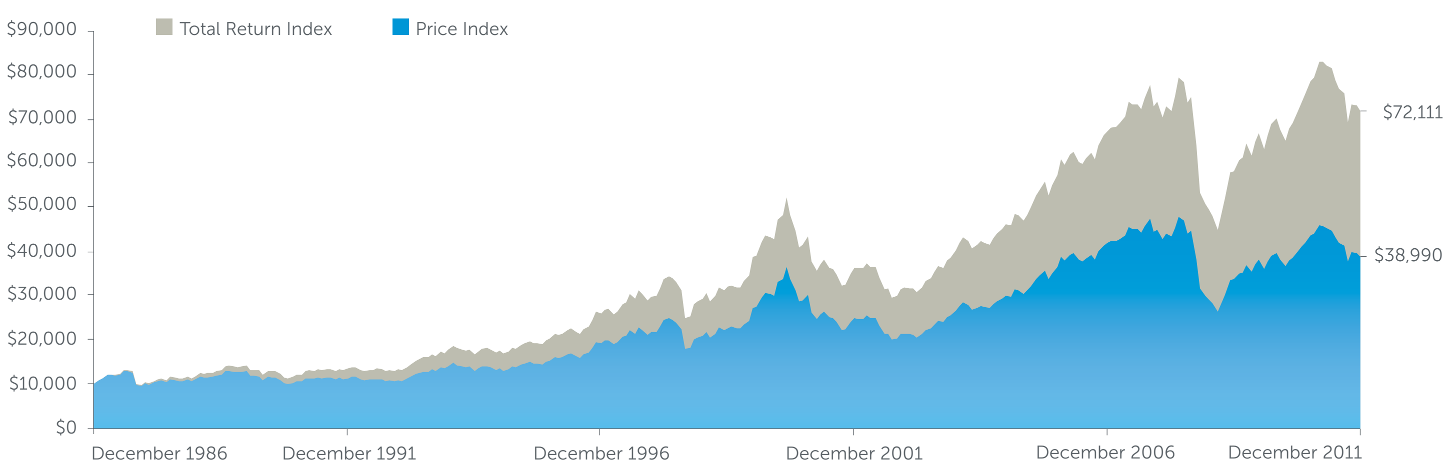
Dividends play a major role in equity market total returns

Earning and reinvesting dividends can play a major role in determining the total returns for an investor over time. As you can see in Figure 1, a $10,000 investment in the S&P/TSX Composite Total Return Index would have increased in value to $72,111 — accounting for both price appreciation and the reinvestment of dividends — over the past 25 years. A similar investment in the S&P/TSX Composite Price Index would have grown to only $38,990 (accounting for price appreciation only).

Figure 1

Significant Impact on Total Returns

Growth of $10,000 - S&P/TSX Composite



Data Source: Bloomberg (Dec 1986 – Dec 2011)

Proof point #2

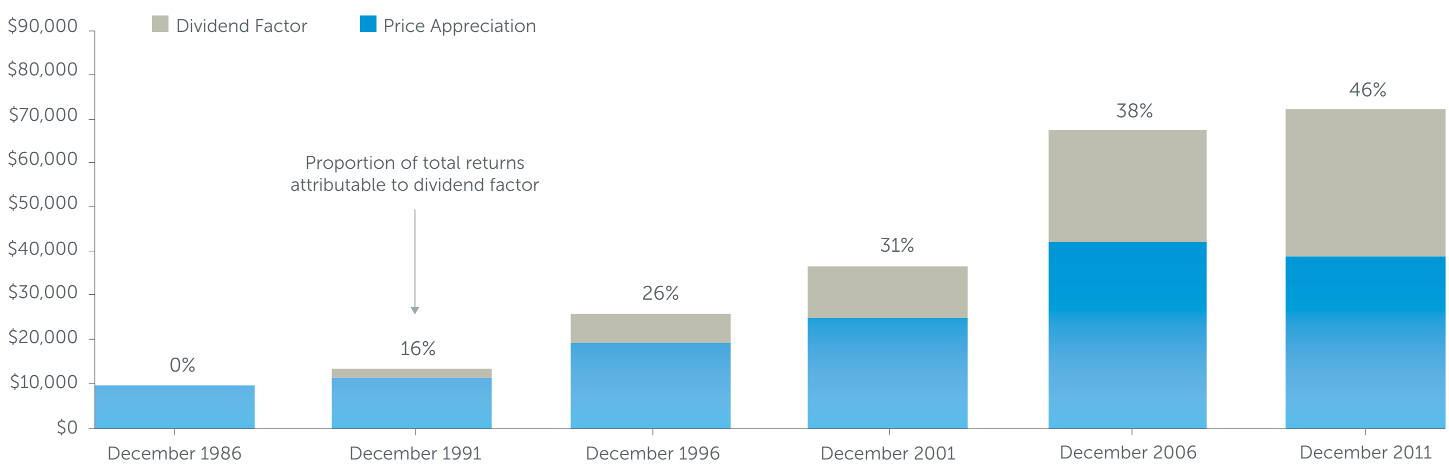
The dividend factor becomes increasingly significant over time

With annual dividend yields in the major stock market averaging between 2% and 5% over the past decade, you might, at first glance, think that dividends are merely the proverbial "icing on the capital appreciation cake" — in other words, an afterthought. However, you cannot afford to ignore the compounding effect of the dividend factor*, which can be significant. In Figure 2, we take another look at the growth of our hypothetical $10,000 investment in the S&P/TSX Composite – from a different perspective. In examining sequential five-year periods, we can clearly see the proportion of total returns due to the dividend factor. In the early years, its impact is understandably small. However, its impact grows significantly over time, providing almost 50% of the total returns for a period of 25 years. In addition, the dividend factor has even grown over the past five years — when the price appreciation component has shrunk.

Figure 2

Compounding Effect of Dividend Factor

Growth of $10,000 - S&P/TSX Composite



Data Source: Bloomberg (Dec 1986 – Dec 2011)

Proof point #3

Dividends are a reliable and stable source of total returns

Dividends can provide a steady stream of income. After all, dividends stem from company profitability over the long term. Capital gains (the "price" component of your returns), on the other hand, can be at the mercy of investor sentiment, which has become increasingly sensitive to market noise (i.e. news and investment pundit views on world markets and economies).

As Figure 3 shows, the average dividend yield on the S&P/TSX Composite stands at about 2.4% over the past 10 years, ranging between 1.5% and 4.6% during this period. This may not seem significant at first glance, but you must also account for the compounding effect of the dividend factor mentioned above. In Figure 3, we can also see that trailing 12-month price returns averaged 7.1% over the same period, but exhibited much greater volatility with returns ranging between -40.2% and +43.2%. During this interval, price returns were also negative 29% of the time. Of course, you can never have a negative dividend yield!

* The dividend factor represents the reinvested dividend portion of total returns.

Figure 3

Reliable and stable source of total returns

S&P/TSX Composite	Minimum	Maximum	Average	Standard Dev.	% Frequency Negative
Price Returns (ttm)	-40.2%	43.2%	7.1%	17.9%	29%
Dividend Yield	1.5%	4.6%	2.4%	0.6%	0%

Data Source: Bloomberg (December 2001 - December 2011)

Proof point #4

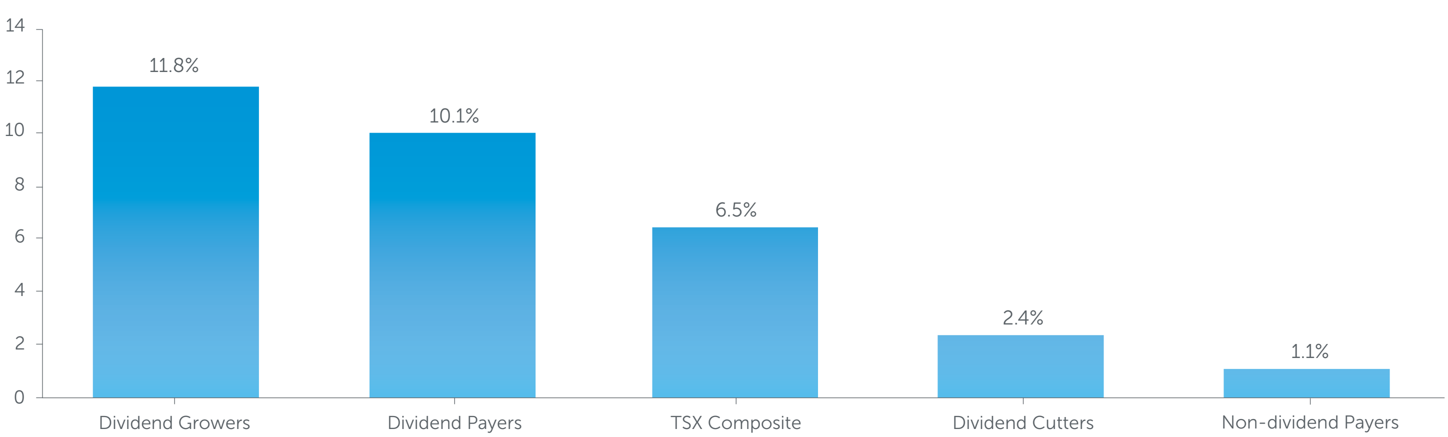
Dividend strategies have historically outperformed

Dividend strategies are not only an important and stable source of investment returns, but can also outperform in the long run. As shown in Figure 4, a recent study by RBC Capital Markets clearly shows the advantages of investing in dividend-yielding Canadian companies. Over the past 25 years, companies with growing dividends have seen 11.8% in annualized returns, compared to just 1.1% for non-dividend payers and 6.5% for the overall TSX Composite. When you apply these rates of returns to the growth of our hypothetical $10,000 investment, compounded over 25 years, the result is $162,572 for a dividend-oriented strategy, compared to $13,145 and $49,423 for, respectively, companies that do not pay dividends and the S&P/TSX.

Figure 4

Dividend Strategies Outperform

S&P/TSX Composite



Source: RBC Capital Markets Quantitative Research (Dec 1986 - Dec 2011, Equal Weighted)

Proof point #5

Dividend strategies have historically provided superior downside protection

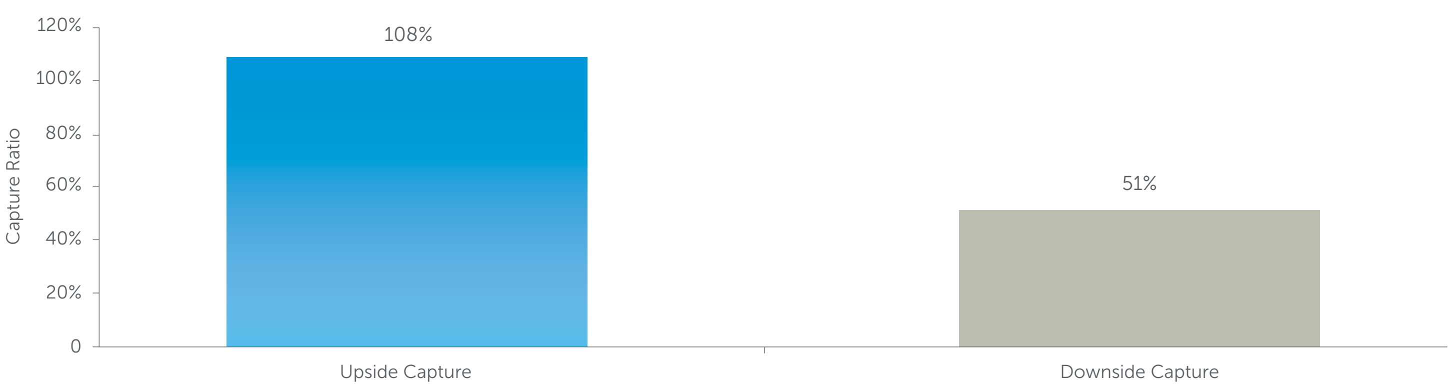
Stock dividend yields naturally provide downside protection. For example, if the price of a stock with a dividend yield of 3% declines 5% over a one-year period, the net loss is effectively reduced to 2%.

You can potentially increase your downside protection with an effective dividend strategy. In Figure 5, the upside and downside capture ratios (which show you how much of the market's move – up or down – you experienced) of the S&P/TSX Dividend Aristocrats Index* versus the S&P/TSX Composite clearly show that a dividend strategy can capture all of the broad market's upside movement and protect assets in weaker market environments, capturing just 51% of downward market movements.

Figure 5

Dividends Provide Downside Protection

S&P/TSX Canadian Dividend Aristocrats vs. S&P/TSX Composite



Data Source: Bloomberg (Jan 2003 – Dec 2011)

* The S&P/TSX Canadian Dividend Aristocrats Index is designed to measure the performance of S&P Canada Broad Market Index (BMI) constituents, which have followed a managed-dividend policy of consistently increasing dividends every year for at least five years.

Concluding comments

No matter how you look at dividends, they just make sense

Intuitively, it makes sense that investing in attractively valued, strong companies provides superior returns over the long run. These companies can typically maintain a healthy dividend track record — dividends stem from a company's ability to grow earnings. In addition, declaring or increasing dividends signals a longer term commitment to share earnings with shareholders. Company executives are fully aware that organizations forced to reduce or suspend their dividend payments often have their stock price punished by investors.

Empire Life Investments recognizes the advantages of dividend investing

At Empire Life Investments, our managers fully recognize the long-term benefits of owning high-quality, dividend-paying companies. Underpinning our conservative, value-oriented management style is our proprietary intrinsic value model that identifies companies with a healthy dividend track record or firms with fundamentals supporting an initiation or increase in dividends. This model also helps avoid companies offering unrealistically high dividend yields that may be cut in the future.

A case in point: Within our Canadian-oriented large cap equity mandates, we have invested in the common shares of major telecom companies, which have looked attractive over the past two calendar years — with bond yields stubbornly anchored at historically low levels. The major names in this industry have attractive yields, a history of increasing dividends and the fundamentals for further dividend increases. Moreover, this sector has dramatically outperformed the broader market (23.6% vs. 8.8%) on an annualized total return basis over the past two years ending January 31, 2012.

For many investors, dividend strategies are an old idea that's new again. We at Empire Life Investments believe dividend investing is a wise way to build and protect the wealth of investors over time.

Contact your Empire Life Investments sales team representative to find out more

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