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Investors Often Told to Flock to Dividend Paying Stocks – But for the right reasons?

Dividends tossed to investors like rice at a wedding! Investors jumping to catch them!

Many of America's largest companies, bolstered by record profits and record levels of cash, have increased their dividends. However, in the view of some, prices are overvalued because so many are seeking dividend stocks. In addition, high dividend paying stocks are often interest rate sensitive like bonds – that lose value as market rates rise unless held to maturity assuming other factors the same.

422 of the S&P500 companies are paying dividends with an average yield of about 1.9% as of May 2018. Only 41 of them have yields over 4%. "Higher yields come with higher risks, though. Many of these stocks' yields are so high because they're struggling, and they may even have to slash their dividends soon." – cabotwealth.com 4/16/2018

Much has been made of reports that dividends were responsible for 43% of the total return between 1930 and 2016 of the S&P500 (Forbes 3/31/2018). What this fails to point out is that the average dividend yield over this lengthy period has been 4%-5% vs. less than 2% today. In short dividends are less important for investors today than most of the years of this study.

Fama and French did regression studies of thousands of companies and found that higher total returns were explained by valuation statistics such as a low P/B ratio related more to "value" stocks. They specifically looked at dividend payout and found it had no meaningful correlation to higher long-term returns -Journal of Financial Economics 60, 3-43.

Larry Swedroe, author of popular investment books and frequent guest on CNBC writes in his blog on CBS Moneywatch: "The historical evidence (at least in the U.S.) is that a high-dividend strategy not only produces the lowest premium, but it's not even a statistically significant premium." (By premium he means it does not produce a better total return.)

Paying Dividends to Shareholders – The cons

Paying dividends to shareholders often shows they don't see enough opportunities to invest for future company growth that could potentially result in higher long-term capital gains for investors vs. currently tossing out cash as dividends.

Dividends are **double taxed** – no tax deduction for the corporation, and taxable - although favorably to investors, if not in qualified retirement plans.

Utilities and older "mature" companies may not have as many profitable growth opportunities because their cash and earnings may be relatively stable and for many regulated. They may be attractive for their dividend. However, this can result in interest rate risk - like bonds – resulting in loss of value when rates increase and as stocks they don't have a maturity date when bonds would repay principal.

"Warren Buffett refuses to pay dividends on Berkshire Hathaway. Why? Because he believes that investors should choose when to take income from the company, and that repurchasing shares is a better way to get rid of unneeded cash. Despite many investors who would rather be told when to take income from their Berkshire Hathaway shares, Buffett makes them do the work. He'd rather not make long-run investors suffer because of the biases of investors who can't shake their need for a dividend." Source: Let's get real about dividend stocks - InvestmentNews

Alternatives

If investors need income, a better approach may be a fixed withdraws strategy: for example, 2%-4% of their portfolio value each year if the goal is to maintain as much value as possible for the future. Or, a withdrawal rate that will deplete principal at, say, age 100 of the younger spouse. However, the math is not perfect since the timing

of withdrawals vs. market gains or losses is important in when the funds will run out.

The best approach is to take out what is needed for a while when the portfolio has had a recent gain and try to not have to take distributions when the portfolio has market losses. Historically markets have always regained losses, but the timing is unknown.

A better corporate option is to **buy back stock** – and many companies are doing this as the result of the 2018 tax cut. This directly increases earnings per share, lowers the P/E and other key equity ratios since there are fewer shares outstanding.

The Positive Side of Dividend Stocks

Some investors like them for the cash flow to fund living or retirement expenses. They tend to lose less in down markets (total return including the dividend) and have less gain in up markets.

Evaluate – Just don't buy because of dividend

Just like with any stock, careful evaluation is needed. Important factors are the dividend payout ratio to earnings, the ratio to free cash flow, P/E ratio, how dividend stocks fit in your overall investment objective, and the current investment cycle based on valuations and outlook.

A complete evaluation of a dividend stock should also include examining the company's debt structure, looking at coverage ratios, and finding how much it costs to insure a company's debt against default risk in the credit-default-swaps market.

My Recommendations

I would neither eliminate nor specifically seek dividend stocks but leave the selections to the research and evaluation of recommended independent managers with a long-term track record of outperformance (Alpha) vs. the risk they took (Beta).

This is an Example of the research we do on various market segments and how seriously we take investment recommendations with ongoing monitoring of both individual portfolios and overall specific recommendations.

Recommended Strategies

1) Growth strategy to help maximize the potential market growth over the next few years. We do not recommend index returns, ETFs or Target Funds, but funds that have historically consistently outperformed the "dumb" indexes with positive Alpha (outperformance vs. risk taken).

2) ""Participate yet Protect" strategies especially for longer-term investments to help minimize the effects of future market crisis.

3) Alternative opportunities without stock or bond market exposure for more cautious investing in what we believe are timely opportunities.

The three strategies can be combined within a portfolio, depending on your objectives.