BBAE Pro

5 Secrets to Dividend Investing

By James Early

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BBAE Pro

Dear Dividend Investor,

I'd like to begin with *why*.

Why you may want to consider dividend stocks – or why you've made a smart decision if you're already investing in them. I'll start with some data my former colleague (and great guy) Morgan Housel shared in *The Wall Street Journal* years ago:

Investment	1957 Starting Investment	2006 Ending Capital
S&P 500	**$1,000**	**$176,000**
10 Highest Yielders in S&P 500	**$1,000**	**$1,300,000**

Along similar lines, Hartford Funds found that from 1960-2001, the S&P 500 would have grown $10,000 into $800,000 on a price-only basis.

But with dividends reinvested? $5,000,000.

The broad reason for investing in dividend stocks is that they've performed well over time – and pay you a portion of your return in cash, which gives you choices: You can harvest the cash now, reinvest it in the company that paid it, or reinvest it in a different company – or reinvest when you're young and switch to harvesting when you retire.

Isn't that what a lot of investors want these days?

In 2011, Kathleen Fuller, a professor of finance at the University of Mississippi and Michael Goldstein, a professor at Babson College in Massachusetts, published "Do Dividends Matter in a Declining Market?" in the *Journal of Corporate Finance*.

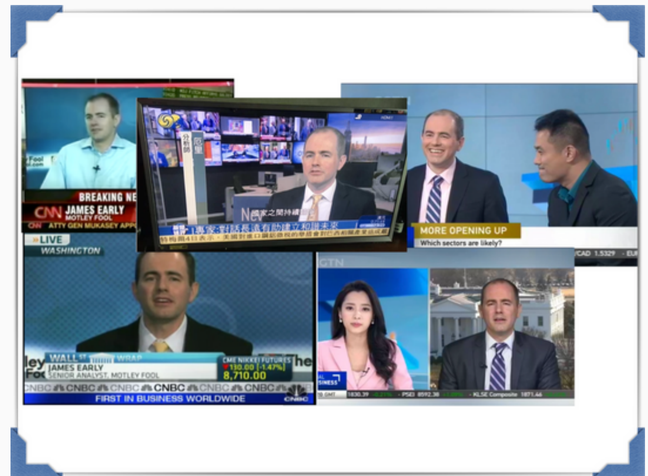
The duo found that dividends do: **in declining markets, dividend-paying stocks outperform non-dividend-paying stocks by 1% to 2% per month.**

And in Surprise! "Higher Dividends = Higher Earnings Growth, Rob Arnott and Cliff Asness found that **companies paying the highest dividends actually had the highest earnings growth over the next 10 years.** Think about that.

While you do, allow me a quick introduction.

My name is James Early. I'm Chief Investment Officer at BBAE.

You may know me from the BBAE Blog, from my Forbes column, or maybe even from my media appearances on platforms like CNN, BBC, CNBC, PBS, NPR, *The Wall Street Journal*, *The New York Times*, *The Washington Post*, *Men's Health*, and others.



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Independent Verifier's Report

The Motley Fool, LLC
Alexandria, VA

We have examined the accompanying Statement of Investment Performance and Notes to Statement of Investment Performance for ***The Motley Fool Income Investor*** for the period August 26, 2003 through March 31, 2014. Management is responsible for the Statement of Investment Performance and Notes to Statement of Investment Performance. Our responsibility is to express an opinion on this performance presentation based on our examination.

Our examination included examining evidence supporting the Statement of Investment Performance and Notes to Statement of Investment Performance for ***The Motley Fool Income Investor*** and performing other procedures, as we considered necessary in the circumstances. Our examination included procedures to obtain assurance that performance results reflected in the Statement of Investment Performance were calculated using criteria as outlined in the Notes to the Statement of Investment Performance. We believe our examination provides a reasonable basis for our opinion.

In our opinion, the Statements referred to above present, in all material respects, the performance record of ***The Motley Fool Income Investor*** based on the criteria set forth in the Notes to Statement of Investment Performance. The Statement of Investment Performance and Notes to Statement of Investment Performance are an integral part of this opinion.

Alpha Performance Verification

Alpha Performance Verification Services
Michael W. Hultzapple, CPA, CFA, CIPM
April 29, 2014

TOTAL RETURN	
Income Investor	37.86%
S&P 500 Index	27.08%
Alpha	10.78%

But I'm also a dividend guy.

In fact, in addition to creating the Motley Fool's research department, I also ran their dividend stock service (*Motley Fool Income Investor*, which was likely the largest in the world at the time) for a decade and concurrently picked British dividend stocks for their UK business for five years.

Why am I telling you this? Because the services I ran beat the market – and beating the market for 10 years isn't easy. My US newsletter, besides listing its stock picks and their returns vs. the market openly for all subscribers, was twice audited along the way.

Rude Awakening

Many investors who started investing during the past 14 years or so have only known a bull market – and not just any bull market, but one distorted by once-in-a-lifetime low interest rates.

Not just low rates, but near-zero in many cases. *Near-zero* rates work like a financial perversion, removing the usual valuation penalties early-stage high-growth companies pay for risk and for having the bulk of their cash flows projected to come far into the future, instead of now.

A generation of investors grew up thinking that *this time is different* (the most dangerous words in investing, by the way) and that all they needed to do was pounce on the latest, hottest, or most famous growth stock.

It *was* different for 14 years. Not anymore.

Aside from the AI theme, which is almost single handedly carrying tech stocks, cash flows, stability, and having a working business model are cool all over again.

Which brings us back to dividend stocks and, to the purpose of this report: dividend secrets.

I could talk at length about tips, tricks, and lessons learned in the dividend universe, but here are five “secrets” (or key points, if you prefer) about dividend investing:

5 Dividend Secrets

1 It's possible for dividends and yields to be too high

In the US, dividend yields are computed by dividend current stock price by the last 12 months of dividend payments. Most American companies are reluctant to cut their dividends, so there's a strong chance you will get at least what the company paid out over the last year, and possibly more (companies like to raise their dividends when possible), but it's not guaranteed. Sometimes, companies need to cut or suspend their dividends.

The other piece here is stock price. It's out of a company's control, at least in an immediate sense, but often, the market will notice a dividend-paying company heading from trouble and respond by selling down its stock. Relative to the new, lower, stock price, the "old" payout may look temptingly high. But it's more of a mathematical artifact in this case, and investors buying a company about to cut its dividend not only won't receive the historical yield but may also experience a further price drop.

There is no exact number for what's an "OK" yield and what's too high. It depends on market conditions, prevailing interest rates, and type of company (Business Development Companies (BCDs), Real Estate Investment Trusts (REITs), Master Limited Partnerships (MLPs) and royalty trusts tend to have high payouts (generally because they're not taxed on the entity level, but we won't get complicated for now). But for an overall rule of thumb, as a yield approaches 10% or so, its credibility drops for me.

2 In much of Europe, South America, and in parts of Asia, dividends are paid as a percentage of earnings, instead of as a bond-like fixed amount.

Dividends are great for instilling corporate discipline, but I would not be shocked if they get phased out over the next 50 years in favor of stock buybacks (so enjoy them while you can). Early US stock investors were familiar with bonds, so stock dividends, which came a bit later, tried to resemble bond coupon payments: fixed payouts that companies treat as quasi-sacrosanct (i.e., they're loath to cut).

Non-US markets don't have this emotional baggage. And non-US markets don't have a large percentage of their populations living off of stock gains and dividends in their retirements (this is a strong compliment to the trustworthiness of US equity markets, by the way). Paying a variable dividend – like, for example, 30% of earnings – is financially healthier for the company because the risk of fluctuation is borne by the recipient instead of the company.

I wish US companies adopted this practice; keeping a steady, bond-like payment may feel like the noble thing to do for all the little old ladies living on fixed incomes, but it's no longer necessary in today's modern security markets: those little old ladies (and everyone else) can not only easily create diversified dividend portfolios to smooth out the ups and downs, but they can also sell a bit stock – capital gains and dividends are taxed at very similar rates in the US currently – for cash flow if need be. The current fixed-dividend practice needlessly burdens companies with the cost of maintaining their dividends at times when that money may either be sorely needed or have high-potential uses elsewhere.

3 Dividends force discipline

Now let me slightly contradict what I've just said. While it's absolutely true in theory that a variable payout is best for company and investor alike (investor because over the long run, a stronger, healthier company should see bigger share price gains), there's also data, like the Arnott-Asness study, showing that higher dividends tend to correspond with higher earnings growth, which seems 100% counterintuitive.

First, as a reminder, when we talk about studies, we're talking about thousands of stocks: high-potential, non-dividend-paying growth companies – like Amazon, Netflix, and Apple in their early days – will always have the fastest earnings growth. But that higher dividend yields and higher earnings can even correlate at all – something that makes no sense on the surface given that if companies are paying out dividends, they've got less of a hugely important resource (cash) to use to drive earings – indicates, in my opinion, some motley mix of selection bias, forced discipline and simply having tapped a good vein.

As the old saying goes: If you want something done, give it to a busy person. Corporate waste is rampant, and strong companies paying strong dividends have not only found lucrative cash flow streams but don't give themselves the luxury of squandering cash. They have (dividend) mouths to feed, so they'd better get serious.

4 Certain dividend stocks have tax complexity that won't come up on a stock screen, and which people don't talk enough about.

I'm talking about those BDC, MLPs, royalty trusts, and REITs that I mentioned earlier. I can't get into every detail of each kind here, but as an example, because REIT payouts are taxed at ordinary income rates, they're great for IRAs and similar tax-deferred retirement accounts (401k and 403b accounts, for instance); this income gets sheltered there. However, while you can hold a BDC in a tax-deferred account, despite what some people claim, it may or may not make the best use of your precious tax-deferred funds. BDCs, for that matter, assign depreciation to each unitholder ("stockholder" in BDC parlance) based essentially on the company's goings-on when the unitholder bought in, and there's a recapture provision for this depreciation upon sale

MLPs, meanwhile, are often notoriously late with their K-1 packets (when you own a partnership, you get a K-1 tax form). None of these considerations is big enough to be a reason the right investor should avoid any of these investments – they offer some of the biggest legitimate yields in the market – but for investors just starting out, especially without a tax accountant, or for non-US investors investing in US stocks, these types of “dividend” payers may be more trouble than they’re worth.

By the way: I used quotation marks around “dividend” because entities like the above that don’t pay corporate-level taxes also technically don’t pay dividends: they pay distributions. And distributions can also contain a return of capital element, which you would not pay taxes on.

5 Dividends can get too fashionable

Yes, like jeans, dividends are always in style to some extent. But when a large portion of the market takes an interest in dividend investing, watch out. Just like how in 2017, some companies – generally aggressive, young companies without a lot of economic substance – were adding “blockchain” to their name for cachet, and how 2023 brought a similar phenomenon in AI, aspiring companies seek to join the dividend club without *really* having what it takes to be a member.

Watch out for companies borrowing money to pay dividends as essentially a shareholder marketing gimmick. Borrowing Peter to pay Paul like this is not a sustainable thing, and that’s the worry. Management may be hoping to jack up the stock price and then sell shares – or perhaps trigger some kind of compensation award, though compensation awards tied to stock price are frowned upon in the first place because they encourage “gaming” the stock price with short-term, unsustainable tricks.

Ironically, some large, “steady” Blue Chip companies occasionally borrow to maintain their dividends when cash flows get scarce, because they don’t want the negative optics or feelings of “investor betrayal” associated with a dividend cut. This is less bad, because these companies do have viable long-term cash flows and generally only take on incremental debt they can easily repay, but I’d argue it’s still a suboptimal economic allocation, and that a variable dividend would be the way of the masters.

Dividend sustainability, usually measured by a payout ratio (sometimes with an industry-specific denominator, such as funds from operations in the case of REITs) is its own science. I have certainly spent time studying this for companies, but as most of my dividend investing leaned conservatively, my rule of thumb was that if I was spending a lot of time trying to figure out if a company’s dividend was sustainable or not, it was time to move on.

Getting Started Dividend Investing

Now you've got five secrets, or key points, about dividend investing. I hope these were helpful – and I hope that this is just the beginning of our relationship, however digital it may be. I'd love to keep sharing via articles, videos, webinars, and whatever else might help.

If you're ready to get started, I'll offer that ironically, the best way to start dividend investing may not be with dividend stocks. Without knowing you personally, my general thinking is that new investors do well to get broad-based exposure via one or more US or total-market ETFs, and potentially a dividend stock ETF or so, too.

I say this because I've seen new investors over-allocate to whatever stock they find exciting at the moment. If that one stock happens to fall, these impressionable new investors may become unduly crestfallen and sour on a practice that, over time, has been arguably the most consistent wealth builder in human history. Or – and weirdly, this can be worse – their first stock does *really* well, making them feel like geniuses and giving them just enough overconfidence to take too much risk… but eventually their inexperience catches up to them and they blow up even worse.

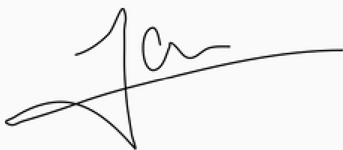
Don't let either be you, my friend.

Do it the right way and build your "boring," steady base first. Then – and this is not even a requirement – you can add more exciting fare. And if you're the type who absolutely cannot resist buying hot and sexy stocks (hopefully not you if you're reading a dividend stock report), at least keep your position sizes small until you build that base.

And when you do venture into individual stocks, at least take a close look at what I'll call "forever" dividend stocks – companies with strong business that are likely to be around in 50 years or more.

I have plenty more to say on this topic, as you might guess. Fortunately, we have plenty more time. Stay with me on this journey, and I believe you'll benefit.

To health and wealth and – most importantly – happiness,



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