Where Next for Investment Returns

After experiencing what has been called a lost decade in terms of investment returns, it would be unusual if investors weren't discouraged. The average return from a balanced portfolio (60% equities/40% fixed income) from 2000 to 2010 was 3.8% per annum, primarily from bonds. And the current state of economic affairs doesn't offer much in the way of encouragement. Interest rates remain at historically low levels; the yield on mid-term Government of Canada bonds hovers around 2.6%. Economic growth in the developed world will be weighed down for years to come as governments seek to slash deficits through reduced spending. Aging populations place growing demands on the public purse and de-leveraging continues by governments as well as among consumers. Emerging markets, while still likely to experience higher GDP growth relative to the developed world, still do not have sufficient domestic consumption to offset lower demand from the developed world. The one bright spot is inflation, which has remained in check for the better part of two decades, and the low rates on long-term bonds indicate that this is not expected to change soon. So where can the long-term investor look for returns?

Dividend-Paying Stocks Will Continue to be Important

In the past year, there has been considerable media coverage promoting investing in dividend-producing stocks. Proponents of this approach point out that most of the growth in the S&P/TSX index in the last few decades was on a total return basis, whereby dividends are included. They say that with dividend-paying stocks it doesn't matter if the stock price declines because you "get paid to wait" with dividends for the price to come back up. But the classic dividend trap is to buy a stock for its current dividend, only to see the share price stagnate and the dividend cut because the company isn't growing.

Remember, a dividend is simply a return to shareholders of the company's excess cash. Giving this cash to investors means that it is not being reinvested in productivity, innovation and expansion for future growth. By only focusing on companies that pay dividends, you can miss out on some of the great growth stories from companies that don't pay dividends. In addition, dividend-paying stocks tend to be found in more conservative, non-cyclical sectors, a potential limiting factor for diversification. We're not against investing in dividend-paying stocks; they have an important role to pay in a well-diversified portfolio. But the focus, when investing in equities, should be on buying good businesses first. If the stock also pays a dividend, all the better.

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Selective Exposure to Emerging Markets

Emerging markets are expected to continue to offer opportunities for above-average growth but these opportunities bring about higher portfolio risk. Rather than investing directly in these economies, we favour gaining exposure through the shares of established multi-national companies that do business in emerging markets. As the home base of these companies is typically in the developed world, investors are assured of the transparency and regulatory oversight associated with established markets while still having a stake in emerging market growth. How much of your portfolio is allocated to these more volatile investments will depend on your investment objectives as outlined in your investment policy statement.

Corporate Bonds in the Mix

Bonds have done a great job of propping up portfolio returns over the last decade. But with interest rates expected to stay low, returns from government bonds are likely limited to the coupon rate. Corporate bonds have the potential to enhance fixed-income returns as they typically offer higher yields because they come with higher risk. Generally, government bonds are considered lower risk because governments can raise taxes to meet debt obligations. However, in Europe today we are seeing governments in a tight spot, unable to meet debt obligations while reluctant to hamper anemic economic growth by raising taxes. In some instances, corporate bonds may actually be less risky than government bonds. The key here, as is the case with every investment, is to be selective and know the risks.

At any point in time, given the prevailing economic conditions, there will always be some investment opportunities that can offer greater growth potential than others. In our view, dividend-paying stocks, emerging markets equities and corporate bonds will continue to be important avenues for potential future growth within the context of a well-diversified balanced portfolio. As always, it is critical that these opportunities are evaluated and only incorporated in your portfolio when they can contribute to achieving your investment goals.

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