

# The dividend effect

Income, growth and downside protection – as more and more Canadians move into retirement, they’re discovering that equity-paying dividends have just what they need.

“Do you know the only thing that gives me pleasure?” John D. Rockefeller reportedly said to a neighbour. “It’s to see my dividends coming in.” Hopefully Canadians heading for retirement will find more sources of pleasure in life than did John D. But in order to enjoy those pleasures, they may be wise to investigate the form of investing that the founder of the Rockefeller fortune found so satisfying.

In fact, it seems they are already doing so. Investment in Canadian dividend funds has grown by 28% in the past 12 months alone, making it the third largest of all Canadian equity mutual fund categories, with CAN\$32.3 billion in assets<sup>1</sup>.

Now is a particularly fortuitous time for Canadian dividend investors. As the chart below shows, Canadian dividend-paying equities (represented by the MSCI Canada Value Index) are currently providing a better yield than other major regions.

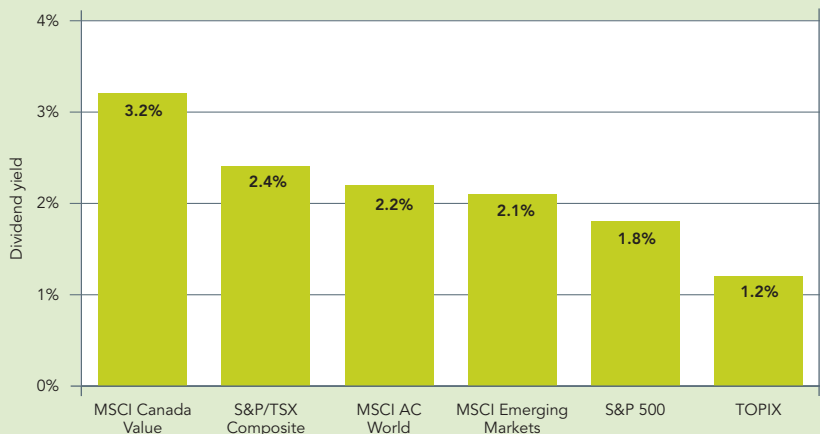
But dividends have more to offer than the current market flavour. When done right, dividend-investing provides benefits that should interest any investor – particularly those in retirement.

## Effect #1: Sustainability and growth

The popularity of dividend-paying stocks makes sense. Retirees typically need three qualities in their investments – income, capital preservation, and capital growth to out pace inflation.

While dividends can never be guaranteed, the ability to pay dividends tends to be self-

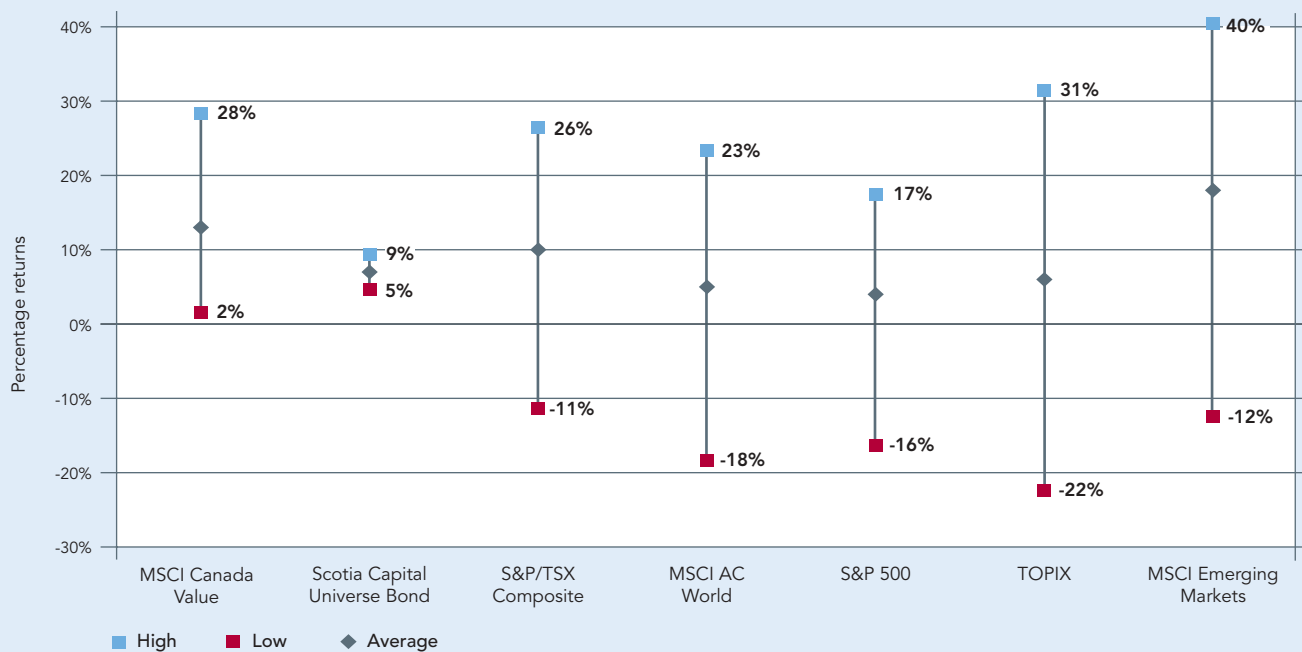
Canadian dividend yields currently outpace the world



Source: Datastream, July 31, 2007

## Dividend-paying investments offer less volatility and downside protection

3-year rolling returns since July 31, 1999 – July 31, 2007



Source: Datastream

perpetuating. Companies that commit themselves to issuing regular dividends usually have good cash flow, strong balance sheets and are involved in economically insensitive areas of the economy where margins and market positions are stable. Otherwise, they simply would not be able to sustain their payments.

Paying dividends is not appropriate for all companies. For example, young, growing organizations may be better off using cash flow for expansion, innovation or capital investment, which in turn will benefit investors. For other companies, however, paying dividends may actually improve performance. In a profitable, mature company, the pressure of cash flowing in can create the urge to spend in ways that are less than wise. (What the famous oilman Hugh Liedtke, president of Pennzoil, irreverently referred to as "The Bladder Theory.") The very fact that a company is expected to pay dividends, and even increase those dividends over time, discourages wasteful spending and

tends to enforce the sort of disciplined management that will keep a company successful.

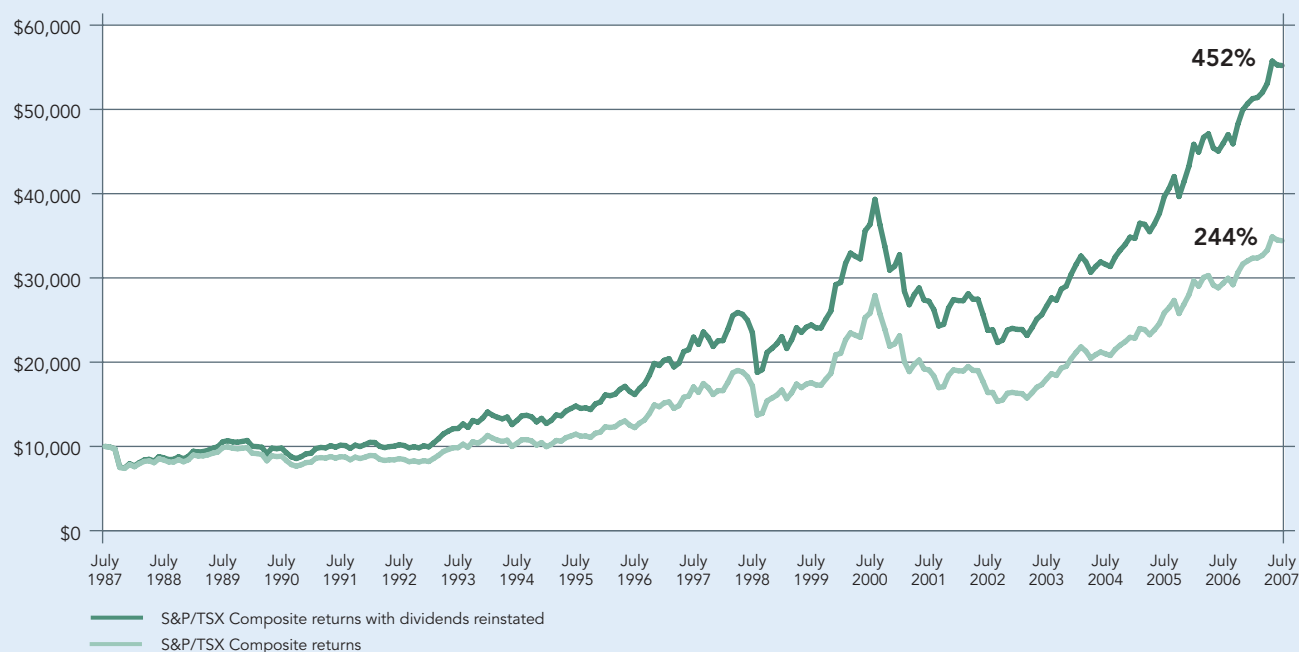
### Effect #2: Downside protection

As Peter Lynch has pointed out, a dividend can act to protect the stock price. If a \$20 stock, paying a \$2 dividend, drops to \$10, the yield will increase to 20% "If investors are sure that the high yield will hold up, they'll buy the stock just for that. This will put a floor under the stock price. Blue chips with long records of paying and raising dividends are the stocks people flock to in any sort of crisis." For example in the stock market crisis of 1987, dividend-payers suffered less than half the decline of the general market.

As the chart above indicates, the special characteristics of dividend equities keeps returns within a narrower range of volatility. The results have been lower volatility without compromising performance.

## The benefits of reinvesting dividends

July 1987 – July 2007



Source: Datastream

### Effect #3: Compounding growth

When the dividends are reinvested, the long-term results can be impressive. Between July 31, 2006, and July 31, 2007, the S&P/TSX composite index showed a return of 20.1%, including dividends. But if dividends were not reinvested, that return would decrease by 2.9%. Over five years, reinvested dividends increased return from 114% to 137%.<sup>2</sup>

For investors who want to take advantage of this effect, dividend funds offer automatic reinvestment. (Fidelity Dividend Fund, for example, gives investors the choice of whether to reinvest dividends or receive them in the form of a monthly distribution.)

Dividend income, low volatility and growth – it's no wonder Rockefeller was a dividend enthusiast. And even the most modest investor, particularly one looking for both growth and some security, stands to benefit.

### Who should invest in dividends?

- **Investors in or close to retirement** – Dividend-paying stocks can provide income plus growth as a hedge against inflation.
- **Investors who already invest in dividend funds** – These funds can make up a large part of a retirement portfolio. It's wise to diversify into more than one fund.
- **Risk-averse clients who need equity exposure** – Dividends can provide a reassuring, relatively low-risk way to get into the stock market.
- **Anyone interested in the combination of income, downside protection and growth** – including the added potential from reinvested dividends.

1 Source: Investment Fund Institute of Canada (IFIC) July 2007.

2 Source: Datastream July 31, 2007.

## Avoiding the yield trap – Fidelity's approach to dividend investing

While managers of dividend funds need to keep a careful eye on yields, they must also beware of the yield trap – paying too much attention to yield and not enough to underlying factors.

As a stock's price drops, its yield will increase, as long as the dividend stays the same. But focussing on the numbers can distract attention from the reasons why that stock is actually falling. If a company is in serious trouble, the stock may continue to drop and the dividend may soon vanish, leaving no yield at all.

Rather than strictly playing the numbers, successful dividend investors also need to do their due diligence on the individual companies. With its extensive research resources, Fidelity has been able to do the bottom-up work necessary to understand what's behind changes in yield.

The fund currently benefiting from Canada's stellar dividend performance, Fidelity Dividend Fund, consistently uses a bottom-up approach to picking stocks. It also ups the results of dividend investing with a couple of twists. The Fund's dividend-paying equities are supplemented by income trusts and bonds, for a target mix of 70% equity, 20% income trusts and 10% fixed income.

Stephen Binder, well-known as portfolio manager of Fidelity True North® Fund, runs the equity portion of the portfolio. Cecilia Mo manages the income trust portion to bring an extra boost to growth and yield. The bond portion, under David Prothro and Brian Miron, cushions the fund against volatility, and adds nicely to the Fund's overall yield.

Lead manager Derek Young, a specialist in risk management, can shift the balance among these three asset classes to get the greatest potential for growth and downside protection for investors.

**This document is for registered Investment Professional use only.** Read a fund's prospectus before investing. Mutual funds are not guaranteed; their values change frequently and past performance may not be repeated. Investors will pay management fees and expenses, may pay commissions or trailing commissions, and may experience a gain or loss. Views expressed regarding a particular company, security, industry or market sector are the views only of that individual as of the time expressed and do not necessarily represent the views of Fidelity or any other person in the Fidelity organization. Such views are subject to change at any time based upon markets and other conditions and Fidelity disclaims any responsibility to update such views. These views may not be relied on as investment advice and, because investment decisions for a Fidelity fund are based on numerous factors, may not be relied on as an indication of trading intent on behalf of any Fidelity fund.

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