

Investing for dividends

Some stocks pay dividends, and some don't. Which ones an investor chooses is, in part, a matter of risk tolerance. In general, larger and, some might say, stodgier firms are more likely to pay a dividend, while younger, smaller, growth-oriented stocks don't. The company that does not pay dividends plows that money instead back into the firm, which, theoretically, is supposed to make the stock price appreciate more quickly. At one time there was a strong tax incentive to take this approach, as dividends were taxed much more severely than long-term capital gains. At the moment this tax disparity is gone, but it is scheduled to return after 2010.

Leaving aside the tax issues, if two stocks have the same total return, but one is entirely from capital gain, and the other is a combination of dividends and capital gain, should they be equal in the eyes of the investor? No, they should not. Capital gains can, with market fluctuations, become capital losses. Dividends, once distributed, never can be taken away from the shareholder receiving them.

Dividends tend to cushion a stock's price from downside pressure, though they are no guarantee against loss. In 2008, share prices of companies without dividends lost an average of 45%, according to *The Wall Street Journal*. Companies that paid dividends lost 39% of their value. At the same time, the dividend payers may have less upside price potential. Through mid-November, the *Journal* reported, dividend payers were up 21.3%, compared to a robust 55% gain for the nonpayers. Payers were ahead in October, however, so the momentum may be shifting.

The fact that a company pays a dividend today does not guarantee that it will pay one tomorrow—many companies have been forced to reduce or eliminate their dividends during this economic downturn. A high dividend rate may indicate that the market thinks the company is on the ropes and won't be able to sustain the payments into the future. Some market observers believe that when the dividend divided by the stock price approaches a percentage in the double digits, the payout can't be sustained.

To avoid nasty surprises on the dividend front, it's important to evaluate a firm's balance sheet for hidden liabilities that could jeopardize the payout. Another important indicator is cash flow—how much cushion does the company have to continue with the dividend payments? Few amateur investors have the expertise needed for such analysis—that's where our investment advisory service can be important. A shortcut used by some investors is simply to focus on companies with a long track record of increasing dividends.

Companies that have started or increased their dividends since 1972 have had an average annual return of 9.5%, according to Ned Davis Research, Inc. As a group they've outperformed stocks with no dividends in 19 of the past 30 years. Accordingly, dividend-paying stocks are likely to have an important role in the portfolios of most investors.

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