The Quest for Dividends

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Investors have long had a love affair with dividend yielding stocks. Investing in high dividend stocks has been a strategy to generate income and enhance total return. The theory is that companies paying dividends usually are optimistic about both their business position and growth prospects. Companies that pay and more importantly, continue to increase their dividend rate, tend to outperform the market on a risk-adjusted basis.

Overview:

Dividends connect you tangibly to the underlying results of the company. This may be because they have developed solid cash-generating businesses and stronger finances – a benefit of their maturity. The dividend also signals confidence from management, linking the return on that business to shareholders in a very practical and public way. This aides in valuation as a type of anchor, connecting the payment stream with the underlying fundamentals of the business

Who pays dividends? The most likely dividend paying company tends to be one that is more mature, confident in its business model and operations, and generating significant cash flow. Utilities and financial companies historically have been large dividend payers, although the latter not so much so following the financial meltdown in 2008 and the resulting limitations the Federal Reserve placed on their balance sheets. It is estimated that utilities represent anywhere from 10-30% of the dividend paying universe. Real Estate Investment Trusts (REITs) and Master Limited Partnerships (MLPs) are required to pay out all of their cash flow.

Positives:

Provide a reliable income stream and give an investor control on how to redeploy it – Investors who want to generate a predictable cash flow love the stable and consistent income stream dividend stocks can provide. In addition, dividends put a portion of the company's return on capital in your hands to reinvest as you wish. This is the opposite of having the company decide to purchase assets overseas, make an overpriced acquisition, or undertake some other action you may not agree with.

Mitigate some market risk - Dividend plays tend to do best in an uncertain market. When investors get skittish and market returns fall, the onus often rests on dividends to drive

total stock returns. Dividends have contributed approximately 34% of the S&P's total return since 1926. In periods of stock declines, such as the 1970s and 2000s, dividends were the only returns investors received. Investors look to these established, larger names with demonstrated earnings generation capability.

Inflation protection - Dividends can also help counter the effects of inflation and protect purchasing power, especially if a company has a dividend payout rate that exceeds the inflation rate. Normally, straight fixed income investments, with the exception of inflation protected Treasuries, will lose ground to inflation. Data from Yale Professor Robert Shiller indicates that over the past 100 years, dividends from a diversified collection of US stocks have grown an average of 4.4% annually, easily beating the inflation rate of 3.2%.

Favorable tax treatment - Interest from bonds and other fixed income investments is taxed as ordinary income at your highest marginal tax rate. Qualifying dividends will be taxed, along with capital gains, at a lower rate. Most dividends from US stocks should qualify for this treatment. Stocks held in taxable accounts can take advantage of the maximum current 20% (23.8% for certain high income tax payers subject to the Medicare surcharge) federal tax rate on stock dividends.

Risks:

Rising rates – Dividend payers may suffer as rates rise. This was evidenced in the spring of 2013, when then Federal Reserve Chairman Ben Bernanke announced the taper of the Fed's purchase of fixed income securities. This caused a dramatic jump in interest rates, which impacted stocks. Rising rates can hurt dividend paying stocks in several ways. First, investors often view these stocks as a proxy for bonds and drag down the value in sympathy with bond prices. Second, investors may move to alternative fixed income products. Finally, a rising rate environment often signals a stronger economy, which favors growth stocks versus dividend payers.

A market that favors growth stocks - When the market enters its more active bull phase, dividend companies are often viewed as those stodgy old grandparents, slower-moving and graying around the edges. The more mature nature of the investment puts it at a disadvantage to its younger and faster-moving growth cousins. Safety and security go out the window and these companies may trail the market.

The dreaded dividend cut – During the bear market that commenced in 2008, S&P companies cut their dividends by 24%, led mostly by financial firms. That was mild compared to what happened during the Great Depression when dividends were cut by 47%, even accounting for the period's deflation. Dividend cuts impact valuations. However, in both cases the cuts in the dividends were not nearly as severe as what happened to overall equity prices.

Questions to ask before you invest: Before embarking on a dividend strategy for your portfolio, investors should look at the following factors:

Is the dividend safe? – Paying too high a dividend rate versus the market, often defined as above the 10 year Treasury yield, may raise red flags. It begs the question of whether the company has no other attractive business options that can help grow its business.

Are the business fundamentals strong? – Investors should analyze if the core operating business is stable or growing and if the balance sheet can tolerate a business downturn while continuing to pay dividends.

Is management committed to a dividend payout? – A management change may signal a sudden change in policy. Or is management so tied to the public perception of the dividend that they are foregoing profitable operating decisions?

Is the company increasing its dividend rate? – A stagnant dividend rate paints a very different picture than one offered by a dynamic company which is ramping up both the earnings and dividend growth rates. Growing dividends trump stagnant high dividends any day.

Are you being sensitive to sector diversification? – Investing in dividend stocks may leave you overexposed to financial and utility sectors. Keep your portfolio safely diversified among many sectors.

Conclusion:

Investing in dividend stocks can be a profitable strategy that generates cash flow and provides stability to a portfolio during volatile market times. However, dividend investing is no guarantee of outperformance as different strategies work better at various points in the market cycle. You may outperform during volatile or down market periods, but underperform when the markets heat up. Finally, purchasing a stock for its dividend only is a risky strategy. Do your homework and find the solid company that has a demonstrated an ability and commitment to grow its dividend.