How to Make Money in **Dividend Stocks**

Stockopedia

How to Make Money in Dividend Stocks

Edward Page Croft

This book is for sale at http://leanpub.com/dividend-stocks

This version was published on 2014-09-01

This is a Leanpub book. Leanpub empowers authors and publishers with the Lean Publishing process. Lean Publishing is the act of publishing an in-progress ebook using lightweight tools and many iterations to get reader feedback, pivot until you have the right book and build traction once you do.

Contents

Introduction

At the end of the twenty year bull market run-up to the millennium, the baby boom generation looked perfectly positioned to cash in. Their era had been a golden age for capital growth. But it couldn't last. Ever since equities have seesawed violently, growth has stalled, and a 'perfect storm' of economic and social factors has loomed ever closer that looks certain to force investors to dramatically change their approach to investment.

When capital growth looks uncertain, income and capital safety become a priority. As a result many investors have opted for the supposedly ultra safe option of stashing their cash in government bonds as an alternative - despite modest, ever diminishing returns.

While government bonds (gilts in the UK) might appear to offer a safe haven, the reality is that holding them at coupon rates paying less than the rate of inflation guarantees a deterioration of wealth. In his excellent book *The Zeitgeist Investor*, Tim Richards has called this a form of 'financial repression'. Governments are cannily planning to pay off the massive debts built up during the financial crisis by underpaying for loans while legislating to ensure demand from pension funds.

Comfort in retirement relies on the income that can be generated from their investments. But these economic conditions, the market cycle and demographics are contributing to a paucity of returns at a time when income is at the forefront of the minds of a generation.

With many high quality dividend strategies offering compound returns of more than five percent, it is perhaps unsurprising that interest in dividend paying stocks is rising. Unfortunately, investor knowledge about dividend stocks and strategies is not only deficient but also littered with myths and misunderstandings. All too often, the message that investors are getting about dividend stocks is unclear, with too much emphasis on the wrong things, little direction on what to look for or guidance on which stock selection methods to employ to ensure lasting success.

Ironically, this knowledge gap is at odds with the dividend policy of UK PLC; dividend payouts from UK listed corporates are growing. While corporates appear to be increasingly willing to reward shareholders, it seems that many investors have yet to evolve their strategies accordingly to the new era. Average stock holding periods among private stock pickers are around eight months and it's clear that many are still more concerned with short-term price appreciation than long term dividend returns. That's a great shame.

As we shall see, the volatile conditions that have plagued equity markets could well continue for many years to come. If investors took to heart the truth, evidenced in the next chapter, that strategies focusing on solid dividend paying stocks will continue to produce the lion's share of returns in these conditions then the early movers may be hugely well rewarded. Not only will they benefit from the sizeable dividends paid but also from the capital growth that comes with an expansion of P/E multiples, as more and more of the market joins in to inflate what may turn out to be a 'dividend bubble'.

This book assesses the concepts behind dividend investing and the strategies that investors can employ to build portfolios that can help them achieve their financial objectives. That means not only looking at why dividend stocks can deliver superior total returns but how to find them, what to look for, what to avoid and how to manage a portfolio over the long term. It also includes insight into some of the most effective dividend investment strategies and why they work.

We have endeavoured to show investors how they can think strategically about dividend stocks. Knowing what to buy is an important part of this, but so is tackling tax, handling reinvestment and knowing when to sell stocks and rebalance a portfolio. Ultimately, this book takes the dividend universe and distils it into an explanation of why a strong focus on yield, growth and safety should give investors a strategy that can excel in the long term regardless of the market conditions.

More specifically, this book has been produced for subscribers of Stockopedia[1], which aims to give investors the essential data, fundamental analysis and screening tools they need to make well-informed decisions. At Stockopedia, we are firm advocates of an evidence-based approach to investing and of learning how to make smarter investments. We aim to equip investors with the knowledge, data, resources and ideas that they need to make money in any market. We hope that this short guide helps you in your dividend investing journey.

[1]http://www.stockopedia.com

Chapter 1

Do dividend strategies work?

“The deepest sin against the human mind is to believe things without evidence” T.H. Huxley

In this chapter, we’ll share the hard research, maths and statistics that show how investing in dividend paying stocks has been a market beating strategy whatever the environment, with the added benefit of lowering portfolio volatility and risk. While there is ongoing disagreement about the exact level of contribution that dividends make to stock market returns, there’s one thing that can be agreed on - dividends, and their reinvestment, drive the majority of the returns that investors receive in the stock market, especially over the long-term.

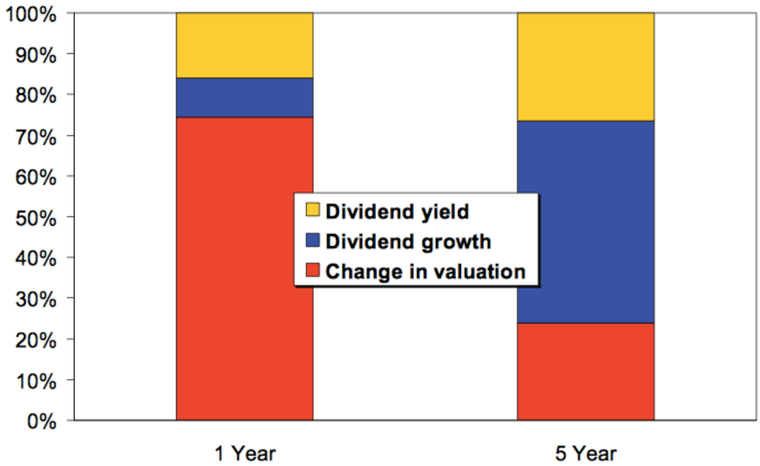
The evidence is incontrovertible. The trouble is that finding it requires digging through volumes of generally rather dry and little known research notes on the subject written by obscure, ivory towered, academics and quants. This is not a task for the faint hearted at all and is one of the reasons you will find that your average journalist or stock broker has almost zero knowledge on the subject (while continuing to promote story stocks at readers or clients on a daily basis)!

But the legendary value investing firm of *Tweedy Browne Inc* has done investors a huge service. They have gathered and collated the results of many of the greatest studies into stock market returns offered by dividend paying stocks into a single paper titled *The High Dividend Yield Return Advantage*. Some of the startling conclusions taken from the research that it references and others that we have gathered include the following:

1. Dividends and dividend growth provide nearly 80 percent of stock returns

The esteemed Robert Arnott published a paper titled *Dividends and the Three Dwarves* in 2002 in which he analysed stock market returns over a 200 year period ending in 2002. He found that the total compound annual return for stocks over the period to be 7.9 percent per year. This broke down into a 5 percent return from dividends, a 0.8 percent return from real growth in dividends, a 1.4 percent return from inflation, and a 0.6 percent return from rising valuation levels. Essentially the return from dividends 'dwarfed' the return from all other sources – *"dividends are the main source of the real return we expect from stocks"*.

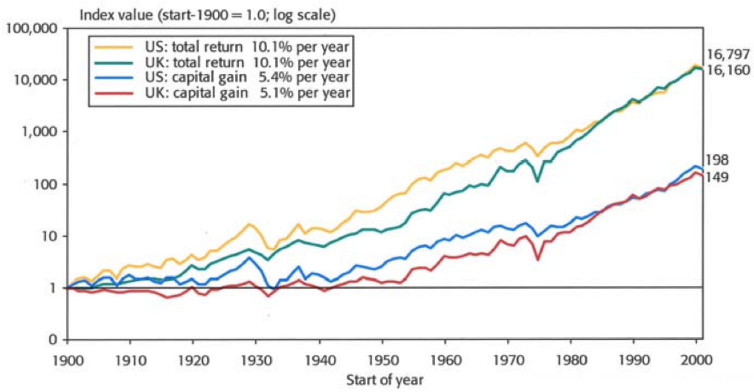
This finding has been verified more recently by another legendary strategist, James Montier. He showed in a 2010 paper (*A man from a Different Time*) that, while in the average single year period nearly 80 percent of the market return has been generated by changing valuations, on a five year timeframe dividend yield and dividend growth account for almost 80 percent of the return – the complete opposite! Now, if everybody in the market is chasing the speculative year to year return rather than the far more certain steady 5 year return, what should the smart investor do?



2. Dividend reinvestment strategies provide blistering compound gains

The dramatic effects of compounding gains - by pumping dividends back into the stocks from which they came - plays a pivotal role in dividend investment strategies. A 2002 book titled *Triumph of the Optimists* published by Princeton University Press showed that, over 100 years, an investment in the market portfolio with dividends reinvested would have produced 85 times the wealth generated by the same portfolio relying solely on capital gains.

Figure 11-2: Impact of reinvested dividends on cumulative US and UK equity returns, 1900–2000

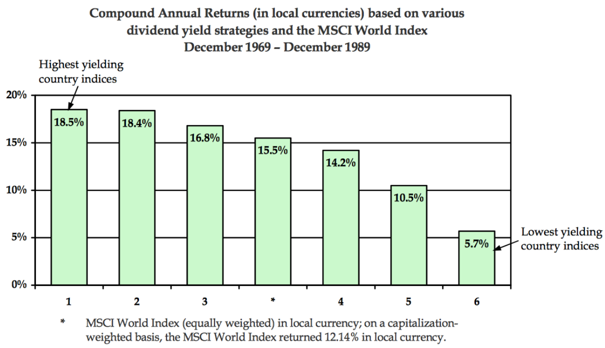


Just as startling are the findings in the annual Barclays Equity Gilt Study. £100 invested into stocks at the end of World War II would have been worth just £5,721 at the end of 2008 in nominal terms, but by reinvesting the dividends the same £100 would have grown to £92,460 – an astonishing 16 times the value!

Now granted, those not reinvesting dividends would have been enjoying extra disposable income during those years, but nonetheless the cumulative impact of this strategy illustrates the awesome power of compounding available through dividend reinvestment.

3. High dividend yield strategies trounce the market... all over the world

While much dividend research is biased towards US stocks, the results are magnified in the few studies into international stocks. Michael Keppler in 1991 set up a test to compare investing in high dividend yield stocks compared with low dividend yield stocks ranked in deciles across an equal weighted portfolio of 18 international indexes. The results were astonishing. The highest yielding portfolio returning 18.5 percent annually, compared with only 5.7 percent for the lowest yielding portfolio. And these weren't emerging market indexes – all were developed world portfolios.



Source: *The Importance of Dividend Yields in Country Selection*, A. Michael Keppler, **The Journal of Portfolio Management**, Winter 1991

These results will not be surprising to readers who have read our book *How to Make Money in Value Stocks*[2]. The Dividend Yield is a classic value ratio and the 'value premium' earned by investors in the higher yielding portfolios is paralleled in low Price to Earnings and Price to Book portfolios. Again there are many other studies into high yield effects that back up these claims by commentators the world over including Jeremy Siegel in *The Future for Investors*, and David Dreman in *Contrarian Investment Strategies*.

4. Dividend stocks provide 90 percent of the market return in bear markets

We shall dedicate an entire chapter to this topic shortly but the point needs to be highlighted here too. The twin bear markets since the dotcom bubble have laid waste to the portfolios of many investors that put their money into the speculative corners of the market. In bear markets, the dips from peak to trough can be vicious as the market averages fall at least 20 percent, but of all the segments of

[2]http://www.stockopedia.com/books/value-stocks/

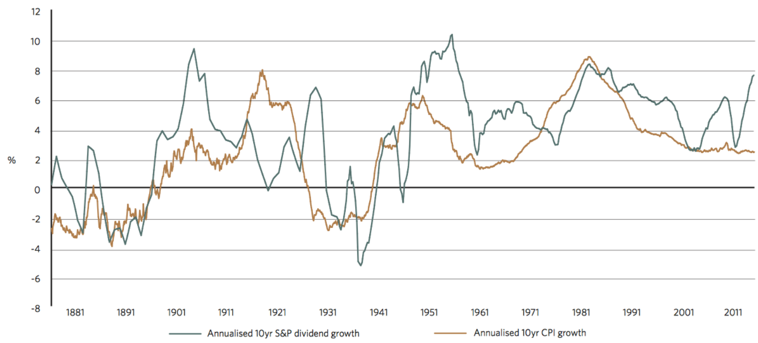
the market, it's high dividend stocks that perform most robustly in such an environment.

In a study from 1970 to 1996 titled *When The Bear Growls: Bear Market Returns*, David Dreman calculated the average performance of different segments of stocks in all the down quarters and compared them with the overall market. It was high yielding stocks (low price/dividend) that fared best, only declining half as much as the overall market. In fact, more generally, Vitaly Katsenelsen discovered in *Active Value Investing* that through 'sideways' markets dividend stocks actually account for up to 90 percent of the returns on offer from the stock market. In the light of that, it's worth asking who would want to invest in anything else during those times?

5. Dividend stocks are a great inflation hedge

Fixed income streams – such as the interest you receive from a corporate or government bond – can suffer greatly during times of higher inflation. The reason is simply that the coupon received and principal returned is fixed and can't grow as the inflation rate grows. Studies into equities have proven that the dividends paid by higher quality stocks do grow with inflation and sometimes even outpace it. Companies are often able to pass on their higher input costs to their customers allowing greater flexibility in raising dividend payments and greater potential for capital growth. The chart below from Societe Generale's research team shows how the dividend growth rate has tracked the inflation rate over many years.

CHART 4. DIVIDENDS AND INFLATION



Source: Robert Shiller, SG Cross Asset Research, November 2011

There are plenty who believe that global money printing can only lead to higher inflation in the years ahead. While all assets may suffer in such a scenario, high quality dividend paying stocks may provide some of the best protection.

6. Dividend stocks are stronger and less volatile

Companies that pay dividends have committed themselves to a higher level of financial discipline and capital allocation. These companies have made a public display of confidence in their own long term health. Indeed, the risk that cutting a dividend will upset shareholders means most dividend policies are pitched conservatively: you can fudge earnings but you can't distribute cash returns to your shareholders if you don't have the money.

Dividend paying stocks also tend to have less volatile share prices for two reasons. Firstly, many 'lottery ticket' seeking investors ignore dividend paying stocks as they see them as mature and unexciting businesses, but secondly the passive income stream dividend stocks offer provides some insurance and stability when share prices fall. It's no surprise to find that dividend stocks can often offer some of the highest returns at the lowest risk in the market as a result - a very attractive pairing for mature investors.

But it’s not all rosy…

While we have certainly painted a rosy picture of dividend returns in this chapter, there are a great number of mistakes that investors make in attempting to replicate these results. The biggest reasons why investors fail come down to their own risk and portfolio management mistakes, most notably overtrading, failing to diversify effectively, failing to use tax efficient accounts, and failing to reinvest dividends. We shall cover these issues in far more detail in the latter half of Part 3.

Chapter 2

When do dividend stocks work best?

"A cow for her milk, a hen for her eggs, and a stock, by heck, for its dividends" John Burr Williams

The tech and trading boom of the last 30 years or so has created a breed of investors who disparagingly refer to dividend paying stocks as being for retirees, widows and orphans and who see the payment of a dividend as a sure sign that a company has gone 'ex growth'. Meanwhile press and broker commentary fuel these attitudes by focusing on hope stocks, hole-in-ones and moon-shots. These attitudes are completely misguided. While the bull market years of the 1980s and 1990s certainly rewarded the average market speculator handsomely, the real winners in the bear markets of the last dozen years have been those that have rediscovered the art of dividend stocks.

A rough guide to surviving market cycles

To understand why dividend stocks perform so well in bear markets, it is worth exploring what actually happens to equity valuations within them. In an excellent book called *Little Book of Sideways Markets*, Vitaliy Katsenelson provides a mental model to help investors think about what drives the market over the long term. In essence, he illustrates with great effect how stock markets have a tendency to move in long valuation cycles from extreme overvaluation to extreme undervaluation.

He begins by making the important distinction between cyclical movements in the market, which last from several months to several years, and secular movements, which last from five to 15 years. These cyclical bull and bear moves may be the prime focus of the media, but really they are just shorter-term waves within broader secular tides that take the market from high valuations (in terms of P/E ratio) to low valuations and back again. Katsenelsen notes that these secular trends have tended to be what he categorises as either long term bull markets or long term 'sideways' markets. The last 100 years have seen four main bull markets, four sideways markets (each lasting 13 to 18 years) and one short secular bear market in the Great Depression. Clearly, our current predicament is a sideways market with a long way still to run.

How and why the P/E ratio drives these cycles: A simple equation to understand stock market return is as follows:

Return = Earnings Growth + Change in P/E + Yield

Historically during bull and sideways market periods the level of earnings growth and dividends haven't been much different – so the prime reason for the long drift upwards or sideways in price has been a result of the P/E multiple expanding and contracting.

If you look at the historic series of peaks and troughs in P/E ratios, it sets quite a sobering scene. The P/E lows (based on trailing 10 year average EPS) that were reached at the beginning of each bull market in the last 100 years have been 11x, 7x, 13x and 12x, but during the long bull market from 1982 to 2000 the P/E ratio of the S&P 500 expanded enormously to hit 48x earnings! At peaks such as this there's only one way for the P/E ratio to go – down – and history shows it can take anywhere from one to several decades to bottom.

Dividend stocks – the only bear market winners?

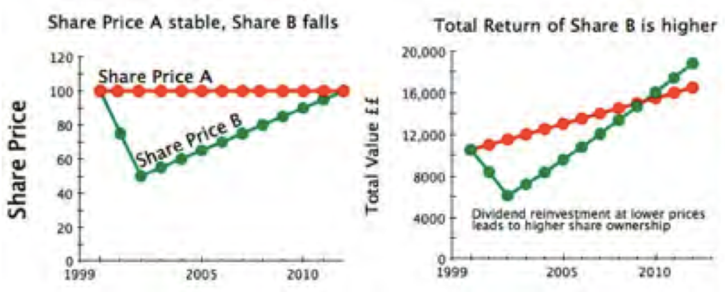
Katsenelsen isn't entirely pessimistic about the outlook for stocks in such an environment. He illustrates that between 1900 and 2000 the average annual return from the S&P 500 was 10.4 percent, out of which 5.5 percent could be explained by dividends. But these returns were extremely lumpy depending on whether the prevailing environment was a secular bear or a secular bull. He discovered that in secular bull markets dividends accounted for only 19 percent of annual average stock market returns (the rest coming from capital growth), whereas in sideways markets they accounted for 90 percent of the returns.

In fact, many studies of equity markets since 2000 have confirmed that dividend strategies have massively outperformed. Research by Societe Generale has shown that the high quality, high yield segment of the market has more than doubled since 2000 versus mar- ket indexes that have stayed completely flat. Clearly under- standing the dynamics of bear markets and which stocks perform within them can have a massive impact on your overall portfolio performance.

These are wake up numbers for the typical equity investor who chases the annual ups and downs in the stock market with the worst timing – buying when markets rise and selling when they fall. The truth is that investors need to start learning to act contrary to their instincts to take advantage of market declines. Not only can dividend stocks provide extra return in lean times, but, as we shall see in the next section, reinvesting those dividends back into the market during market breaks can actually be hugely beneficial in the long run as prices recover.

How to recoup bear market losses dramatically faster through reinvestment

In *The Future for Investors*, Dr Jeremy Siegel, a finance professor at Wharton, shows the extraordinary impact that dividend reinvestment can have on equity portfolios when bear markets recover. Siegel explains that there are two ways that dividends help your portfolio in bear markets. Firstly, the greater number of shares accumulated through reinvesting dividends can help 'cushion' the fall in value of the portfolio in a bear market, but also *"those extra shares will greatly enhance future returns. So in addition to being a bear market protector, reinvesting dividends turns into a 'return accelerator' once stock prices turn up."*



Return Acceleration - Source: Stockopedia

The maths of how this 'return acceleration' works are very simple but quite enlightening. Imagine two companies that both pay a stable 5p dividend over a dozen years. Share A holds a steady price at £1, whereas Share B declines over the first two years to 50p before recovering to parity 10 years later. The very counter-intuitive result of such a price decline on total returns to shareholders in B is that they end up wealthier. The greater number of shares that can be bought at cheaper prices with the consistent 5p cash dividend results in the shareholder owning a larger stake of Share B which ultimately ends up being worth more. It may well be that long term dividend investors really ought to welcome bear markets instead of loathing them!

Further Reading

- The Future for investors[3]
- Little Book of Sideways Markets[4]

---

[3]http://www.amazon.co.uk/The-Future-Investors-Tried-Triumph/dp/140008198X
[4]http://www.amazon.co.uk/The-Little-Book-Sideways-Markets/dp/0470932937

Chapter 3

Three Pillars and Two Pitfalls

In the next three chapters we are going to introduce and explain the three key pillars that comprise many of the great dividend strategies – yield, safety and growth. We'll introduce some important techniques and ratios that can be used to measure each factor and the ways in which they can be combined to achieve a required market-beating return.

According to our statistics at Stockopedia, there were 804 dividend paying companies in the UK market in 2011-2012 with a median yield of 3.1 percent but in terms of £ sterling value, more than 80 percent of total dividend payments were paid by just 15 blue chip FTSE 100 companies. On paper, that might imply that tracking down suitable investment candidates is relatively straightforward. Unfortunately, things are rarely that simple. Dividend policy, or the company's stated intentions when it comes to shareholder payouts, is heavily influenced by management decision-making. That means there are psychological factors at play – from the decision to initiate a dividend and make annual increases through to cutting or even suspending payouts. Bearing in mind that even the biggest blue chips with the proudest dividend records can (and do) suffer catastrophes, then the job of the investor is complex. It's a delicate balance as we shall see.

Dividend Yield - Crown Jewel or Emperor's New Clothes

"Do you know the only thing in life that gives me pleasure? It's to see my dividends come in" John D Rockefeller

We all share the fantasy that we might stumble upon an unloved, misunderstood or otherwise incorrectly priced gem that's just throwing off cash. In a low return world, who wouldn't want to own a stock with a dividend yield of 10 or 12 percent? But while the dividend yield may be highly promoted in the financial press it can't be taken at face value. Its interpretation requires nuance without which the 'chase for yield' can lead to an exceptional amount of pain.

In simple terms, the yield measures how much a company has paid (or will pay) in dividends relative to its share price. It is a crucial metric for investors because, in the absence of any share price gains, the yield is the only return on investment for a stock. It also allows investors to compare the relative income streams available between stocks and bonds.

But whereas the interest on a bond is fairly certain to be paid, there is no such guarantee with dividends. While company management are always reluctant to cut the prevailing level of dividends, at times of crisis companies have to preserve cash. That makes the choice between defaulting on debt payments or cutting dividends an easy one.

The typical yield cycle

Successful listed companies generally travel through a cycle from fledgling growth outfit to mature stalwart over many years and during that time their dividend policies change substantially. In the early growth period, dividends are rarely paid because stakeholders often prefer to see profits reinvested back into the business. When cashflow starts being generated sustainably and reinvestment needs lessen, dividend payments are initiated at a very low level (generally at a 0.5 percent to 1 percent yield). From here, they can then consistently rise while still allowing enough cash to remain in the business to fuel growth. Typically, the yield will then grow more quickly than earnings until the company reaches maturity, at which point the yield reaches a sustained level of 4 percent or more and the majority of profits are returned to shareholders each year.

Of course many companies run into trouble or go 'ex-growth' before they ever get to that stalwart stage - sometimes due to no fault of their own - and whenever investors smell trouble they sell the stock, driving up the dividend yield in the process. As a result, the types of companies that offer higher yields can be a mixture of both steady payers as well as those that are unpopular, at business cycle lows or in states of distress.

As we saw in Part 1, the evidence suggests that this diverse group of high yield stocks does generate anomalously high returns. One of the studies in the previously mentioned *Tweedy Browne* paper looked specifically at the UK market over 35 years up until 1988 and found that the highest yielding decile of stocks outperformed the lowest yielding by almost 6 percent annually. In order to build confidence in an investment strategy that seeks to harvest this 'yield premium' systematically, it's worth understanding why the anomaly may persist and why there aren't more investors chasing the returns on offer.

Why do high yield stocks provide higher returns?

Dividend yield investors are a curious lot - they usually prize certainty of income over everything else. Pension funds especially are under pressure to pay out a constant stream of income and need their investments to bear expected fruit in order to match their liabilities. So whenever a stock looks to be having trouble and at risk of suffering from a dividend cut, a large group of shareholders will start to ask questions… *"where will the yield end up?"*, *"will these problems continue?"* and more importantly *"how will we meet our income liabilities if the dividend is cut?"*…

As a result many investors over-react to bad news in dividend stocks, feeling obliged to just dump their shares regardless of price in order to reinvest in safer, more certain waters. These worries often drive prices down too low for the risk, providing an opportunity for canny contrarians.

If you do invest in these stocks you could be the beneficiary of two bangs for your buck. Even if a dividend cut does occur, you may still end up getting a half-decent yield after all, but more importantly you could end up with a nice capital return to boot as the uncertainty surrounding the stock dissipates. But as is so often the case in these situations, it takes the mentality of the value investor to venture forth and pick up the returns left on the table.

Income investors aren't all stupid - the trouble with high yield

While the group of income investors throwing away the very highest yielding stocks are leaving some return on the table for contrarian vultures to pick up on, they do realise that the risks associated with these stocks may not be worth the hassle. High risk, high yield dividend strategies come with a generally unpalatable array of nasties that most investors don't have the thickness of skin to cope with - perhaps that's what high yield investors get paid for dealing with. Let's investigate four common high yield hazards worth being aware of.

Hazard 1: The very highest yielders can be more volatile

Whenever the market is expecting and pricing-in future problems for a company, the price can see-saw as the apparent size of the dividend becomes detached from the true expectations around the stock - analysts may be slow to downgrade their dividend forecasts while the previous dividend may be unrealistic to achieve again this year.

Let's say that a stock's annual dividend per share is £1 while the stock price is £10 per share to yield 10 percent. If the price of the stock plummets to £5 per share because of, say, cashflow problems, the new yield percentage is 20 percent (£1 dividend / £5 price). When screening the market for stocks this might look really juicy to you because it looks like the yield is increasing. The problem with this logic is that it actually rewards a stock for tumbling in price…

In this confusion over expectations, the highest yielding decile of stocks can have a tendency to become vastly more volatile as new buyers are lured in by the headline yield and recovery possibilities, while sellers become willing to throw it away at any price. Many shareholders just can't stomach that kind of the volatility in their portfolios.

Be prepared to weather high volatility if investing in the highest yielding stocks.

Hazard 2: High yields bring higher risk of dividend cuts

Back in September 2008 Lloyds Banking Group was boasting a head-turning yield of around 8 percent. Investment commentators were amusing themselves over the fact that the banking giant's shares offered a stronger return than a Lloyds TSB internet saver account. However, the banking collapse that followed shortly afterwards put Lloyds' dividend loving shareholders to the sword. Stocks may be priced as bargains for a reason - the market thinks the company is in trouble and is worried that the dividend can't be sustained or will be cut, as a result high yield stocks come with a price-tag of increased risk and share price volatility.

Often, in the highest yielding segment of the market at least half the stocks will be paying more in dividends than they make in profits, if they make profits at all. Intuitively one would expect these stocks to be the most susceptible to dividend cuts, and the evidence does seem to back this up.

A Credit Suisse study of S&P 500 stocks from 1980 through to July 2006 found that the 2nd and 3rd highest yielding deciles outperformed the top yielding decile significantly. Similarly, Bank of America-Merrill Lynch divided Russell 1000 constituents into quintiles from 1984 to 2010, again finding that the second highest yielding quintile provided the highest risk-adjusted returns. In other words the highest yielding stocks in the market actually don't pay out what you expect them to! They are the ultimate temptress.

Avoid picking stocks from the highest yielding decile in the market. Pick from the second, third or even fourth highest decile preferentially.

Hazard 3: High yield strategies create sector over-exposure

Companies within sectors have different policies when deciding how much cash to pay out in the form of dividends. As legal monopolies, utilities by their nature tend to have reliable revenue and high dividends, whereas technology and energy companies generally need to reinvest their earnings. Focusing purely on building a portfolio with high yield stocks could lead you to concentrate too narrowly on one sector.

In a similar way, the best dividend payers in the market tend to be a handful of FTSE 100 companies. Focusing your portfolio on just the high-yielders creates stock or sector-specific concentration risks that can leave portfolios overexposed - as illustrated by the millions of investors whose income was slashed when dividends were cut in the banking crisis of 2008.

Some investors are happy to accept these kinds of risk – one such example is Neil Woodford (previously at Invesco) who has been firmly over-weight in the large-cap pharmaceuticals sector for some time in order to pick up the attractive yields there. However, this is a risk that should be consciously undertaken based on a macro sector view, rather than just assumed by accident.

Beware of becoming overexposed to specific sectors in high yield strategies.

Hazard 4: High yield strategy returns can be inconsistent

There are contrarian voices heard against pure yield strategies, most notably in the very decorated academic Ken French. He discovered that high yield stocks have very variable returns depending on the decade chosen. In some decades, notably the 1970s and 1990s, the highest yielding stocks actually underperformed the lowest yielding stocks. It appears that during inflationary periods or periods of rising interest rates high yield stocks can behave much more like bonds and lose value. As we saw in the previous chapter, the best conditions for investing in higher dividend paying stocks are during sideways markets as bull markets tend to favour speculative growth stories. Don't get caught pushing on a string!

Ensure that market conditions favour strong dividend returns before venturing into high yield strategies.

Share Buybacks - the dividend yield's blind spot?

For many years, companies have been increasingly spending their excess cash on buying back their own shares in the open market rather than just paying it out as cash dividends. These 'buybacks' have increased massively in popularity since the early 1990s: between 2000 and 2012 Next Plc returned over £2.6 billion to shareholders by way of share buybacks compared to only paying £1.2 billion in dividends.

As a result the reported yields for many shares have fallen. As both dividends and buybacks are designed to return cash to shareholders it ought to be vital to factor buybacks into an overall dividend yield analysis - yet so many investors fail to do it.

Introducing the Net Payout Yield

One way to take advantage of this blind spot is to calculate the so called 'Net Payout Yield'. This is defined as the level of dividends plus buybacks minus any share issuance divided by the company's market cap. A 2004 paper by US researchers Boudoukh, Michaely, Richardson and Roberts found that the net payout yield was a *"superior predictor of equity returns than simply using the dividend yield"*. This has been confirmed in the book, *Your Next Great Stock*, where Jack Hough showed that between mid-1983 and the end of 2005 using the Net Payout Yield would improve the returns of a high yield strategy by almost 3 percent per year. Clearly, when searching for high yield stocks, not factoring in buybacks by using the Net Payout Yield may mean that you miss out on some excellent opportunities.

Reasons for caution

While clearly the net payout yield is more comprehensive than the bare vanilla yield in some regards, there are reasons to remain sceptical that it should be given equal status in dividend strategies:

- Firstly, some high net payout yield companies may not pay out a dividend at all, which could be a trap for those seeking high income.
- Secondly, buybacks may be initiated by management for the wrong reasons. Many management teams are encouraged to increase earnings per share as part of their incentive plans. Initiating a buyback campaign reduces the number of shares in issue, thus increasing EPS and therefore also their bonuses!
- Thirdly, buybacks are often mistimed. In 2012, Thomson Reuters[5] examined returns on stocks in the S&P 500 in the periods following buybacks and found that the majority of companies un- der analysis had typically timed their buyback activity poorly. As Warren Buffet has noted, *"many CEOs never stop believing their stock is cheap"*.
- Finally, net payout yields are usually more volatile than dividend yields. As opposed to dividends, which generally

[5]http://alphanow.thomsonreuters.com/2012/01/stock-market-valuations-may-be-low-but-buying-still-has-its-risks/

require a long-term commitment to distributing surplus profits, buybacks can be made with a lot more flexibility and then carried out (or suspended) as the managers sees fit.

Look before you leap!

Despite yield playing such a central role in dividend investing, it's important to realise that, by focusing on yield alone, you may be exposed to the vagaries of the market – not to mention the occasional disasters that may befall companies and sectors. Dividend yields which look too good to be true usually are. Reaching beyond a yield of 8 or 9 percent is not going to pay any further dividends. It's actually more likely that you'll receive less. As we'll see in the next chapter the dividend yield needs to be interpreted in light of the rest of the company's financials to determine its safety and sustainability.

Further Reading

- Tweedy Browne – the Dividend Yield Advantage[6]
- Aswath Damadoran: Investment Fables[7]
- CSFB: High Yield and Low Payout[8]

[6]http://www.tweedy.com/research/papers_speeches.php
[7]http://www.amazon.co.uk/Investment-Fables-Exposing-Strategies-Financial/dp/0131403125
[8]http://papers.ssrn.com/sol3/papers.cfm?abstract_id=946448

Chapter 4

Dividend Safety - how to sleep better at night

"The whole secret to winning and losing in the stock market is to lose the least amount possible when you're not right" William O'Neill

While nothing can prepare the dividend investor for the kinds of disasters that have hit a handful of high yielding blue chip companies recently, there are some important steps that can be taken to minimize the risks we've been discussing. In particular, research by Societe Generale suggests that 'financial robustness' - defined as companies having strong balance sheets but also good underlying business economics - is a better indicator of dividend sustainability than even the dividend track record itself.

The irony is that giving up on the high yield dream and searching for more moderate yielders that promise greater dividend safety can actually improve portfolio returns materially, while lowering volatility to boot - a win-win proposition. We will shortly cover some of the traditional and modern approaches to assessing dividend safety, but as the best offence is a good defence, let's first investigate the terrain of dividend cuts and traps as a prophylactic measure.

On dividend traps, cuts and other nasties

A dividend trap is a situation where a high headline dividend yield lures unwitting investors into its snare only for them to discover that it was a temporary illusion. Broadly speaking, we can think of three perfect setups for a dividend trap which you should be aware of:

1. **A Cow Feeding Itself Its Own Milk** - where a company has bad cashflow but attempts to maintain its dividend policy it

may financing the payout with debt. This is highly likely to end in tears.

2. **A Falling Knife** - where an apparently compelling yield is actually the result of a substantial freefall in the share price of a dividend paying stock. Because earnings ultimately drive dividends, a sustained drop in anticipated earnings usually foreshadows a dividend cut or, in severe cases, bankruptcy.
3. **Fools Gold** - where a company decides to pay a large one off dividend payment in one year without any intention for it to persist. This might be the result of a windfall, such as a disposal, and naive extrapolation of this payment level into the future can lead investors astray.

As we'll repeatedly hammer home, dividends are not certain cash flows and can be illusory. While CEOs do fear the repercussions of cutting dividends, sometimes management feel they have no choice. In 2011, 438 UK quoted companies paid a dividend, 59 of those actually cut their payouts while a further 31 firms cancelled their payments altogether bringing extremely unwelcome news for the shareholders involved.

Given the typical volatility in corporate earnings and cash flows, it might seem surprising that we don't see even more dividend cuts. Wouldn't it be rational for firms to actively reassess how much they should pay in dividends as their prospects change? It seems not. In his classic 1956 study on dividend policy, Lintner interviewed corporate managers and found: *"a reluctance to reduce regular [dividend] rates once established and a consequent conservatism in raising [dividend] rates"*. As a result, dividends tend to follow a much smoother path than earnings - the variability from 1960 to 2008 of year-to-year changes in dividends was just 5.2 percent, compared to 14.7 percent for earnings. Management are hell bent on sustaining them.

You would think that paying an unsustainable level of dividends is going to be worse for investors in the long term, especially if it leads to a dilutive capital raising. However, the evidence suggests that this simply doesn't wash with investors. Research shows that the investor response to a dividend cut tends to be brutal. Several studies show that in 80 percent or more of cases, the stock prices of firms that cut dividends drop sharply at the time of the announcement. Furthermore, research by Michaely, Thaler and Womack found that that stock prices then continue to drift downwards in the weeks following a dividend decrease.

The traditional approach to safety

So given that dividend cuts have a tendency to reduce not only income but also the capital value of the shares, it makes sense for investors to value safety above all else. One approach to assessing this to rely on qualitative analysis aimed at identifying companies with a sustainable competitive advantage and a robust operating model. Warren Buffett likened businesses to castles at risk of siege from competitors and the marketplace. Great companies are able to dig deep economic moats around their castles that become increasingly impregnable to competition and market pressures. These moats bring either pricing power, scale advantages or cost reductions which help sustain very high returns on capital, leading to higher cashflows and returns for investors.

Judging a company's "economic moat" is an important but time-consuming exercise. However, there are also some helpful financial ratios and indicators that can be handy short-cuts to assessing financial robustness. Obviously excessively high yields and lack of dividend history are key warning signs that all is not well, but here are a few other key health indicators which should be monitored closely.

Dividend Cover / Dividend Payout Ratio

Perhaps due to its simplicity and universality, the dividend cover has earned a reputation among investors and analysts as the essential dividend health metric. It gives investors a quick fix on how much a company is paying out in dividends in relation to the earnings it is generating. As we'll see in the Strategies section, it's so important that Charles Carlson gave it a 30 percent weighting in his Big, Safe Dividend formulation.

It is easily calculated by dividing the earnings per share by the dividend per share (EPS/DPS). In the United States, they prefer to invert this ratio and express it as a percentage which they call the Dividend Payout Ratio (DPS/EPS).

The preferred level of dividend cover

The usual rule of thumb is that dividend cover of less than 1.5x may indicate a danger of a dividend cut, while more than 2x is typically viewed as healthy. 1.5x cover is ultimately an arbitrary line in the sand, but it reflects the need for some margin of safety. At a cover of 1x or less, the company is distributing all of its earnings as dividends and even dipping into reserves from previous years. That's usually a big red flag.

Because many companies are reluctant to cut payouts even if profit levels fall, dividend cover is a useful indicator of earnings persistence and financial health, particularly when tracked over a long period of years. The issue of dividend cover only really comes to the fore when a stock looks vulnerable. Companies themselves will often refer to their preferred level of cover in their overall dividend policy, which tends to get discussed in preliminary results and an- nual reports.

The debate over dividend cover

In spite of the above, there's a lot of debate over whether investors should prefer a low or a high dividend cover.

The traditional view is that, if a company is paying out too much in dividends, it does not have the ability to reinvest profits back into the business which could hurt the business's growth prospects longer-term. On this view, low dividend cover is bad whereas high dividend cover is good. In support of this claim, in 2006, analysts at Credit Suisse attempted to discover the optimum balance between yield and cover. What they found was that, between 1990 and 2006, S&P 1500 stocks with high yields and high dividend cover produced annualised returns of 19.2 percent – beating every other variation of payout ratio and yield. By comparison, over the same period the S&P 500 (large cap companies) delivered a return of 11.16 percent.

But in the opposite corner, in a 2003 paper entitled *Surprise! Higher Dividends = Higher Earnings Growth*, US finance commentators Robert D. Arnott and Clifford S. Asness concluded that high rates of dividend cover historically precede periods of low earnings growth. Essentially they showed that management of companies with low dividend cover are forced into being more disciplined with their retained profits. They become less likely to indulge in *'inefficient empire building and the funding of less than ideal projects'* which lead to 'poor subsequent growth' rates.

Regardless of which camp you are in it's still likely to be worth checking out the dividend cover. After all, dividend cover of less than 1 means that a firm paid out more than it earned as dividends – an unsustainable approach in the long-term!

Gearing

For investors who find the toing and froing over high or low dividend cover confusing, an alternative is to focus more directly on a company's balance sheet strength and cashflow. Clearly, if the company is highly leveraged, and is having trouble meeting its short-term liabilities, then this is going to be a big red flag for the dividend. If the company has recently acquired another company, how did it finance this? Did it make a huge cash payment from its cash reserves or borrow money from banks?

There are some rules of thumb that analysts like to use to assess balance sheet strength. While we won't go into too much detail here, a safe level of gearing (debt to equity) on the balance sheet is generally considered to be 50 percent or less. While many are comfortable with gearing of up to 100 percent the likelihood of default obviously increases as the gearing rises. It is essential to look at gearing levels in comparison to sector and industry norms as clearly high levels of gearing are more usual in some industries than others.

Other ratios

Other common ratios to use in assessing balance sheet strength include watching the current ratio (current assets / current liabilities) which assesses the ability of the company to service short term debts. A current ratio of less than one tends to be a worry.

A modern approach to safety

At Stockopedia[9] we are big advocates of using more advanced quantitative indicators to assess balance sheet and financial strength. The benefits of using checklists and algorithms are that they can weigh up many more ratios and indicators more effectively than a typical traditional approach, and don't suffer the inherent bias and overconfidence that can plague human judgement.

Our eyes were really opened to the possibilities of using these indicators in dividend strategies by the astonishing results of Societe Generale's *Quality Income Index*. We go into its construction in more detail in the Strategies section, but in a nutshell by filtering high yield stocks using a quality score (specifically the F-Score described below), and a balance sheet risk score they were able to improve the returns from equities since 1990 from a market

[9] http://www.stockopedia.com

average of 5.6 percent to a remarkable 11.6 percent annualised at a significantly reduced volatility.

Assessing financial robustness - The Piotroski F-Score

The primary indicator used by SocGen to assess quality is an indicator known as the F-Score. A nine test checklist[10] that is applied to a company's financial statements as developed by Joseph Piotroski, now associate professor of accounting at the Stanford University Graduate School of Business. A company either passes or fails each of the nine tests adding up to create a score between zero and nine.

Each of these rules looks at one aspect of a company's financials, with six of the nine rules looking at the change in a company's financials. Whereas most ratios (e.g. dividend cover) look solely at a company's current financial state, the F-Score looks more deeply into the direction in which it's financial state is moving, and herein lies it's secret sauce - it captures fundamental momentum, earnings quality and balance sheet strength in a single very smart number.

Piotroski found that any stocks scoring 8 or 9 points had a tendency to massively outperform companies with scores in the 0-2 range in a test by 7.5 percent annually over 20 years. These findings that have been confirmed in live tracking tests in our model portfolios on Stockopedia.

Assessing Balance Sheet Strength - The Altman Z-Score

Rather than look at gearing and interest cover ratios, SocGen used a 'distance to default' measure to assess balance sheet risk in their paper. This methodology is lesser known and numbers aren't widely

[10] http://www.stockopedia.com/apps/piotroski/

dispersed but a commonly used alternative used by credit analysts since the 1970s. It was developed by Professor Edward Altman and is known as the Z-Score.

There are several forms of the Z-Score for different classes of company but essentially they come down to the same thing – a company with a low Z-Score signals a high probability of financial distress over the next 12 months. It weights four or five strict balance sheet factors[11] into a single number that can be easily interpreted. Clearly avoiding companies such as these makes sense for the keen dividend investor.

In the Strategies section, we'll also discuss a custom algorithm known as the 'BSD' formula for finding high safety dividend paying stocks. While not 'academically' derived, it again illustrates that modern approaches to dividend safety are evolving beyond simple ratio analysis.

A Technical approach to safety

There are many technical analysts and efficient market theorists who would swear that all market information is held within a company's share price. No matter how much regulators would wish otherwise, different investors have different information and a collapsing share price on no news is a huge red flag. The following indicators are all useful factors in any sound approach to dividend safety.

1. **Does the share price have good relative strength?** This check is used by US research firm Russell Research as part of its Russell High Dividend Yield Index Series. In order to protect against the price "freefall" dividend trap, they filter out the bottom 10 percent of stocks based on 12 month price

[11] http://www.stockopedia.com/apps/altman/

momentum. In a similar vein, a Charles Schwab study ranked the highest yielding stocks by 6-month price momentum, divided them into five segments, and found that highest yield stocks with the highest 6-month price momentum outperformed all the other momentum segments. Yet again, these studies show that price momentum works - even with dividend strategies.

2. **Is it a low volatility (beta) stock?** Another measure you can use to judge a potential dividend candidate is its "beta". Used by traders, beta measures how much the stock price moves up and down relative to the whole market. A "high" beta stock (more than 1) is generally more volatile and prone to wider swings in either direction compared to the broad market, while a stock with a "low" beta (less than 1) is generally more 'boring', less volatile and less likely to excite most equity investors. Of course when things are boring, there's a systematic tendency to leave them underpriced, which can in turn lead to higher future returns. Like anything, it's not a silver bullet and beta has always had its critics. Even a low beta stock could tumble in price or suffer financial troubles but, in general, it looks more likely that a high beta stock with a toppy yield could turn out to be a dividend trap.
3. **Is the market cap big enough?** The small cap market is of course a wonderful hunting ground for potential market inefficiencies but, notwithstanding the recent lessons from the banking sector, it remains true that larger-cap companies tend to be more stable. Work by Bank of England analysts Andrew Benito and Garry Young has found that the smaller scale of a business is correlated with an increased chance of a dividend cut, so it's important to measure the potential greater capital gains against the increased risks of capital destruction.

Our recommendation for income investors seeking safety is to use a combination of the above techniques. It is worth factoring in both traditional safety measures such as good Dividend Cover combined with modern filters such as the F-Score to avoid companies at high risk of default. Focusing on large, low volatility stocks will also ensure that you aren't exposing yourself to the perils of the highest yielding, highest risk segments of the market.

Further Reading

- Surprise! Higher Dividends = Higher Earnings Growth[12]
- One Indictor to Rule Them All: The Piotroski F-Score[13]

---

[12]http://papers.ssrn.com/sol3/papers.cfm?abstract_id=390143

[13]http://www.stockopedia.com/content/one-indicator-to-rule-them-all-the-piotroski-f-score-66530/

Chapter 5

Dividend Growth - a new holy grail?

"Here's a simple way to succeed on Wall Street: buy stocks from the Moody's [Dividend Achievers] list and stick with them as long as they stay on the list" Peter Lynch

While factoring dividend safety into high yield strategies is clearly a smart move in terms of improving returns, another school of thought favours a focus on dividend growth. Rather than prioritising the highest yield plays, Dividend Growth Investors aim to select stocks that may offer a lower initial yield but have a history of growing that payout over time. The emphasis here tends to be less on the absolute rate of compound dividend growth over time and more on the number of consecutive years of dividend increases - known as a *dividend growth streak*.

Why the Dividend Growth Streak matters

As we've discussed, companies with growing dividends are signalling confidence about their future earnings. They tend to be stable businesses, which are well positioned in their industries and are able to perform throughout market cycles. More specifically, a steadily growing dividend streak is an important signal for the following reasons:

1. It provides a rich seam of information about the stability of company management, the corporate culture and whether the dividend is important to the company even in times of financial stress.

2. It maximizes the potential for dividend reinvestment.
3. It is an indicator of management confidence in cash flow.
4. It provides protection against the dreaded effects of inflation.

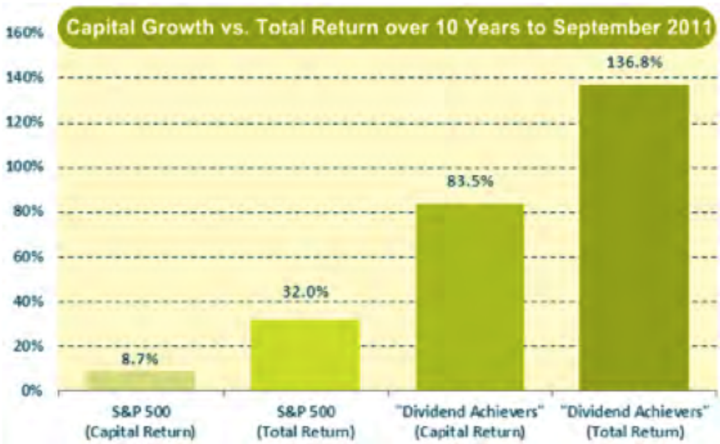
In a 1985 paper entitled *A Survey of Management Views on Dividend Policy*, US academics Baker, Farrelly and Edelman found that management were *'highly concerned with dividend continuity'* and felt that dividend policy affected share value. The findings tallied with the seminal 1950s paper by Lintner we discussed previously which outlined a behavioural model whereby managers typically 'smoothed' dividend increases over time and only made upward changes when they were sure that earnings could support the increase.

In other words, companies think very carefully before implementing and then increasing dividends, so this is an important sign to inves- tors in search of dividend longevity, reliability and growth.

The past can be a signal…

Of course, investors are routinely drilled on the risks of extrapolating too much from the past when trying to predict the future performance of a stock – but when it comes to dividends, the past can be a useful guide. Ned Davis Research discovered that over the past 40 years stocks in the S&P 500 index that had increased their dividend payouts annually averaged a 9.4 percent annualised return, whereas companies that paid a dividend but didn't increase that payout had an annualized return of about 7 percent.

Similarly, the following M&G Investments chart shows the total cumulative return from the S&P 500 Index in the ten years to 2011, including the reinvestment of dividends, as 32 percent. However, if you put cash solely into US companies that grew their dividends for at least 25 consecutive years, the total return was over 136 percent.



As a result of this evidence, a long term dividend growth streak has earned a reputation as a yardstick for effective dividend investing and resulted in big name index providers like the S&P and Moody's closely tracking companies which boast them. As ex-Fidelity fund manager and investing legend Peter Lynch wrote in his 1994 book *Beating the Street*:

> "The dividend is such an important factor in the success of many stocks that you could hardly go wrong by making an entire portfolio of companies that have raised their dividends for 10 to 20 years in a row. Moody's Handbook of Dividend Achievers – one of my favorite bedside thrillers – lists such companies."

The importance of compounding & Rule 72

The related reason to focus on dividend streaks is that the wonders of dividend growth and reinvestment can have some remarkable effects over the long term. A friend once remarked that the dividends he received from his investment in the shares of the UK pawnbroker Albermarle & Bond were now worth more than his entire initial investment. That is a classic example of the real power at the heart of any form of stock market success and something that Warren Buffett has called the *“eighth wonder of the world”* - the power of compound growth. At a 15 percent growth rate your annual return will be greater than your initial stake in the 16th year.

Investors have an affection for calculating how long it will take to double the value of their investments – and this can be done very easily with dividend growth stocks. Using what’s known in finance circles as Rule 72, you can get an instant fix on how many years it will take a dividend stock to double. In simple terms here’s how it works. If you invest £1,000 in a stock with growth of 6 percent per year, the Rule 72 calculation would involve dividing 72 by 6 ⇒ 12 years. That’s roughly 12 years for the investment to be worth £2,000.

We will look more closely at a few dividend growth strategies in the next section, however, it’s important to note that assessing the future dividend growth prospects of a company should not just be a mechanical exercise based on the company’s historical track record. It also involves focusing on a company’s ability to sustainably increase its cash flow – which requires hard graft and diligence to understand the quality of the underlying business franchise.

Opposing pillars? The trade off between growth and yield

Of course, it would be ideal to combine a very high yield with a long dividend growth streak. Unfortunately, those kinds of opportunities don’t come around very often. So – if given the choice - how should an investor decide between, say, a stock with a 2 percent yield increasing at 10 percent a year, versus a stock with a 6 percent yield increasing at only 5 percent a year. Which is better?

The answer rather depends on your timeframe. Given a long enough time horizon, the dividend growth will compound out to make up for the shortfall in initial yield. However, many folks that plan on retiring may not have the time to wait for a dividend growth stock to make its original 2 percent dividend yield high enough to live off. A general rule of thumb sometimes used is that, if your time horizon is less than twenty years, a higher beginning yield is likely to be more important, but if it's twenty plus, higher growth tends to win out.

10 by 10 Table for Dividend Investors

Initial Yield

Annual Growth Rate	2%	3%	4%	5%	6%	7%	8%	9%	10%
4%	40	30	23	17	12	8	5	2	1
5%	32	25	18	14	10	8	4	2	1
6%	27	19	15	12	8	6	3	1	1
7%	24	17	13	10	7	5	3	1	1
8%	21	15	12	9	6	4	3	1	1
9%	19	14	11	8	6	4	2	1	1
10%	17	13	10	7	5	4	2	1	1
11%	15	12	9	7	5	3	2	1	1
12%	14	11	8	6	5	3	2	1	1
13%	13	10	8	6	4	3	2	1	1
14%	12	9	7	5	4	3	2	1	1
15%	12	9	7	5	4	3	2	1	1

To better understand the relative trade-off between growth and yield, David van Trapp of *Serious Stocks* has developed a useful table (above) which looks at the number of years that would be required to achieve a 10 percent return on your investment. Across the X axis, the table has Initial Yield and down the Y axis, it has the Annual Growth rate. The values in the table are the numbers of years of compounding required to achieve the target return. The 10 percent targeted return is an arbitrary number but it is used on the basis that it's a healthy return, almost equal to the long-term total return of the stock market.

If we take the scenario discussed above, the table suggests that a 2 percent yield compounding at 10 percent a year would take 17 years to reach a 10 percent return on investment. By comparison, a 6 percent yield increasing at 5 percent a year would take just 12 years.

Don't accept too low a yield in dividend growth stocks

As Van Knapp notes: *"An additional 1 percent in initial yield reduces by 2 percent to 4 percent the growth rate needed to reach 10 percent yield on cost in a given time"*. He argues that this is important since, the faster you hit your targeted yield on cost, the fewer years you are subject to the risk that you have overestimated its rate of dividend growth. This analysis suggests that it simply isn't worth chasing stocks with yields as low as 1-1.5 percent, however fast they are growing. It will just take too long to get to the targeted return. Admittedly this analysis doesn't factor in the impact of reinvesting dividends and it ignores the rising share prices that are often associated with growing dividends. Still, one of the key conclusions from this table is that, percent-for-percent, the initial yield carries more weight than the dividend growth rate.

Further Reading

- 10 by 10: The Interaction of Dividend Yield and Growth[14]

[14]http://seekingalpha.com/article/261754-10-by-10-the-interaction-of-dividend-yield-and-growth

Chapter 6

The Two Worst Pitfalls for Dividend investors

"I wish it grew on trees, but it takes hard work to make money" Jim Cramer

In the last few chapters, we've rammed home the truth that investing in high yield stocks comes with a lot of risk - especially of dividend cuts and volatility - but there are two other temptresses that dividend investors often fall for to their detriment. We must bang the table at this point because, without taking the following two lessons to heart, the expected returns of long term dividend investing could be found to be a complete mirage.

Pitfall 1: Failing to buy in tax-efficient wrappers

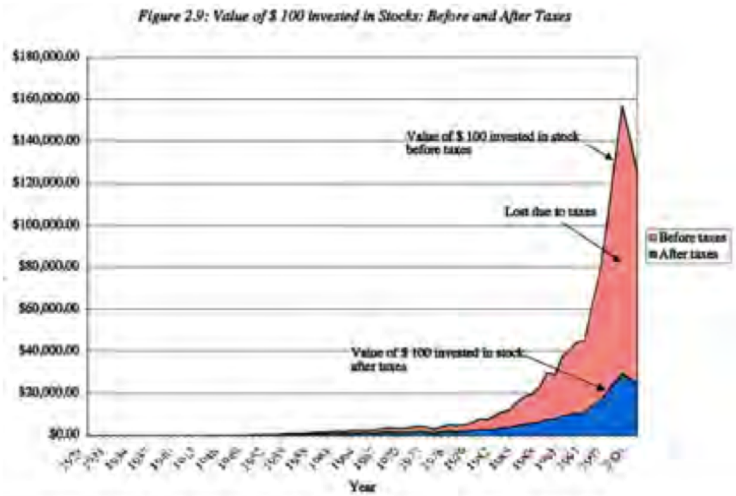
It's important to remember almost all those stellar gains reported in the research reports do not account for tax! In the real world, dividends are taxed as income which is higher than capital gains tax thus creating a massive drag on reported returns.

Income taxes are high!

Historically, dividends have almost always been taxed more punitively than capital gains. According to research by Legg Mason Capital, in the US over the last 50 years dividends have been taxed on average at a rate of 50 percent. Meanwhile in the UK, dividends are taxed on a sliding scale according to your income band meaning that top-rate tax payers pay an awful lot more (36.1%+) for dividend income than capital gains (20%).

Income taxes also need to be paid *now*

Capital gains taxes can be deferred until they are realised which means they essentially become an interest free loan - providing leverage in your portfolio that can compound growth rates.



Source: Aswath Damadoran - Investment Fables

Aswath Damadoran illustrates in his book *Investment Fables* (see figure above) that if you actually factor in the drag that these high income taxes have on some dividend stock strategies, they actually massively underperform the market over the long term, arguably rendering the statistics in Part 1 completely redundant!

But it's not all bad. You can benefit from the reported outperformance of dividend stocks as long as you always buy them in a tax-efficient wrapper like an ISA or a SIPP in the UK. With these investment accounts taxes are either waived or deferred allowing dividend income to accrue and allowing it to be reinvested at the full face amount. One of the biggest mistakes an investor can make is to forget this. For a further discussion of this very important point, please see the tax breakout pages in the appendix.

Pitfall 2: Failing to always reinvest dividends

There's a famous fable about an arrogant young Sultan prince who challenged all comers to a game. Boasting of his boundless wealth, the prince offered the winners the prize of their choice. A canny courtier decided to teach him a lesson asking for the winner's prize to be a chess board with one square each day to be filled with rice - a single grain on the first square, 2 on the second, 4 on the third and doubling in number until the board was filled after 64 days. The prince, thinking he was mocking him by asking for such a measly prize, agreed and subsequently lost the game. Little did he know that by the 64th day the courtier would be demanding 18,446,744,073,709,551,615 grains of rice - a number which could fill the surface of the entire earth several times over!

This is the power of compound interest which we've already talked about. Every study into the wealth that can be achieved from dividend strategies has relied on the assumption that all dividends are reinvested back into new shares of the underlying company. By consistently reinvesting dividends, in bear markets or bull, investors can ensure that they are exposed as much as possible to this power of compounding, not only growing their stake in each company, but growing their exposure to price appreciation and dividend growth.

This graph illustrates the growth of $1,000 invested in stocks over the period 1871-2003. With only $243,386 coming from capital gains, that makes dividends the bigger wealth creator.

Source: The Future for investors. Jeremy J. Seigel 2005

But the evidence suggests that investors who directly own individual stocks reinvest less than 10 percent of the dividends they receive. In fact most investors receive dividend cheques in the post and spend the income quite happily, unaware that they are falling for the ultimate seduction and a brutal unwinding of their potential long term returns.

Very few investors take advantage of so called DRIPs (dividend reinvestment plans) which are often offered for a small fee by companies to automatically reinvest dividends paid back into the company's shares for you or even better reinvest their dividends systematically themselves. And when investors do reinvest their dividends they are most likely to do so during bull markets, not during the bear markets when dividend reinvestment can provide the 'return accelerator' we described in Part 1. Without a consistent dividend reinvestment strategy, dividend investors can only expect sub-par investment returns from dividend stocks.

Chapter 7

A compendium of income strategies

Previously we looked at the reasons for using yield, safety and growth as the main concepts around which to shape a dividend investment strategy. In this section, we're going to look at how six well known income strategies have sought to track down great dividend stocks and see how these approaches stack up, both in theory and in practice. As will see, these three factors are rarely treated equally - different investors place more or less emphasis on one or another, as they see fit.

These strategies are quantitative and/or semi-mechanical. As part of evaluating them, dividend investors have to ask themselves whether they wish to approach dividend investing with an active stock picking approach (as alpha hunters) or with a passive quantitative portfolio approach (as beta farmers). Making that decision depends on your tolerance for risk and personal day to day passion for stock picking. As we discovered in a chapter of *How to Make Money in Value Stocks*[15] many modern investors are learning that the passive approach can be just as lucrative, less stressful and can help to avoid the myriad ways in which investors manage to trick themselves out of their fortune.

We have deliberately made the following pages concise & formulaic to allow quick comparison of the pros and cons of each strategy. We track the relative performance of each of these strategies in our Screening Centre[16], including our own variants where we see scope for improving the approach (we also review a couple of more obscure dividend strategies in the Appendix).

[15]www.stockopedia.com/books/value-stocks/

[16]http://www.stockopedia.com/screens/

Strategy 1: Dogs of the Dow

"Beating the Dow is based on simple logic that will produce exceptional returns in any rational market", Michael O'Higgins

Perhaps the most famous high yield investing strategy around is the "Dogs of the Dow", first popularized back in 1991 by Michael Higgins in the book *Beating the Dow*.

How it works Simply invest an equal sum in the top 10 highest yielding stocks ("the Dogs") in the Dow Jones Industrial Average (or an equivalent large-cap index such as the FTSE 100) once per year. Rinse and Repeat. O'Higgins argued that, by doing so, you could beat the Dow and with it probably the majority of most active fund managers.

Why it works The thinking behind the Dogs of the Dow strategy is that blue chip companies do not alter their dividend to reflect trading conditions whereas share prices fluctuate. Companies with a high yield, i.e. high dividend relative to price, are therefore near the bottom of their business cycle and should see their stock price increase faster than low yield companies. The screen theoretically offers a conservative option that produces a list of well-financed companies that have long histories of weathering economic turmoil. But of course there's theory and there's practice…

Can it beat the market? In his back-testing, O'Higgins demonstrated that over a 17-year period from 1973 to 1989, the Dogs strategy averaged a return of 17.9 percent annually, compared to 11.1 percent for the Dow. The Dogs of the Dow website suggests that, for the 20 years from 1992 to 2011, the Dogs of the Dow matched the average annual total return of the Dow (10.8 percent) and outperformed the S&P 500 (9.6 percent). It did however struggle to keep up with the Dow during latter stages of the dot-com boom and the 080/09 financial crisis, suggesting that an investor would be best served by viewing this as a longer-term strategy.

Key issues

- *No safety filter (other than index membership):* Although the Dogs approach has the advantage of simplicity, the great disservice that O'Higgins did for investors was to encourage them to look primarily at the list of highest yielding stocks in an index without filtering for dividend sustainability and growth. In the 80s and 90s Dow Jones index stocks were extremely stable, but these days with the disruptive nature of internet competitors and tough credit markets, the giants of yesterday are more at risk than ever before.
- *Higher risk of dividend cuts:* The singular focus on the highest possible yield means that the approach has had a tendency to pick for inclusion troubled names like Eastman Kodak whose broken business models led to bankruptcy.
- *High sector concentration risk:* Stocks in the same sector tend to go out of favour or into trouble at the same time e.g. Lloyds and RBS in the UK during the financial crisis.
- *Trading costs:* The annual review of the portfolio is likely to mean making major changes thus triggering trading costs and possibly crystallising capital gains taxes.

Stockopedia Subscriber Screening Resources

- Forecast Dogs of the FTSE Screen - qualifying UK stocks[17]
- Dogs of the FTSE Screen – qualifying UK stocks[18]

Further Reading

- Michael O'Higgins, Beating the Dow[19]

[17] http://www.stockopedia.com/screens/forecast-dogs-of-the-ftse-100-screen-86/
[18] http://www.stockopedia.com/screens/dividend-dogs-of-the-ftse-100-screen-14/
[19] http://www.amazon.co.uk/Beating-Dow-Michael-OHiggins/dp/0066620473/ref=sr_1_1?s=books&ie=UTF8&qid=1340012674&sr=1-1

- Aswath Damadoran. Investment Fables[20]
- Jack Hough, Your Next Great Stock[21]

Strategy 2: Geraldine Weiss' Yield Range

"Anyone can be a successful investor... you confine your selections to blue-chip stocks, you buy them when they are undervalued, and you sell them when they become overvalued" Geraldine Weiss

Rather than focusing on high absolute yield, an alternative strategy focuses in on relative yield over time - the most renowned advocate of this kind of 'range-trading' approach was Geraldine Weiss, known as the Grand Dame of Dividends. For more than 50 years, Weiss has been regarded as one of the investment community's most astute dividend hunters. The now retired editor of the US dividend newsletter *Investment Quality Trends*, Weiss developed a formula for identifying companies with strong dividend track records that are attractively valued in the market, which she documented in two best-sellers, *Dividends Don't Lie* and *The Dividend Connection*.

How it works At its heart, the technique uses the dividend yield as the critical measure of its valuation. If the yield is high, it may signal a buying opportunity and, if the yield is low or drifting lower, then that could be an indication to sell. As well as looking for low yields on a historical basis, there is a filter for high quality stocks - each company needs to have a good quality track record and pass an additional set of robust "blue chip" criteria to prove it.

Stock Selection Criteria: 1. Dividend yield must be undervalued vs. its historical average 2. It must be a growth stock that has raised dividends at a rate of at least 10 percent over the past 12 years.

[20] http://www.amazon.co.uk/Investment-Fables-Exposing-Myths-Strategies/dp/0131403125

[21] http://www.amazon.co.uk/Your-Next-Great-Stock-Performers/dp/0470117931

3. It must be selling for two times book value or less. 4. It must have a P/E ratio of 20-to-1 or below. 5. It must have a dividend payout ratio in the 50 percent area (or less) to ensure dividend safety with room for growth. 6. Its debt must be 50 percent or less of total capitalization. 7. It must be "blue chip", defined as: - The dividend raised five times in the last 12 years - It should carry an A rating from S&P - It should have at least 5 million shares outstanding - It should have at least 80 institutional investors hold the stock - It should have had 25 uninterrupted years of dividend history - There should be earnings improvements in seven of the last 12 years.

Why it works It's easy to understand the blended emphasis on relative value and quality. Weiss argues that stock valuations from a yield perspective move in their own specific bull to bear cycles as sentiment ebbs and flows. The average time for a stock to raise from undervalue to overvalue is three years, while the downhill run is usually two years. This strategy seeks to exploit those relatively predictable cycles.

Can it beat the market? Weiss has now retired but, as of 2002, *Investment Quality Trends* was said to be the number one performing investment newsletter in the US over the previous 15 years, earning an impressive 12.4 percent annualised. It had placed third for the prior ten years and third over the prior five years.

Key issues

- *Charting based:* This approach involves aspects of technical analysis. Its reliance on historic patterns may concern fundamentals-focused investors, although the charting is not purely based on price action.
- *Higher risk of dividend cuts:* Focusing on historically high yields may lead investors into dividend traps, although the quality filters help here.
- *Accessibility:* It's difficult to replicate some of these criteria exactly for the UK market (e.g. the S&P A rating or the 25

year dividend history as this is as rare as hen's teeth in the UK market).

Stockopedia Subscriber Resources

- Geraldine Weiss 'Lite' Screen[22] – a similar strategy for UK investors

Further Reading

- Geraldine Weiss, Dividends Don't Lie[23]
- Forbes: Dividend Stocks Pay Off[24]

Strategy 3: HYP - High Yield Portfolio

"You buy the top high-yielding stocks - building a diversified portfolio across all sectors. And you simply sit back and allow the dividends to pile up" Stephen Bland

A strategy which shares some of the same thinking as Dogs of the Dow is the 'High Yield Portfolio', a passive large-cap income investing strategy popularized by the writer and investor Stephen Bland in a series of Motley Fool articles back in 2000.

How it works This is a buy and hold forever strategy aiming to build a well diversified portfolio of shares in big, solid companies chosen primarily for high yield to provide increasing retirement income from dividends. All forecasts and opinions on stocks are ignored and stock positions are never sold. The stock selection approach is as follows:

[22] http://www.stockopedia.com/screens/geraldine-weiss-lite-dividend-screen-80/

[23] http://www.amazon.co.uk/Dividends-Dont-Lie-Finding-Blue-Chip/dp/0793100232/ref=sr_1_1?ie=UTF8&qid=1323984465&sr=8-1

[24] http://www.forbes.com/2002/02/12/0212adviser.html

1. Rank a large-cap universe by highest forecast yield.
2. Select one stock from each different sector
3. Examine fundamentals to make sure the yield is sustainable: a) Less than 50 percent gearing, except in special cases like utilities, b) Dividend cover of at least 1.5x), and c) A history of dividend growth over, say, the last five years. However, Bland also notes that these rules are flexible "for the sake of essential sector diversification".

Can it beat the market? Over the 10 years to November 2011, the strategy was reported to have generated a 4.95 percent income return per annum.

Key issues

This is a combined yield and safety approach but the safety filters are fairly basic and - as with the Dogs - the focus on the very highest yielding stocks looks misguided (the 2nd and 3rd decile tend to deliver higher risk-adjusted returns). Perhaps unsurprisingly, in the 2008 credit crunch, the HYP portfolio suffered a number of high profile issues from a capital perspective, including picking Lloyds and BP.

Stockopedia Subscriber Screening Resources

- What is HYP investing?[25]
- PYAD Screen[26] – Another model screen developed by Stephen
- Bland. We will be adding a HYP version too.

Further Reading

- How to select High Yield Portfolio shares[27]

[25]http://www.stockopedia.com/content/introducing-the-high-yield-portfolio-78349/
[26]http://www.stockopedia.com/screens/pyad-screen-17/
[27]http://www.stockopedia.com/content/hyp-1-how-to-select-high-yield-portfolio-shares-78749/

Strategy 4: DGI - Dividend Growth Investing

"The stockmarket also contains an escalator, one that allows you to stay invested and ride the roller coaster with something approaching peace of mind" Roxann Klugman

This is an increasingly popular income investing strategy in the United States. One of the earliest books to focus on DGI in detail as a strategy was Roxann Klugman's 2001 title, *The Dividend Growth Investment Strategy*[28]. As a more populist school of investment thinking, Dividend Growth Investing has emerged in recent years out of the blogosphere, via sites like Van Knapp's *Sensible Stocks* and the writings of oth- ers like David Fish, Chuck Carnevale and Norman Tweed on social finance site, *Seeking Alpha*.

How it works This approach involves buying stocks with a long history of increasing dividend payments, i.e. Dividend Champions[29], and reinvesting any proceeds. While a long dividend streak is considered crucial, it's also important to find a company that is growing at a sustainable rate, with low debts and lots of cash inflows. There is usually a strong Buffettesque focus on the quality of the underlying business franchise to ensure sustainability of the dividend payment. As with the HYP approach, there is more emphasis on the income stream generated by the portfolio, than the portfolio value *per se*.

Stock Selection Criteria DGI is a fairly broad church but a typical set of criteria to find candidate stocks might be: 1. *Consistent history of dividend increases:* This usually starts with the list of companies with a 25+ year record of maintaining or increasing dividends. 2. *Strong historic dividend growth rate:* A minimum five-year dividend growth rate of 10 percent or more, or a 10-year dividend growth rate at the same level. 3. *A minimum dividend yield*

[28]http://www.amazon.com/The-Dividend-Growth-Investment-Strategy/dp/0806521821

[29]http://www.dripinvesting.org/Tools/U.S.DividendChampions.pdf

of 3 or 4 percent: If the current yield of an existing holding drops below 3 percent, this might trigger a decision to sell and deploy the cash elsewhere. 4. *Increased dividend payout yield (either in relation to EPS or free cash flow):* This is more controversial since some DGI investors target low payout ratios as a sign of sustainability.

Why it works We discussed earlier the way companies with long dividend streaks are signalling the stability of their business model, their confidence about future earnings and their commitment to paying dividends. Companies think very carefully before increasing dividends in this way - as a result, they tend to be very high quality businesses that are able to grow profits over a long period of time by selling / manufacturing / distributing products that people really need.

Can it beat the market? Given its popularity, the evidence whether Dividend Growth Investing delivers excess long-term returns is surprisingly mixed. While a number of its supporters have back-tested the performance of the Dividend Champions list, this work is based on a data-set that suffers from significant survivorship bias (i.e. it does not show companies that cut their dividends or went bankrupt). However, one international study by Cass University of UK stocks, *Consistent Dividend Growth Investment Strategies* examined data for the London Stock Exchange from 1975-2006. It found that firms with 10+ years of consistent dividend growth (especially small-caps) returned considerably more than the equity market as a whole, with the additional benefits of lower volatility and smaller drawdowns.

In any case, the idea is that, rather than beating the market through capital growth, a portfolio of DGI stocks should provide a sufficient income stream to retire on, without the need to touch the principal (i.e. the appropriate benchmark is total return).

Key issues

- *Unbalanced approach* – As blogger Financial Uproar writes,

the proponents of DGI can appear somewhat myopic in their focus on growth to the exclusion of other concerns: "I like dividends too. The problem is with the almost singular focus on it. As long as a company is growing the bottom line and their inves- tors get that yearly dividend hike, dividend growth investors are happy to buy, all other metrics be damned".
- *Limited focus on valuation* – Given the lack of focus on yield, there is a risk that valuation may be overlooked as a key parameter for these kinds of stocks. A related concern is that the DGI approach is becoming very popular in the US, which could lead to a bubble in these kinds of stocks (discussed below).

Stockopedia Subscriber Resources

- Dividend Achievers Screens[30] – inspired by Indxis' index.
- What is Dividend Growth Investing?[31]

Further Reading

- The Dividend Growth Investment Strategy[32]

Strategy 5: BSD - Big Safe Dividends

"Find stocks with above-average appreciation potential and safe and growing dividends, and buy them at attractive prices" Charles Carlson

Charles Carlson is the boss of an investment advisory and publishing group called Horizon which publishes "*The DRIP Investor*"

[30] http://www.stockopedia.com/screens/dividend-achievers-screen-78/
[31] http://www.stockopedia.com/content/what-is-dividend-growth-investing-67683/
[32] http://www.amazon.com/The-Dividend-Growth-Investment-Strategy/dp/0806521821

newsletter. Carlson wrote a book called *The Little Book of Big Dividends* in which he laid out his own algorithm for picking safe yielding stocks. He is generally wary of high yield stocks and, unlike some of the previous strategies, he suggests that investors should be cautious about stocks with dividend yields that greatly exceed the yields of companies in the same sector or industry, the overall market, or the stock's own long-term historical average.

How it works Carlson discuss two approaches - Advanced & Simple *Big, Safe Dividends (BSD).* The Simple version relies on the Dividend Payout Ratio and his own proprietary Quadrix score, the details of which are not disclosed. However, the Advanced BSD Formula uses the following ten weighted fundamental and momentum factors to arrive at a composite score. The idea is to focus on the best-scoring companies and Carlson's website provides a list of them for the S&P 1500.

Primary Factor

- Dividend Payout Ratio (30 percent Weighting) – Using this ap- proach, the most important factor is how well covered the divi- dend is by company profits.

Major Factors

- Interest Cover (10 percent Weighting) - measures how well a company profits cover its interest payments. Companies with lots of debt may struggle to pay the dividend if business conditions deteriorate.
- Three Year Dividend Growth (10 percent Weighting) – Carlson observes that companies that have a history of raising their dividend on a regular basis tend to continue to do so.
- Long Term Expected Growth (10 percent Weighting) - While not a perfect measure given the poor record of analyst forecasts, Carlson feels that it is a reasonable way to get some view on a firm's future growth prospects.

- Tangible Change in Book Value (10 percent Weighting) - This is used as a check on a company's balance sheet quality.
- 6 Month Relative Strength (10 percent Weighting) - Carlson notes that weak share price movements can often anticipate dividend cuts.

Minor Factors

- Cashflow to Net Income (5 percent Weighting) - While profits can be seen as the primary funding source of dividends, you need actual cash to pay the dividend.
- Three Year Cash Flow Growth (5 percent Weighting) – A focus on companies that have a record of boosting cash flows on a regular basis.
- Three Year Earnings Growth (5 percent Weighting) – Preferable to bet on a company with a history of boosting earnings than one that does not.
- Dividend Yield (5 percent Weighting) - Carlson includes it but warns against focusing overly on dividend yield.

Can it beat the market? According to the book, Carlson back-tested his approach to 1994. A hypothetical investor that bought all of the S&P 1500 stocks that were in the top 20 percent of the Advanced BSD screen and in the top 25 percent of his Quadrix ranking system, with annual rebalancing, would apparently have outperformed the S&P 1500 Index by more than 6 percent per year.

Key issues

- *Debatable parameters:* While Carlson's approach is interesting, it does appear to be something of a laundry list of financial indicators that might (or might not!) impact dividend safety, plus a fairly arbitrary set of weightings. The approach is said to be focused on safety but also seems to include factors that are assessing the prospects for dividend payout growth.

- *Omissions:* There are a few surprising omissions from the algorithm such as the size of the firm in question which do tend to be predictive. Finally, as we've discussed, it's not always clear that a low payout ratio is always a good thing so its heavy reliance on this metric is open to question.
- *Proprietary aspects:* The full back-tested results rely on Carlson's Quadrix ranking system, the details of which are not disclosed.

Further Reading

- The Little Book of Big Dividends[33]

Strategy 6: SG Quality Income

"There are very sound logical reasons for being biased towards high quality/low risk stocks. There are even more sound reasons for being biased towards sustainable dividend payers" Dylan Grice, Societe Generale

In May 2012, the equity strategy team of SocGen sought to produce an investment strategy that would provide a tonic to ten years of depressed equity growth and stagnating bond returns. What SocGen's team came up with was a '*Quality Income Index*' designed to track large cap stocks with robust balance sheets, strong fundamentals and healthy yields. The barometer of quality essentially rests on the broad shoulders of the Piotroski F-Score. They have subsequently launched an ETN based on the Index.

How it works Their stock selection criteria consists of the following metrics: 1. As a measure of quality, a stock must have a Piotroski

[33] http://www.amazon.co.uk/The-Little-Book-Big-Dividends/dp/0470567996

F- Score of 7 or greater (out of 9) 2. It must also have a balance sheet risk score in the safest 40 percent of the universe. 3. A forecast dividend yield above 4 percent or 125 percent of the average universe yield. 4. Market capitalisation has to be at least $3bn.

Their “universe” is a global mix of ‘eligible countries’ subject to a few turnover minimisation techniques, quarterly rebalancing and a basket size of between 25 and 75 stocks. Financial companies are excluded.

Why it works The idea of bringing both high quality and high income together into a portfolio strategy has some very sound behavioural foundations as it helps in avoiding overconfident managers and avoiding overpaying for lottery tickets. We’ve already looked at why high yield stocks tend to do well; the fact that company management are generally bad at allocating capital means that distributing cash to shareholders seems to improve the discipline and skill of managers at reinvesting capital. Meanwhile, high quality businesses tend to be steady stalwarts that are often ignored by fund managers as being just too boring. Fund managers have to do something from day to day and need a bit of pizzazz to keep them excited about their work and possible bonuses. As a result they’ll tend to pay more money for stocks that have the capacity to double from year to year. Just like lottery ticket buyers, they pay over the odds to play, systematically underbidding quality stocks in the process.

Can it beat the market? Many in the market now appreciate that both higher ‘quality’ stocks and higher yielding stocks tend to outperform. According to SocGen’s backtesting, stocks that share both qualities put together offer total returns that have averaged 11.6 percent per year since 1990, more than doubling the return of the global equity markets at a significantly reduced volatility.

But what is more striking is the return of the portfolio since the market topped in 2000 - a genuinely miserable time for all. While the total return of stock markets has actually been negative in that time period, the Quality Income index almost tripled. We're now tracking the screen for the UK market to see how it holds up under live tracking as opposed to back-testing.

Key issues

Of all the dividend strategies discussed, this is the one we consider has the soundest foundations in terms of the underlying research and thinking. On the negative side, the Distance to Default measure used to assess balance sheet risk is somewhat esoteric, although in our own modelling of it, we've used the Altman Z-Score as a substitute.

Stockopedia Subscriber Resources

- SocGenesque Quality Income Screen[34] – UK stock screen

[34] http://www.stockopedia.com/screens/socgen-esque-quality-income-screen-808/

Chapter 8

Diversification - the only free lunch

"The only investors who shouldn't diversify are those who are right 100 percent of the time" Sir John Templeton

Diversification is the only free lunch in investment and the idea is so simple that even a child can understand, if not execute it – *"Don't put all your eggs in one basket"*. But in practice stock portfo-lio diversification remains a contentious topic among investors.

On the one hand, there are those who argue that a portfolio should be concentrated on a small, highly selective group of stocks (less than 10 stocks, perhaps as few as 4 or 5) to be monitored closely and frequently. Warren Buffett has occasionally placed up to 40 percent of his funds into exceptional stocks like Coca-Cola and American Express. On the other hand, there are those who argue that a portfolio should include a fairly large number of stocks (20-30, or as much as 50).

This topic is especially relevant in dividend investing. Seven blue chip companies account for a massive 50 percent of dividend payouts in the UK and when events come out of leftfield literally millions of investors can feel the pain simultaneously. In 2010, oil group BP slipped from fifth to seventh best payer following the Gulf of Mexico oil spill, while in 2009 Lloyds lost its seventh place in the wake of the banking crisis.

A 1990's study of study of 60,000 private investor portfolios by Kumar and Goetzmann at one of the US's biggest discount brokerages found that investors on average owned only 4 stocks. We strongly favour much wider diversification than this because the most important thing in income portfolios becomes the health and dividend generating capacity of the whole. By spreading out your portfolio, you reduce the chances that one stock or industry issue could derail your investment plan. Sure, Warren Buffet may run a focused portfolio but how many investors have his command of the detail?

Parsimony Investment Research suggest some useful rules for a dividend portfolio – they argue that an investor can reduce portfolio risk meaningfully by holding a combination of stocks that are not 100 percent positively correlated along the following lines:

Maximum Stock Position: 3-5 percent of total portfolio. The idea here is that a portfolio should include 20-30 high-quality dividend stocks, with no stock accounting for more than 5 percent of the total portfolio.

Maximum Industry Position: 15-20 percent of total portfolio. Their view is that a portfolio should include stocks from a variety of industries and certainly no one specific industry or sector account for over 20 percent of the total portfolio.

Maximum "High Yield" Exposure: 20-30 percent of total portfolio. They define high yield as stocks with yields greater than 6.0 percent, as these tend to be either speculative in nature or involve special circumstances (e.g. REITs). Clearly, this will be a matter of debate, depending on one's appetite for high yield.

Maximum Portfolio Beta: less than 0.75

While these guidelines look sensible, we'd suggest some simpler rules of thumb to play it safe…

> Limit any single holding or sector to no more than one-third of your portfolio. Weed out less successful holdings that shrink to become an insignificant part of your portfolio, for example less than 2 percent (other than recovery shares which you are actively monitoring).

Further Reading

- Building A DIY Dividend Portfolio[35]

[35]http://seekingalpha.com/article/829241-building-a-diy-dividend-portfolio-part-3-asset-allocation-rules

Asset Allocation & Rebalancing

"Gentlemen who prefer bonds don't know what they are missing" Peter Lynch

While equity investors enjoy nothing more than spending hours labouring over which stock to buy, evidence suggests that this could be misplaced energy. Research presented by Ken Fisher in his book, "*The Only Three Questions That Count*", shows that only 10 percent of an investor's portfolio returns come from stock selection, with 70 percent of investment returns coming from overall asset allocation!

Asset Allocation is the proportion in which an investor splits his port- folio across different asset classes - i.e. stocks, bonds, funds, real estate, commodities and cash. While many believe it to be bunkum, Modern Portfolio Theory suggests that since risk levels and portfolio returns are directly related, you should balance your desire for return with your ability to withstand the ups and downs of the market. But how do you do this systematically?

Determining need – the 4 percent Rule

Under conventional retirement planning, one accumulates assets during his or her working years, and then begins selling assets upon retirement to provide income. The rate at which an investor sells down assets is determined by things like the 4 percent Rule. This is a rule of thumb proposed in the 1990s by Bill Bengen, a financial adviser. He suggested that, if you spend 4 percent of your capital in your first year of retirement, you can go on spending that much until you die. Based on this, you can back out the capital sum required to fund your longer-term needs, for example you would need £250,000 in savings to provide £10,000 per year in needed income.

While this can be a useful guide, it does assume a standard 30-year retirement period. It may not accurately reflect future inflation rates, the risk of stock market downturns and your own longevity/health care bills. It is also worth noting that DGI investors tend to focus on the income generation potential of your investments, rather than the size of the capital pot.

What is your risk tolerance?

When thinking about how to achieve your target level of capital, you can use the following guidelines to estimate your comfort level with risk:

High risk tolerance: You are likely to be far away from retirement. You're comfortable with the possibility of steep losses in order to maximise potential return, and you're able to sleep at night when the market is in turmoil.

Average tolerance: You can handle drops in price, even for extended periods, but extreme swings makes it hard for you to sleep at night.

Low tolerance: You need your investment income to fund your lifestyle in the near term. In this case, you're likely to be weighted heavily towards cash, bonds and blue-chip dividend stocks.

Own your age in bonds?

Once you've decided where you stand, coming up with a targeted asset allocation does not need to be overly complex. The higher your risk tolerance, the higher the proportion of equities in your portfolio basically.

An old rule of thumb is that your stock allocation percentage should be 100 minus your age (this is the same as "own your age in bonds"). For example, if you're 30, you should keep 70 percent of your portfolio in stocks. If you're 70, you should keep 30 percent of your portfolio in stocks.

However, with people living longer, financial planners have altered this to a more aggressive "110 – age" or even "120 – age". That's because if you need to make your money last longer, you'll need the extra growth that stocks can provide. Others suggest using your adjusted "allocation age" (i.e. the average age for everyone who has an interest in your portfolio). For example, if your spouse is 8 years younger than you are, your adjusted allocation age would be 4 years younger than your own age.

Alternatively, John Bogle (the founder of Vanguard) has advocated a simple 50/50 portfolio for many years. In a 2001 essay, *The Twelve Pillars of Wisdom*, he argued: "There are an infinite number of strategies worse than this one: Commit, over a period of a few years, half of your assets to a stock index fund and half to a bond index fund. Ignore interim fluctuations in their net asset values. Hold your positions for as long as you live, subject only to infrequent and marginal adjustments as your circumstances change. When there are multiple solutions to a problem, choose the simplest one."

The issue with these "simple" approaches, however, is that a) they don't factor in other asset classes (e.g. commodities) and b) you usually end up owning a lot of bonds. One of the themes of this book is that judicious dividend stock investment can provide a stable income stream that may partly offset the needs for bond investments. As we'll soon be discussing, on the back of a 30 year bond market bull run and with interest rates at an all-time low, being too overweight in bonds might not be such a good idea after all.

In any case, the key is finding something that you are comfortable with (remembering that, on the whole, people overestimate their risk tolerance). It's then important to track your allocation closely and to look at rebalancing at least once a year. When assessing your actual vs. targeted asset allocation, don't forget to factor in your exposure to asset classes through your pension (usually very bond-heavy).

Rebalancing

Portfolio rebalancing means that as some assets appreciate and others depreciate, you periodically adjust your allocations to stay in line with your original plan. This involves taking counter intuitive action of selling investments in markets that are performing well and buying more of less well-performing asset classes. This is done because markets have cyclical tendencies, meaning that a poorly performing asset class won't always do badly and a high-flying asset class will eventually come back down to earth.

The balance of your portfolio will change constantly, even if you do nothing. Markets rise and fall over time. Dividends will be paid and (hopefully) re-invested. Some holdings may acquired or - despite your best efforts - go under. If a portfolio is not rebalanced, it will gradually drift from its target asset allocation to higher-return and, therefore, higher-risk assets. How should you respond to these changes? Broadly speaking, here are the options:

1. Do nothing , i.e. you decide to let the portfolio take care of itself
2. Annual/Periodic Rebalancing: Aim to restore the balance each year, or fairly constantly, as you buy and sell
3. Threshold-Based Rebalancing: You impose upper and/or lower percentage limits and let the portfolio fluctuate within those limits.
4. Tactical/Dynamic rebalancing: This is where an allocation is shifted once certain pre-agreed market conditions come into

> being. For example, a neutral equity allocation might be 50 percent but with an agreed tactical shift down to 40 percent if P/E ratio is higher than, say, 18.

Each approach has advantages and disadvantages. The most important thing is to be rigorous in the implementation. Rebalancing tends to clash with our normal 'fear and greed' response, which is why it's best to set down the approach in writing so you can refer back to it.

Further Reading

- Siegel: The Future for Investor[36]s
- The 50/50 Portfolio Solution[37]
- Vanguard: Best practices for portfolio rebalancing[38]

---

[36]http://www.amazon.com/The-Future-Investors-Tried-Triumph/dp/140008198X
[37]http://portfolioist.com/2011/12/08/the-50-50-portfolio-solution/
[38]http://www.vanguard.com/pdf/icrpr.pdf

The merits of dividend stocks vs bonds

"When reward is at its pinnacle, risk is near at hand" Jack Bogle, founder of Vanguard Group

Bond prices are generally less volatile than equities, dividend paying or not. Bond prices fluctuate with interest rates, inflation, fear and the credit ratings of the issuer, but these price fluctuations are dampened by the flow of a guaranteed stream of interest income and the guaranteed return of the principal.

Most bonds are 'secured' against the company's assets, so that even in the case of bankruptcy bondholders are likely to be paid back by the administrators first. The common shareholder is only entitled to whatever remains after all bondholders, preferred shareholders other creditors are paid out, which is regularly nothing at all!

So dividend stocks don't carry a promise that you'll get back what you paid. We've also seen that there is always the chance that the yield will be cut due to market uncertainty and the temporary poor health of the companies paying the dividends. As a result share prices tend to be a lot more volatile. Jeffrey Gundlach, the famed bond investor, illustrated the difference between bond and equity volatility by saying:

> "If the yield on the ten-year bond doubles overnight from 3 to 6 percent, you've lost about 20 percent of your principal – but if Microsoft's yield doubles from 3 to 6 percent overnight, you've lost 50 percent of your principal."

However, while these facts are generally true, it's important to recognise some important caveats about bond risk that may mean they are far more risky right now than most investors are expecting.

Firstly, bond markets have been in the longest bull run (30 years +) in history, with bond yields having dropped to levels not seen in at least 50 years. It is certainly arguable that interest rates have nowhere to go but up. Of course, it may be that the economy will continue to stagnate and interest rates will stay low but when any market is at an extreme in terms of values, reversion to the mean is a decent bet.

Secondly, bonds provide zero hedge against inflation. Government bonds are regularly yielding less than the rate of inflation or even, in the case of a recent German auction, less than zero. So even if you do receive your principal back it may be worth far less in purchasing power than it was when you initially bought your bonds.

Inflation looms - why the time for stocks is near

The one aspect where dividend stocks beat bonds hand-down is in combatting the ravages of inflation. If you buy a bond at a par value of £100, when it matures you will only receive the same £100 without any adjustment for inflation - in the same way, the reason that bonds are known as “fixed income” investments is that their coupon rate (essentially their yield) never rises. As a result there is a significant risk that the income you earn while holding a bond to maturity won’t compensate you enough for the loss of purchasing power. In contrast, the dividends from well-chosen dividend stocks can typically grow much faster than inflation - providing a far better hedge than bonds.

As mentioned in the introduction, we may be living in an era of ‘financial repression’ where governments legislate to ensure enough demand for their AAA rated bond issuances while paying yields that are so low they pay out less in interest than is required to match inflation.

Effectively these bonds are losing value after factoring in inflation so the case for dividend stocks as an alternative source of portfolio income is stronger than ever. Could it be appropriate for an investor to switch their asset allocation to more heavily weight stocks over bonds? Yes. Especially if the forecast is for higher future interest rates and better economic times ahead (as interest rates rise, bond prices go down).

But it's important not to be blind to the risks that exist with dividend stocks as they do have a lower place in the hierarchy of the corporate capital structure. Dividend income streams are theoretically more risky than the equivalent income stream from high yield bonds.

One concern that's been raised of late is the possibility of a dividend bubble forming, given the weight of retail and institutional money moving into the space. Deluded by their quest for yield, are inexperienced investors sleepwalking into a dividend trap?

Could a dividend bubble be on the horizon?

So far, this looks to be a stretch. As Dan Kadlec notes, not every rally is a bubble. Bubbles and investment manias tend to display several characteristics. Usually, investors start buying with the expectation that they will be able to flip the asset to a more willing buyer. This demand is often fuelled by leverage, which magnifies gains, which in turn draws in more buyers. Investors become more and more exuberant, dismissing risks and discarding traditional valuation methods with talk of a "new era" to justify the ascent in prices.

Dividend stocks do fortunately have a self-correcting mechanism built in. If the price rises, the yield falls, making the shares less attractive. In theory, that should keep prices from getting too out of line, although the strong focus of DGI investors on dividend growth arguably breaks that link.

In absolute terms, this is not yet a low-dividend yield environment. P/Es and valuations may seem stretched relative to many non-dividend paying stocks - but only relative to them. As of late 2012, there's very little evidence of dividend stocks selling at absurd valuation multiples (e.g. P/Es north of 30x+). There continues to be very juicy dividend yields available from really solid companies.

It could still get ugly…

This is not to say that there is not a fair amount of yield chasing going on or that defensive / dividend paying sectors of the market are not becoming relatively expensive. Clearly, there are many reasons why you could see a nasty / painful exodus from dividend stocks:

- Interest rates could rise substantially - since the TMT bubble burst, interest rates have been on a relentless march down but this could reverse as inflation spikes.
- The macro-economic picture could improve markedly, encouraging money out of defensive stocks.
- There could be a structural change in the market (for example, a tax change) that might make it less attractive to pay (or receive) dividends.
- A long recession could cause seemingly perpetual "dividend growers" to cut or stop increasing temporarily their payments.

As ever, the most important thing is to focus on robust stock selection methodologies, apply a margin of safety, and avoid warning signs such as:

- Soaring valuation multiples vs. the market or other sectors..

- Low dividend yields in absolute terms (e.g. less than 3 percent)
- A high risk of a dividend trap.
- Flashing momentum indicators, such as prices well above the 200-day moving average.

Further Reading

- Why Dividend Stocks Aren't the New Bonds[39]
- The Bond Bubble and the Case for Stocks[40]
- [The Bond Buyer's Dilemma] http://online.wsj.com/news/articles/SB10001424
  wsj&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB1000142405297020

[39] http://online.wsj.com/news/articles/SB10001424052970204542404577158761922787578?mg=reno64-wsj&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB10001424052970204542404577158761922787578.html

[40] http://online.wsj.com/news/articles/SB10001424053111903639404576516862106441044?mg=reno64-wsj&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB10001424053111903639404576516862106441044.html

When to sell

"I never buy at the bottom and I always sell too soon" Nat Rothschild

"Buy low and sell high" is the mantra of a lot of investors, but is less often adhered to by dividend investors who tend to subscribe to a "buy and hold" philosophy. They tend to be more comfortable holding onto their investments even as they soar in value far above what they are realistically worth because the focus is on the dividend income, not the share price.

Still, if an investor buys in at a high yield, but later the current yield becomes much smaller due to price appreciation, should they look to sell? They are still getting that high yield but the opportunity cost of the investment has increased, assuming the price has appreciated faster than the market, and better investments may be available.

Many dividend investors argue against selling or rebalancing, maintaining that the original yield on cost locked in with the purchase is there to stay, as long as the dividend is at least maintained. If a stock you purchased had a current yield of 8 percent, your yield on cost is 8 percent. It doesn't really matter if the stock is currently yielding 1 percent or 2 percent - you still earn 8 percent on your cost. One consideration worth making on this point, however, is the impact that a falling yield could have when it comes to reinvesting dividends. While you may have locked in a healthy yield with an initial purchase, you may not necessarily get that yield again when it comes to reinvesting. Once again, it comes down to your strategy – yield or growth – and it requires regular monitoring, as we'll discuss in a moment.

Why sell ever?

Indeed, some dividend growth investors, such as David van Knapp, argue that you shouldn't need to sell dividend stocks ever. Why is that? Under conventional retirement planning, an investor accumulates assets during his or her working years, then begins selling assets upon retirement to provide "synthetic" income (using the 4 percent Rule discussed above), i.e. income not generated naturally by the investments themselves.

Instead, van Knapp suggests that ideally nothing should be sold at all by a dividend growth investor. Instead, the income generated naturally by the assets should be all that is removed from the investment account. On this view, price falls or even a bad economy should pose no particular threat to most of this dividend income, because there is little correlation between dividends and stock prices.

Nevertheless, while a "buy and hold" approach to dividend investing may have some merit, this should not be the same thing as "Buy-And-Forget" – a better approach is likely to be "Buy, Hold & Monitor". Dividend investors do still need to be vigilant and keep a close watch on their investments to ensure that their dividend income stream remains intact. Things may change in an uncertain world and adjustments must be made from time to time. A purist "buy and hold" approach also isn't really practical if you have press- ing and unexpected liquidity needs that exceed your current / planned income.

With that in mind, here is a "sell signal" checklist of four key questions which cover the major scenarios where it would make sense for a dividend stock investor to review their position:

Question 1: Has there been a dividend cut?

If a company reduces or eliminates its dividend, then this may be an appropriate time to sell for a dividend investor. This is not just because of the loss of the long-term passive income stream but also because the market response to such cuts tends to be indiscriminate. As we've discussed, several studies have shown that investors simply flee from the shares and in the large majority of cases the stock price of firms that cut dividends drops dramatically on the news.

While some commentators may present this as a hard and fast sell rule, it's still worth being circumspect. Firstly, you might be selling out at the bottom and, secondly, as we've discussed elsewhere, a dividend cut is not always bad news from a medium-term perspective. Companies may cut or suspend dividends for several reasons; some clearly have negative implications for the future prospects and the value of the firm, whereas others have more positive implications.

It may be: a) a last ditch response to operating problems (declining earnings and losses), i.e. the company has finally run out of other options (very bad news), b) a pre-emptive action to increase financial flexibility and avoid future problems e.g. by using the cash saved to retire debt (moderately bad news), or c) it could simply be because the firm wants to invest more than it expected, e.g. a dramatic improvement in its strategic options (potentially very good news for its long-term prospects).

A classic example of a 'good news' dividend cut is Florida Power & Light in the US. In 1994, FPL cut dividends by a significant 32 percent, marking the first cut by the company in 47 years. It was a decision taken in the midst of uncertainty caused by deregulation in the electric utilities industry. Far from financial distress, FPL announced, at the same time as it cut dividends, that it was buying back 10 million shares over the next three years and emphasised that dividends would be linked more directly to earnings. As expected, on the day of the announcement, the stock price dropped 14 percent but recovered this amount in the month after the announcement and earned a return of 23.8 percent in the year after, significantly more than the S&P 500 over the period (11.2 percent) and other utilities (14.2 percent).

So, while sometimes the cancelled payout is a sign that the company is toast, in other cases, the action may be in the shareholders' long-term interests. A company may be taking prudent measures to conserve cash in tough times or it could be a wise decision to divert cash to exciting new projects. The level of scepticism shown by investors towards claims by companies of increased investment requirements at the time of a dividend cut is understandable, especially if the firm also reports lower earnings and has a history of poor project returns. However, the data suggests that the market tends to be overly-sceptical. So, if you're still a shareholder in a company that decides to scrap its dividend, it may not make sense to sell the stock straightaway. Each individual case should be taken on its own merits. There looks to be value to examining closely timed earnings and dividend cut announcements to see if the market reaction is justified.

Question 2: Has there been a fundamental change in the business?

If a company changes dramatically, it's worth reviewing its usefulness as an investment to you. It's always worth writing down at the time of purchase the specific thesis that underlies the investment and any metrics for tracking this. This allow you to monitor how future events have impacted that thesis objectively, without getting caught up by hindsight bias or issues of loyalty or saving face. Using this, it's very good practice to periodically review your investments and ensure that you still own them for logical reasons.

Examples of major changes that may undermine your reasons for investing in that company include massive M&A, or a re-focusing of the business, or a huge macro-economic shift, or that the company is increasing its debt beyond the point that you are comfortable with. In the case of M&A, frequently, such deals are made with a lot of cash — meaning there may be less to pay out in dividends. Alternatively, you might find that a company with a great yield and good potential for shares has been bought by a stingier or less favorable competitor. It may be better to dump the position instead of accepting the resulting shares from the buyout. Another example of fundamental change could be the oil disaster in the Gulf of Mexico for BP Plc. The company was just not prepared for the situation and, as the damage claims mounted, investors lost confidence in management to resolve the issue, leading to a sell- off and a dividend cut.

Question 3: Is the stock down by over 50 percent since your purchase?

Jeff Reeves of InvestorPlace.com suggests another circumstance where dividend investor should maybe look towards the exit. He notes that, while fluctuations in share price are not necessarily a problem for dividend investors, watching a position decline by over half should set off warning bells. His rationale: *"A dividend stock with a yield of about 2 percent will take 50 years to "double your money" via dividends… Waiting five decades (if not reinvested) just to get back to square one doesn't make any sense no matter how healthy the dividend payout is"*. Sometimes you may be better off taking the loss and moving on to greener pastures, rather than relying on a recovery that may never come.

Question 4: Is the stock severely overpriced?

As we've discussed, dividend investors are mostly focused on the dividend income rather than the stock price. However, there are some circumstances where even the most hardened income investors might be cautious, namely where the stock has become so overpriced that you're unlikely to earn a Total Return, even factoring in the dividends, because there is material and significant risk to the share price. One way to spot such a scenario is where the dividend yield has declined to historic lows. This was the approach used by a range-trading dividend investor like Geraldine Weiss, the time to sell was when the dividend yield declined to historic lows. This suggests that it's likely that the stock will "mean-revert", leading to a significant loss of capital.

Keeping a cool head

It's important to remember dividends typically increase over time on average while cash in the bank typically loses its purchasing power over time. As a result the investor who takes profits today might lose out on any increases in dividends as well as on any future price gains.

If the price of a stock falls dramatically in a short period of time, this is often a reason NOT to sell a position. You have to keep a cool head and remember the reasons why you invested in the company. If the fundamentals remain the same, the dividend is in no danger, earnings and revenue appear to be growing and the valuation is attractive, this may be an opportunity to average down and lower your cost basis on a holding.

However, paying attention to the above questions should help you manage your downside risk. If, however, the market is exiting a stock because of serious issues this would be a good opportunity to review the company's financial information and make sure the long-term health is intact. If it's not, then one of the above three criteria are likely to apply and you'll likely want to sell and redeploy that capital.

Timing any sells

A final thing to bear in mind in terms of when, rather than whether, to sell is the well documented price action around the ex-dividend day – as we've discussed, stock prices tend to see a run-up in the period immediately before the ex-div date and fall by less than the amount of the dividend on the ex-div date itself. While market timing on its own is generally futile, this does provides a relatively predictable pattern that is worth bearing in mind when you're considering a stock sale or purchase for other reasons.

SocGen research indicates that, in Europe, with its often annual or large final dividend payments, ex-dividend dates and payments are highly concentrated in April and May. The bulk of these ex-dividend events occur in these two months, which contain over 65 percent of all the ex-dividend events and 50 percent of total dividend payments for the year. Unless you're a forced seller for liquidity reasons, it's best not to sell a stock around these dates.

Further Reading

- When is it time to sell a Dividend Stock[41]
- 3 Reasons to Sell a Dividend Stock[42]

[41] http://investorplace.com/2012/08/when-to-sell-your-dividend-stocks/
[42] http://dividendmonk.com/3-reasons-to-sell-a-dividend-stock/

Chapter 9

Where to find dividend stocks

Where can you find good ideas? Of course, that's the million dollar question and there is no one definitive answer. While many of the 'City grade' resources used by professional investors have been around for a long time, the good news for all of us is that a great deal of it is now available on the Internet. Combine that with improved access to market data, increasing scrutiny of companies and their accounts and the explosion of successful investors documenting their activities through books and blogs, and the prospective Dividend Investor has an armoury of resources close at hand.

To generate ideas, we're big believers in a) starting with quantitative stock-screening b) leveraging the power of the Web and c) reading as widely as possible to learn from others, following Charlie Munger's words of counsel:

> "In my whole life, I have known no wise people (over a broad subject area) who didn't read all the time – none, zero… You'd be amazed at how much Warren [Buffett] reads – and how much I read."

The Quant Approach - Screening and Indices

"A man who dares to waste one hour of time has not discovered the value of life." Charles Darwin

Screening the market by using a set of quantitative criteria is a great way to generate dividend stock ideas. It's the basis of our ap- proach at Stockopedia and follows in the footsteps of Benjamin Graham, Joel Greenblatt and other investing luminaries. The benefit of quant screening is that it is a dispassionate approach that highlights out of favour names that may be being overlooked.

Humans are emotional, spontaneous and biased animals designed primarily for a bygone hunter gatherer age, certainly not for advanced financial analysis! Too often, that means that people tend to generate their investment ideas in anecdotal or circumstantial ways based on gossip or tips, rather than focusing systematically on the best ideas. Screening helps to counteract these behavioural weaknesses and can help you find the real hidden gems.

Screening for dividend stocks can come in several forms, all of which are worth considering:

1. Checking daily ranking lists like the list of the highest yielding stocks in the market and highest forecast dividend growth rates. These 'raw' lists can often highlight surprising names.
2. Following Guru screens based on the approaches of investors that you respect - for example the Dogs of the Dow or Geraldine Weiss strategies previously discussed. There are many highlighted at the Stockopedia Screening portal, including all of the strategies discussed in the previous sections.
3. Running your own screens, based on metrics you've found useful (and ideally back-tested).

For this, apart from Stockopedia itself, there are the usual financial data website suspects, but relatively few of these sites have much of an income focus. One site that does is Dividend-Investors.com. Registration is required but it has a handy UK version (www.dividendinvestor.co.uk). It provides investors with basic divi- dend data as well as its Dividend All-Star Ranking, which lists top- performing dividend-paying stocks. It also includes some basic in- come screening capabilities, along the lines of our High Yield lists and our screens like the Dogs of the FTSE.

Dividend History Indices

Any dividend growth investor worth his salt is keen to examine dividend histories over long timeframes. In the US, this is easy as there are publicly available indices or lists:

Dividend Achievers - This is a list maintained by Indxis of US companies that have increased their annual regular dividend payments for the last 10 consecutive years.

Dividend Aristocrats – This is a list of large cap, blue chip companies within the S&P 500 that have consistently increas- ing dividends every year for at least 25 years. It is maintained by S&P.

Indxis has also launched a UK Dividends Achievers Index but it just defines Achievers as a meagre 5 years of increased dividends (not such an achievement really!). Fortunately, S&P has now launched a UK equivalent of its Dividend Aristocrats Index, SPDR S&P UK Dividend Aristocrats. This tracks the 30 highest dividend- yielding UK companies that have increased or held dividends stable for at least 10 consecutive years. They have also launched a related ETF. S&P also produces an index of consistent dividend payers for European companies, the S&P Europe 350 Dividend Aristocrat index. However, you can also screen for up to 10 years of Dividend Streak on Stockopedia, and then layer on any other value, growth or other filters as you see fit.

For globally minded investors, it's worth checking out a Dutch site called Top Yields, which has good global data. And for those interested in fixed income more generally, it's worth checking out the resource built by Mark Taber at fixedincomeinvestments.co.uk.

Stockopedia Subscriber Tips

In addition to these lists, it's also worth consulting the Drip Investing Resource Center. This site is updated by David Fish and the master spreadsheet includes 3 different lists: ⊠ - Dividend Champions - a list of US companies that have increased their dividends for 25 years. - Dividend Contenders - a list of US dividend streak compa- nies from 10-24 consecutive years. - Dividend Challengers - a list of US companies who have increased their dividends from 5-9 consecutive years.

Until recently, there’s been no real UK equivalent to these lists, apart from within the investment trust space where the Association of Investment Companies publishes a list of trusts that have increased dividends for the longest number of consecutive years. Top of the table are the City of London Investment Trust, the Alliance Trust and the Bankers Investment Trust, all of which boast 45 year dividend growth streaks!

Stock Screens[43] - we are tracking a growing collection of investment models and stock screens based on investment classics, academic research and famous investors (including all the strategies discussed earlier). For the current top performers, click here[44]. Alternatively you can ‘fork’ our models and tweak.

The Scuttlebutt Approach

Screening can sometimes throw the baby out with the bath water. As a hard edged approach it can’t pick up the many sizeable dividend opportunities that may be available in ‘the cracks’ of the stock market. The best way to find them (without doing the work yourself!) is to dig into the ‘scuttlebutt’ of conversation that lies out there in the blogosphere.

Blogs

There are a growing number of high quality investment blogs that focus on value opportunities and dividend payers. In the UK, the best blogs are mostly value-focused (e.g. Richard Beddard of Interactive Investor) which often have a significant overlap with

[43]http://www.stockopedia.com/screens/
[44]http://www.stockopedia.com/screens/

dividends. But the best dividend focused blogs tend to be North American which are well worth reading even if you don't invest there, especially:

The Dividend Guy Blog - Dubbed as "one guy's journey to passive income through dividend investing", this is a popular US stock idea & analysis blog that has been around since 2005.

Dividend Growth Investor - Set up in 2008, this blog shows how one investor has implemented the dividend growth strategy and is a useful source of stock ideas.

Dividend Growth Stocks - A blog/site dedicated to the proc- ess of identifying superior dividend investing using a value- based approach. He also writes as Dividends4Life.

Div-Net - This is an aggregation site and investor network set up by various bloggers which is focused on dividend invest- ing.

Disciplined Investing - This is the blog of David Templeton and Horan Capital Advisors. It covers a range of topics, in- cluding macro, but there's some good dividend coverage in there.

Other useful North American blogs include Dividend Ninja, Dividend Monk, Dividend Maven and Passive Income Earner.

The UK dividend blogging scene is a bit lacklustre frankly. Still, it's worth checking out the blog of the Munro Fund. Munro is a tracker fund which uses gross cash dividends to weight its holdings so they focus hard on the dividend universe. The Monevator blog has some good dividend coverage, including an excellent four part guide to building your own HYP. Another good blog is DIY Income Investor – it also discusses bonds etc. but has some good coverage of dividends and a good, free e-book. Steven Dotsch's Dividend Income Investor is also worth a read.

Bulletin Boards

Bulletin boards can be a useful source of ideas and ways to track "scuttlebutt". It's worth being aware of the herding instinct that can exist on social media sites, though. Social finance site, *Seeking Alpha* is the spiritual home of income invest- ing discussion, albeit with a strong US focus. The most followed / active contributors in the DGI space tend to be David Van Knapp, David Fish, Chuck Carnevale and Norman Tweed.

The High Yield Portfolio (HYP) discussion area on the Motley Fool UK is also worth perusing. Incidentally, on the Motley Fool USA, Todd Wenning has also published a number of useful 'Dividend Report Cards' for both the UK and US markets.

Tip Sheets

Since we believe in self-education/reliance, we are generally not keen on tipsheets but we'd make an exception for Stephen Bland (a writer for Fool & Moneyweek). He writes the Dividend Letter and is one of the better online advocates for high yield. Amongst the investing magazines, the Bearbull column of the Investor's Chronicle magazine is often insightful. From 2000-2011, the returns from the Bearbull Income Portfolio income fund were apparently 9 percent, versus just 0.3 percent for the FTSE All- Share index.

And, last but not least, there's a useful application and online resource called… Stockopedia[45]!

Key Stockopedia Subscriber Tips

Scuttlebutt - On top of our own market analysis, we syndicate many of the best blogs and research on the web and host a vibrant discussion community. You may find some of the best ideas & comment on our boards.

Piggybacking the best fund manager ideas

"Where are the customers' yachts?" Fred Schwed

[45]http://www.stockopedia.com

While there are many well managed mutual funds that can be a great source of dividend ideas, for the most part we'd hazard against investing in them. In other books we've discussed how most actively managed funds struggle to outperform due to high fees and misaligned incentives of the managers. But that doesn't mean that they can't be a great source of ideas… if you know how to look!

Perhaps the best known “Equity Income” focused fund manager in the UK is Neil Woodford. Previously at Invesco and now running his own fund, Woodford has had considerable historic success. It could be argued that those funds will struggle to match their historic record due to the asset bloat that comes with long term success - but there are certainly many other smaller funds in the UK Equity Income sector that are worth tracking.

Fund managers tend to keep their cards fairly close to their chest so their public commentary can be a little bland. Still, the Web makes it relatively easy to build a list of the better professional investors, particularly those whose philosophies you share, and look at their holdings directly. This is much easier in the US due to differences in disclosure requirements, but TrustNet still provides a very useful resource for UK stock pickers looking to piggy back the pros.

As a starting place to find the better UK income funds, Sanlam Private Investments in Bath publishes an influential guide. Its half-year review divides UK Equity Income funds into a white ‘buy’ list, a grey ‘hold’ list, and a black ‘sell’ list based on total returns and risk over five years. Clearly, this is just a backward-looking exercise but it's as useful a way as any other for separating the sheep from the goats. It's worth noting though that much research suggests that recent 3-5 year top performers tend to gather 95 percent of new investor's money and as a result often fail to replicate returns.

For each of these managers, you can see a list of their top 10 holdings on TrustNet. However, these lists are just a starting point as they are usually only a very small sample of the stocks held. To dig a bit deeper, it's best to revert back to the Annual Report for each Fund.

Further Reading

- Fred Schwed: Where are the Customers' Yachts?: Or a Good Hard Look at Wall Street[46]
- Sanlam Private Investments, The White List[47]

---

[46]http://www.amazon.co.uk/Where-Are-Customers-Yachts-Investment/dp/0471770892
[47]http://www.whitelist.co.uk

Chapter 10: Conclusion

"Education is an admirable thing, but it is well to remember from time to time that nothing that is worth knowing can be taught" Oscar Wilde

Dividend investing has come a long way since it was first invented during the 1600s – and some of the earliest lessons on what works and what doesn't still very much apply. Back then, the Dutch East India Company was emerging as an international powerhouse with a menacing mix of colonial and trade ambition, and it claimed a handful of corporate firsts in the process. It was the first business to issue stock to raise capital – and it founded the world's first stock exchange to do it, in Amsterdam. It also pioneered dividends as a means of regularly liberating profits to the investors that were backing its risky, albeit lucrative voyages to the East.

For 200 years the Dutch East India Company paid an average 18 percent annual dividend and in 1669, the payout on its shares represented a heady 40 percent of its stock price. But as competition increased and revenues were squeezed the company took increasingly drastic measures to prop up those shareholder payments. Inevitably, paying out dividends that exceeded surplus cash contributed to the company's implosion in 1798. Among its dubious achievements, the Dutch East India Company showed the world what damage could be done with a frothy yield and no cover!

More than 300 years later, keeping track of dividend yields, corporate quality, and the potential for long-term dividend growth remain the key challenges for income investors. But these are challenges that the brightest minds in finance have been learning to overcome ever since and it's been our goal throughout this book to learn all that they have to offer.

But a note of caution. Many investors wish to build the kind of low volatility high return portfolio that dividend strategies can deliver, but so few manage to stick to this route due to a perceived lack of excitement. The most important challenge we all face is to take to heart the sound underpinnings of why these strategies work and have faith that the return drivers are still in place even when they underperform in the short term.

As Warren Buffett has said, *"Investing is simple, but not easy"*, and the hardest thing to do is to stick to a well conceived plan when everyone else is having a party. If you can learn to avoid excitement, lengthen your investment timeframe from a few months to a few years and focus on higher quality, higher yielding stocks then you are well on your way to lasting success - just don't forget to reinvest those dividends!

Safe Investing.

Chapter 11: Appendix

Dividend Basics

What are Dividends?

Dividends are the profits distributed to shareholders by the corporation, when a company decides to share part of its profits with the shareholders this is called the dividend. When a company produces a profit it can be either reinvested into the business to fuel further growth or it can be distributed to shareholders. When a company is established and has a strong cashflow it will start distributing dividends - you won't find many start-up companies paying dividends.

How much is paid and when?

A company's Board decides how much each dividend payment will be. Each company will typically have its own dividend policy in which it outlines what percentage of the profits will be distributed, but companies are under no obligation to pay a dividend of any set level. Usually, this percentage ranges between 15-50 percent depending on the strength/maturity of the company and the volatility of its cashflows. Once the dividend has been declared, it will be paid to every shareholder.

In the UK dividends are normally paid semi-annually, after a company's interim and full-year results (e.g. split one-third at the interim stage and two-thirds at the year-end). However, some larger companies pay out dividends each quarter. The process of paying a dividend has several stages:

1. **Announcement/Declaration Date**: When a company publishes its results, normally between one and three months after the end of each half-year period, it will declare how much and when its next dividend payment will be. At the

time a dividend declaration is made, the company will typically announce three dates alongside the payment. These are the record date, the payment date and the ex-dividend date, although the phrasing used in the announcement may be different, eg. the dividend "…will be paid on [payment date] to shareholders on the register at [record date]".

2. **Ex-dividend (or ex-div) date**: This is the date by which a buyer needs to have bought shares in order to be entitled to a divi- dend payment. It's usually a Wednesday. Shares normally trade on the basis of cum (with) dividend so, on the ex-dividend date, the share price will typically fall by roughly the amount of the dividend. If you hold shares in a company and do not realise what's happening, this drop can be rather disturbing but it does make sense as the company is now effectively worth less for new buyers of shares. If a seller has sold the shares prior to the ex-dividend date and has received a dividend, this has been paid in error and a dividend reclaim will be raised to pass the dividend to the correct owner.
3. **Record date**: (also known as the 'books closed' data or the 'on-register date') This is the date (usually a couple of days after the ex-dividend date) when the company checks its register to see who is entitled to a dividend. Dividend entitlement however is still based on the ex-dividend date. This is often a Friday. On the standard T+3 settlement system operated in the UK (i.e. a trade settles three days after it is executed), investors need to buy a stock three days prior to the record date (that's to say, the day before the ex-dividend date) to be sure of qualifying for the dividend payment, since three days for settlement is needed before the shareholder's name goes on the register.
4. **Payment date**: This is the date that dividend cheques are posted or bank accounts are credited. It typically comes two weeks after the record date but it may even be months after the record date, so it is important to be aware precisely when

the payment is likely to be made. Note that if you buy the shares between the ex-dividend date and the payment date then you won't be entitled to that dividend. In newspapers, this period is often denoted by the letters 'XD' next to the share price.

How to calculate dividend yield

To calculate the historical dividend yield, you need to divide the last year's dividend per share by the current share price. Make sure you are using all the payments in a given year or use a 'trailing twelve month' period. Simply multiplying the half-year (interim) payment by two is unlikely to work, because companies typically make a larger final payment than the interim payment.

A key problem with historic yield is that a company's current share price valuation is likely to factor in expectations about the future, not just information about its past payments. In contrast, the forecast dividend yield is based on an estimate of what the total dividend payment for the current year will be (e.g. by using consensus forecasts from analysts). It is therefore more subjective but may capture important information about the company's future prospects.

The **rolling yield** is based on weighting the current and forecast yield depending on how far the company is through its financial year-end – this adds comparability across stocks.

Worked example

Let's imagine that in March you bought into pharmaceutical group Astrazeneca at 2958p a share. It paid a full year annual dividend of $2.80 last year end in December and is forecast to pay $2.94 next year. In that case, the historic yield would be 5.97 percent at the time of purchase and the forecast yield would be 6.27 percent, whereas the 'rolling' yield would be 6.04 percent a quarter of the way between.

Which yield should you focus on?

It rather depends. If you're evaluating a well-monitored blue chip share, analysts' forecasts are likely to be more accurate so it's probably safer to base your decisions on the forecast yield or a rolling yield. If you're considering investing in a more neglected, small-cap business, you may want to approach it with a greater degree of scepticism or consider developing your own forecast. Either way, it's worth checking if there are special circumstances that could mean that the dividend payment in question is unrepresentative (for instance, has the company made a one-off special dividend due to an asset disposal?).

Current Yield vs. Yield on Cost

A final distinction worth being aware of is between current yield and yield on cost. The yield on cost is the current dividend per share divided by the original pur- chase price. It is often the number focused on by an investor but it doesn't actually reflect the opportunity cost of continuing to hold your shares versus other higher yielding opportunities that may be available to you in the market right now.

How to minimise dividend taxes

As we've discussed, it's important to keep a close eye on taxes when investing in dividend stocks. Historically, dividend income has almost always been taxed less favourably than capital gains and income is taxed upfront. Berkshire Hathaway's Charlie Munger illustrates why this matters with the example of an investment offering a 10 percent annual return which pays taxes every single year against one that pays all taxes in a lump sum at the end: *"You add nearly 2 percent of after-tax return per annum from common stock investments in companies with tiny dividend payout ratios."*

But it's not all bad. The Treasury is kinder to basic rate tax payers and you can prevent taxes from eroding your portfolio performance, as long as you remember to always buy them in a tax- efficient wrapper like an ISA or a SIPP in the UK. We'll make a few suggestions below for maximising total returns.

In essence, dividend investment is basically subject to three forms of tax: stamp duty, capital gains tax and income tax.

1. **Stamp Duty** This is a flat 0.5 percent tax on buying all shares (but not unit trust shares as the trust pays it). There's not much that can be done about this. Frankly, this is an arbitrary tax on investing that most sensible commentators think should be repealed but, unfortunately, this looks unlikely to happen any time soon for political reasons. Of course, stamp duty is not applicable if you're spread-betting and, while you might assume that dividends are not payable when spread-betting, in fact they are. However, it's important to calculate the interest charges built into the spread and compare this

cost vs. the stamp duty you're saving on. While spread-betting may be attractive over the short-term, it's likely to be far less attrac- tive for long-term "buy and reinvest" dividend income investors.

2. **Capital gains and capital gains tax (CGT)** A capital gain is made if you sell a dividend stock for more than you paid for it. Each tax year you have a capital gains tax (CGT) allowance which is known as the annual exempt amount. This is the amount of profit you can make from disposing of assets in that tax year without having to pay any CGT. Any profits above this amount are taxed. The profit is added to your taxable income for the year and any part of the profit falling within your basic-rate band is taxed at 18 percent, anything more at 28 percent. However, some investments are exempt from CGT such as gilts, most corporate bonds and stocks & shares ISAs. It's important to keep track of off-setting capital losses but remember - you can't use losses on ISA investments to reduce Capital Gains Tax on profits from investments outside the ISA.
3. **UK Dividend Income Tax** If you have ever been a shareholder in a UK company, it's likely that at some time you've received a dividend cheque in the post and the joy that comes with knowing that this is income that you haven't actually had to earn. But you also receive with your cheque a tax voucher that shows the amount of the dividend you've received from your shareholding and an additional tax credit line. These both add up to your gross dividend in- come and generally create a bunch of confusion.

Double Trouble: What is this tax-credit anyway?

Dividends are paid out of a company's net (after tax) profits. But dividends are treated as income by the taxman, and as a result are liable to be taxed at the prevailing rate of income tax. This effectively leads to a form of 'double taxation' whereby if a company paid out all its profit as dividends, the cash received by the investor would be taxed twice - first by corporation tax, secondly as income tax.

Since 1999, all UK company dividends have carried a tax credit of 10 percent. The tax credit applies to all dividends regardless of whether the shares are held directly or in a fund such as a unit trust, OEIC or investment trust. The 10 percent tax credit can be set against your tax liability, but your ability to “use” that tax credit depends on whether you are a non-taxpayer, a basic rate taxpayer or a higher rate taxpayer. This effectively means that basic rate tax-payers get their dividends tax-free, while still hitting the higher tax payers at an effective rate of 25 percent or 36.1 percent depending on the tax band.

How it works

At the basic level this works a bit like PAYE. The divi-dend issuing company is deemed to be paying the basic rate of income tax (10 percent) for you at source on your gross dividend income, before sending you your post-tax dividend cheque. Once this whole shenanigan has been applied, the dividend you actually get in the cheque is the actual dividend advertised by the company. Phew.

In reality, the tax credit system means that investors earning a total annual taxable income below £42,475 (i.e. 34,370 plus the tax free allowance of £8.105) are required to pay no tax whatsoever on their dividend income **(figures correct as of December 2012)**. This is because, for these individuals, dividend income is taxed directly at source at a rate of 10 percent.

If, on the other hand, your total annual taxable income is more than £34,370 above the allowance but less than £150,000 you will be required to pay dividend tax at a rate of 32.5 percent. However, the 10 percent tax credit mitigates your liability, bringing the ‘real’ rate down to 25 percent. Similarly if you pay a total of 42.5 percent tax on dividend income that exceeds the higher rate Income Tax limit of over £150,000, the effective rate owed on the dividend income would be 36.1 percent.

- **Non-tax payers lose out** If your total income (including divi- dend income) is below the annual £8,105 allowance (i.e. you are not a taxpayer), you don't have to pay any more tax on the dividend, but unfortunately you cannot recover the tax you've already paid (or which you are credited as having paid). In effect the 10 percent is lost.
- **Basic rate tax payers effectively pay 0 percent tax on dividends** So if you are a basic rate taxpayer (< £34,370 income above your £8,105 base allowance) you end up paying no tax at all on your dividend as your income tax liability is exactly equal to the tax-credit issued and paid for you by the company (10 percent!). If you receive a £90 dividend cheque the company has actually issued you with a tax-credit adjusted £100 gross dividend but paid the £10 in tax for you. As a result basic rate tax-payers then don't need to worry about whether dividends are received in an ISA or not, as effectively they are paying no tax on dividends anyway.
- **Higher rate tax payers effectively pay 25 percent tax on dividends** Higher rate tax payers (> £34,370 but < £150k income above your base allowance) pay 32.5 percent tax on gross dividends, but as they've already paid 10 percent before receiving their net dividend cheque the effective additional tax they have to pay becomes 25 percent. An example helps - imagine you receive a gross dividend of £1111 (i.e. a dividend cheque of £1000 + a £111 tax credit). That £1111 is taxed at 32.5 percent to leave you with £750 net after all taxes - so on top of the £111 tax paid at source, you effectively have to pay an additional £250 (25 per- cent) on top. Unfortunately tax payers in this band are suffering from the aforementioned dreaded double taxation.
- **Additional rate tax payers effectively pay 36.1 percent on dividends** Additional rate tax payers (> £150k income above

the base allowance) pay 42.5 percent tax on dividends, but as they've already received the 10 percent tax credit effectively the rate becomes 36.1 percent. e.g. imagine you receive a gross dividend of £1111 (dividend cheque of £1000 + a £111 tax credit as in the example above). In this case the £1111 received is taxed at 42.5 percent to leave you with £638.88 net - i.e. you effectively have to pay an additional 36.1 percent on your dividend cheque received or just over £361.

Tax-efficient investing

Still, you can benefit from the reported out-performance of dividend stocks as long as you always buy them in a tax-efficient wrapper like an ISA, a Child Trust Fund or a SIPP. With these investment accounts, taxes are either waived or deferred allowing dividend income to accrue and allowing it to be reinvested at the full face amount. The higher your income tax bracket, the more important it is to do this. One of the biggest mistakes an investor can make is to forget this.

Any gains from investments in an ISA are tax-free and income is also tax-free although you cannot reclaim the tax credit paid on dividends. Contributions into a pension scheme attract income tax relief. Also, when you sell the investments to buy an income in retirement, part of this money can be taken as a tax-free lump sum.

If you are an ambitious shareholder, you'll be planning on reinvesting dividends and growing your pot over time. While basic rate taxpayers may think that it doesn't matter whether they buy dividend paying stocks in a tax-free wrapper or not (as they effectively pay 0 percent dividend tax) the truth is that if they reinvest their dividends consistently their shareholdings will grow to the point where their dividend income will tip them over to the higher rate tax band. At this point they'll suffer from double taxation and dearly wish they had bought them elsewhere. Given this it might be wise to always buy dividend paying stocks in a tax-free wrapper!

Other Dividend Strategies

Dividend Surprises

"Dealing with 'known knowns' not only reduces forecast risk but enables an intuitive approach to stock selection", Gerard Lane, Shore Capital

One seldom discussed – but very interesting – strategy is the one recently outlined by investment strategist Gerard Lane in a Shore Capital note. This involves focusing in on dividend surprises as a sign of company quality. A dividend surprise is not only a welcome financial boost but it's also a confident message from management that's likely to have a positive influence on the share price as well. However, according to Lane, *"there is much more proliferation of story around earnings upgrades and downgrades"*, which means there is a greater tendency to move sales and earnings numbers among analysts and less tendency to focus on the resulting dividend change.

How it works ShoreCap defines the 'dividend surprise factor' as the difference between what was forecasted 12 months ago for the forthcoming 12 months and what was actually delivered during the period on a dividend per share basis. By comparing historic 12-month dividend forecasts with how stocks then go on to perform, it is possible to lift the lid on those companies that are confident enough about their future to beat market expectations.

Why it works The line of thinking here isn't actually too far removed from the concept of scouring the market for Earnings Surprises as a source of superior returns. This phenomena is known as 'Post Earnings An- nouncement Drift' – and research has found that stocks that beat analyst forecasts tend to outperform the market for the next 6-12 months. This is generally credited to the fact that analysts are slow to revise these forecasts and the market does not fully react to the information about future growth conveyed by the earnings surprises.

As it turns out, this thinking can also be applied to dividends too – and it works even better. According to research by Michaely, post-dividend price drift "is distinct from and more pronounced than that following earnings surprises".

A higher than expected payout combined with management signalling optimism about the future mean that dividend surprises offer an intriguing and exciting pursuit for dividend investors that are looking for outperformance from their stocks. According to Lane, dealing with 'known knowns' not only reduces forecast risk but enables an intuitive approach to stock selection of favouring those companies that have over-delivered on dividends compared with previously held expectations.

Can it beat the market? The original research by Michaely suggested that going long surprises could be a profitable strategy in 22 out of 25 sample years but this also involved going short dividend cutters, which may not be feasible for many investors. Lane's research suggests that the pursuit of companies that have produced dividend surprises can be a strong trading strategy even in troubled times. It's a short time frame but, during the 12 months to the beginning of April 2012, companies with the top 10 percent of dividend surprises apparently returned over 3.6 percent more on an equal-weighted basis in capital returns versus the FTSE 350 benchmark.

Key issues

- Limited empirical evidence, especially as applied to the UK

Further Reading

- Price Reaction to Dividend Initiations[48]

Dividend Stripping

"A change in dividend policy could cause a costly change in shareholder wealth", Edward Elton

A final way to play the dividend game is to the idea of 'arbitraging the dividend calendar' using an approach known as dividend-stripping. What happens on/around the ex-dividend day has been the subject of quite a lot of academic research because of two surprising phenomena. Firstly, there is often a small but noticeable run-up in the share price of a company just before it goes ex-dividend. This is possibly because of buying interest from investors wanting to hold the shares on the ex-dividend date and thus qualify for the payment. Secondly, when the ex-day occurs (when the dividend becomes payable), the share price drops but usually by less than the value of the grossed up dividend. Researchers Elton and Gruber did one of the earliest studies in the 1960s observing that stock prices drop on average by 77.7 percent of the dividend paid.

How it works A number of traders advocate a strategy of "dividend capture", also known as "dividend stripping" or "ex-dividend trading". This involves buying a stock before the dividend is paid, holding it for a predetermined period (perhaps just overnight), and then selling it and moving on. In essence, dividend capture is about collecting (capturing) the dividend which provides income, and making a capital loss when the shares fall in value (in normal circumstances) on going ex-dividend. This may be profitable if the income is greater than the loss, or if the tax treatment of the two gives an advantage.

Why it (might) work This strange anomaly in the price fall is most often attributed to the unfavorable tax treatment of dividends

[48]http://forum.johnson.cornell.edu/faculty/michaely/Price%20Reactions%20to%20Dividend%20Initiations%20and%20Omissions.pdf

versus capital gains in most markets. A tax advantage available to everyone would be expected to show up in the ex-dividend price fall. But an advantage available only to a limited set of investors might not. Alternatively, it might be because collecting & reinvesting dividends is administratively more cumbersome than dealing with capital gains. Or perhaps naive investors simply forget that there is a dividend payout and plunge more money into the stock at higher prices the next day.

Can it beat the market? On the all-important question - is there money to be made here? - the evidence is very mixed! One academic paper titled "*Taxes, Price Pressure and Order Imbalance around the Ex-Dividend Day*" focused on the Australian market found that dividend capture yielded positive profits in the 45 day run-up to the ex-dividend date. However, other studies have been less encouraging, so the results may reflect peculiarities of the Australian environment.

Key issues Success with this strategy is likely to turn on being able to select those issues whose stock prices are most buoyant post the fall.

For example, stocks with good price momentum often don't fall as much. However, that sounds more like stock-picking, with all its related risks, rather than a form of easy "arbitrage". Hence, dividend capture and ex-dividend strategies are likely to work best in a neutral or rising stock market while, in a falling market, it's going to be more difficult.

Further Reading

- Taxes, Price Pressure and Order Imbalance around the Ex-Dividend Day[49]
- Institutional Trading around the Ex-Dividend Day[50]

[49]http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1314087

[50]http://69.175.2.130/~finman/Turin/Papers/Institutional_Trading_around_the_ExDividend_Day.pdf

Bibliography etc

Books

Unfortunately, the dividend investing literature is just not as interesting or well populated as in the value investing space. Overall, we'd say that the books most worth reading (apart from this one!) are: - Aswath Damadoran: Investment Fables (it punctures a lot of investing myths). - Geraldine Weiss: "Dividend Don't Lie" & "The Dividend Connection" (there has also been a revised edition by Kelley Wright – "Dividends Still Don't Lie"). - Charles Carlson: "The Little Book of Big Dividends" (he pushes his BSD system fairly hard but it's still an interesting introduction to the topic). - David van Knapp: "Top 40 Dividend Stocks of 2012" (this is a good, practical exposition of the DGI philosophy). - Rodney Hobson: "The Dividend Investor" (this is fairly basic but a good introductory text on the subject).

Research papers

In terms of the best research papers on dividends, one handy (free!) synthesis is "Tweedy Browne – the Dividend Yield Advantage". It summarises a number of studies analyzing the importance of dividends and how they drive investment returns (for example Robert D. Arnott's renowned paper, "Surprise! Higher Dividends = Higher Earnings Growth").

We recommend getting hold of any of Societe Generale's Quality Income papers. While not generally available on the Web, you can find them if you ask the right people and they are some of the most eye opening dividend pieces you will read.

It's not mentioned in the Tweedy Browne study but well worth reading is a study by Cass University called "Consistent Dividend Growth Investment Strategies". This paper examined data for the London Stock Exchange from 1975-2006 for a range of income investing strategies.

It's also worth searching SSRN for the latest research papers.