IE FOCUS ON PRODUCTS

FEBRUARY 2021

What to look for in global dividend ETFs

Total returns for the category lagged last year, but many funds offer healthy payouts

BY RUDY LUUKKO

Global ETFs that employ dividend-focused strategies have attractive attributes for income-oriented equity investors. They typically offer above-average yields while providing broad foreign diversification, and their management fees are usually only modestly higher than those of passive, market-capitalization-weighted index ETFs in their peer group.

Yet these ETFs currently occupy an unheralded place in the global equity category. Nearly all of them lagged broad global indexes in 2020. Worse, many lost money last year even though global stock markets rebounded strongly from the short-lived bear market that began in the first quarter of 2020. Another negative is that for investors in non-registered accounts, foreign dividends don't qualify for tax credits, as Canadian dividends do.

This subset of global equity ETFs has a relatively modest $1.9 billion in assets under management in the Canadian market. By comparison, there's nearly $7 billion under management in Canadian dividend and income equity ETFs, which belong to a distinct category recognized by the Canadian Investment Funds Standards Committee.

Though global dividend-oriented equity ETFs lack that distinct status, a common expectation is that these funds will have higher dividend payouts than the global category as a whole. "Typically, dividend portfolios should be paying at least a percent more than the broad index," said Chris Heakes, director and portfolio manager, ETFs, with Toronto-based BMO Asset Management Inc.

The BMO Global High Dividend Covered Call ETF, which Heakes oversees, exeeds that income threshold by a comfortable margin with a dividend yield of 3.3%, or about 1.5 percentage points higher than the MSCI World Index. On top of that, the BMO portfolio managers write covered call options on select holdings, bringing the ETF's total distribution yield to about 6.5%.

"Covered call dividend-based funds can really help generate income, particularly when fixed income yields have certainly decreased even further," Heakes said.

The lagging total returns of most global dividend-focused funds is attributable to their underweight positions in the market's hottest sectors. The $172-million iShares Core MSCI Global Quality Dividend Index ETF, for example, recently held a combined total weight of about 15% in the information technology and communications sectors, or roughly half that of the MSCI World index.

"Those sectors tend to have a lower representation in dividend-oriented strategies than higher-dividend sectors like utilities or financials," said Steven Leong, head of ETF product with Toronto-based BlackRock Asset Management Canada Ltd. "In 2020, technology-oriented sectors really were a big driver of the rebound in markets following the crash."

Over the long term, Heakes expects dividend strategies to have similar returns to the broad market, but with slightly less volatility because of their focus on large-cap stocks.

Over short periods, however, anything can happen. With its combination of high-dividend and low-volatility screens, the $11-million Invesco S&P Global ex. Canada High Dividend Low Volatility Index ETF — CAD Hedged Units lost 12.6% last year, the worst of any global dividend strategy.

Leong warned against assuming that income-rich sectors are less volatile than others. "I'd be cautious about expecting that certain sectors like financials or utilities would be less vulnerable or less risky than higher-flying sectors like communications and technology. Certainly in 2020 it did not play out that way."

Leong cited real estate investment trusts as a type of security that, despite its reputation for slow and steady returns, wasn't spared during the 2020 crash.

Looking ahead, technology will continue to be an important investment theme. But Heakes believes there's potential for value-style dividend strategies to do relatively better this year as Covid-19 vaccines are rolled out and economies reopen. "There's a natural correlation between dividend and value," he said. "And we know value as a factor has not performed very well."

Dividend strategies generally employ some form of screening for positive attributes such as historical and projected dividend growth, and sustainable payout ratios, as opposed to the potential "value trap" of simply choosing the highest-yielding stocks. "Sometimes securities have a very high yield, effectively because the market has basically taken the view that the business is unsustainable," said Leong.

Beyond their similarities, global dividend ETFs fall into two main types: those that rely primarily or exclusively on quantitative screening, and those whose stock-picking is actively managed.

TD Asset Management Inc. is represented in both camps. TD Active Global Enhanced Dividend ETF, managed by a TDAM team led by Ben Gossack, is tilted toward growth stocks. Though it can hold up to 15% of its assets in non-dividend-payers, covered calls are used to generate options premium income from these stocks. TD Q Global Dividend ETF, managed by TDAM's quant team, employs a value style and holds only dividend payers.

"We're going to get very different outcomes from both of those ETFs despite the fact they're both in that dividend category," said Jonathan Needham, vice-president, ETF distribution, with Toronto-based TDAM. That was certainly true in 2020. The active strategy returned 19.7%, while the quant-driven ETF reported a 5.8% loss.

The low-cost provider among global dividend ETFs is BlackRock, whose management expense ratios for iShares Core MSCI Global Quality Dividend and its currency-hedged version are only 23 basis points, or about half the MER of the passively managed iShares MSCI World Index ETF's 0.47%.

Though all global dividend strategies have MERs of less than 1%, active managers charge fees at the higher end of that range. Needham contended that the 0.71% MER of TD's active global dividend ETF is a cost hurdle well worth paying. "So far, not only have we generated an income stream that's almost double the benchmark, but your total return as a client has been much better served with our active strategy."

The $1.1-billion Dynamic Active Global Dividend ETF achieved an even higher 2020 return of 35.3%, with a 0.81% MER. By far the largest of the group, the fund is an outlier among self-identified dividend strategies. Its most recently reported 12-month dividend yield was zero. In fact, since its inception in January 2017, it hasn't paid a dime in dividend distributions.

Managed by David Fingold and Peter Rozenberg of Toronto-based 1832 Asset Management LP and holding a concentrated portfolio of about 25 mostly large-cap names, the ETF's mandate is to invest in companies that are expected to "initiate or grow" their dividends. With a concentrated portfolio that's highly differentiated from the broad market, the managers seek to invest in companies with attractive valuations, superior expected dividend growth, and growth prospects underestimated by the market.

"The fastest dividend growth tends to come from companies with the lowest yields and the lowest payout ratios. So it's not an income strategy," said Fingold. "The income you generate is going to be substantially less than the benchmark."

The Dynamic ETF is the only self-styled dividend ETF that has the top five-star Morningstar rating for historical risk-adjusted returns in the global equity category. Despite pursuing a strategy that has paid no dividends, making it unsuitable for income seekers, its total return to date has provided ample reward for investors. IE

ISTOCKPHOTO.COM / ALEXL