Stewart Financial

Thoughts that count

April 2024

Fashion sense

Cotton is among the most breathable fabrics, which is why it's used to make clothing. Cotton's natural fibers are lightweight, comfortable against skin and minimize sweat and body odour. To deliver these qualities however, cotton is prone to shrinking, is damaged easily and tends to retain moisture.

Prior to WWII, the US Army issued all troops plain cotton uniforms. As war progressed, the military realized troops required more durable outfits. The War Department needed to find a more resilient fabric that included the desired qualities of cotton but minimized the drawbacks. They could have used canvas, which would have been much stronger, but also heavy. Linen might have been an option given its light weight, but would have been too flimsy to be practical. In the end, the Army decided on a fabric that used a weaving technique called *Harringbone Twill*, which allowed material to be made stronger but still comfortable. The military found the best of both worlds in fashion; function and comfort.

Interest rates began their march upwards 24 months ago and will likely stay elevated for the foreseeable future. While this is unwelcome news for those with debt, it is great news for investors. The 'correct' interest rate set by central banks for an economy is what is known as the 'neutral' rate; a level which neither hinders nor stimulates participants. In other words, the goal of interest rate policy is to allow individuals to make financial decisions without feeling oppressed nor stimulated by the cost of associated interest charges. This is more art than science and is always a moving target.

When investors seek to take on risk, they need to find investments that exceed short-term interest rates. This is because investors always have the option of simply buying government debt (commonly known as T-bills) that will pay something close to prevailing interest rates. Because governments can always create more money if they get into trouble, government debt is viewed as the "safest" asset class. Of course, whenever governments print money, inflation will surge unless the economy is growing at an equal or greater pace. This means that while government debt is safe from 'default', it is highly subject to inflation risk (loss of buying power).

Investors interested in generating returns exceeding government debt often search for securities with a high 'yield'. Yield, which is expressed as a percentage, represents the amount of cash returned by interest or dividend payments from an underlying investment. For example, if your bank account pays you 1% on your deposits, it means for every $100 on deposit, the bank gives you $1 per year. The 1% the bank gives you is the yield.

Yield can be generated from many things; interest from GICs or bonds, rent payments from real estate and dividends from stocks. Expressing cash flow from securities as yield (%) allows investors to compare the attractiveness of assets from different groups; at a glance we can compare the cash returns available from fixed income, real estate, and stocks. This is a popular way to select investments.

There is a shortcoming in comparing yields; it does not tell us anything about risk. This is a significant problem. Let's look at five investments we could invest in and their associated yields:

Investment	Yield
Constellation Software stock	0.2%
CN Rail stock	1.9%
CN Rail bond maturing in 1 year	4.6%
Choice Properties, Canada's largest real estate investment trust (REIT)	5.9%
Enbridge pipelines stock	8.2%

If we only consider an investment's yield, we will certainly choose to invest in Enbridge pipeline stock, which currently has an 8.2% yield. This means $100,000 invested in Enbridge stock will generate $8,200 per year in cash payments to us, certainly an attractive return. This does not include any appreciation in the stock, which would be added to our total return.

Just like selecting fabric solely for comfort without regard to its durability, yield is only telling us one half of the story. Investors need to consider what risk a company is taking to be able to offer such attractive returns. One way to look at this risk, is to consider why a company pays cash flow to investors at all;

When a company makes profit, they have two general choices, invest in growth, or return cash to shareholders;

1) Grow: reinvest the profits back into the business with the intention of accelerating further growth by doing things like buying more equipment or expanding sales programs.
2) Pay out cash: where earnings are not required to be reinvested, pay cash to shareholders. This should only occur when reinvesting in the business would not provide further growth.

The first thing we should note is that yield investing is only appropriate in assets that don't need capital for growth. If a company can grow its business, it would make little sense to pay out profits. Only where a business has no better prospects, should it return profits to shareholders. If a business is not expanding, it can choose to return its profit to shareholders, who themselves can find a better use for the cash. However, there is a minimum level of capital all organizations need to hold onto, to ensure continuing operations. If a company pays out too much of its profit, it may have difficulty meeting financial obligations should it experience any unforeseen events. One way to evaluate this relationship is to look at an organization's 'payout ratio', which is the percentage of a company's earnings paid as cash to investors.

The five investments and their payout ratios are listed below. In the case of Enbridge, they are paying out 125% of profits. This means they are currently giving shareholders more money than the business generates over the year. To accomplish this, they must borrow money, internally from operations, or externally from a financial institution, to make their yield payments. Payout ratios at this level are not sustainable, which means unless Enbridge is able to substantially grow its profit in the short term, it will not be able to support its yield for long.

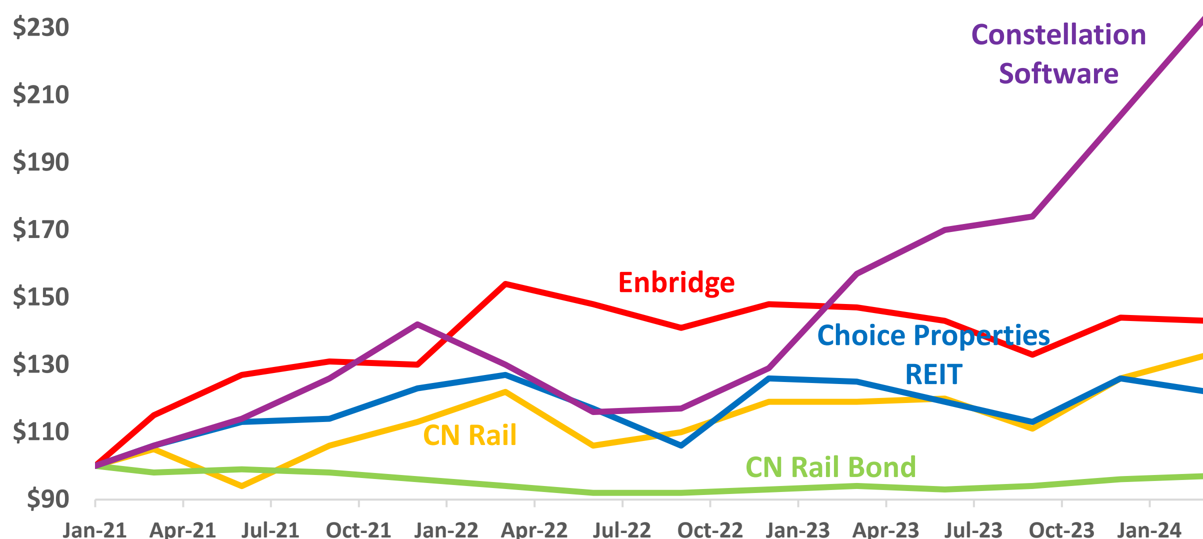
Investment	Yield	Payout Ratio
Constellation Software stock	0.2%	15%
CN Rail stock	1.9%	37%
CN Rail bond maturing in 1 year	4.6%	0%
Choice Properties, Canada's largest real estate investment trust (REIT)	5.9%	68%
Enbridge pipelines stock	8.2%	125%

At the other end of the payout ratio spectrum is the CN Rail bond. Unlike stocks, which pay dividends out of profits, bonds are contractual obligations of their issuer. Bond issuers do not have a choice about how much or whether they feel like making interest payments to bondholders, they must make regular payments as stipulated in the legal document filed when the bond was sold. This makes bonds far more stable than stocks or real estate investments, but typically also means a lower yield.

The investment with the lowest yield, Constellation software stock, belongs to a fast-growing technology company that needs most of its profit to be reinvested to fund its expansion. Given it only pays out at a paltry 0.2%, with a payout ratio of only 15%, its yield is not at risk, but investors should not be buying this for cash flow. Both CN Rail stock and Choice properties have good yields and acceptable payout ratios, so they might make good candidates for yield investments.

When investing for yield, sustainability is critical, which means payout ratios less than 70%. An acceptable ratio differs by industry and business cycle position, but yields that appear too good to be true often are. High yields can be a good thing,

but just as choosing fabric based on only one criterion, they are not the sole determinate of a good investment. As seen below, companies that pay out significant earnings, which means less reinvestment, often have lower total returns.



Complete portfolios should have a variety of investment types, and yield can be an important element. When interest rates are high, as now, yield helps to counter the harmful effects of inflation. As interest rates fall, which might be later this year, investments with significant yields will increase in attractiveness, as substitute government bonds will look less appealing. Stewart Financial clients' portfolios have significant exposure to sustainable yielding investments, but we are mindful that portfolios need to be designed for both function and comfort.

Your *looking forward to wearing cotton t-shirts soon* portfolio manager,

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Note: I have used the above-mentioned investments as examples only and am not recommending CN Rail, Constellation Software, Choice Properties or Enbridge.