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# As rates rise avoid more utility stocks

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I often hear complaints about Enbridge's customer service. But when it comes to Enbridge's stock, I never hear a critical word.

Enbridge common shares have returned an average 13.5 per cent a year in the past decade and 16.6 per cent a year in the past five years. (This is just price appreciation, not the return with dividends included.)

Very few Canadian equity mutual funds can boast of double-digit returns over the past five-year and 10-year periods.

Pipeline companies have done well as a group because of the potential to make money transporting gas from western Canada to the United States and overseas markets.

Investors like the growth potential and solid dividend yields of Enbridge, TransCanada, Pembina Pipeline and Inter Pipeline Fund. Protests by environmental activists don't seem to hurt these stocks.

But there's a potential buzz killer: Higher interest rates.

Canadian interest rates could start rising in 2013, a year ahead of U.S. rates, as Bank of Canada governor Mark Carney tries to dampen housing prices.

What's ahead for pipelines, utilities, telecoms, banks and real estate stocks with healthy yields and rising dividends?

In a recent report calling higher interest rates a clear and present danger, BMO Nesbitt Burns urged investors to look at other stock sectors — such as life insurance — that can benefit from rising rates.

Investors have piled aggressively into "steady-eddy stocks" and pushed up their prices beyond the growth in earnings and dividend payments, said equity strategist Stephane Rochon.

Brookfield Infrastructure Partners (a top-performing pick for Gordon Pape) had a total shareholder return of 41 per cent in the year ended Feb. 29. Enbridge and Pembina both had 35 per cent returns.

Real estate investment trusts also did well. CAP REIT was up 25 per cent during the same one-year period and Riocan was up 18 per cent.

These steady-eddy stocks are expected to give back some recent gains if bond yields go up and investors rotate back into fixed-income investments.

Investors can't always sell because of capital gains taxes. But at a minimum, they shouldn't add to their positions until long-term interest rates normalize, the report advises.

Canadian banks are an exception to the rule. Unlike other high-yield stocks, they can improve their profit margins as rates rise.

“Banks may be able to lend money at higher interest rates while still paying little or nothing on deposits,” says Rochon. (Isn’t that depressing?)

“Barring a collapse in economic and lending activity, investors thirsty for income should consider the purchase of Canadian bank stocks.”

Life insurance companies also benefit from rising rates. They invest policyholders’ premiums in bonds and use the interest to cover claims. The funds left over translate into profits.

As rates rise, life insurance companies can reinvest the proceeds from maturing bonds into higher-yielding securities, thus earning extra profit.

Investors anticipating higher long-term interest rates should look at stocks such as Manulife or Great-West Life, the report recommends.

Hold on. There’s no rush, says Tony Demarin, chief investment officer at BCV Asset Management in Winnipeg, which only holds dividend stocks.

“The Bank of Canada won’t raise rates until next year, so we have blue sky in front of us for the rest of the year,” he points out.

Moreover, a big increase is unlikely since economies are still recovering from recession. Meanwhile, governments would face ballooning deficits if rates skyrocketed.

Among stocks he likes are Canadian banks, CN Rail, Enbridge, TransCanada, Tim Hortons and Saputo (a big dairy producer). He’s also keen on U.S. stock Coca-Cola, which announced a two-for-one share split.

“Rising rates will take the shine off some stocks at the margins,” he says. “But where will investors put their money? Interest rates are close to zero. Even if they rise a bit, returns will still be modest.

“There’s no reason you can’t hold conservative defensive stocks for years.”

My advice: Rates won’t stay this low forever. If you’re heavily exposed to rate-sensitive stocks, start trimming your positions ahead of an increase, which could come more quickly than you think.