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Q&A From Our June 26 Webinar

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On Tuesday, June 26, I hosted a *DividendInvestor* online seminar (or webinar) titled *Getting a Good Start With Dividends*. In case you missed it, you can replay the event at http://register.webcastgroup.com/L4/?wid=0579505940.

As usual, turnout was great, and we received far more questions than I could handle during the live session. As a thank-you for those who participated--and a thank-you to all *DividendInvestor* subscribers--I've answered the 10 most frequently asked questions below.

1. How do dividend-paying stocks compare with other financial instruments such as MLPs, REITs, and so on?

Traditional dividend-paying stocks cover much broader territory in terms of sector and industry exposure, and the dividends themselves are currently taxed at a maximum federal rate of 15%. The business activities of REITs and MLPs are sharply restricted to real-estate and energy-related activities; the income they distribute to investors is generally taxed at ordinary tax rates. However, businesses that are structured as REITs and MLPs don't have to pay income taxes themselves, which enhances their earning power. Better yet, these structures essentially require that the bulk of cash flows are distributed to investors--while most traditional corporations pay out 20%-40% of earnings and many pay nothing at all, REITs and MLPs often pay out 80% or more of the recurring cash they generate. For investments in real estate and energy logistics, it's hard to beat these structures from an income perspective.

However, MLPs are much more complicated than traditional dividend-paying stocks or even REITs. REITs may not benefit from the 15% tax rate, but they report income to the IRS with the simple Form 1099, and there's no problem with owning REITs in tax-deferred accounts--IRAs, Roth IRAs, 401(k) plans, and the like. By contrast, the taxable income of an MLP flows down directly to individual investors on a complicated form called Schedule K-1. Taxable accounts can benefit from high up-front depreciation charges that can defer the tax liability associated with cash distributions, but this type of income is not qualified for tax deferral in the type of accounts mentioned above. (An IRA or similar account that earns more than $1,000 from MLP investments in a year might have to file its own tax return and pay tax.) With MLPs, then, it's essentially a trade-off. Many provide high current yields as well as solid, inflation-beating prospects for distribution growth, but there's extra paperwork involved, and they should not be held in tax-deferred accounts. It's a good idea to consult a tax professional

before investing in MLPs.

2. Do you consider sector diversification within your portfolio strategy?

Sector diversification is important, but it's not quite as simple as just spreading money around. We go where the dividends are, and--for better or worse--high yields are concentrated in certain sectors such as utilities, consumer staples, Big Pharma, telecommunications, and energy. It's hard to build a high-yielding portfolio with heavy concentrations in technology or health care (except for the major pharmaceutical stocks). As we pursue large, reliable, and growing dividends, we naturally wind up with a portfolio that looks different than a broad market index like the S&P 500. It also performs differently--outperforming at times, and underperforming at others.

I'm not bothered when our results lag the S&P, but I am bothered very much when our dividends become unsafe. The point of diversification is to minimize the hit our portfolios might take as a result of bad analysis or bad luck. So I look carefully at the individual industries and companies in which we are invested to see that they can maintain and even grow their dividends through tough times. Fortunately, the sectors with the highest yields tend to have resilient cash flows under stress, which gives our strategy a natural advantage.

3. Should I diversify my dividend-paying stocks with ETFs and mutual funds?

I don't own any ETFs or mutual funds in the Builder and Harvest portfolios, but that's because *DividendInvestor* focuses primarily on individual stocks. The decision to own managed products like ETFs, mutual funds, or separately managed accounts is totally up to you, and as usual, it involves a trade-off. If you own individual stocks directly, you collect 100% of the dividends. In managed products, fees and expenses are deducted from the dividend income first, which results in lower yields. However, paying a manager relieves the investor from doing homework on individual stocks and sectors, and that's a choice that many investors have found worthwhile.

Here's one way you might look at the question. If you can look at a company like Johnson & Johnson JNJ or Clorox CLX, come to your own conclusions, and sleep well at night as a long-term shareholder, there may not be much point in paying a manager (whether passive or active) to act as an intermediary. But if you're looking for dividends in emerging markets, it may well be worth the expense to pay professionals who are knowledgeable about local economies and markets.

4. How do I make my retirement plans more secure with dividends?

Two of the great advantages of dividend-paying stocks are that (1) dividends have a habit of growing faster than inflation, and (2) dividend-paying stocks don't have nearly as much reinvestment risk. If you bought a five-year Treasury bond a few years back that yielded 4%, you got your 4% a year, but inflation eroded the purchasing power of your income and your original investment. Worse, that five-year bond will soon mature. If you roll the money into a new five-year Treasury, it will earn you just 1%. But if you bought a stock with a 4% yield, and its dividend was at least flat, nothing forces you to sell it and reinvest at a lower yield today.

Better yet, to the extent your dividend has grown, you're just that much further ahead. A dividend that grows 7% a year will nearly double every 10 years. If you've got 30 years to retirement, a 4% yield today has the capacity to become 8%, then 16%, then 32% on what you paid today. If you reinvest your

dividends before retirement, your earning power will grow even faster--though in this case a stock price that rises faster than the dividend will see its yield fall, and reinvestment purchases might carry less bang for the buck.

At the same time, no dividend is guaranteed, and stock prices are much more volatile than high-grade bonds. The key is to find high-quality stocks that won't reduce their dividends and will continue to grow them over time, and to pay a reasonable price when buying.

5. What is the potential for future tax increases on dividends?

Since politics play such an enormous role in tax policy, this situation is very hard to predict. Since 2003, dividends (and long-term capital gains) have been taxed at a maximum federal rate of 15%. As is now well known, these rates will automatically expire at the beginning of 2013. If Congress and the President do not act, dividends will go back to being taxed as ordinary income. Tax rates on long-term capital gains will go up too, but not nearly as much.

Despite the dysfunction in Washington, I think the odds of falling off the "fiscal cliff" are very low. The current tax treatment for dividends and long-term capital gains already has been passed by one Congress and reaffirmed by two more. It's always risky to project logic on government action, but I think politicians understand that there's no reason why capital gains and dividends should be taxed differently. I suspect the most-likely outcome is another one- or two-year extension of current tax rates, while Washington continues to ponder more comprehensive tax reform.

In the longer run, I think there is some chance that the tax rate on dividends and capital gains will head somewhat higher, at least for wealthy households. Today's fiscal deficits aren't sustainable, and virtually any compromise to close the gap will probably involve both spending cuts and tax increases. No one likes to pay higher taxes, but as long as dividends and capital gains continue to be taxed at the same rate, I don't believe dividend-paying stocks would be disproportionately hurt.

But even in a worst-case outcome--reversion to the pre-2003 rates--here are a few points to consider. First, the interest paid on taxable bonds is already taxed as ordinary income, so there would be tax advantage in switching from dividend-paying stocks to other income-generating securities. Second, few investors actually pay the top marginal rate. The way the media reports on the topic, you'd think everyone's tax rate on dividends was heading from 15% to 39.6%, but the reality is that the majority of investors would fall in the 15% to 31% range. Third, dividend-paying stocks (especially high-yielders) have historically outperformed low- and no-yield stocks, even under the much higher top marginal tax rates of the past. Finally, investors have plenty of tools to manage their individual tax circumstances. Dividends received in tax-deferred accounts wouldn't be affected by a change in dividend taxation, nor would dividends paid by REITs or distributions paid by MLPs. In other words, this is not a pleasant topic, but it's hardly the end of the world as far as dividend investing is concerned.

6. How should my approach for dividends change if I am retiring soon?

There's no point in trying to predict, much less control, the market value of a portfolio of stocks. I think the best way to organize a portfolio is around the total amount of income it throws off over the course of a year, rather than its market value at any point in time. Both of *DividendInvestor's* model portfolios are managed and measured on this basis. I multiply the number of shares I own of each individual stock by the annualized dividend rate, then sum this figure for all of our positions. The goal of my portfolio

strategy is to keep this total income steady and moving higher at least as fast as inflation.

For example, as of June 29, the 18 securities we own in the Harvest were throwing off an annualized income of $7,860.51. Divided by the account's market value of $151,886.78, its current yield was 5.2%. If the account lost 10% of its value in a market correction and none of its dividends were cut, the income would be the same--as it would if the market rallied and the Harvest gained 10%. All of this income could be taken out of the account over the course of a year without dipping into principal; we don't have to have capital appreciation in order to pay the bills. By contrast, investors who are relying primarily or solely on capital gains to meet living expenses run a serious risk of depleting their portfolios during bear markets.

If you're new to a dividend strategy, and looking to shift funds out of other securities and strategies, my advice is to build an income stream like this by averaging in over a series of months, or perhaps a year or two. But by no means is a strategy like this only for folks who are near retirement or already retired. Younger investors can invest the same way, building themselves a stream of dividend income that will grow all the faster as dividends are reinvested.

7. What are your screening criteria for dividend-paying stocks?

Quantitatively, I look for stocks with (1) yields of at least 3%, (2) Morningstar economic moat ratings of narrow or wide, and (3) stock prices that are low enough relative to our fair value estimates to earn 4- or 5-star ratings.

The yield rule is simple enough; a stock that yields only 1% or 2% doesn't generate enough income for its dividend to play a meaningful role in total returns, but at 3% the dividend can become a powerful driver of future results.

My insistence on economic moats plays two roles. First, an economic moat--identifiable and sustainable competitive advantages that lead to superior returns on capital--helps protect the earnings of a business from competitive threats. Since dividends are ultimately paid out of earnings, an economic moat is a key factor in the long-run safety of a dividend. Second, an economic moat implies that a dollar of profits that is retained in the business should generate more than a dollar's worth of future dividend value by driving future dividend increases. Businesses that generate poor returns on capital are better off paying out as much of their profits as they can stand, because a dollar retained in the business may be worth less than a dollar in the future.

Finally, I insist on reasonable prices when buying. I love a bargain, but I've learned not to be too much of a cheapskate in this area, primarily because the highest-quality high-yielders are rarely mispriced enough to earn our 5-star ratings. A stock whose uncertainty we rate low requires only a 5% discount from our fair value estimate to earn a 4-star rating; those with a medium rating require a 10% discount. When combined with dividend yields of 3% and up, the discount to fair value plus the cash we receive in the first few years of holding an investment helps limit our downside risk.

Screening will only carry us so far, though. When evaluating individual stocks, there are a number of other factors I look at, from financial strength to management discipline. These are harder factors to quantify, but I use three simple questions to organize my research: Is the dividend safe? Will the dividend grow over time? What's the likely total return as the sum of the stock's current yield and future dividend growth potential?

8. Have dividend-paying stocks become overpriced?

Popularity, at least in the stock market, carries a potential curse. As more investors have grown interested in dividends--the product of an environment of persistently low interest rates, aging demographics, and strikingly poor performance of the classic "buy low, sell high" approach--valuations have gone up. Historically, regulated utility and telecom stocks have typically traded at lower P/E ratios than the market average because of their modest growth, but today they trade at premium multiples. REITs look particularly pricey to me; some yield less than 3%!

On the whole, however, I don't think the universe of high-payout stocks is overvalued; I would describe it as being fairly valued, give or take. Low interest rates are inflating the value of many financial assets, and there aren't a lot of attractive options left on the table. Long-term Treasuries have become "certificates of confiscation" with yields too low to even offset the likely rate of inflation. High-grade corporate bonds are better, though there's a bit more risk and still no hedge against inflation. Low- and no-yield stocks are still a bet on capital appreciation that may not materialize. Commodities don't earn or yield anything. Classic high-payout stocks may not be cheap--and I would not be buying stocks like Verizon Communications VZ or Southern Company SO at today's prices--but there are enough fairly priced stocks to pick from that I think the strategy is still by far the best option in today's environment.

9. How do I know when to sell a dividend-paying stock?

I don't trade often, but when I do, it's usually because of the dividend. On defense, I look to sell when I have concerns that the dividend has become unsafe--particularly if the stock price hasn't already dropped to reflect this risk. (If the stock is already down sharply, as was the case with bank stocks in late 2008 and early 2009, the situation gets a lot more complicated.) But I also play offense on the court of opportunity cost. If two stocks are of equal quality, and both have the capacity to grow their dividends 7% a year, but the one I own yields 3% and the other pays 4%, I might make a swap. Most of the trades I've made in recent years have followed this pattern--get more income without sacrificing growth, more growth without sacrificing current income, or higher quality for the same return profile.

In an extreme situation, I might sell and go to cash--it's conceivable that a stock could become so overvalued that even cash at a 0% yield is better than taking a likely loss when valuations contract. Most of the time, however, I try to stay fully invested to keep earning as much reliable dividend income as possible.

10. How do you evaluate dividend-paying growth stocks?

For the most part, I don't--unless a stock yields at least 3%, I'm unlikely to consider it a candidate for purchase.

Don't get me wrong: Dividend growth is an essential part of my strategy; except for a few preferred stocks I bought in 2009 (when they were extremely cheap), I've never bought anything unless I was confident in future dividend growth that would at least exceed inflation. Furthermore, the lower the yield on the stock when I buy it, the more dividend growth I'm going to require. I was very happy to buy General Mills GIS with a 3.5% yield last week, because I figure its dividend can keep growing at 7%-9% a year for many years going forward. But if I only saw General Mills' dividend growing 5% a year, or the growth rate was intact but the stock only yielded 2%, I would have passed.

But a "growth stock" that yields only 1% or 2% is unlikely to be a good fit for a high-income strategy. Take Apple AAPL, for instance. It made headlines around the world when it announced plans to pay quarterly dividends of $2.65 a share. Indeed, the annual dividend payout is likely to total around $10 billion a year, making it one of the largest dividends on earth. But Apple is also the most valuable company on earth, and the stock's yield is still less than 2%. The key question I ask myself is: Will the dividend be a prime mover for future total returns? For General Mills, AT&T T, or Abbott Laboratories ABT, the initial yields are high enough that the dividend is certain to be both relevant and remunerative. Apple, though, is still a momentum stock--its future returns lean so heavily on capital appreciation that the dividend just doesn't mean that much yet. Perhaps in the future Apple will grow its dividend faster than the share price goes up, or the stock price will go down--either way, the yield could improve. Then I might give the stock a look. But I find dividend growth useful only in the context of a current yield that is already meaningful.

We also received questions about a number of individual stocks, and I wasn't surprised that the most common requests involved some of the highest-yielding stocks in the market today. This can be a little dangerous: While high-yielding stocks typically outperform low-yielding ones, the highest yields in the market or within individual sectors are frequently a sign of fundamental weakness--either the dividend is clearly unsafe and a plunging market price has produced a fat but shaky yield, or the dividend rate itself is highly variable from quarter to quarter.

Three of the most-requested names flunk my basic tests: Annaly Capital Management NLY, Pitney Bowes PBI, and R.R. Donnelly RRD. The latter two are both covered by Morningstar analysts who have given them economic moat ratings of none. The 8.7%-yielding Donnelly operates in a fiercely competitive business with a heavily leveraged balance sheet. Pitney Bowes, which yields an attention-grabbing 10.3%, had a great business in postage meters, but it is now in secular decline. Management hasn't helped matters by spending piles of cash (much of it borrowed) on questionable acquisitions. In both of these cases, I think the market is correctly signaling that these dividends are in jeopardy over the next few years.

We don't currently cover Annaly, which yields 13.0% based on its most recent quarterly dividend. However, as you can see from even a cursory inspection of its record, Annaly's highly variable earnings and dividends are a function of the shape of the yield curve. If you can't understand this highly leveraged business, or you aren't willing to speculate where interest rates are headed, I think it's a good stock to stay away from no matter how high the yield is.

Another high-yielding stock that came up in our question file was Old Republic International ORI, which I think is a fascinating story--but not one that I'd buy into here. Some of its subsidiaries--mostly those that wrote private mortgage insurance before the housing crash--are generating huge losses and are in the process of running themselves off. However, Old Republic does not have to and will not pour any more money into these subsidiaries; the losses do not reflect on the parent company's real-world results. The company is funding its generous dividend from other operations that are profitable, and it looks like management is pulling out all the stops to avoid cutting the dividend.

However, Old Republic has a $500 million convertible bond that could become due immediately if regulators in North Carolina declare any of the mortgage insurance subsidiaries insolvent. Management doesn't think this will happen, but even if it does, they believe the company could refinance this bond.

That point isn't entirely clear: Old Republic isn't in a position to draw all $500 million from its profitable subsidiaries to meet an early redemption. To make up the difference with newly borrowed money, lenders might force Old Republic to trim or eliminate its dividend for a while. The company had planned to spin its troubled subsidiaries off into a separate, publicly traded entity to eliminate this risk, but that plan didn't pan out, and the stock recently dropped from more than $10 to around $8.

At this point, Old Republic's dividend is too risky for me to buy the stock, even though it yielded 8.7% as of Tuesday's closing price. This isn't a question of solvency; the book value of Old Republic's ongoing operations tops $14 a share, and the company doesn't have a lot of other debts to deal with. But the potential liquidity crunch described above and its consequences for the dividend make the stock too speculative for my purposes.

The best stock that came up in the question file was Philip Morris International PM. This company has performed exceedingly well; we've doubled our money since our May 2010 purchase. The dividend (up 33% since then) hasn't grown nearly as fast, though, and the stock's yield has declined to a recent 3.4%. This isn't a risk-free company, either--it faces challenges from a weak European economy as well as the threat of a rising dollar (Philip Morris earns all of its money overseas, and has to convert those earnings back into dollars in order to pay our dividends). However, despite--or perhaps because of--considerable ethical concerns, this is one of the world's most profitable businesses, and I'm inclined to think the stock has earned its capital gains with outstanding fundamental performance. Our fair value estimate is $92 a share, and I would call the stock a buy again under $82.80.

Best regards,

Josh Peters, CFA
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Disclosure: I own the following stocks in my personal portfolio: AEP, APU, CLX, CVX, GE, GIS, GPC, KMI, KMR, MMP, NGG, O, PAYX, RDS.B, SYY, WFC.

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