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Divining the merits and pitfalls of dividends

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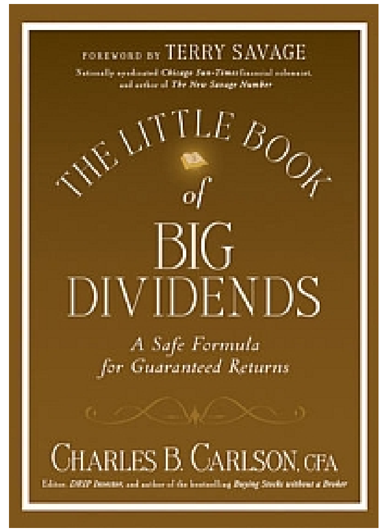

With a myriad of investment methods to choose from, equity investors in today's volatile stock market conditions might feel bewildered given the seemingly sound arguments supporting the opposing principles of the value and growth investing philosophy.

Charles B. Carlson (http://www.bigsafedividends.com/about_chuck.asp), author of "The Little Book of Big Dividends: A Safe Formula for Guaranteed Returns" (http://as.wiley.com/WileyCDA/WileyTitle/productCd-0470567996.html), presents a middle way with his "Big Safe Dividends" concept. The CEO of Horizon Investment Services LLC (http://www.horizoninvestment.com/index.asp) and CFA charter-holder incorporates both elements of value and growth into his formula while allowing the investor to generate an income with a steady stream of dividends. Written primarily for American investors, he backs up his thesis with stocks investment ideas available on the US stock markets and considerations such as US-tax specific issues. However, this book nevertheless contains ideas and concepts that are applicable for non-American investors.

Dividends do matter

A stock's total return is comprised of capital gains and dividends. In fact, roughly 40% of the stock market's long-run total return comes from dividends. This fact is especially poignant as investing in the stock market during the 'lost decade' of 2000 to 2010 would have left a shareholder back at the proverbial square-one in terms of the stock's price. But the dividends reaped over that period would have rewarded or at least compensated the shareholder for his patience.

However, since dividends are an outflow of a company's assets – most typically in the form of a cash payout to shareholders, these same assets can no longer be used to fund the firm's growth. Thus, small and growing firms often choose to retain most, if not all of their profits, to fund future growth. It is generally the larger and more established companies that are able to pay dividends. These mature companies are likely to have already experienced their biggest growth spurt and do not require all their cash flow to fund their on-going operations. The way Carlson sees it, "implementing a dividend initiates an implicit contract with shareholders, a contract that says that you can depend on this dividend though thick and thin".

Historically, companies have been reluctant to omit or reduce dividend payouts even in the face of tough economic conditions, as this sends a powerful and strongly negative signal to the market. More often than not, a brutal sell-off will ensue. This explains why some firms either decline to distribute a dividend, or for those that do, they have to be confident of the stability and dependability of their profit streams.

Sustaining dividends

Carlson emphasised that a sustainable dividend has to be one that comes from profits. If the profitability of a firm takes a dip, the firm, for a while, can still borrow or dip into its cash reserves to maintain the dividend payout. But, this must ultimately end. And if the payouts are indeed lowered, the share price will suffer along. Hence, Carlson believes that monitoring the payout ratio (defined as the amount of dividends versus its total profits) is necessary: "The higher the payout ratio, the more danger the company is in of reducing or eliminating the payout if problems develop." Thus, Carlson sees the payout ratio as "the single most important factor in analysing the health, stability and growth potential of a stock's dividend".

Carlson also sought to correct some perceptions. For one, given the role of dividends in the total returns of a stock, investors may consider the highest yielding dividend stocks as the best investments. He does not buy this view, for he thinks that "dividend yield is a pretty good proxy for investment risk". Carlson's explanation is that a high yield might be a precursor for a dividend cut or omission. Since the dividend yield is calculated as the percentage of dividend per share over share price, a stock's yield can rise if dividends increase, or the share price falls. Thus, if the yield is extraordinarily high, it is likely to be from a plummeting share price as opposed to a massive dividend hike. Considering that markets are generally efficient in pricing an asset, yields considerably higher than its long run average should be seen as a red flag and not an enticement to buy.

Big and safe

In the book, Carlson also shares his basic Big Safe Dividend (BSD) formula. This formula is premised on two key ideas. Firstly, a company can only pay dividends if it has sufficient funds to do so. Secondly, stocks should be chosen for their total-return potential. His basic formula consists of the payout ratio and his firm's proprietary Quadrix score. Quadrix ranks stocks based on a hundred different variables across six parameters. These are momentum (growth in earnings, cash flow, and sales), quality (return on investment, return on equity and return on assets), value (the price/sales, price/earnings, and price/book ratios), financial strength (debt levels), earnings estimates (where it uses consensus estimates) and relative stock price performance. These variables are of course not plucked out of the air, but weighted based on past effectiveness.

Obviously, some of the specific stocks recommended in the book might become stale since its time of publication last year. Thus, it was an opportunity for Carlson to plug his website, [www.bigsafedividends.com (http://www.bigsafedividends.com/)](http://www.bigsafedividends.com/), which contains updated Quadrix and BSD scores for all dividend paying stocks in the S&P 1500 index.

Filtering the index stocks for payout ratios less than 60% and with overall Quadrix scores greater than 75, back-testing indicates that the portfolio of all stocks meeting these two criteria at the beginning of each year, would outperform the S&P 1500 index by more than four percentage points each year going back to 1994. Even in a tough year like 2008, 60% of the portfolio stocks had increased its dividend. And these returns were on the back of a lower risk level than the index, where risk is measured by standard deviation.

Carlson has also come up with an advanced version – built on the basic formula and includes parameters such as earnings and cash flow growth – to help capture stocks that are likely to also grow its dividends. The advanced formula does not automatically exclude high-yielding stocks and captures the idea that dividend growth can help combat inflation.

Income investors, or those who invest with a need or desire to generate a stream of predictable cash flow to finance current expenditures, might find useful guidelines in the book. For example, how to create a portfolio of stocks structured to pay out their dividends at different times. Careful planning and selection of different quarterly dividend payers can provide an income stream from dividends every month.

Reits, drugs, etc

For the Singapore stock market, Reits, or real estate investment trusts, is by now a very popular yet relatively recent sub-group of investment. Investors are drawn to Reits because of their regular payouts and relatively high yields. While focused primarily on stock-picking, Carlson has also included a chapter on other dividend yielding instruments which, besides Reits, also includes open and close ended mutual funds, exchange traded funds (ETFs), master limited partnerships (MLPs), royalty trusts, annuities and preferred stocks.

To vividly describe his view of the dangers associated with instruments like these, Carlson used the analogy of performance-enhancing drugs: specific risks might also bring risk-related rewards. Reits, MLPs and royalty trusts typically pay out most of its income to its unit-holders, which is great in good times, but leaves them susceptible to dividend cuts and omissions in economic downturns. Homeowners might also end up with too much exposure to real estate if they invest in Reits.

Carlson went on to explain how direct-stock purchase schemes, which allow investors to buy shares directly from the company, might lower transaction costs (as always, read the prospectus, as there might be restrictions on trading and the pricing is unlikely to be real-time) and allow the buying of a fractional share.

For those who do not need income from dividends, dividend reinvestment programmes, which reinvests the paid out dividends back into the same stock, can produce a strong compounding effect and help investors overcome psychological barriers to keep investing – even through turbulent markets. These are usually available as part of the company's direct investment schemes or can be done directly by the shareholder, who would buy more of the stock with the dividend's cash flow.

More than just dividends

The book goes beyond expounding the merits and pitfalls of dividends. Carlson has also covered important investment ideas that are not unique to dividend paying stocks but are nonetheless crucial in investing, such as the benefits of diversification, including international diversification, tax considerations as well as asset allocation based on risk-tolerance.

In conclusion, dividends can be a useful indicator to the quality of the company's earnings stream, but as Carlson noted, this needs to be weighed against the potential for dividend growth. Chasing the highest yields might prove dangerous, and diversification, through a portfolio including domestic and international stocks, and other asset classes, is important to guard against the vagaries of capital markets.

He pointed out that keeping investment expenses low is crucial in creating the best conditions for profitable investing, since costs reduces capital, and has also suggested direct investment schemes by the target companies as a possible mechanism to keep costs low.

Carlson's '*Little Book of Big Dividends*', along with the other books in the Little Book Big Profits series, can be considered as an important addition to the Investments 101 body of literature, but represents just one of several approaches to successful investing.

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