

Bank stocks rise on hope dividend taxes to fall: Speculation by investors

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Canadian bank stocks soared to record highs yesterday as investors bet that Ottawa will soon announce a dramatic overhaul to the way shareholders are taxed on dividend income.

The Standard & Poor's/TSX financials index jumped to an all-time high, with Bank of Nova Scotia, Royal Bank of Canada and Toronto-Dominion Bank all hitting record highs. Scotiabank shares rose \$1.28 to close at \$44, while RBC closed at \$86.30, up \$1.76. TD closed at \$58.74, up \$1.52.

Bank stocks pay generous dividends, with average yields of 3.5%, which means investors could benefit handsomely from any adjustment to the dividend tax rate. Bank stocks would also look more attractive next to bonds and income trusts, whose distributions are taxed more heavily.

"The potential of a more level playing field between banks and income trusts may be a catalyst to narrow the major valuation disconnect/gap," said Kevin Choquette, an analyst at Scotia Capital, in a research note yesterday.

But would dividend tax cuts light a rocket underneath dividend-paying stocks? If Canadian stocks follow the lead of their U.S. counterparts, the benefits to investors might be modest.

In 2003, the U.S. administration hacked personal tax rates paid on dividends down to 15% from a high of almost 40%. The reason was straightforward: By putting more money into consumers' hands, the tax cut would help stimulate a struggling economy. As well, it was designed to breath life into a moribund stock market that had recorded three straight years of losses.

However, the impact on the equity market wasn't huge. Yes, dividend-paying stocks went on to outperform non-dividend paying stocks in 2003 and 2004, but this trend had been established years earlier when tech stocks -- which generally don't pay dividends -- began to wobble in 2000.

And yes, a number of companies have either raised their regular quarterly dividends, initiated dividends or paid out special dividends.

According to Standard and Poor's, 378 companies in the S&P 500 paid dividends in early 2005, versus 351

companies in 2002 -- a 7.7% increase. S&P estimates that member companies will distribute a total of US\$203-billion in dividends in 2005, up US\$22-billion or 12% from 2004. But the gains are hardly monumental and may in fact have little to do with the tax cut.

"The dividend payout ratio has been gradually increasing and dividend-paying stocks have been outperforming, but to attribute all these changes to the legislation would be a major leap," said Fred Pynn, portfolio manager at Bissett Investment Management.

Of course, a Canadian dividend tax cut would have little to do with stimulating the economy or igniting a lifeless stock market, considering that both are performing fine.

Rather, it would have more to do with Ottawa's reaction to the income trust juggernaut. Income trusts, which minimize their taxes by paying out most of their free cash flow to investors, have become all the rage in recent years as more and more Canadian companies convert to the tax-efficient structure.

Now, Ottawa appears to be growing alarmed by the dwindling tax revenue and decreased competitiveness of Canadian companies that income trust conversions could cause. On Sept. 19, the federal government halted advance tax rulings on trusts.

Also, the Senate Standing Committee on Banking, Trade and Commerce will begin hearings today and tomorrow on the issue of income trusts.

The expectation that these hearings will lead to a tax cut may prove more rewarding for investors than the tax cut itself.