

# Dividends: It's Payback Time!

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## The markets are rewarding companies that pay dividends. Here's how to load up—smartly.

Slow economic growth. Whipsawing volatility. In an environment like this, it is little wonder investors are piling into stocks with steady dividend payments.

Mutual funds specializing in dividend stocks have seen inflows of \$12.6 billion so far this year, four times as much as in all of 2010—even as stock funds as a whole have posted outflows of nearly \$25 billion, according to fund tracker Lipper.

But dividend stocks aren't a panacea—and buying them willy-nilly can lead to disappointment down the road. Dividend stocks are notorious laggards during big rallies, which often start when investors are most averse to risk. And the market is full of "dividend traps"—troubled companies that pay hefty dividends merely to keep investors from bailing out, a risky gambit that usually isn't sustainable.

The best way to view dividends, say money managers, isn't as an end in themselves but rather as a means to other goals such as reducing volatility or boosting (but not turbocharging) income. Used smartly, dividend stocks can even generate returns that match the overall market—with beefier income streams. But investors shouldn't live on the div alone.

"A focus on dividend-yield strategies is an important part of an investor's tool kit," says Rob Arnott, chairman of money manager Research Affiliates in Newport Beach, Calif., which helps oversee \$80 billion. "But they're a little bit overrated today."

The key to dividend investing, say strategists, is to be selective. That means avoiding the juiciest dividends and concentrating instead on companies that are boosting their payouts—and have the growth potential to keep those payments coming.

"You should never be taking shortcuts," says Ben Inker, director of asset allocation at money manager GMO LLC in Boston. "Just because a stock pays a dividend doesn't mean you don't have to worry about the rest of the company."

### Strong Case

Make no mistake: The general case for dividend stocks is strong now. The 10-year Treasury yields just 2.19%—which translates, at best, to a 0% yield after inflation. The five-year Treasury pays just 0.94%. For an investor willing to hold stocks for five or 10 years, the Standard & Poor's 500-stock index's 2.3% "dividend yield"—the payout as a percentage of the stock price—is tantalizing.

Dividends could make up a bigger part of the market's total returns in the future. The slow economy means corporate earnings growth, the main driver of stock returns, is likely to slow as well, says Jason Trenner, chief investment strategist at Strategas Research Partners LLC. That would make dividends all the more appealing.

Dividends fell out of favor during the 1980s and 1990s as investors chased faster-growing companies. During the 1980s, only about 25% of total returns came from dividends. During the 1990s, the percentage fell below 20%. Companies felt less pressure to boost their dividend payments, and yields dropped. The result: The market's paltry 1.8% annual yield from 2000 to 2009 wasn't enough to make up for its 2.7% annual capital loss.

Once again, investors are beginning to reward companies that pay dividends. During the past 14 months, the 25 companies that paid

the most dividends as a percentage of their market value beat the S&P 500 by 8.9 percentage points, while the 25 companies that increased their cash on their balance sheets the most lagged by 8.4 points, according to Strategas.

And with the largest nonfinancial companies holding a record \$1.5 trillion in cash, more dividends may be on the way, says Morgan Stanley strategist Adam Parker.

But investors shouldn't expect miracles. While the S&P 500's yield has risen a bit in the past few years, its current level is still barely half the 4.2% average since 1929. "The payout is so low, you won't get rich off of dividends directly," Mr. Inker says.

When you buy a dividend payer, you are placing a bet on a certain type of stock—one that is typically large, slower growing and less volatile. If the market suddenly rips higher, dividend stocks could lag behind.

NAME (TICKER)	RETURN		YIELD	BETA
	YEAR TO DATE	3-YEAR ANNUALIZED		
Federated Strategic Value Dividend Fund (SVAAX)	4.18%	2.96%	3.47%	0.66
Rochdale Dividend & Income Fund (RIMHX)	0.25	4.46	3.75	0.76
SPDR S&P Dividend ETF (SDY)	-3.48	5.61	3.33	0.88
First Trust Morningstar Dividend Leaders ETF (FDL)	2.24	5.65	3.71	0.94
Vanguard High Dividend Yield ETF (VYM)	-1.87	1.04	2.82	0.98
WisdomTree Equity Income ETF (DHS)	1.93	2.57	3.57	1.09

Note: All data as of Aug. 25 Source: Morningstar

That is because two types of companies tend not to pay dividends: those that are perceived to have better growth opportunities and spend their cash internally rather than return it to shareholders, and those that are in such dire straits they can't afford to pay a dividend. Both types beat the market when investors feel like taking risk, says Mr. Arnott of Research Affiliates.

Ron Glaser, a retired federal government worker in Haymarket, Va., is trying to strike the right balance. Mr. Glaser, 61 years old, has been buying such high-yielding stocks as Altria Group Inc., Duke Energy Corp., Verizon Communications Inc. and AT&T Inc. this year to get some income and bring more stability to his portfolio. But dividend-paying stocks aren't his only equity investments.

"With people living longer, you can't just rely on dividends," Mr. Glaser says. "You have to take some risk."

Here are some ways to add quality dividend payers to your portfolio without sapping its growth potential.

### Size Up Yields

A dividend can be less than meets the eye. Barnes & Noble Inc. had a dividend yield of more than 5% before the company suspended its payment on Feb. 22. In this case, the high yield was a sign of trouble, not stability.

At the same time, a low yield might not be a problem if the company seems poised to raise its payment. Take UnitedHealth Group Inc., a favorite of Richard Helm, manager of the Cohen & Steers Dividend

Value Fund. It has a yield of just 1.2%, but it raised its dividend payment from three cents per share to 50 cents in 2010, and then raised it again in May 2011 to 65 cents.

“We favor those that have lower payout ratios, but higher rates of dividend growth,” says Mr. Helm, whose fund is down 6.7% so far this year, better than the S&P 500’s 7.8% decline through Thursday.

Of course, a fat yield does no good if a company can’t make its payments in the future. How do you tell if a dividend may be unsustainable? First, look at a company’s payout ratio—the dividend payment per share divided by earnings per share. A common rule of thumb: If the number is more than 50%, the dividend may be too high, especially for companies where earnings fluctuate with the economy.

In stable sectors, such as utilities and telecommunication companies, higher payout ratios might not be a sign of trouble because companies’ income fluctuates less.

But if the dividend is too high, it could be a red flag. Consider Frontier Communications Corp. The telecom outfit has had to dip into its free cash flow to maintain its 75-cents-a-share dividend payments over the past year—more than four times its per-share earnings. If that trend continues, Frontier’s hefty 10% dividend yield could be at risk.

“Based on Frontier’s free cash flow guidance to investors for 2011, we project our dividend payout ratio to be approximately 65%,” says Frontier spokeswoman Brigid Smith. “This is a ratio which we currently view as appropriate and sustainable.”

Financial planner Emily Sanders, chief investment officer of Sanders Financial Management in Norcross, Ga., isn’t convinced. She passed on buying the stock recently, choosing Verizon, PepsiCo Inc. and Abbott Laboratories instead.

“We decided that the stability of the dividend wasn’t ensured enough to buy the stock,” Ms. Sanders says.

### **Think Broadly**

Picking the “right” dividend payers doesn’t make much sense without fitting them into an overall strategy. Do you want stability, income, growth or some measure of all three?

If you seek a high level of income with less dramatic price swings, you should focus on stocks with a high yield and a low “beta,” a measure of risk that shows a stock’s tendency to move with the market. A stock with a beta of 1.0, for instance, should have the same amount of volatility as the S&P 500. A stock with a beta of 1.5 should have 50% more volatility than the S&P, while a stock with a beta of 0.5 should have half the volatility.

A high-yield, low-beta strategy would steer you toward consumer staples like General Mills Inc., which pays a dividend yield of 3.3% and has a three-year beta of just 0.2. Utility PG&E Corp. yields 4.4% and carries a beta of 0.2; and health-care company Abbott Laboratories yields 3.8% and has a beta of 0.3.

Several mutual funds and exchange-traded funds generated fatter yields than the S&P 500 and provided more safety. The SPDR S&P Dividend ETF, which tracks the S&P High Yield Dividend Aristocrats index of S&P 500 companies that have raised dividends every year for 25 consecutive years, has dropped 8.6% in August, compared with a 13.1% fall for the S&P. It yields 3.3% and has a beta of 0.88.

The Federated Strategic Value Dividend fund yields 3.47% with a beta of just 0.66. Rochdale Dividend & Income fund yields 3.75% and has a beta of 0.76. The two funds’ returns are down 4.3% and 7.3%, respectively, during the past month.

Dividends also can be used as the “safe” portion of an equity portfolio, allowing an investor to take more risk with the rest of their stock allocation. Sam Katzman, chief investment officer at Constellation Wealth Advisors LLC in New York, advises most investors to make dividend payers between 50% and 60% of their domestic and international stock holdings. “You need something that makes you look at your stocks differently,” Mr. Katzman says.

Mr. Katzman is looking at adding risk via small-cap stocks, which have dropped 14% this year, about six percentage points more than the S&P 500, and should rise faster during a rally.

Investors willing to brave foreign markets might also consider venturing into Europe, says Mr. Inker. For instance, French oil giant Total SA pays a 6.8% dividend, compared with Exxon Mobil Corp.’s 2.6%. France Telecom SA yields 10.65%, nearly double AT&T’s yield of 6%. “You’re not going to find companies of that caliber trading at those dividend yields in the U.S.,” he says.

Another way to create a portfolio of safe companies, says Mr. Trennert of Strategas, is to seek those that seem best poised to make good on their debts. He suggests looking at how much it costs to insure a company’s debt against default in the credit-default-swaps market, and compare that with the cost for Treasuries.

For example, it cost about \$38 to insure \$100,000 worth of McDonald’s Corp. bonds on Thursday, compared with about \$47 for the same in Treasuries.

All told, there are about 50 such companies, including a mix of high yielders like Duke Energy (5.3%), Bristol-Myers Squibb Co. (4.6%) and Lockheed Martin Corp. (4.2%), alongside faster-growing but lower-yielding stocks such as Google Inc., which doesn’t pay a dividend, International Business Machines Corp. (1.8%) and Walt Disney Co. (1.25%). The overall portfolio yields about 2.96%, and has an average beta of 0.89.

### **Get Aggressive**

Other investors might prefer more upside potential alongside a fat yield. One strategy: build a portfolio that pays a high dividend but tracks the S&P 500. By leaning toward stocks with above-average yields, but higher betas, investors can match the S&P’s price gains while beating it on a yield basis.

Joe Wolfe, director of quantitative research at Northern Trust Corp., recommends higher-beta dividend payers like Microsoft Corp., which has a dividend yield of 2.6% and a beta of 0.98, and Intel Corp., which has a dividend yield of 4.3% and a beta of 1.1.

Among the higher-beta dividend payers that Jeff Layman, chief Investment Officer at BKD Wealth Advisors LLC in St. Louis, has been accumulating for his clients are ConocoPhillips, which yields 4% and has a beta of 1.2, and Aflac Inc., which yields 3.4% and has a beta of 2.0.

High-beta income ETFs include First Trust Morningstar Dividend Leaders, which yields 3.7% and has a beta of 0.9, WisdomTree Equity Income, which yields 3.6% and has a beta of 1.1, and the Vanguard High Dividend Yield, which yields 2.82% and has a beta of 1.

“In the future, dividends will be a stronger portion of returns,” Mr. Wolfe says. “But we want market exposure too.”

### **Corrections & Amplifications**

Frontier Communications has a dividend yield of 10%. An earlier version of this article said the yield is 1%.