Best Canadian Dividend ETFs of 2023

Description

A great strategy for beginner investors is targeting Canadian dividend stocks via the use of exchange-traded funds, or ETFs. This approach can help investors access a dividend investing strategy with little knowledge of stock picking and at a low cost.

Investing in a dividend ETF versus individual dividend stocks can help new investors learn the ins and outs of the market, while remaining diversified.

So, what is a dividend ETF, and which ones are the best for you? Keep reading to find out.

What is a dividend ETF?

A dividend ETF is an investment instrument that trades on an exchange under its own ticker. Imagine that a fund manager purchased a portfolio of dividend stocks and put them in a basket. Then, the fund manager divided this basket up into different shares. These shares are created/redeemed when investors buy or sell the ETF. Buying and selling occurs on an exchange, where the ETF trades under its own ticker.

Dividend ETFs focus on holding dividend-paying stocks. Typically, they employ one of the following two investment approaches:

- **High-yield**: These dividend ETFs hold stocks that have historically paid out higher-than-average yields.
- **Dividend growth:** These dividend ETFs hold stocks that have historically increased their dividend payout amount on a consistent basis.

Dividend ETFs can also be categorized as either active or passive. The differences are:

- **Passive ETFs:** Often tracks an external dividend stock index and must follow its rules.
- **Active ETFs:** The fund manager picks and chooses dividend stocks based on predetermined criteria.

Finally, some dividend ETFs are categorized based on the country of origin of their underlying dividend stocks. The options are:

- **Canada:** Tracks dividend stocks from Canadian markets.
- **U.S.:** Tracks dividend stocks from U.S. markets.
- **International developed:** Tracks dividend stocks from developed countries such as Europe, Australia, Japan, and the U.K.
- **International emerging:** Tracks dividend stocks from developing countries such as Russia, China, Africa, and those in the Middle East.

One important thing to note about dividend ETFs is that their distribution frequency, or how often the dividends are paid out, can be different than that of dividend stocks. Most Canadian dividend stocks pay dividends on a quarterly basis. Dividend ETFs can sometimes pay on a monthly basis by dividing up the underlying quarterly dividends from the stocks held. An investor seeking more consistent income may find a monthly distribution beneficial.

Top dividend ETFs in Canada

The following Canadian dividend ETFs have a combination of low fees, broad diversification, and high assets under management.

Name	AUM	MER	12-month trailing yield
Vanguard FTSE Canadian High Dividend Yield Index ETF (TSX:VDY)	$1.8bn	0.22%	4.18%
iShares S&P/TSX Composite High Dividend Index ETF (TSX:XEI)	$1.3bn	0.22%	5.09%
iShares S&P/TSX Canadian Dividend Aristocrats Index ETF (TSX:CDZ)	$945.3mn	0.66%	4.18%

As of December 29, 2022

Vanguard FTSE Canadian High Dividend Yield Index ETF

VDY is a passively managed ETF that tracks the FTSE Canada High Dividend Yield Index. This ETF holds a total of 47 Canadian stocks screened for above-average dividend yields. Most of this ETF is dominated by large-cap stocks, especially those from the financial and energy sectors, which make up 53.5% and 27.8% of the ETF, respectively. The ETF pays dividends on a monthly basis.

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iShares S&P/TSX Composite High Dividend Index ETF

XEI is a passively managed ETF that tracks the S&P/TSX Composite High Dividend Index. This ETF holds a total of 75 Canadian stocks selected for above-average dividend yields. Most of XEI is still large-cap stocks, but sector representation is more uniform with the largest being financials at 30.6%, energy at 29.1%, utilities at 13.4%, and communications at 12.1%. The ETF pays dividends on a monthly basis.

iShares S&P/TSX Canadian Dividend Aristocrats Index ETF

CDZ is a passively managed ETF that tracks the S&P/TSX Canadian Dividend Aristocrats Index. This ETF holds a total of 93 Canadian stocks that have increased ordinary cash dividends every year for at least five consecutive years. Once again, large-cap stocks dominate most of the fund, with financials, energy, and utilities being the highest-weighted sectors at 24.3%, 14.6%, and 13.2%, respectively. This ETF also pays dividends on a monthly basis.

How to pick dividend ETFs in Canada

One of the most important features to check when screening Canadian dividend ETFs is the fund's yield. This is the annual percentage return an investor is expected to receive from dividends. It can be calculated in two ways, one backward- and one forward-looking.

- **12-month trailing yield:** This is the yield the investor would have received if they held the ETF over the last 12 months given the fund's current net asset value (NAV). To calculate this, sum up all dividends received over the last 12 months, and divide that by the ETF's current share price.
- **Distribution yield:** This is the yield projected if the most recent dividend payment remained consistent for the next 12 months. To calculate this, take the most recent dividend amount, annualize it (multiply by 12 if paid monthly or 4 if paid quarterly) and divide it by the ETF's current share price.

Both metrics are useful for gauging a dividend ETF's yield. However, the 12-month trailing yield is a more accurate metric given that it represents what an actual investor would have received holding the ETF over a period of time. Keep in mind that the yield does not reflect any fees or trading costs incurred.

Speaking of fees and trading costs, choosing the right dividend ETF in Canada isn't just a matter of selecting the one with the highest yields. The most popular funds tend to have a combination of the following traits:

- **High assets under management (AUM):** This measures how much investor money is currently held by the ETF. The higher this is, the more popular the fund is. ETFs with a higher AUM are at a lower risk of being delisted and have a higher daily traded volume (liquidity), which is good for minimizing bid-ask spreads.
- **Low management expense ratio (MER):** This is the percentage fee charged by the fund manager on an annual basis, calculated against the value of your total investment. For example,

if you invested $10,000 in a dividend ETF charging a 0.20% MER, your annual fees would be around $20 ($10,000 investment * 0.20% MER = $20).

Do all ETFs pay dividends?

Not all ETFs pay dividends. Some ETFs hold stocks that do not pay out dividends themselves. Think about technology sector stocks, or growth stocks, which usually do not pay a dividend. Thus, an ETF holding those assets is unlikely to pay a dividend.

To get technical, some other ETFs may pay out money, but it isn't technically a dividend. Broadly, this is known as a distribution, and it can be in the form of interest income (commonly for bond ETFs), return of capital (commonly for commodities ETFs), or capital gains (for any ETF). You'll still receive a periodic payment in these cases, but it isn't from underlying dividends paid by stocks.

Are dividend ETFs a good investment?

The answer to this question depends on your investment objectives, risk tolerance, and time horizon. Dividend-paying ETFs might be more suitable for older investors seeking more consistent income from their portfolio. For younger investors, focusing on maximizing total returns might be a better idea.

While reinvesting dividend payments can help portfolio returns compound faster, the risk of under-diversification cannot be ignored. Many dividend ETFs tend to be concentrated in only a few sectors, like energy, financials, or utilities. They also tend to hold mostly large-cap stocks.

This can cause investors to neglect sectors such as technology or consumer discretionary stocks, which do not usually pay high dividends. These sectors often hold growth stocks that can strongly outperform in bull markets. In addition, missing out on small-cap stocks isn't great for diversification.

That being said, dividend ETFs are a great way to start investing overall. These ETFs can be taxed at the lower eligible dividends rate when held in a taxable account. They can help investors learn the importance of reinvesting dividends, compounding returns, and holding quality companies.

TICKERS GLOBAL

1. TSX:CDZ (iShares S&P/TSX Canadian Dividend Aristocrats Index ETF)
2. TSX:VDY (Vanguard FTSE Canadian High Dividend Yield Index ETF)
3. TSX:XEI (iShares S&P/TSX Composite High Dividend Index ETF)

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