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

Ticking Time Bomb as The Motley Fool points out: With a slight up tick in interest rates bonds, REITs, and high dividend stocks plunged. I continue to warn about interest sensitive investments as rates slowly may begin to normalize.

As 24/7 Wall Street pointed out 6/12/2013, "Short sellers could have cleaned up by betting against the high dividend stocks in May and into June" (as prices declined).

Dividend Stocks: Lose-Lose-Lose Proposition

Seeking Alpha 6/7/2013 - "With yields on "high" dividend stocks at near-record lows and P/E ratios near record highs, there is not much room for price appreciation amongst dividend stocks in the next few years. Under any scenario of "normalization," long-term interest rates will rise significantly. This suggests poor total returns for dividend stock investors during this period of normalization."

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.

412 of the S&P500 companies are paying dividends with an average yield of 2.5% as of June 2013.

Much has been made recently of an S&P report that dividends were responsible for 44% of the total return over the last 80 years of the S&P500. What this fails to point out is that the average dividend yield over this lengthy period has been 4%-5% vs. only 2.5% 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. Fama, E. F., Babiak. H., Dividend policy: an empirical analysis, American Statistical Association Journal 63, 1132-1161 and Fama, E. F., French, k. R.. Disappearing dividends: Changing firm characteristics or lower propensity to pay, 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.

Many companies believe they can continue to increase profits and sales without having the burden of hiring more workers. With the record amounts of cash built up many companies are paying more out as dividends.

Utilities and older "mature" companies may not have as many profitable growth opportunities because their cash and earnings may be relatively stable. 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.

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 might be to **buy back stock** with the excess cash – and many companies are doing this. This directly increases earnings per share, lowers the P/E and other key equity ratios since there are fewer shares outstanding.

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

- Continued back side -

"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." Wall Street Journal

"A security with a robust yield could be a value trap, a rich payout sitting atop a business or asset that's flailing beneath that attractive veneer. Also stay attuned to the possibility that a company could cut its dividend in the future, as was the case with many financial stocks that boasted robust yields during the 2008 financial crisis." Morningstar

The Positive Side of Dividend Stocks

Most studies show that over the long-term dividend stocks basically match the S&P500 index. 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, Beta, Alpha, 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 of recommended managers who have a good long-term track record (excess return or Alpha) vs. the risk they took (Beta).

I believe that security choices through the independent evaluation of managers looking for long-term outperformance (Alpha) vs. Risk (Beta) continues to be the best way to make equity recommendations.

For income or less equity risk/recovery potential, I continue to recommend alternatives without bond or equity market risk. Obviously bonds are at very high interest rate risk, as eventually rates should rise which will decrease bond values unless held to maturity. If you can't stand the pain or feel worldwide economies are about to collapse with no recovery anticipated, then you might consider moving to, or staying in cash.

When markets are in valuation bubbles like tech stocks in 2000 with the market clearly irrationally exuberant, it would be a time to reposition investments.

While corporate earnings are back to record 2008 levels, unlike in the tech bubble, the market was actually quite reasonably priced in 2008; it was corporate earnings that collapsed, GDP plunged and we had massive job losses.

Today we are in the opposite kind of market from 2000 – Valuations are reasonable or fairly low, amid concerns about continuing slow job growth, European concerns and the slowdown in China to "only" about 7% growth - vs. 10%+ of the past few years.

S&P500 earnings are expected to continue to grow, from already record highs – even if we continue to have a slow economic recovery. However, interest sensitive high dividend stocks overall have higher valuations and as interest rates rise are likely to lose value similar to bonds.

Recommended Investment Strategies

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

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

3) Alternative opportunities - without stock or bond market exposure - for cautious investing in what we believe are timely opportunities, especially for income in retirement.

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