

Update Edition

THE INCOME INVESTOR

Volume 19, Number 15

Issue #2115

August 12, 2021

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August 26

BANK ETFs

By Gordon Pape, Publisher and Editor

Last month I replied to a reader question about bank ETFs. In doing so, I pointed out we have two such ETFs on our recommended list: the BMO Equal Weight Banks Index ETF (TSX: ZEB) and the BMO Covered Call Canadian Banks ETF (TSX: ZWB). I also suggested looking at CI Canadian Banks Income Class ETF (TSX: CIC). All three have been posting impressive returns.

That prompted another reader to ask about some of the other bank-based ETFs available. He wanted to know about two funds with lower MERs than the ones I mentioned, namely the Hamilton Canadian Bank Mean Reversion Index ETF (TSX: HCA) and the RBC Canadian Bank Yield Index ETF (TSX: RBNK).

He also noted that Hamilton offers a 1.25x leveraged version of its bank fund with a 0.65% MER (TSX: HCAL).

What, he asked, is my opinion of these funds?

The short answer is they're all good and are currently generating outstanding returns. But let's delve into this more deeply.

We'll start with HCA. What does "mean reversion" mean exactly? The company's website describes it in this way:

"Mean reversion is one of the most popular themes in Canadian bank investing, given the individual Canadian banks have tended to perform similarly over time. HCA attempts to take advantage of these tendencies by rebalancing the portfolio monthly and investing 80% of the portfolio in the 3 banks which have recently underperformed, and 20% in the 3 banks which have outperformed."

Does it work? Yes, in the sense the return looks impressive. The one-year gain to June 30 was 47.7%. We don't have any more history to work with because the fund was only launched in 2020.

As for HCAL, it has only been around since last October, so we don't even have one year of results yet. It's designed to provide higher yields by leveraging and the website says the current yield is 5.25%. That's impressive but we don't have enough history to know if it's sustainable.

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The BMO Equal Weight Banks Index ETF (TSX: ZEB) did much better over the same period, gaining 55.2%. It has averaged 11.5% over the past decade.

BMO's Covered Call Canadian Banks ETF (TSX: ZWB) returned 46.7% over one year to the end of June. It also has

a much longer history than the Hamilton entries, with a 10-year average annual compound rate of return of 9.2%.

The Royal Bank entry has the best one-year record, with a gain of 58.3% to June 30. Not many people are aware of it, so I've chosen it as my Top Pick for this month. Details follow.

TOP PICK

Here is my Top Pick for this month. Prices are as of the close of trading on Aug. 6.

RBC Canadian Bank Yield Index ETF (TSX: RBNK)

Type: Exchange-traded fund (ETF)

Current price: \$25.34

Entry level: Current price

Annual payout: \$0.86

Yield: 3.4%

Risk Rating: Moderate risk

Recommended by: Gordon Pape

Website: www.rbcgam.com/en/ca/products/etfs/RBNK/detail

The security: This ETF invests in a portfolio of the top six Canadian banks. There are no other bells and whistles, like covered call writing or leveraging.

Why we like it: Performance. The fund has produced excellent results over all time frames since its launch in 2017. As well, we expect to see a big jump in dividends when the Office of the Superintendent of Financial Institutions lifts the ban on increases it imposed at the start of the pandemic.

Portfolio: The investment strategy is to invest in the constituent securities of the Solactive Canada Bank Yield Index in substantially the same proportion as they are reflected in the index.

The weighting may surprise many readers. About one-quarter of the portfolio (25.1%) is in Bank of Nova Scotia, the weakest performer among the Big Six banks in recent years. Almost the same percentage (24.8%) is in CIBC, so together those two banks account for almost half the fund's assets.

The rest of the portfolio consists of Bank of Montreal (16.8%), TD Bank (16.7%), Royal Bank (8.4%), and National Bank (8.3%). That's not the kind of mix most people might expect but it works.

Risks: Bank stocks have moved sharply higher in recent months as the economy recovers and commercial interest rates edge higher. That trend could reverse if a new coronavirus variant develops that is able to break through existing vaccines, thereby forcing new economic lockdowns. That in turn would slow economic growth and probably reverse the rate trend, both bad news for banks.

Key metrics: The fund was launched in October 2017 and is quite small compared to its BMO peers, with only \$174 million in assets under management. By contrast, ZEB has \$2.1 billion in assets and ZWB has \$2.3 billion.

RBNK has a better three-year average annual compound rate of return than the BMO entries, at 12.2%, compared to 10.8% to ZEB and just over 8% for ZWB. The low MER of 0.33% contributes to its outperformance.

Distribution policy: The fund makes monthly distributions of about \$0.07 a unit. The amount varies slightly from one month to another.

Tax implications: Most of the distributions (90% in 2020) are received in the form of dividends and are eligible for the dividend tax credit in non-registered accounts. The rest are received as capital gains or return of capital.

Who it's for: This is a good choice for those who want to devote a section of their portfolio to the Canadian banking sector but don't want to make decisions on which stocks to buy.

How to buy: Trading volume can be low (sometimes less than 10,000 units a day), so enter a limit order and be patient.

Summing up: Talk about hidden gems! Most investors haven't discovered this fund yet. All the Canadian bank funds are generating good returns, but on balance, if you are choosing just one right now, I'd opt for RBNK.

Action now: Buy.

GORDON PAPE'S UPDATES

(Prices as of the close on Aug. 6)

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

Type: Common stock.

Originally recommended: June 23/09 at C\$14.78

Current price: C\$40.24, US\$32.05

Annual payout: \$2.52

Yield: 6.3%

Risk rating: Moderate

Website: www.pembina.com

Comments: Pembina owns pipelines that transport hydrocarbon liquids and natural gas products produced primarily in Western Canada.

Second-quarter results released last week showed a year-over-year increase in revenue but a slight drop in profits.

Total revenue for the period was just under \$2 billion, compared to about \$1.3 billion in 2020. For the first six months of the fiscal year, revenue was almost \$4 billion, up from \$2.9 billion last year. The company said volumes across Pembina's pipeline systems and facilities continued to rise, reflecting the impact of higher commodity prices and strong Western Canadian Sedimentary Basin fundamentals.

Earnings were almost flat from a year ago. The company reported second-quarter profits of \$254 million (\$0.39 a share) compared to \$258 million (\$0.40 a share) last year. Earnings for the first half were \$574 million (\$0.91 per share, down slightly from \$577 million (also \$0.91 a share) in 2020.

Cash flow from operating activities was \$638 million (\$0.98 a share), down from \$586 million (\$1.07 per share) last year.

Total volumes of 3,500 mboe/d for the second quarter represents an approximately two percent increase over the same period in the prior year.

Pembina has apparently lost out in its attempt to buy Inter Pipeline in the face of an aggressive hostile takeover bid by Brookfield Infrastructure Partners. However, Inter shareholders have yet to approve the deal. Assuming they do, Pembina will walk away with a break fee of \$350 million.

Action now: The dividend yield is still attractive and the \$0.21 a month pay-out seems secure. Buy.

Harvest Brand Leaders Plus Income ETF (TSX: HBF)

Current price: \$11.43

Originally recommended: Aug. 18/17 at \$8.84

Annual payout: \$0.65

Yield: 5.7%

Risk: Moderate

Website: www.harvestportfolios.com

Comments: This fund invests in an equal-weight portfolio of 20 large companies selected from the world's Top 100 Brands. Top holdings include highly recognized names like Royal Dutch Shell, Alphabet, Nike, Procter & Gamble, Johnson & Johnson, McDonalds, and PepsiCo. These are all industry leaders that can survive any recession. The managers use covered call writing to enhance income. The units have performed very well so far in 2021, with a year-to-date gain of 11.8%. That doesn't include the monthly dividend of \$0.054. The unit price is currently near its all-time high. The increase in the unit price has knocked the yield back to 5.7% but that is still respectable.

The only negative about this fund is the high management fee of 0.75%.

Action now: Buy.

CI First Asset Tech Giants Covered Call ETF (CAD Hedged) (TSX: TXF)

Current price: \$22.42

Originally recommended: Feb. 23/17 at \$13.92

Annual payout: \$2.732 (trailing 12 months)

Yield: 12.2%

Risk Rating: Higher risk

Website: www.firstasset.com

Comments: This ETF invests in a portfolio of at least 25 of the largest tech companies, such as Advanced Micro Devices, Snap, Oracle, Intuit, and Alphabet. The managers write covered call options to generate additional cash flow, a process that can generate wide swings in the quarterly payouts. The units took a deep dip in May but have been on an upward trend since. The fund is ahead about 14% so far this year, excluding distributions. We have a 61% gain since the original recommendation. Tech stocks look pricey right now so I would not add more at this time.

Action now: Hold.

MEMBERS' CORNER

Reaching for yield

Member comment: I enjoy your columns very much. They always give me something to think about. I'm a DIYer who is more interested in income than capital gains, so I trade infrequently. Mainly when I have some surplus cash, or a holding no longer looks suitable.

I have a slightly different way of looking at yields. In a recent column when you discussed the returns on BMO, you say that because the price has gone up while the dividend has been unchanged, investors are getting a lower return on their capital. I look at things a little differently. While a new purchase would give a lower yield on the investment, the yield on what they originally invested would be unchanged.

If the current yield is much less than it was when the stock was bought, maybe selling it and investing in something with a better yield is worth considering. Although the amount to be reinvested would be after the capital gains tax, which might mean buying something riskier to get a better yield.

That is why I tend to buy and hold. I'm no longer particularly interested in growing my portfolio, I'm more interested in the cash flow. Capital gains are

nice. They are great to have during the ups and downs of the markets in case something needs to be sold in an emergency, but my holdings are generally on the conservative side, so the dividends are seldom cut.

Of course, investors wishing to grow their portfolio could consider locking in their profit and investing the net return in something with a better yield. – Robert F.

Response: There are many ways of looking at this situation. It's true that the yield on the original investment (BMO in this case) is unchanged. But the value of the BMO assets has increased and could be earning more income if invested in a higher-yield security.

But we need to consider the fact that the banks were told last year to not implement any dividend increases during the pandemic. When the Office of the Superintendent of Financial Institutions lifts that ban, I expect to see double-digit increases in bank payouts across the board.

The bottom line is I would hold off selling any bank stocks for higher-yielding securities until we see how this plays out. – G.P.

YOUR QUESTIONS

Firm Capital

Q – I am an over 70-year-old senior and planning to invest in Firm Capital mortgage stocks yielding approximately 6% for my retirement income. Can you please give me your insight as to what effect higher inflation and higher interest rates have on this stock?
– Bob

A – First, I would never suggest investing all your assets in one stock, good as it may appear. I'd put a maximum of 15-20% on any security.

Firm is a conservatively managed mortgage lending company, so higher rates mean it can charge higher interest on its loans.

If you look at its chart, you'll see Firm Capital is doing very well during this period of above-average inflation and gradually rising interest rates. The shares were trading below \$13 at the start of 2021 and are now over \$15. That's near the stock's all-time high so I would phase in your purchases over several months and take advantage of any pullbacks.

Also, remember this is a small company with an average daily volume of less than 25,000, so place limit orders. – G.P.