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Desperately Seeking Yield

FINDING YIELD IN A LOW INTEREST RATE ENVIRONMENT

BY TYLER SIMMS

In today's market of low interest rates, how are investors able to generate portfolio cash flow without taking on undue levels of risk?

GOVERNMENT BONDS, MONEY
MARKET FUNDS AND GICS . . .
ARE NOT OFFERING INVESTORS
AN ADEQUATE RETURN ON
THEIR INVESTMENT

INVESTORS ARE ASKING
WHERE TO FIND YIELD ACROSS
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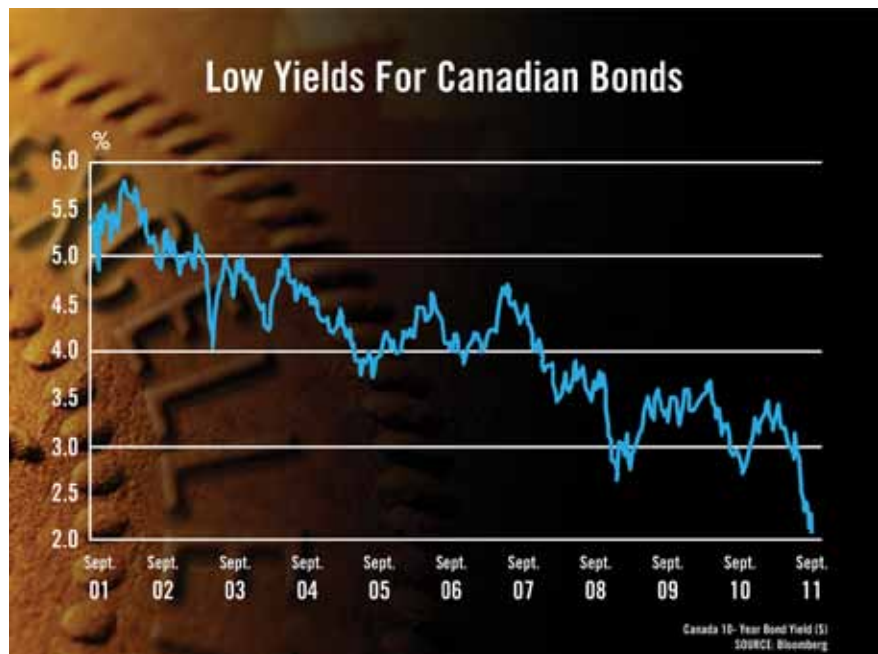
Currently, more traditional sources of investment yields such as government bonds, money market funds and GICs look relatively unappealing due to the continuously low interest rates. The aforementioned asset classes are not offering investors an adequate return on their investment and in some instances are also losing the purchasing power of their savings as a result of inflation. While rates are expected to move upwards over time, stagnant global economic growth and the deflationary pressures stemming from the European Debt Crisis are expected to keep interest rates at depressed levels. With markets mired in a range-bound environment, investors will be increasingly focused on producing yield within their portfolios. As a result, many investors are asking where to find yield across the different asset classes. We provide a brief review of the different asset classes that can be incorporated into a yield-based portfolio.

Government Bonds, GICs & Money Market Funds

Government bonds, GICs, and money market funds are characterized at the low end of the risk spectrum because they are highly liquid and secure, and commensurately, offer the lowest yields for investors. Yields on Canadian and US government bonds have continued their downward trend over the past decade with the 10-year Government of Canada bond yield hovering just above 2.0% as seen in Figure 1. The payoffs from shorter term saving vehicles like GICs and money market funds are even more underwhelming. As an example, a recent posting for Bank-issued GICs quoted interest rates of 1.2% for 2 years and 1.8% for 5 years. Returns for money market funds have almost been entirely consumed by management fees leaving little left for the investor. While these traditional savings instruments offer a high degree of safety and liquidity, we believe that investors can attain superior value for yield by re-allocating amongst other asset classes.

INVESTORS CAN ATTAIN
SUPERIOR VALUE FOR YIELD
BY RE-ALLOCATING AMONGST
OTHER ASSET CLASSES

FIGURE 1



Corporate Bonds & Debentures

For investors looking for saving instruments, investment grade corporate bonds offer a reasonable combination of yield and principal protection. Although rates are higher than government bonds and GICs, they remain low compared to historical averages. Investors should remain aware that corporate bonds are sensitive to changes in credit worthiness of the underlying companies, in addition to shifts in interest rates. That said, with economic pessimism prevailing, corporate bond spreads have been expanding of late and we are finding more opportunities to add to investment grade issues in this space. In the high yield sub-sector, bond yields are implying default rates far greater than actual levels. And with corporate balance sheets in much better shape than in pre-crisis levels, there appears to be attractive valuations amongst high yield issues.

CORPORATE BONDS (ARE) WELL POSITIONED FOR GAINS WHEN MARKET PANIC SUBSIDES AND CREDIT SPREADS EVENTUALLY NARROW

Through a disciplined research process and proper security selection, we consider corporate bonds to be well positioned for gains when market panic subsides and credit spreads eventually narrow. Currently, we are able to invest in a diversified portfolio of corporate bonds and debentures for clients, with yields ranging from 3.0 – 6.0%.

Preferred Shares

Preferred shares tend to be less understood by some investors, given their hybrid characteristics of being in between common shares and corporate bonds along the risk spectrum. However, when actively managed and evaluated properly, preferred shares can be an attractive alternative for investors seeking yield, particularly on after-tax basis given the lower rate applied to dividend income. Prices for preferreds have slumped along with the broader equity market over the past few months which has created opportunities to add yield to the portfolio. Recently, we have been able to capture yields of 4.0 – 6.0% from quality corporate issuers.

Dividend-Paying Stocks

INVESTORS CAN EARN HIGHER RATES OF RETURN FROM COMMON SHARE DIVIDENDS THAN FROM LONG-TERM GOVERNMENT BONDS

With the combination of the recent stock market downturn and ensuing stampede to the safe haven of treasury bonds, dividend-paying stocks have created a rare market circumstance where investors can earn higher rates of return from common share dividends than from long-term government bonds as seen in Figure 2.

This phenomenon isn't unique to the domestic market, as the United States and major European markets are experiencing this rarity as well.

FIGURE 2



INVESTORS ARE BEST SERVED
BY A RIGOROUS ANALYSIS OF THE
COMPANY'S ABILITY TO SUSTAIN
THE DIVIDEND PAYOUT

At current, the S&P/TSX Composite Index is yielding 2.9% while the Canadian government 10-year bond yield is at 2.2%. So what does this mean for investors? The numbers imply that even without potential capital appreciation, which stocks have historically done over time, company dividends will pay investors more than a risk free bond. But while high dividend yields are looking attractive at the moment, investors should not be seduced by the yield alone as dividends are but one consideration of the value and risk of a stock. Instead, investors are best served by a rigorous analysis of the company's ability to sustain the dividend payout, and ideally, to grow that payment over time.

A carefully managed portfolio of dividend-paying stocks can be rewarding, since it can lead to growth in dividend income over time and even provide a partial hedge against inflation as companies are able to pass along rising prices to consumers. For this reason, it is our principle to target well-managed, large capitalization companies that are committed to maintaining and growing dividend payments over time.

Through this process, we've been able to add new positions in quality names with dividend yields between 3.0 – 4.0%.

Market Alternatives

The market alternative space is comprised of a diverse range of investment options including hedge funds, private equity, real estate, infrastructure and other exotic assets. We have targeted a specific type of option strategy that has a number of advantages for investors. Through a combination of large cap equities and indices, and options on those securities, investors can lower risk and enhance yield on a tax efficient basis. These options-based strategies can produce yields ranging between 4.0 – 5.0% stemming from stock dividends and option premiums received. In addition to yield, these strategies offer investors a way to manage volatility by diversifying their sources of market risk.

THESE STRATEGIES (ALSO) OFFER INVESTORS A WAY TO MANAGE VOLATILITY BY DIVERSIFYING THEIR SOURCES OF MARKET RISK

Below is an example of what a diversified yield portfolio might consist of, including a range of achievable yields for each asset class.

ASSET CLASS	ESTIMATED YIELD RANGE	
	BEFORE TAX	AFTER-TAX*
GOVERNMENT BONDS	1.0 - 2.2%	0.6 - 1.3%
CORPORATE BONDS	3.0 - 6.0%	1.8 - 3.7%
PREFERRED SHARES	4.0 - 6.0%	3.4 - 5.0%
DIVIDEND PAYING STOCKS	2.5 - 4.5%	2.1 - 3.8%
MARKET ALTERNATIVES	4.0 - 5.0%	3.2 - 4.0%

* assuming the Alberta investor is in the highest marginal tax bracket

During this time of uncertainty in the market environment, investors are looking for ways to find positive returns in their portfolios through low risk investments. As we have discussed ways of doing so, there are many opportunities for investors to reallocate their assets to produce positive yields.

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Alternative Income Class

- ✓ Attractive 5% annual capital gain income distribution
- ✓ Low equity correlation, extremely low volatility

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Alternative Growth Class

- ✓ Protective growth strategy
- ✓ Low-medium correlation to the market

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Global Dividend Growth Pool

- ✓ Global diversification by sectors and countries
- ✓ Focused on dividend paying stocks

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Global Balanced Pool

- ✓ Diversification in global equities and fixed income investments
- ✓ Quarterly income payout available

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International Equity Pool

- ✓ Diversification outside North America
- ✓ Focused on dividend paying stocks

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Global Segregated Portfolios

- ✓ Customization of a globally diversified portfolio
- ✓ Customization for income and taxation needs

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