Dividend Yield Hunting

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Dividend paying stocks have been volatile over the past year in large part due to the market trying to understand when, and at what pace, the Federal Reserve will raise interest rates, after six years of being at 0%. As interest rates increase, the price of yield oriented securities can go down. For bonds, this inverse relationship holds because at higher interest rates, investors can seek better income in other bonds than what they currently own. In regards to dividend paying stocks, as interest rates rise, and bonds become attractive, investors will demand a higher dividend yield, in return for taking on more risk in owning the stock. In anticipation of Fed policy action, the market is attempting to price the correct difference between the yield on bonds, (which should be less risky because in the worst case scenario, say a bankruptcy, bond holders get paid first, and stock holders are left with whatever remains) and the yield on dividend paying stocks.

For example, in 2013, the Federal Reserve announced its plan to "taper" its quantitative easing program. Upon this announcement, bonds and all yield oriented securities sold off hard. Reacting to this change in Fed policy, many investors positioned their portfolios for a rising interest rate environment the following year. In 2014, the opposite happened; bonds rallied as did utility, REIT, and other income oriented securities; Utilities in particular appreciated 25%! This year, the market had been expecting the Fed to raise rates, which continues to offer mixed signals about the health of the economy. As a result, the Utility sector is down ~9.5%, the Vanguard REIT ETF (VNQ) is down ~7%, the Ishares Dividend ETF (DVY) is down 8.5%. The S&P 500 is off 6% year to date. Historically, these sectors have been significantly less volatile relative to the S&P 500, and have been used as bond proxies for an equity portfolio. Risk adjusted, a sell off of 9% plus in these sectors is quite dramatic.

The recent market sell off has provided investors with a good opportunity to buy high quality, dividend paying companies at attractive prices. Since 1950, dividends have been more than one-third of the total return of the S&P 500, which is quite significant. Total return is important for investors, particularly retirees. The main problem with relying on bonds as a major source of income is right in the name of the asset class: fixed income. In bonds, the income is fixed. As inflation rises, the income of the security does not change, neither does the value as there is no chance for growth! With a dividend stock, particularly one in which management and the board of directors have a history of supporting a policy of growing the dividend, the income can grow at or above the rate of inflation. Barring a credit default, the allure of a bond is getting your money back with an interest rate being paid. With a stock, the focus is on total return: capital appreciation plus dividends. Over the past six years, income oriented investors have added stocks to their portfolio to compensate for the lack of yield in bonds.

There are certain companies and sectors that believe heavily in returning cash flow to shareholders in the form of dividends. Stocks in the utility, telecom and consumer staples sectors, though not exclusively, have historically paid out a large portion of the earnings to shareholders in the

form of dividends and have also grown their dividend annually. Those companies that have done so consistently have had the esteemed privilege to be named a “Dividend Aristocrat.” To be included in this category a company must have not only paid, but ***increased*** its dividend, every year, for 25 years or more. Those investors needing income and wanting dividends as a portion of their total return typically favor these stocks.

There are bargains to be found for the investor willing to look through the headline-driven market. Here are three dividend aristocrats that we find interesting in today’s environment:

Walmart (WMT). With the job market improving, and gasoline prices declining, WMT’s sales should continue to grow. Additionally, at current prices, WMT offers investors a 3% dividend yield, vs the S&P 500 dividend yield at 2%, the US 10 year Treasury at 2.1%, and cash yielding 0%. Finally, WMT has grown its dividend 14% annually since 2006. **Helmerich & Payne (HP)**, one of the largest land drillers in the US, is in a unique financial position. The company recently completed its fleet upgrade and has one of the youngest, most advanced set of rigs compared to peers. In addition, HP has barely any debt on its balance sheet. HP has proven its commitment to its dividend, growing it annually for more than 25 years. At current prices, shares of HP yield 5.19%. Finally, **Procter & Gamble (PG**), once the leading consumer products company in the world, is in the process of a turn around. They are selling off underperforming brands, and refocusing the product portfolio. The share price of P&G is off 25% year to date. The current dividend yield is 3.7%, and the company has increased that dividend 10.1% annually for the past 10 years!

Unless a global recession is upon us, at some point soon the Federal Reserve will raise interest rates and remove “crisis level monetary policy,” which is typically what an economy must be in if interest rates have been at 0% for 6 years. The economic crisis in the US is over. Over the past 12 months the US has added 250k jobs per month on average. The unemployment rate is at 5.1%, and wages are starting to increase. However, the major question is at what pace will the Fed raise rates? Going from 0% to 0.25% is symbolic rather than “game changing.” The most recent Fed comments suggest that inflation will not reach their target until 2018, indicating the Fed is in no rush. Therefore, the FOMC will embark on a very slow and measured pace of raising rates. In this environment, dividend paying stocks should perform well as rates on bonds will stay relatively low for a longer period of time and the focus will remain on total return and growing income.