May 2019

RBC WEALTH MANAGEMENT

Global Insight

Focus Article

Defense mechanisms

Investors should use the recent rally as an opportunity to take a more defensive posture by upgrading the quality of U.S. equity portfolios.

Bogdanova and Allworth

For important and required non-U.S. analyst disclosures, see page 8

All values in U.S. dollars and priced as of April 30, 2019, market close, unless otherwise noted.

Focus article

Defense mechanisms

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Yes, the stock market has come all the way back and pushed to a record high. No, it's not an unusual time to think about cushioning portfolios. Given the expansion's advanced age and lurking uncertainties, investors shouldn't be caught flat-footed in the event markets get rocky. We look at how to use the recent rally as an opportunity to take a more defensive posture by upgrading the quality of U.S. equity portfolios.

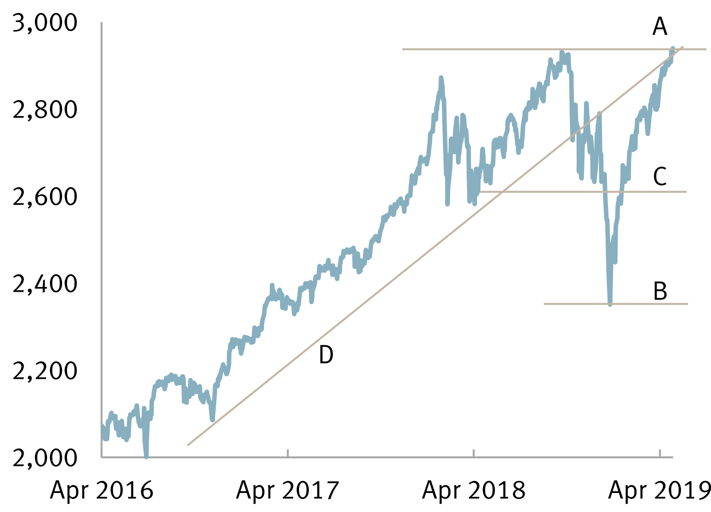
The U.S. equity market has rallied forcefully so far this year, with the S&P 500 climbing 25% since its December 2018 low. It recently pushed above last autumn's peak to reach a new all-time high.

Although the indicators we monitor are signaling positive GDP growth should continue for at least the next year, in our view this is a time to be vigilant.

At nearly 10 years old, the current economic expansion has grown long in the tooth by most of our objective measures. Valuations for major U.S. equity indexes and most sectors, while still reasonable, have shifted to above-average levels. The earnings and revenue growth outlook is much more muted than last year, and the forecast involves greater uncertainties. To this list of fundamental factors we can add potential trade frictions, reduced fiscal stimulus, and political headwinds both at home and abroad.

We think the recent rally has created an opportunity to take a more defensive posture by upgrading U.S. equity portfolios with an eye toward swapping into dividend-paying stocks and improving the overall quality of holdings.

S&P 500 Index with technical guides



"The overall range is still in place even after the recent uptrend in the market."

– Bob Dickey, RBC Capital Markets, LLC Technical Strategist

Note: Light gray technical guides illustrate the wide trading range (A-B), support (C), and long-term trend (D)

Source - RBC Wealth Management, Bloomberg; daily data through 4/26/19

Consistency is key

In our view, dividends should play an even greater role in portfolio construction late in the economic cycle and during recessions. Although dividend payouts have fluctuated over time, historically they have been much less volatile than stock prices, including during challenging periods for equity markets and the economy as a whole. The certainty of dividend returns can provide some welcome ballast when share values are under pressure.

A basket of large-capitalization U.S. dividend-paying stocks has outperformed the S&P 500 in all but one decade since the 1930s. The 1990s was the exception because Technology shares, most of which did not pay dividends, enjoyed a strong run late in the decade that had an outsized influence on overall returns. All of that advantage—and more—was given back in the "tech wreck" bear market early in the following decade.

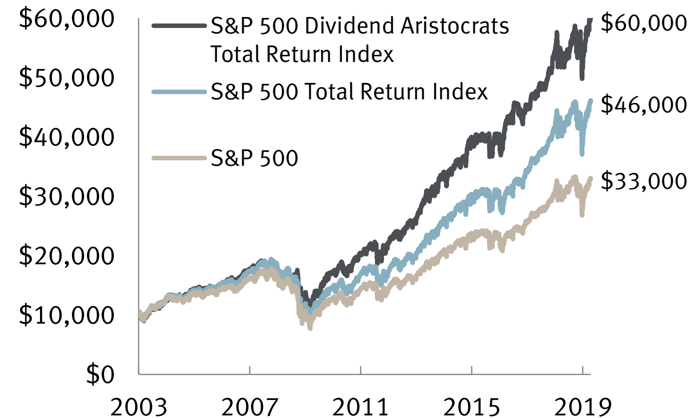
We recommend taking a total-return approach to selecting dividend-paying stocks by considering both income and capital appreciation potential. A third factor, dividend growth, can add substantial extra performance.

A company that has regularly grown its dividend tends to be of higher quality, and more likely to deliver dividend payments consistently over time, than a company that doesn't increase its dividend regularly. Dividend growers also tend to have more capital appreciation potential.

For example, a $10,000 investment in 2003 in the S&P 500 Dividend Aristocrats Total Return Index (comprising companies that have raised dividends annually for at least 25 consecutive years) has increased at almost twice the rate of the S&P 500 and has exceeded the S&P 500 Total Return Index (which includes reinvested dividends) by a meaningful margin (see chart).

RBC Capital Markets, LLC Head of U.S. Equity Strategy Lori Calvasina views current dividend trends as favorable. Corporate confidence is positive, and this tends to be supportive of higher dividend payments. During the Q4 2018 earnings reporting season, 30% of S&P 500 companies raised their dividends.

Current value of $10,000 investment in 2003



Stocks of companies that consistently grow their dividends (Dividend Aristocrats) have significantly outperformed.

Note: The S&P 500 Dividend Aristocrats Total Return Index measures the performance of S&P 500 Index constituents that have increased dividends every year for at least 25 consecutive years. There are currently 57 companies in this index.

Source - RBC Wealth Management, Bloomberg; daily data through 4/17/19

The strength to persevere

We also think high-quality stocks have the potential to stand up better to the challenges the equity market is currently facing, such as late-cycle economic dynamics and a changing earnings and revenue environment.

A basket of high-quality U.S. stocks has outperformed a basket of low-quality stocks for the past year, including over the last six months when the market corrected and then rebounded.

"High-quality" companies typically exhibit several characteristics including strong free cash flow relative to enterprise value (high free cash flow yield); sturdy balance sheets; and consistent, reliable earnings streams. They also tend to deliver high returns on invested capital and equity, and enjoy high credit ratings (A+ to B+); as a result, they have strong earnings relative to interest expense. Finally, they are typically led by proven, highly regarded management teams.

Companies that grow dividends year in and year out are an important part of the quality basket. Consistent dividend growth has usually been a reliable sign of financial strength and dependable earnings performance versus peers. It is also a sign that management has delivered in good times as well as in challenging ones, and is focused on shareholders.

See our "Quality checklist" at the end of this article.

It's important to keep in mind that "quality" may not persist indefinitely. Economic conditions change, new competitive forces arise, and some companies inevitably stumble. What was a "high-quality" stock 10 years ago may not fit the bill today. In our view, this is one of several factors that support incorporating active portfolio management into the equity investment process.

While on balance our set of recession "early warning" indicators strongly suggests that U.S. economic growth will remain positive through the next 12 months and perhaps longer, it's always possible the next recession could arrive sooner than expected. It's also true that bear markets associated with recessions usually begin some months before the recessions take hold. Prudent portfolio management requires building in a margin of error for being wrong on timing, among other things. We believe now is the right time for investors to assess individual holdings and ask, "Would I be comfortable holding this stock through a protracted economic/market retrenchment?"

RBC Wealth Management U.S. economic indicator scorecard

Indicator	Status: Expansion	Status: Neutral	Status: Recessionary
Yield Curve (12-month to 10-year)	–	✓	–
Unemployment Claims	✓	–	–
Unemployment Rate	✓	–	–
Conference Board Leading Index	✓	–	–
ISM New Orders Minus Inventories	✓	–	–
Fed Funds vs. Nominal GDP Growth	✓	–	–

No sign a recession is imminent.

Source - RBC Wealth Management, Bloomberg, FRED Economic Data St. Louis Fed

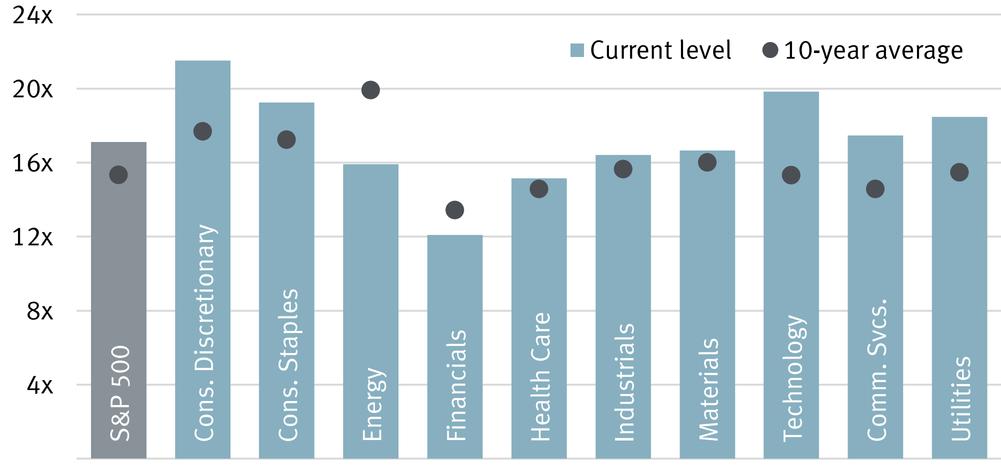
Preparing for turbulence

Whether the S&P 500 breaks out decisively above its very wide trading range of the past year or bounces back and forth within it for some months yet, we think there is scope for additional gains over the next year. Our primary leading economic indicators are signaling that the domestic economy can keep growing at a reasonable pace. Earnings are likely to increase over this period, as are share values.

But it could be bumpy along the way given the possibility of somewhat slower economic growth, a much less robust earnings and revenue growth environment, reduced fiscal stimulus, and lingering trade and political uncertainties. A heightened level of vigilance is warranted.

While we continue to recommend Market Weight or benchmark positions for U.S. equities, and would carry total equity exposure at the same level, the recent strong rally provides an opportunity to take a step toward more defensive positioning in which quality considerations should predominate.

12-month forward price-to-earnings ratios based on consensus forecasts



Note: Real Estate sector not included because data are only available from 9/30/16

Source - RBC Wealth Management, Bloomberg; data through 4/26/19

See our "Quality checklist" on the following page.

Quality checklist

Leading companies – Being the leader in an industry or product segment confers tremendous competitive advantages, which makes top-ranked companies very difficult to dethrone. They offer a successful product or service that has proven itself in the marketplace. Very often they occupy the strongest position in the minds of consumers, and those minds are hard to change. Such companies usually enjoy wider margins and larger profits than their competitors, allowing them to invest more heavily in growing their businesses and in developing new products, or improving old ones, than their competitors can afford to do. “Good management” of these companies largely consists of doing what it takes to hold onto that lead.

Unstressed balance sheets – If a company can consistently generate a higher return on its invested capital than the prevailing rate of interest on debt, then debt becomes a relatively inexpensive form of capital. That’s why most companies have some debt. How much debt a company can carry may become an issue in an economic downturn if some or all of that debt has to be refinanced when interest rates may have become prohibitive and capital markets more difficult to access (or impossible, as in the financial crisis).

We would avoid companies with debt loads that could become problematic in a recession. We would be especially alert to large maturities coming due over the next few years, and to restrictive covenants on existing debt that could be triggered in a business downturn, potentially forcing the company into a disadvantageous restructuring.

High internal growth rate – As discussed earlier, dividends are an important component of investment return and growing dividends are even more valuable. But the greatest source of wealth accumulation for the shareholder is the compounding effect of earnings that are not paid out but rather retained in the business, adding to its invested capital. For most successful companies, that internal growth rate is substantially higher than the rate of return available from interest-bearing instruments or most other investable assets including unlevered real estate.

The fact that these retained earnings accumulate and compound inside the company for the shareholder’s benefit, usually without attracting personal tax until the shares are sold (and then often at a reduced capital gains rate), makes this the most powerful driver of equity investment returns.

Dividend “quality” – We prefer companies that pay and grow their dividends—but not at any cost. Ideally, paying dividends out to shareholders should be somewhat painful for management teams because they would rather allocate the funds to high-return growth opportunities within the business. To some extent (but not always) a high payout ratio indicates a dearth of such opportunities and signals a slowdown in earnings growth may be somewhere down the road. We also look askance at companies that are only able to achieve steady growth in dividend payments by constantly raising the payout ratio or by borrowing the necessary funds.

Our preference, then, is for companies that can maintain or increase their dividends without impairing their financial conditions or forgoing growth opportunities.

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Hold [Sector Perform]	589	40.07	107	18.17
Sell [Underperform]	87	5.92	5	5.75

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