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Dividend yields an easy way to profit

Improving tax efficiency and defensive positioning

At this time of year, many investors are examining their portfolios to re-assess tax efficiency. They will find that one of the easiest ways of improving tax efficiency is by adding dividend-yielding investments. The advantages can be quite significant.

On an after-tax basis, dividends are generally worth 1.31 to 1.45 times more than the earnings on interest income. Case in point: an Ontario investor in the highest tax bracket would have to purchase a bond yielding 5.36% in order to achieve the same after-tax income generated from a stock with a 4.0% dividend yield.

On average, investors in the top tax bracket earning more than $128,800 per year keep $75-$85 of every $100 in dividends. This is a significant advantage over interest income, where investors in the top tax bracket normally retain only $55 to $61 of every $100.

For investors in the lowest tax bracket, the benefits are even greater. For instance, investors in Ontario will net $103.93 for each $100 of dividends and BC investors will net $109.42. Rates vary according to provinces and income levels, so investors should check with their advisors.

Dividend investing has a number of benefits beyond tax efficiency. They may not be glamorous but dividends play an important role in the total return of a portfolio. Over the past 40 years, 58% of the returns earned in the MSCI World Index were attributable solely to dividends.

Companies paying dividends tend to be more defensive in nature and much less sensitive to interest rate fluctuations, historically generating superior total returns on a lower risk basis compared to the overall market.

As we look into 2011, dividend-yielding companies are likely to benefit from a shift in fund flows. Since March 2009, approximately $33 billion has moved from money-market funds into higher yielding products, particularly dividend-producing equities. Much of it was a rushed reallocation and some of those equities benefited from the exuberance rather than sector growth potential or fundamentals. Therefore, investors now need to be more selective in choosing dividend investments.

When analyzing a dividend-yielding investment, investors should assess the quality of the company and its ability to pay the dividend. The most consistent dividend-paying companies generally have large market capitalizations and solid credit ratings. Procter & Gamble is a good example. They've paid a dividend for 120 consecutive years and 2010 marked the 54th year in a row of dividend increases.

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Canaccord Genuity analysts prefer high-quality, high-dividend yielding companies offering stable cash flow and significant potential for capital appreciation. Their current equity picks, with dividend yields exceeding long-term Government of Canada bonds, include Capital Power (TSX: CPX), Crescent Point Energy Corp. (TSX: CPG), First Capital Realty Inc. (TSX: FCR), Telus Corp. (TSX: T), Toronto-Dominion Bank (TSX: TD), and TransCanada Corp. (TSX: TRP).

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