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Hello and welcome to the Fidelity ETF Exchange powered by Fidelity Connects, connecting you to the world of investing and helping you stay ahead. This is the first of a five part series called Factors in Focus, where cohosts at Etienne Joncas Bouchard and Katrina Wilson explore investment factors, with today's topic being high dividend factor ETFs. Over the course of the coming weeks, Etienne and Katrina will offer their outlook on various investment factors, describe how they have performed in the past and more importantly, how advisors and investors can incorporate them into their portfolios.

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Hello, everyone, and welcome to the seventh episode of the Fidelity ETF Exchange. I'm your host Etienne Joncas Bouchard, also known as EJB, and we have a great episode set for today. This will be the first of a five piece segment called Factors in Focus. The episodes will be slightly shorter than usual at around twenty to twenty five minutes. We'll try to keep them short and sweet, but filled with some great content for you guys. The objective is to provide a deep dive on various investment factors and how they have performed in the past, and kind of what to expect going forward, how you can incorporate them into your portfolios, and just an overall sharing of information regarding how these types of factors behave through different market environments. So some of you may be asking what are investment factors: investment factors are quantifiable characteristics that can explain differences in stock returns. So the objective of these factors isn't necessarily to just outperform a broad benchmark, but to isolate a certain style of investment, to achieve a specific investment objective. The factors that we will be analyzing over the coming weeks are high dividend, low volatility, high quality, momentum and value. All of these factors are based off of past academic research and have shown in the past to be able to predict certain returns for these categories of stocks. So, as you can guess, investors are able to take advantage of these through ETFs, otherwise they wouldn't be part of our podcast here, whether that is that Fidelity or with another firm in the Canadian market space. Today we'll be kicking it off with high dividend stocks. But before we do, we have some news. For those of you that have been listening to our previous episodes, you might be wondering why Mike Riccio is no longer kicking off the podcast. Our dear friend Mike has decided to take on a new challenge outside of Fidelity and will therefore no longer be hosting the podcast unfortunately. This was his brainchild and we will miss him dearly and wish him all the best. Mike did play an integral role in launching this podcast. So thank you, Mike. Thankfully, as you all know, Fidelity has an abundance of talented individuals in its ranks. Without further ado, I'm very excited to introduce my new co-host, Katrina Wilson. Katrina is an ETF strategist at Fidelity covering Western Canada. Katrina and I actually started in this position at the same time back in September of 2019. She had previously worked at Fidelity as a district vice president in sales and is also a CFA charter holder. Katrina, welcome to the show.

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Yes, thank you EJB. Thanks for having me.

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It's my pleasure. I hope you're as excited as I am. This is a new next step for the podcast and I know we're going to find tons of great stuff to talk about. And today, to kick it off, as I mentioned, we're going to be looking and taking a deeper dive into high dividend factor ETFs, high dividend factors and just high dividend stocks in general.

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So the first thing that I'm going to ask you, I guess, is what comes to mind in the in the perception of most advisors and investors is that dividend stocks are boring old blue chip type companies often referred to as either lower beta. And I just wanted to get your opinion on how you would describe these mandates. And do you think that that's fairly accurate?

[00:04:55]

I think that's a great point. It's definitely something we hear about, and especially when nothing sounds more exciting than investing in tech stocks. So it does seem like a lot of these companies seem more mature or old and a lot of investors just don't feel the excitement or connection to them anymore. There's actually a lot of really interesting things to take into consideration, especially since we've seen yields come down so much. What we're actually starting to see is maybe there's money rotating out of fixed income into some of these stocks just sort of ideal to your portfolio, add income to your portfolio in an environment where you might not be getting it from other sources. What are your thoughts? Is that something you're still thinking about?

[00:05:38]

Absolutely. And that's a great point. And you actually stole one of my future questions with that. But that's fine. Yes, I agree. I think one of the strong tailwinds for high dividend stocks, I guess. Dividend stocks have been around for such a long time. It's one of those classical investment theories that if you are buying stocks with the ability to generate income, that will do very well for retirement accounts in particular. But it is going to be, I think, put in the spotlight a little bit with yields coming down. And I think in Canada, and I'd like to get your opinion on this, I think we have a stronger bias towards dividend stocks than most other investors in other regions just because of the way our index or the TSX is structured, like the average dividend yield on the TSX is higher than a lot of other broad benchmarks. Do you have anything to add on that?

[00:06:32]

No, I think it's a good point. I mean, if you think about the US yielding around 50 basis points or 150% around less than the TSX. So while a lot of people are looking for exposure outside of Canada for certain reasons, maybe they're trying to reduce exposure to energy. But to your point, it's actually one of the most effective ways to get income in your portfolio. So definitely maybe not the exciting tech companies in Canada, but to your point, a great way to add income.

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Absolutely. And it's also… I think it comes back also to diversification, like you always want to have different styles and we're going to get into all the different ones over the next coming weeks. But dividends can be used for many different reasons. So we've highlighted one right here, obviously, with income generation. And I think really that's the key. The main argument behind it is to generate that income. That being said, it is also a great diversifier to those tech stocks that you mentioned. For example, if we look at our products as a typical benchmark or look into this type of factor, the sectors that you're overweighting are completely different from what you're overweighting with a factor like quality or momentum or even growth to a certain extent. Definitely. And I think that's maybe a little bit why a lot of investors were surprised with the performance of dividend stocks since the beginning of the year. We tend to see… As an investor, we think that these larger cap dividend stocks are dividend payers will generally protect well on the downside, but that's not exactly what happened during the COVID-19 drawdown. Why do you think it was different this time around?

[00:08:21]

I think… I mean, COVID what a time, first of all. Obviously, there was force closures. Everything happened at an accelerated rate. I was looking the other day at bond spreads and it took them about one tenth of the time to get to the point of where they were in 2008, which is just a shocking statistic to see. So I think the main thing with dividends is, you know, investors really put a lot of emphasis on stock price as it relates to what the dividend yield is. And so you're paying 4%. The idea is the stock price has taken that into consideration. And I think just so much panic and COVID drawdown sort of got priced into the market that a lot of people were discounting the fact that I think companies are just not going to be able to keep up with their dividend payments. And it almost like shocked the entire dividend universe. And people started assuming that, well, the stock's pricing on a 4% dividend yield and everybody's expecting that to be cut. Should I be owning these companies? So it's almost a shock to the expectation of dividend payments and just so much uncertainty around even standard or mature great companies and how they would actually survive in a forced shutdown. So I really think it's the idea of discounting that dividend or the expectation of dividend payments going forward. I don't know if you had kind of similar observations.

[00:09:56]

Absolutely. I mean, it's I think that makes so much sense. And we tend to forget that dividend stocks remain attractive as long as they're able to pay that dividend. And what happened during COVID-19, I think, is that a lot of the companies that were in these types of portfolios were forced to, like you mentioned, cut, halt, reduce their dividends. And that sent investors fleeing to other safe haven assets; whether that be bonds, whether that be cash, whether that be, you know, just other segments of the equity market. And I think another good point is that depending on how the ETF mandate you use is built, you're actually going to have quite a wide array of sector allocations. And we tend to forget that a lot of dividend paying or high dividend paying sectors are actually quite cyclical in nature. So the ones that really come to mind, right off the top of your head usually, we got real estate, that's classic dividend payers, we have utilities, we have telecos, but we also have pipelines, energy companies, integrated energy companies, we also have financials, to a certain extent, which have been really low beta in Canada, but in Europe have not. So, for example, if we look at an international dividend mandate, that segment was hit quite hard. And I think it comes down to the way that you're building these types of products. But I think it's easy to forget that there is some cyclicality in dividend payers.

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Yeah, I think that's a good point. I think something we also maybe don't take or spend enough time thinking about is everyone we always thinks about dividend yields as dividends, but then obviously there's other aspects like payout ratio. And obviously that's a huge, I mean, energy. They might have attractive dividend yields, but I don't know if that's something either you're hearing talking to advisors or… That's such a great point.

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And I kind of wanted to go there, but I didn't know exactly how to how to address it. But it's so true, right? We always look at the absolute dividend yield when we're comparing these mandates. But there's so many other criteria that you have to look for like the payout ratio, like dividend growth. So you do want a company that's continually increasing their dividend, or do you just want a company that has no more growth and is paying out the cash that it's generating? And I guess that's fine until you have no more cash flows. So and I think that was the case also in COVID where all the companies that had a high payout ratio were the ones that particularly got burned. So if your revenues go down 50% in one quarter, well there's no way you're going to be able to pay out that dividend to your shareholders. So, yeah, I think that really explains the performance so far year to date. But I think there's still some optimism that should be held there for dividend stocks going forward, because, as you mentioned, whether that's the macro tailwind from lower bond yields, but it's also on a valuation standard. And I think that we're getting close to historically cheap valuations for dividend stocks to the broad benchmark. Do you have a few comments on that, Kat, that you like that?

[00:13:07]

No, you're right. And we're definitely starting to see that. I mean, if we think about the COVID recovery, if we can use that official term, obviously dividend stocks have done so well. And it was almost exactly what you just touched on, the idea that a dividend stock just became so cheap. I mean, think about the Canadian banks. They don't have a track record of cutting their dividend. And do low rates impact them? It could. But if you're looking at where they're trading from a valuation standpoint, those businesses aren't going anywhere. And they were paying such attractive dividend yields at that point. So I think valuation is something absolutely we need to pay close attention to. And I know what the most recent report we saw, right, looking at that 12 month excess return from a forward looking standpoint.

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Yeah, that's I think thanks to our friends at FMR, so Fidelity US, which provides us this great quant data. Obviously we're working in partnership with them for our factory lineup and they shared some great information on historical valuations of different factors. And I guess we can touch on it as we go through these various factors to kind of position ourselves on where we are respective to the benchmark. And basically what it was showing us is that dividend stocks in Canada, the US and on the international space as well, from a price to book or forward price to earnings basis, we're talking in between the 5th and 20th percentile of historical valuation. So, you know, really, really attractive from that perspective. But was even what was even more interesting and what you were alluding to is that when we get to these valuations, historically speaking, so this is going back to 1996, we can see that there is an average excess return generated over the next 12 months. That was in the range of between 10 and 22%, depending on the on the geography. So this is somewhat of buying the dip type thing where adding a dividend mandate to diversify your equity exposure might make sense not only just to reduce your overall risk

or your equity risk that you're taking, but to also benefit from a potential outperformance to come. And I think following the 2008-2009 Great Recession, dividend mandates were actually some of the strongest performers in 2010 and 2011. So definitely something to keep an eye on.

[00:15:34]

Yes. Yes, great point. Obviously something that… To some degree I mean, we definitely saw out of COVID asset classes reacting very similar to what we saw coming out of the Great Financial Recession of 2008-2009. So it certainly was a period of time that we were able to look to for some ideas through April and May.

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Absolutely. So this brings me to my next question, and it's regarding maybe a headwind. So we've been positive, we've been relatively positive on dividends right now. I think for all the reasons that we've described so far, it seemed like it would be the right time to buy this type of factor. Now, I'm going to put you on the spot and say do you think there is a headwind to high dividend stocks going forward? Like what's going to maybe keep them undervalued for maybe a prolonged period of time? Do you see anything anyways?

[00:16:30]

I don't know, I'll play devil's advocate here, because I think the market needs two sides of every story. So I think we did a good job of expressing the case for why dividends. And if we're going to look at in what scenario does that not play out… If we think about equity market returns and we actually break it down, you have dividend yield, you have multiple expansion or contraction, you've got earnings growth. Dividend yield has just not been a massive contributor to stock market returns over the last 10 years. It's come from earnings growth. It's come from multiple expansions. So, like I said, the market needs two sides of every story, that's how you make a market, or sort of two sides of the equation. So I think what will sort of prevent dividends from seeing significant growth is if we keep seeing multiple expansion in sectors like tech and we see earnings growth accelerating even more than what we've seen in the last 10 years. So I think it's not so much anything against the companies, but I think it's going to be very much dependent on the leaders that we've seen in the last 10 years. Can they keep running? And the reality is… And I mean, we've seen it right. Dividend yield has a negative correlation, excess correlation to these momentum strategies. And so really, in order not to say that we need to see a big tech drawdown, not to say we need to see these companies going away, but we technically will eventually have to see a slowdown in the stock market returns of those types of companies. I don't know if you have similar thoughts.

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Yeah, and from what I'm getting from your comments is I think that high dividend stocks are becoming more and more like value stocks. And for them, I think to have a sustained outperformance, it's kind of the same arguments that you'd have to see for value to come back, which is, you know, an acceleration of economic growth, maybe a bit of inflation and just an overall better outlook or more clear outlook on the macro backdrop going forward. That being said, regardless of what your outlook is for the forward dividend stocks, there are certain types of investors. So if you're an advisor listening in or if you're an investor, how does this fit the bill for those types? Like what is the ideal investor look like for dividend companies? Is it the young earners who are starting to invest? Is it people getting closer to retirement? Is it for everyone? Is there a prototypical type of investor, you think, for these types of mandates?

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You know, one use case I love to have, it is not another specific type. But anyone that's looking to save in TFSAs, what a great way to do it with high dividend ETFs, because you not only get, hopefully, capital gains through equity market exposure, but if you can get and generate income of some of the high dividend strategies yielding two to four percent tax free, that's a really attractive compounding strategy right there. So I think that can be across demographics ages. But certainly anyone that's looking to state has capacity in their TFSAs, I'd say that's probably the number one sort of use case where at least especially right now, we're in a lot of money flowing to. What would you say?

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I 100% agree with you and what a beautiful tool the government has given us with TFSAs. And it makes so much sense because that income will not be taxable. And obviously, this applies mostly to foreign. You know, if you're buying a US dividend mandate, for example, particularly advantageous because it's not Canadian dividend income that you're getting, which is taxed at a lower rate, obviously. So definitely I think that makes a lot of sense. And I think that's why we're going to continue to see that. And I'm going to come back to the first initial point, because I truly think it is maybe the most important argument that can be made for dividend stocks, and that is the decrease over the past 10 years in overall bond yield. So fixed income investors, especially as we're going towards retirement, so for investors that are heading towards finally retiring and taking advantage of all those investments that you've made over your career, investing in bonds only or in a purely balanced portfolio that isn't aiming to generate an excess yield… It's going to be harder and harder to generate a certain amount of income to meet those needs, those expenses that you're going to have going forward. So what's your opinion on that? And how do you think dividend stocks can maybe bridge the gap between bonds and just pure equities without a dividend focus?

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You know, that's such a great point. I've had so many discussions about that lately, whether it's looking at GICs, high interest savings accounts or even traditional bonds. We thought earlier this year that yields couldn't go any lower and we've seen them come down drastically since the COVID drawdown. And what's been really fascinating to see is, well, yields have come down; actually looking at dividend yields in the equity markets, they're either flat or they're slightly up. So, for example, if you look at the TSX, if you look at a high dividend ETF in Canada, the yield on these products are actually up from where they were on January 1 of this year. So it's pretty eye opening to see that. And for investors looking to generate cash flow, this can be a really great way to do it. And in particular, for those that may traditionally be investing in fixed income and bonds, this can be a great solution to help cushion some of the lower income we're seeing from that asset class. And one of the things we often hear about, too, is, OK, well, great, what if I just go out and buy a handful of dividend paying stocks? But if you're looking at a high dividend ETF, for example, in Canada, you're going to be diversified not only across all the sectors, but across 60 or so names. So it can be a great way, you know, if you're looking to complement income, you're getting on the fixed income side, but maybe don't want to take on that company specific risk by buying one or two or five stocks, this is a great way to hedge that risk out. You know, another topic that we haven't covered off yet today EJB is preferred shares and obviously a topic we're hearing a lot about as well. What are you hearing on your side?

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Absolutely. So actually, I'll just make one quick comment on what you were saying before I jump in that one, because that is another big one. And I think that I've been receiving a lot of questions recently about where some are even being called back. But quick parentheses on the first subject of the opportunity set in fixed income being obviously much less attractive than it was fi5-ve, five, 10 years ago. And I think there is an underlying risk that we might not be taking into consideration with fixed income. And that is if you're looking at a purely passive fixed income index, either in the Canadian space, US or global, the risk profile for what you're getting paid to take on is significantly higher than what it was 10 years ago. And if we just use duration as one metric, having a duration of eight at a yield that is sub one percent or close to one percent, that is completely different from what it was, even as close back as 2015-2016 when you're getting paid 2.5% for a duration of approximately 4.55. So you almost have twice the risk for half the return. And I think that's something to take into consideration. Obviously it hasn't materialized as a risk. It's been more of actually a net positive over the past five years because the longer duration you had as rates went down, the better returns you had. But those capital gains opportunities seem to be shrinking, if not becoming more or less non-existent, especially on the government bond side. I'm not talking corporate bonds necessarily, but definitely on the government bond side.

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Definitely. And for any new listeners out there, just a quick refresher on what duration is. When we talk about risk of fixed income, what duration tells us is not risk from a standpoint of whether the bonds are actually going to pay their coupons, that's what we refer to as default risk. But duration tells us is how sensitive is the price of that bond as it relates to movements in interest rates. And so we think about how much is that bond price going to fluctuate with a one percent move in interest rates. A duration of eight would mean if rates go up 1%, price of that bond falls by 8%. So you can see that that's in today's environment, adding some risk to fixed income overall. And as EJB pointed out, we're really seeing that sensitivity to interest rates increase over time.

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Absolutely. So I guess I'll just make a quick comment on preferred shares, which is definitely an asset class. I'll be nice. I'll play nice. It's not my favorite asset class, but obviously there are some advantages. They wouldn't be this popular if there wasn't. That being said, if you look over the past 10 years, it really has been a dog. It's been a really tough space. Obviously, there's been some great prefs. But if you look at the overall market as a whole, that yield is now very, very similar to your high dividend ETFs and your risk profile is exactly the same, but you have less upside. So for us, it's just a great alternative because you're not capped to the upside. You're taking on the same volatility, you're getting the same yield. It just seems like a very simple mathematical switch opportunity that you can make in your portfolios. Obviously, if you're an advisor listening in, preferred shares can be rated differently as equities in your compliance and all that stuff. But definitely one thing to keep an eye on going forward, I think and there is obviously quite a bit of assets in that space as well.

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So definitely important to highlight, I believe.

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I guess I have to ask that and put you on the spot. Are you buying preferred or high dividend ETFs right now?

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Definitely buying high dividend ETFs. I think that was easy to figure out here. But nonetheless, definitely an important point to mention. I think we're getting close to wrapping it up here. Like I mentioned, we want to keep these not too long. Just get some good content in there. We're going to have the next factors coming out over the coming week. So keep your eyes open, keep your ears open.

[00:27:38]

Kat, any closing messages you would like to share with our audience? No, hopefully this was sort of a good rundown of what one might look for or expect from a high dividend strategy. And I guess for next one, all I need is a nickname so I can be an official host with EJB.

[00:27:56]

Absolutely. All right. We'll try and figure that out between now and then. Thank you, everyone, for joining us. Kat, awesome job on your first podcast. Welcome to the team. And we look forward to doing some more episodes in the future. Thank you, everyone.

[00:28:12]

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