Dividend Yield versus Distribution Yield
Options for sustainable investment income

A popular investment product these days is the ‘Income Fund’. An income fund is a mutual fund that is structured to provide regular income, typically monthly. An example would be Canada’s largest mutual fund in the Canadian Dividend and Equity Income category: RBC's Canadian Dividend Fund Series T8, which pays a target distribution of 8%.

When compared to other income-oriented investments, this seems quite attractive. Consider for example the iShares Dividend Aristocrat’s Index ETF: an exchange traded fund that tracks an index entirely comprised of Canadian companies that pay dividends, and have increased their dividends 5 years in a row. Currently this ETF features a 12 month trailing yield of 3.27%.

Or there is the Raymond James Dividend Plus Guided Portfolio, consisting of 17 Canadian stocks, all of which pay dividends. Currently the portfolio yields 3.48%.

When you consider that all 3 investments have similar mandates, and in fact have many of the same underlying investments, how is it then that the income fund pays so much more.

There is a simple answer. In the case of the mutual fund, the 8% is a distribution yield (not a dividend yield). The fund does earn dividends, but not at 8%. To be precise, in 2013 the fund’s dividend yield was 1.5%.

So with a distribution that came in at 8.2%, where did the remaining 6.7% come from? Return of capital, as it happens. In other words, investors were paid back their own money.

This can be a good thing, and here is why: Return of Capital is not taxed. So by keeping the dividend yield low, the amount of tax that will need to be paid is also low. This does create a deferred tax liability, but in some cases it is worth it.

However, it is a double-edged sword: the more you withdraw over and above the dividend yield, the more you rely on a rising market to make up for what you withdraw. When you consider that fees also need to be covered, an 8% distribution is not easy to maintain. If you are intent on keeping your principal in-tact, consider the following options:
- Opt for a lower distribution. The above-mentioned fund, for example, also has a 5% option. There will still be down years. But in the long run, a 5% distribution will be more sustainable.

- Invest in a portfolio of dividend-paying stocks, and only take the dividend income. The underlying stocks are likely to rise in value over time, as are the dividends. Your income will start lower, but will increase from year to year.

For more on this topic and which approach is best for you, free to call Jim at 250-594-1100, or email jim.grant@raymondjames.ca.

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