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Dividends the safest route back into markets

Canadian utility stocks appeal to nervous investors

Investors have long viewed dividends as an attractive supplement to their investment portfolios, simultaneously providing both income and tax advantages. Dividend-paying companies are not usually glamorous or exotic. They are blue chip large-caps in mature industries and, although they may experience a lower growth rate, they offer very stable earnings. Given that dividends represent part of the total return of a portfolio, the income stream they provide helps to mitigate any potential depreciation in their stock prices.

However, in extremely volatile markets, even dividend stocks do not provide sufficient comfort for investors and they flee equities in search of safer investment vehicles, most often running to money markets and bonds. The unfortunate irony of the recent exodus to products like government bonds is that their yields have declined as a result.

Recent market upturns have forecasters debating whether or not the rallies will continue. Personally I think it's a bit early to break out the champagne but I do believe it's time for those who have fled equities to assess their holdings and start planning portfolio recovery. For those who are still not quite comfortable with the equity markets, a good starting point could be solid, blue chip companies paying consistent dividends.

Even recovering markets continue to have ups and downs so investors might also consider the advantages of being sector specific. In Canada, the utilities sector is a favorite of dividend investors because it's defensive and offers more security in market downturns. Additionally utilities act as a leading indicator, normally recovering either before or coincident with a broader market recovery.

Canadian utilities are currently earning higher after-tax dividend yields than long-term Government of Canada bonds. Combining this with capital gains, they have historically better total returns on a risk-adjusted basis than the overall stock market. And, with current prices, their shares have significant potential for upward movement.

Wherever you live in Canada, whether in a high tax bracket or low, the tax advantages of dividends over bonds are significant. Highest tax-bracket investors generally keep $75-$85 of every $100 in dividends. Only Newfoundland, Nova Scotia and Quebec are lower at $73, $72, and $70 respectively. If you're in the lowest tax bracket, it's even better. With the tax credit mechanism, you will receive more than the value of the dividends. For example, if you're in Ontario you'll get $107.71 for each $100 and in BC you'll get $114. Rates vary according to provinces and income levels, so investors should check with their advisors.

Investment decisions must always include fundamental analysis and investors should properly assess any company being considered. Look for those that have secure, long-term contracts and possess stable assets. Demand clean balance sheets and a good management team. Finally, when looking for a good defensive play, always consider credit quality.

Paying dividends and having them grow are two important indicators of quality and Canadian utilities tend to meet these tests. For instance, Fortis has paid a dividend since 1949, Enbridge since 1952,

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TransCanada since 1964, and TransAlta since 1956. Utility dividends grew 5% in 2005, 9% in 2006, 4% in 2007, and 9% in 2008. Utility earnings followed suit and, during the same years, increased 6%, 17%, 7%, and 9% respectively.

Increasing defensive positioning is a wise approach for the conservative investor and, given the current depressed prices in the markets, this could be a good time to examine dividend-paying utilities. As always, think carefully, choose wisely, and act appropriately.

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