



# Building an Income Portfolio With ETFs

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**A** growing number of Canadian investors are focused on generating income rather than long-term growth with their portfolios. This continues to be a challenge with low yields on government bonds and GICs and the disappearance of most income trusts.

Dividend-paying stocks, preferred shares, real estate investment trusts and bonds are all part of the solution, but each carries its own set of risks. By diversifying your investments across several asset classes, you can build an income-oriented portfolio that should hold up well against inflation, rising rates and the possibility of a market crash.

One option for doing this at low cost is to use exchange-traded funds. Canadian ETF providers are acutely aware of the demand for income-bearing investments, and in 2010 they launched several new products designed with yield in mind. Many also changed their distribution schedules to monthly, rather than quarterly, making cash flow more regular and predictable.

Here's an overview of the best ETF options available in the most important income-oriented asset classes. After we review them, I'll offer a suggested ETF portfolio for the yield-hungry investor.

## Canadian Dividend Stocks

The two most popular Canadian dividend ETFs use quite different strategies and complement each other nicely. The iShares Dow Jones Canada Select Dividend Index Fund (TSX: XDV) holds 30 companies screened for dividend growth, current yield and payout ratio. The Claymore S&P/TSX Canadian Dividend ETF (TSX: CDZ) has stricter criteria: it tracks the well-known Dividend Aristocrats Index, which includes only companies that have raised their dividends for at least the last five years.

The upshot is that the Big Six banks make up more than a third of XDV, but just 4% of CDZ, which is much more heavily weighted to energy and consumer services. There's really no reason to choose one ETF over the other: holding equal amounts of both would offer excellent diversification.

## U.S. and International Dividend Stocks

Investing in foreign stocks presents some challenges for Canadians, including a 15% withholding tax on dividends, no dividend tax credit, and the potential for currency exchange fees. The Claymore Global Monthly Advantaged Dividend ETF (TSX: CYH) offers a way around these issues. Its index includes some 275 income-bearing securities from the U.S. and overseas (plus a small allocation to Canada). But rather than holding these companies directly, the ETF uses a forward agreement (a type of derivative) that allows it to pay distributions as non-taxable return of capital rather than as foreign dividends. While this sounds like financial sleight of hand, it's not a new idea, and it shouldn't scare you off. Just make sure you read the prospectus and understand how it works before investing.

If you prefer something more straightforward for U.S. companies, have a look at the Vanguard Dividend Appreciation ETF (NYSE: VIG) or the iShares Dow Jones Select Dividend Index Fund (NYSE: DVY). For overseas stocks, the iShares Dow Jones International Select Dividend Index Fund (NYSE: IDV) covers a lot of ground. WisdomTree, an ETF provider based in New York, also offers a broad menu of dividend-focused ETFs covering every corner of the world.

## Preferred Shares

Because they combine consistent yields with the tax advantages of dividend stocks, preferred shares in Canadian companies are getting a lot of attention. These securities can be complicated, however, and an ETF is an easy way to build a diversified portfolio of preferreds without having to select individual issues.

The incumbent here is Claymore's S&P/TSX Canadian Preferred Share ETF (TSX: CPD), which holds 120 issues, the vast majority from financial institutions. An alternative is the brand new iShares S&P/TSX North American Preferred Stock Index Fund (TSX: XPF), which splits its holdings between the U.S. and Canada. Dividends from American preferreds are subject to the 15% withholding tax and are not

eligible for the dividend tax credit, but there's a trade-off. According to iShares, U.S. preferreds currently yield about 7%, compared with 5.3% for Canadian shares, so the after-tax returns would be very similar for most investors.

## Real-Estate Investment Trusts (REITs)

REITs were not subject to the legislation that doomed income trusts, so they remain an excellent vehicle for generating healthy yield. (Note, however, that the tax treatment of REIT income can be confusing, and a bit unpredictable. The distributions can include return of capital, eligible dividends, other income, capital gains, or some combination of these.)

The iShares S&P/TSX Capped REIT Index Fund (TSX: XRE) was for many years the only ETF in this space. It holds 13 trusts, but because it's weighted by market capitalization, the giant RioCan makes up a quarter of the fund. A better choice may be the new BMO Equal Weight REITs Index ETF (TSX: ZRE), which, as its name suggests, holds equal amounts of 17 trusts. Both ETFs have similar yields and fees, but because the BMO fund minimizes the influence of any single company, it might be considered less risky.

## Government Bonds

While government bonds are not likely to deliver high returns in the immediate future, they play a critical role in a diversified portfolio, since they are the only income-bearing assets that reliably go up when stocks go down.

If you're concerned about rising rates, the usual advice is to keep your bond maturities short. Claymore's 1-5 Year Laddered Government Bond ETF (TSX: CLF) uses a proven strategy to spread out maturity risk: one-fifth of the portfolio matures in one year, another fifth in two years, and so on. If you want to go farther out, the iShares DEX All Government Bond Index Fund (TSX: XGB) is half short term, 20% intermediate (maturing in five to 10 years) and 30% long term. Because it includes bonds with these longer maturities, XGB has a yield almost 1% higher than CLF, but it will lose more value if interest rates shoot up.

## Corporate bonds

Investment-grade corporate bonds should be a core holding in an income-oriented portfolio. You can expect them to have a slightly higher yield than government bonds of the same maturity, albeit with correspondingly more risk. Claymore's 1-5 Year Laddered Corporate Bond ETF (TSX:

CBO) uses the same laddered structure as CLF, and is a good choice for investors who want to keep their bonds short. The iShares DEX All Corporate Bond Index Fund (XCB) is more broadly diversified (417 holdings) and includes 30% intermediate and 20% long-term issues.

Several ETFs devoted to high-yield (junk) bonds appeared in 2010. These are paying distributions in the range of 5.5% to 7.5%, so their appeal is obvious, but they come with the risk that some of the companies will default. Some portfolio managers argue that taking credit risk in a bond portfolio is not usually rewarded in the long term, and they advise against high-yield bonds altogether. However, while buying individual junk bonds is fraught with danger, an ETF can diversify away some of the risk.

Claymore, iShares and BMO all offer ETFs of high-yield bonds issued by U.S. companies, since the American market for these securities is vastly bigger than Canada's. (All three use currency hedging, so there is negligible risk from a rising Canadian dollar.) The Claymore Advantaged High Yield Bond ETF (TSX: CHB) should be the most tax-efficient because it uses a forward agreement similar to the one used by Claymore's global dividend ETF, described above. This could be complemented by the iShares DEX HYBrid Bond Index Fund (TSX: XHB), which holds Canadian corporate bonds rated BBB or below.

## Putting It All Together

The table below shows how all of these asset classes might come together in an all-ETF income portfolio. The suggested allocations would be suitable for investors with a moderate risk tolerance, but feel free to adjust them to suit your needs and comfort level.

## Note – The Yield Illusion

The yield paid by bond ETFs is deceptive, and investors can easily be fooled into expecting a higher return than they will actually receive. Claymore's 1-5 Year Laddered

Allocation	Exchange-traded fund	Ticker	MER	Yield*
15%	Claymore S&P/TSX Canadian Dividend	CDZ	0.64%	4.06%
15%	iShares Dow Jones Canada Select Dividend	XDV	0.53%	3.65%
10%	Claymore Global Monthly Advantaged Dividend	CYH	0.67%	4.07%
10%	iShares S&P/TSX North American Preferred Stock	XPF	0.48%	5.70%†
10%	BMO Equal Weight REITs	ZRE	0.62%	6.12%
15%	iShares DEX All Government Bond	XGB	0.37%	2.90%
15%	iShares DEX All Corporate Bond	XCB	0.42%	3.86%
5%	Claymore Advantaged High Yield Bond	CHB	0.53%	7.36%
5%	iShares DEX HYBrid Bond Index Fund	XHB	0.51%	5.54%
<b>100%</b>			<b>0.52%</b>	<b>4.40%</b>

\* As of December 10, 2010. For bond ETFs, the figure given is the yield to maturity.

† estimated

Government Bond ETF (TSX: CLF), for example, pays distributions of about 4.5% annually. However, while the bonds in this fund have high coupons, all of them were purchased at a premium. That means every time one matures – or is sold before maturity – the ETF will suffer a small capital loss and drop in value. Whenever you invest in a bond ETF, ignore its current yield and consider its *yield to maturity*, which indicates the total return you can expect. For CLF and other short-term bond ETFs, don't expect more than about 2% these days.

In fact, you can make a compelling argument that GICs make more sense than short-term government bonds. If you shop around online, you can easily build a five-year GIC ladder with a yield of at least 2.5% with virtually zero risk. The only concern is that GICs are less liquid than bond ETFs.

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