The First Step to Creating the Ultimate Dividend Portfolio

Description

The identification of companies that will be able to pay a stable and growing stream of dividends for years to come is the first step to constructing an equity income portfolio. The next step is to use modern portfolio theory, and a fair dose of simple logic, to reduce the risk in your portfolio without detracting from investment returns.

My criteria for the identification and selection of companies that qualify as dividend champions have been laid out in a previous article but to summarize briefly, investors should be looking for companies that have:

1. A track record of consistent and growing dividend payments,
2. A rock-solid balance sheet, and
3. A dividend payout ratio that leaves room for unforeseen events.

Selecting companies for an income portfolio based on these guidelines will at least provide investors with the comfort that the company has the pedigree of a true dividend champion and the balance sheet strength to support ongoing payments even if business conditions become tough. Scanning the horizon for factors that will impact the ability of the company to continue to pay and grow dividends should supplement this analysis.

Modern portfolio theory tells us that the application of a few simple rules can improve the risk profile of a portfolio without reducing the return potential. The math behind the theory is somewhat complicated, but fortunately the application is intuitive and in its most elementary form is based on the old adage of “never put all your eggs in one basket”.

In practice, investors will be looking to combine companies that derive their profits from different geographic areas and economic sectors, which should reduce the statistical correlation between their stocks and effectively lower overall portfolio risk.

The table below identifies a number of Canadian stocks that qualify as dividend champions based on the criteria indicated above, and also satisfy the criteria for exposure to various economic sector or macro-economic drivers. By combining these stocks, an investor can reduce portfolio volatility without sacrificing investment performance.

The five stocks indicated below have all been weighted equally. This portfolio achieved an investment return of 129% over the past five years compared to a total return of 68% for the broad market index. On top of the excellent return, the volatility of the portfolio was considerably lower than the overall market, with a standard deviation reading of 8.7% compared to the market volatility of 11.2%.

This is remarkable, as the optimal risk reduction point is normally reached only when 20 or more stocks are combined in a portfolio. This low portfolio volatility is probably best explained by the fact that these companies are exposed to different macro-economic or industry factors, contributing to the offsetting and lowering of risky exposure to single factors.

Company	**2014 Expected Dividend Yield**	**Main Sector Exposures**	**Volatility**	**Correlation Market**
Telus (TSX: T)	3.8%	Telecommunications	12%	0.23
Toronto Dominion Bank (TSX: TD)	3.4%	Banking; interest rates	9%	0.62
RioCan (TSX: REI.UN)	5.2%	Real Estate	11%	0.20
Fortis (TSX: FTS)	4.0%	Utility	6%	0.30
North West Company (TSX: NWC)	4.8%	Consumer staples	18%	0.28
Overall Portfolio	**4.2%**		**8.7%**	**0.48**
Thomson Reuters Canada Equity Index (^TRXFLDCAP)	2.7%		11.2%	1.0

Source: Thomson Reuters

The investing landscape over the next five years will almost certainly be very different from the past five years, but the evidence from this portfolio illustrates the attraction of disciplined dividend-based investing. The addition of some basic portfolio construction techniques can further enhance the risk/return profile of this portfolio.

There are more ways to further reduce the risk in this portfolio, including increasing of the number of stocks and widening the macro factors to which the companies are primarily exposed. This, as well as the growth potential of the portfolio income, will be the subject of a follow-up article.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:FTS (Fortis Inc.)
2. TSX:NWC (The North West Company Inc.)
3. TSX:REI.UN (RioCan Real Estate Investment Trust)
4. TSX:T (TELUS)

5. TSX:TD (The Toronto-Dominion Bank)

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