ScotiaMcLeod
exchange
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PROFESSIONAL INVESTMENT ADVICE

In a bull market, dividend-paying stocks can enhance total returns by generating a steady flow of quarterly, tax-advantaged income. In a bear market, this same flow of income can help offset capital losses, and potentially reduce portfolio volatility. At ScotiaMcLeod, we believe dividend-paying stocks make sense for a wide range of investors, especially when the market's direction is uncertain.

Dividends: income and stability for your portfolio

Tara Quinn, MBA – *Associate, Portfolio Advisory Group*

Equities have a history of providing positive returns over the long term, but in the short term, it's nice to have investments in your portfolio that can generate steady income — even if the market is not rising. Bonds are often relied upon for tried-and-true income generation, but dividend-paying stocks offer compelling advantages of their own.

For one thing, they allow you to participate in the growth of the market with less risk than other equities. Whereas non-dividend-paying stocks need earnings growth and investor optimism to support their price, the prices of dividend-paying stocks are usually supported by their own quarterly dividends.

When the price of a dividend-paying equity falls, its dividend yield rises, which tends to attract buying interest from income-seeking investors. Indeed, this phenomenon helped some dividend-paying shares outperform their non-dividend-paying counterparts over the past year.

Another powerful benefit of dividends is the potential for generous after-tax returns. 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 when it is received from a Canadian corporation.

As a result, an interest payment and a dividend payment of the same amount before tax will produce two very different outcomes after tax. Based on the 2009 top marginal tax rate* in Ontario, an investor who earns $10,000 in interest will keep only $5,359, while an investor who earns $10,000 in dividends will keep $8,583. This can make a very big difference, especially if you rely on your investments for retirement income.

How to choose a dividend-paying stock? In general, you need to select companies with attractive dividend records and strong underlying fundamentals, including a proven history of dividend growth, solid earnings, and favourable industry conditions. For example, companies in highly regulated industries, such as utilities, tend to have predictable cash flow and reliable dividends.

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CONSIDER PREFERRED SHARES

Preferred shares are a special class of dividend-paying stock. Although they are considered equities, they have a par value and their dividend rate may be fixed, which gives them bond-like attributes. Preferred shares are considered "preferred" due to the fact that their dividend must be paid to shareholders before a common stock dividend can be paid.

Preferred shares offer a number of advantages:

- Stable income – Preferred shares provide consistent dividend income along with certain guarantees that aren't available from regular dividend-paying stocks.
- Financial strength – Preferred shares are generally issued by companies with strong cash flow, and their creditworthiness is monitored by independent rating agencies.
- Potential for capital gains – In the current risk-averse market environment, some high-quality preferred shares have been discounted, creating the potential for capital gains once the market regains its equilibrium.
- Tax-advantaged returns – Dividends from Canadian corporations are taxed at a considerably lower rate than interest income.

When it comes to preferred shares, one size certainly does not fit all. They are issued by a diverse array of companies in a variety of industries, and can include complex features. For example, they might offer a fixed or floating dividend rate, come with or without a maturity date, and may or may not be converted by the issuer into cash or common shares at a future date.

It's important to discuss your specific needs and goals with an advisor who can analyze your situation and present you with well-reasoned recommendations. It's certainly worth a conversation, as preferred shares have shown tremendous resilience in volatile markets and can offer predictable, tax-advantaged income quarter after quarter.

Please get in touch with your ScotiaMcLeod advisor to discuss your portfolio, or to request additional research and information on dividend-paying stocks.

WHAT ARE THE RISKS?

Here are some of the risks your ScotiaMcLeod advisor can help you manage:

- **Interest rate risk** – Similar to bonds, preferred shares tend to fall in price when interest rates rise.
- **Credit risk** – The credit rating of a preferred share issuer can change over time.
- **Call risk** – Some preferred shares can be "called in" by the issuer and converted into cash or common shares.
- **Liquidity risk** - Preferred shares generally attract fewer buyers and sellers than common shares.

*Rate as at May 2009 is 46.41%.

Reflections

"Wealth is not his that has it, but his that enjoys it."

Benjamin Franklin

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