Update Edition

THE INCOME INVESTOR

Volume 19, Number 9 **Issue #2109** **May 13, 2021**

IN THIS ISSUE

Limiting risk 1

Top Pick: Canadian Utilities 2

Gordon Pape updates BCE, Pembina Pipeline, Enbridge 3

Members' Corner: Thanks to Paul Bamford 4

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Next issue:
May 27

LIMITING RISK

By Gordon Pape, Editor and Publisher

The stock markets continue to set new records, and investors keep piling in, even though many feel prices are uncomfortably high.

It's the same problem we've been facing for months – there are no acceptable alternatives. Bonds, which are the normal offset to stocks in a balanced portfolio, are having a bad year. As of May 7, the FTSE Canada Universe Bond Index was down 4.69% year-to-date and we're unlikely to see a reversal any time soon as inflation heats up. Bottom line: bonds look like a money loser for the rest of 2021.

You can avoid losses by moving to cash, but don't expect much of a return. RBC is paying a pitiful 0.05% on its High Interest eSavings account. You can earn more at some smaller financial institutions, but many people are uncomfortable dealing with them, even though many have CDIC coverage.

What's the solution? One strategy is to reduce the equity risk in your portfolio by using low-volatility, dividend-paying stocks in place of bonds. Think of them as bond substitutes. Associate Publisher Richard Croft wrote about this strategy in the last issue of The Income Investor. I think it's important enough to expand on it.

The stocks to consider should have a low beta, which measures their level of volatility against the broad market. These will perform better when the market drops but will lag when stocks are on the rise. The market beta is 1.0 so the more the stock is below that, the less volatile it is.

The dividend payout will tend to provide a floor – companies try to protect their dividend to the extent possible, knowing that a cut will negatively impact the share price and erode investor confidence.

This does not mean that bond substitutes won't lose value in a market plunge. But they will typically hold up better than the rest of the crowd.

Here's an update on a stock I consider to be a bond substitute. See Top Picks for another one. Prices are as of the close on May 7.

Continued on page 2…

Limiting risk - continued from page 1…

Emera Inc. (TSX: EMA, OTC: EMRAF)

Type: Common stock
Current price: C$56.12, US$46.28
Originally recommended: Oct. 8/15 at C$44.01, US$33.36
Annual payout: $2.55
Yield: 4.5%
Risk: Lower risk
Website: www.emera.com

Comments: This utility is based in Halifax. Its business is primarily in regulated electricity generation and electricity and gas transmission and distribution. Emera has investments throughout North America, and in four Caribbean countries.

It's not exciting stuff but the company is about as stable a stock as you'll find. It has a beta of only 0.21, which means that if the broad market dropped 10%, this stock should in theory lose only a little more than 2% of its value. In the meantime, you'd continue to collect a quarterly dividend of $0.6375 a share, which is expected to rise by mid-year. The company has guided to annual increases of 4-5% through 2022.

First-quarter results had not been released at the time of writing. However, fiscal 2020 produced profit gains, despite the effects of the pandemic.

The company reported adjusted net income of $665 million in 2020 ($2.68 per share), compared with $621 million ($2.59 per share) in 2019. When normalized for the operating earnings impact of previously announced and closed asset sales, 2020 and 2019 adjusted net income were $660 million ($2.66 per share) and $554 million ($2.31 per share), respectively.

The major contributor to the profit increase was the company's investment in Tampa Electric, which contributed $501 million, compared to $419 million in 2019.

Looking ahead, Emera's $7.4 billion capital investment plan over the 2021-2023 period and the potential for additional capital opportunities of $1.2 billion over the same period, is expected to generate rate base growth of 7.5-8.5% through to 2023.

As I said, there is nothing exciting about this business. But its stable share price and decent yield make it a very attractive bond substitute.

Action now: Buy.

TOP PICKS

Here is our Top Pick for this month. Prices are as of the close of trading on May 7.

Canadian Utilities (TSX: CU, OTC: CDUAF)

Type: Common stock
Current price: C$34.94, US$28.79
Entry level: Current price
Annual payout: $1.7592
Yield: 5.0%
Risk Rating: Lower risk
Recommended by: Gordon Pape
Website: www.canadianutilitis.com

The business: Canadian Utilities is based in Calgary. Its operations include electricity generation, transmission, and distribution and natural gas transmission, distribution, and infrastructure development. It also provides energy storage and industrial water solutions and has been heavily investing in green energy projects for over 20 years.

CU's main operations are in Alberta, but it also has natural gas and mining interests in Australia, Chile, and Mexico. It owns 87,000 km of electrical transmission lines and 64,500 km of pipelines. The company has approximately 4,600 employees and assets of about $20 billion. It is 52.7% owned by ATCO, which is also Alberta-based.

The security: We are recommending the common shares of CU, which trade on the TSX and over the counter in the U.S.

Why we like it: Solid and stable, good yield, and a low beta of 0.53.

Financial highlights: Despite the negative impact that the pandemic has had on the Alberta economy, CU reported a 2.5% increase in first-quarter revenue, to $911 million. Adjusted earnings were also higher, at $191 million ($0.70 per share), compared to $179 million ($0.66 per share) in the first quarter of 2020.

The company said that higher earnings were mainly due to cost efficiencies and growth in the asset base, as well

Continued on page 3…

Top picks - continued from page 2…

as earnings from ongoing transition work related to a long-term contract to operate Puerto Rico's electricity transmission and distribution system. Increased demand for natural gas storage services also contributed.

Outlook: Last year was a difficult one for CU, as the pandemic combined with low oil prices at the start of the year to grind down Alberta's economy. The prospects going forward look more encouraging, especially with petroleum prices back up.

Risks: The strength of Alberta's economy will impact earnings although as we have seen the company is doing reasonably well despite the province's struggle with COVID and an economic slowdown.

Distribution policy: The stock pays a quarterly dividend of $0.4398 per share ($1.7592 per year), to yield 5%. The dividend has been raised annually for 49 consecutive years, albeit usually by small amounts.

Tax implications: Payments are eligible for the dividend tax credit if the shares are held in a non-registered account.

Who it's for: The stock is suitable for conservative investors seeking a bond substitute.

How to buy: The shares trade actively on the TSX. However, trading volume on the U.S. over-the-counter market is thin so place a limit order if you have to buy there.

Summing up: A good choice for investors seeking cash flow and limited risk.

Action now: Buy.

GORDON PAPE'S UPDATES

BCE Inc. (TSX, NYSE: BCE)

Type: Common stock
Current price: C$59.11, US$48.71
Originally recommended: July 25/12 at C$41.98, US$41.49
Annual payout: $3.50
Yield: 5.9%
Risk: Moderate
Website: www.bce.ca

Comments: BCE is Canada's largest communications company, providing a comprehensive suite of broadband, mobile, landline, and cable communication services to residential and business customers through Bell Canada and Bell Aliant. Bell Media is the company's multimedia arm, with assets in television, radio, and digital media. Television assets include the CTV television network and many of the country's most-watched specialty channels.

The chart looks very choppy but the stock has gradually moved up in recent weeks, although it is still off its 52-week high of $60.14.

The company's first-quarter results showed a modest increase in revenue and adjusted EBITDA, but earnings were off slightly compared to the same period in 2020.

Operating revenue was $5.7 billion, up 1.2% from the year before, driven by an 18.6% growth in product sales, including premium mobile phone and business data equipment. That helped offset drop-offs in revenue from media advertising and business wireless roaming.

Adjusted EBITDA grew 0.5% to $2.4 billion, driven by a 2.1% increase at Bell Wireline and partly offset by declines of 0.5% at Bell Wireless and 7.7% at Bell Media. Net earnings attributable to common shareholders totalled $642 million, ($0.71 per share), down 5.3%. The decrease was due to higher severance, acquisition, and other costs as well as higher depreciation and amortization expenses. Free cash flow was $940 million, up from $611 million last year. That's an increase of 53.8%.

The company's balance sheet is in good shape, with $6.5 billion in available liquidity at quarter-end.

The beta is very low, at 0.31.

Dividend: BCE raised its quarterly dividend by 5% to $0.875 per share ($3.50 a year), effective with the March payment. The stock yields 5.9% at the current price.

Outlook: The company is forecasting revenue growth of 2-5% this year. Adjusted earnings per share are projected to increase 1-6%.

Action now: Buy.

Continued on page 3…

Updates - continued from page 3…

Pembina Pipeline Corp. (TSX: PPL, NYSE: PBA)

Type: Common stock.
Originally recommended: June 23/09 at C$14.78
Current price: C$38.06, US$31.35
Annual payout: $2.52
Yield: 6.6%
Risk rating: High
Website: www.pembina.com

Comments: Pembina shares had been trading near their 52-week high but pulled back after the company released first-quarter results that were mostly improved over 2020 but fell short of analysts' estimates.

Revenue for the quarter was a little over $2 billion, up from about $1.7 billion in the prior year. Higher prices for oil and natural gas liquids contributed to the rise in revenue, driving improved results in Pembina's marketing business and steady increases in volumes on many of its systems compared to the average levels in 2020.

Earnings were virtually flat from a year ago, at $320 million ($0.51 per share). Cash flow from operating activities was $456 million ($0.83 per share), up from $410 million ($0.79 a share) in the first quarter of 2020.

The company reiterated its 2021 adjusted EBITDA guidance range of $3.2 - $3.4 billion. It said its 2021 capital program is fully funded by cash flow after dividends and towards the middle and upper end of the guidance range. Excess cash flow will be available "for debt reduction, dividend increases, or opportunistic common share repurchases," management said.

I wouldn't put too much credence in the idea of a dividend increase this year. The current monthly payout of $0.21 a share is quite rich and the yield of 6.6% is very attractive. At this stage, deploying any extra cash flow to debt reduction would be the most prudent course.

Action now: Hold.

Enbridge Ltd. (TSX, NYSE: ENB)

Type: Common stock
Current price: C$48.09, US$39.66
Originally recommended: Sept. 21/06 at C$19.58
Annual payout: $3.34
Yield: 6.9%
Risk: Moderate
Originally recommended by: Tom Slee
Website: www.enbridge.com

Comments: The stock has moved up sharply since the last update in January and touched a 52-week high on May 5.

On May 7, the company reported first-quarter results. Earnings on a GAAP basis were $1.9 billion ($0.94 per share), compared with a loss of $1.4 billion (-$0.71 per share) in 2020. Distributable cash flow (DCF) beat expectations at $2.8 billion ($1.37 per share), compared with $2.7 billion ($1.34 per share) last year, Enbridge reaffirmed its 2021 full year guidance range of EBITDA of $13.9 to $14.3 billion and DCF per share of $4.70 to $5.00.

"Our strong operational performance combined with highly contracted and utility cash flows translated into strong financial results," said CEO Al Monaco. "Distributable cash flow for the quarter is up over the first quarter of last year, which was largely unaffected by the pandemic. That's an excellent outcome and it shows how resilient our business is in the most turbulent economic conditions. Our balance sheet is in great shape and provides us with a lot of flexibility."

The elephant in the room is Michigan's attempt to shut down Enbridge's line 5, that runs under the Straits of Mackinac, over environmental concerns. That was supposed to happen on May 12 but Enbridge is fighting it in the courts and the whole situation is becoming a major irritant in Canada-U.S. relations. The line supplies a large portion of the petroleum needs of Ontario and Quebec, as well as those of Michigan and Ohio. It will probably take months or even years to resolve this issue, but if the line were to be shut down it would directly impact the company's revenue and earnings.

Action now: Hold.

MEMBERS' CORNER

Thanks to Paul Bamford

Member comment: I'd be grateful if you would pass on my thanks to Paul for his recommendations on bank preferreds in the Aug. 13, 2020 issue of The Income Investor. I bought 500 each of the suggested Royal Bank and CIBC issues and as of today have realized an aggregate return of $5,620 – or 29% in eight months. Not bad. Just wish I'd followed through on my original intention to buy 1,000 of each. – David C.