

The Ultimate Dividend Playbook

Income, Insight, and
Independence for
Today's Investor

Josh Peters



WILEY

John Wiley & Sons, Inc.

The Ultimate Dividend Playbook

The Ultimate Dividend Playbook

Income, Insight, and
Independence for
Today's Investor

Josh Peters



WILEY

John Wiley & Sons, Inc.

Copyright © 2008 by Morningstar, Inc. All rights reserved

Published by John Wiley & Sons, Inc., Hoboken, New Jersey

Published simultaneously in Canada

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 750-4470, or on the Web at www.copyright.com. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at <http://www.wiley.com/go/permissions>.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993 or fax (317) 572-4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books. For more information about Wiley products, visit our Web site at www.wiley.com.

ISBN-13 978-0-470-12512-0

Library of Congress Cataloging-in-Publication Data:

Peters, Josh.

The ultimate dividend playbook : income, insight, and independence for today's investor / Josh Peters.

p. cm.

Includes index.

ISBN 978-0-470-12512-0 (cloth)

1. Dividends. 2. Stocks 3. Investments. I. Title.

HG4028.D5P48 2008

332.63'22—dc22

2007038108

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

Contents

Acknowledgments	VII
Introduction	IX
Chapter 1 Income? From Stocks?	I
Chapter 2 Dividends, Values, and Returns	25
Chapter 3 Corporations: Dividend Machines	49
Chapter 4 Dividend Insight	69
Chapter 5 Dividends Past, Present, and Projected	87
Chapter 6 Is It Safe?	101
Chapter 7 Will It Grow?	125
Chapter 8 What's the Return?	149
Chapter 9 Independence	169
Chapter 10 Managing a Dividend Portfolio	183
Chapter 11 The Future of Dividends	205

Epilogue	221
Appendix 1 The Nuts and Bolts of Dividend Payments	225
Appendix 2 Dividends and Taxes	241
Appendix 3 Banks	257
Appendix 4 Utilities	277
Appendix 5 Real Estate Investment Trusts	295
Appendix 6 Energy Partnerships	313
Appendix 7 Other Dividend Opportunities	333
Index	337

Acknowledgments

THE TWO INDIVIDUALS most directly responsible for bringing my ideas to life, both in this book as well as in the monthly issues of *DividendInvestor*, are Morningstar designer Christopher Cantore and editor Sylvia Hauser. These fine professionals both worked long hours on short deadlines without sacrificing the humor, creativity, and keen eyes for detail I've come to rely on over the past three years. I can't thank either of them enough.

My content was improved mightily by the feedback of Pat Dorsey, Morningstar's director of equity analysis, and Haywood Kelly, chief of security analysis. Maureen Dahlen, Courtney Dobrow, and Paul Justice, along with many other folks I've worked with at Morningstar and John Wiley & Sons, helped speed the writing and editing process to its blessed conclusion. And since seeds without soil might just as well be stones, I have to add my thanks to Morningstar founder Joe Mansueto and individual investor segment president Catherine Odelbo. Along with Pat and Haywood, they've provided the

VIII ACKNOWLEDGMENTS

patient, inquisitive environment in which I could develop the strategies I'm now able to pass along to you.

There's basically no chance I would even be interested in stocks if it wasn't for the early encouragement of my parents, Henry and Susan Peters. I'm sure they were puzzled by a 13-year-old's desire to hang out at brokerage offices rather than at hockey rinks, but they ensured I was able to learn everything I could. And my primary teacher, in so many things in addition to the stock market, was and still is Glen Bayless. He took that kid with a \$200 account under his wing when there was nothing (except possibly a bit of amusement) in the deal for him. I can never repay the debt I owe my mother, father, and "big brother" Glen; I can only hope to serve others as generously as I have been helped in life.

The biggest thanks of all go to my wife, Jaime, for the marvelous grace, wisdom, and beauty with which she has immeasurably enriched my life. It is to her that I dedicate this book.

Introduction

YOU MAY HAVE heard that the basic idea of the stock market is to buy low and sell high. Pardon me for saying so, but that sounds like a lot of work. An investment represents money that is supposed to work for me, right? Having earned my money once already, why should I have to work for it all over again?

When it comes to redundant and wasted effort, nothing tops the stock market. I came to the conclusion long ago that investors, professional and individual alike, work much harder than necessary. As J. P. Morgan once promised, stock prices will fluctuate—everyone knows that. Even blue-chip businesses can see their market values swing 50 percent or more over the course of a single year. These ups and downs seem to promise great wealth, if only the investor can time the buys at low points and the sales at high ones.

The trouble with this mentality—in addition to poor odds of consistent success, of course—is that it puts almost 100 percent of the responsibility for profits on the back of the stockholder rather than the stock. It's as though the

stock market is not about business at all, but rather a grand game pitting wily investors against each other in attempts to beat the market.

Yet the fact remains that stocks are capable of providing attractive returns to their owners. Treated as partnership stakes in profit-seeking businesses, stocks are highly useful tools—tools for storing value, tools for generating income and accumulating wealth, tools effective enough to meet a lifetime's worth of financial goals. But if we are to shed the game mentality of our fellow investors, our stocks must provide an alternative source of reward. Rewards with no additional effort. Rewards not subject to the whims of Wall Street. Above all, rewards paid in cash.

Those rewards are cash dividends. This book is not only about how dividends work, but about how dividends can work for you.

I should state up front that *The Ultimate Dividend Playbook* is about as far from a get-rich-quick guide as you're likely to find. In *Morningstar DividendInvestor*, I once wrote that subscribers shouldn't expect the 1,000 percent returns other newsletters promise, at least unless they were willing and prepared to follow my advice for the next 25 years. But that's the point: A 10 percent annual return, well within the reach of a simple, low-maintenance dividend strategy, turns \$100,000 into \$1.1 million over a quarter of a century. As of this writing, it's also possible to generate income from a portfolio of dividend-paying stocks equal to 6 percent or 7 percent of its initial value without any need to trade. Best of all, this income can and should grow faster than the cost of living. In a world where we're lucky to find bonds and CDs paying even 5 percent, and these options providing no respite from the threat of inflation, I hope these observations will come as welcome news.

Rather than promise sky-high returns—which would probably sell a lot more copies of this book—only to deliver the mud beneath my boots, this book sticks to three core principles:

1. *Income.* At the bottom of it all, it is income, not capital gains, that most investors need to meet their financial goals. Fortunately, many conservative, well-managed, and economically attractive businesses are prepared to provide good income through dividends.
2. *Insight.* Dividends are worth much more than the sum of income they generate. No matter how routine on the surface, each dividend is a critical signal of the financial health, growth, and value of a business.

3. *Independence.* The taste for gambling and speculation is not equally distributed through the population—and thank heaven for that! I strongly suspect that most investors would just as soon not live their lives entangled with Wall Street’s never-ending pageant of fear and greed. Dividends, by contrast, set the investor free from fickle market prices and unreliable capital gains.

What Are Dividends, Anyway?

Glad you asked! Strictly speaking, a dividend is a transfer of assets (almost always cash) from a corporation to its shareholders.

A share of stock—any stock—represents a bit of partial ownership in a business. A successful business typically has a good deal of assets (even after deducting its debts), and management employs these assets to turn profits.

Yet a corporation is an entity separate from its shareholders. You might look at a corporation as a lockbox containing all the assets and earnings of the business. As a shareholder, you own part of that lockbox, but you don’t have direct access to its contents. The key to the lock is held by the corporation’s management. Only when they decide to unlock the box and hand part or all of the cash inside to shareholders do those shareholders—the ultimate owners of the box—get to benefit directly from what is held inside.

Not all corporations, even those with enormous profits and sizable cash reserves, are willing to unlock the box for shareholders’ benefit, preferring instead to keep control of the cash for themselves. But many corporations do. Some pay out only a little, while others—the kinds of stocks we’re interested in—pay out a lot.

Furthermore, corporations that have paid dividends in the past have a very strong tendency to continue dishing out cash in the future. The box is opened and cash disbursed on a predictable basis, and over time, these payouts tend to grow larger and larger. From the investor’s perspective, the value of a share of the box isn’t about the box itself, but rather the growing stream of cash it will provide in the years and decades to come.

To consider just one example out of hundreds, let’s look at the shareholder experience at Associated Banc-Corp (ASBC) over the past 20 years. At the end of 1986, shares of Associated sold for \$4.08 apiece (adjusted for subsequent stock splits, as are all similar references in this book). Back then, Associated’s *dividend rate*—the amount of cash paid on each share annually—was running

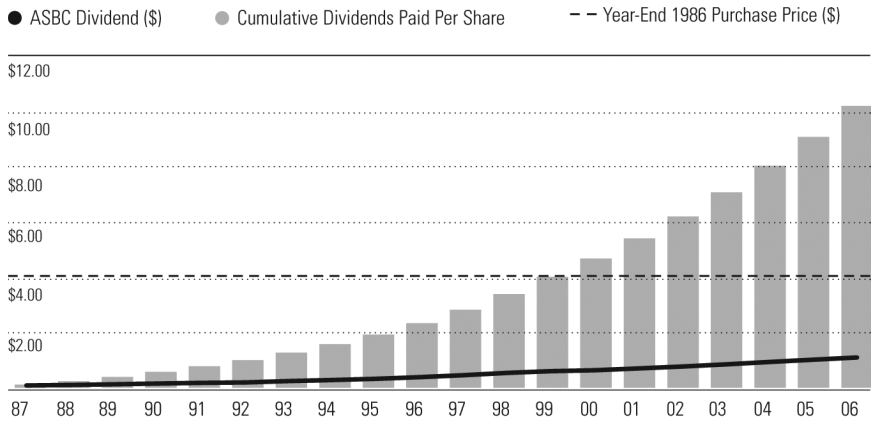


Figure I.1 Associated Banc-Corp (ASBC): Cumulative Dividend Income

at just 10.6 cents a share. Dividing the 10.6 cents in annual dividends by the stock price of \$4.08, we can say the stock provided a dividend yield of just 2.6 percent. The investor looking for income probably could have walked into one of Associated’s bank branches and received a much higher rate of interest.

Dividend yields may look like interest rates, although neither the dividend nor the stock that is paying it has a fixed, guaranteed value. But unlike the interest paid on a bond or a CD, Associated’s dividend payments rose every single year thereafter. (See Figure I.1.) Despite the initial yield of just 2.6 percent, just look how those dividends accumulated!

By 1999, Associated had paid out cash dividends equal to the purchase price of the stock 13 years earlier. Seven years later, by the end of 2006, those cumulative dividends were 2.5 times the 1986 stock price. In 2006 alone, payments totaling \$1.14 a share were equal to 28 percent of the 1986 purchase price. And even this was not the end: Associated raised its dividend yet again in early 2007. If history is any indication (and in this case, I believe it is), many more decades of steadily rising payments lie ahead.

But before you focus too closely on this ascending pile of accumulated dividends—attractive though it is—step back to visualize the peace of mind this kind of performance inspires. Between 1986 and 2006, a period containing some of the great bull runs of all time, I count three major bear markets, a number of smaller corrections, and four major stretches of rising stock prices.

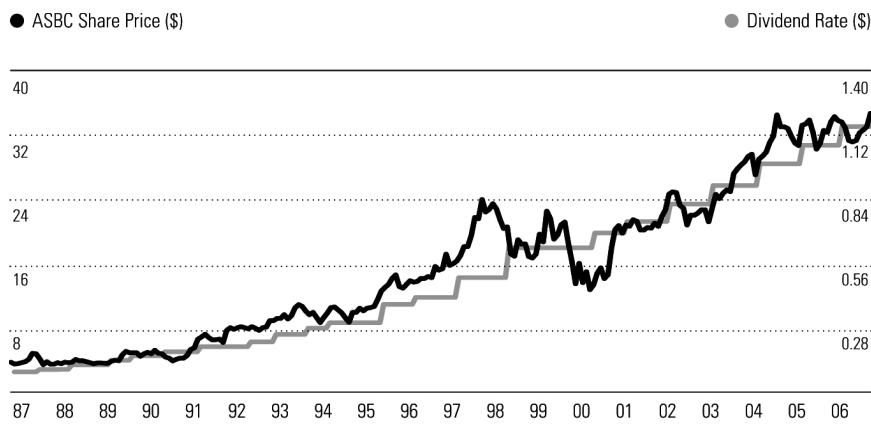


Figure I.2 Associated Banc-Corp (ASBC): Share Price and Dividend History

Yet for the truly patient holder of the stock through this whole period, these fluctuations mattered not one bit. I can't go so far as to say that a dividend strategy is maintenance-free—one needs to be aware of factors that could slow dividend growth or even lead to reduced or eliminated payments—but it's hard to imagine a better way to have your money working for you, rather than the other way around!

And not only did Associated's rising dividend provide more and more income as the years rolled by, but each dividend increase made the stock more desirable to own. Those dividends drove the market price of the stock higher in tandem, as shown in Figure I.2.

You may look at this chart and conclude that Associated's stock price alone might seem to have been a pretty nice investment; who needs dividends? But let's now invoke the concept of total return: capital gains and dividends working together to provide profits and build wealth. Associated's stock price rose an average of 11.3 percent annually over this 20-year stretch. Without dividends, that would have turned a \$10,000 investment into roughly \$85,000. But with dividends—specifically, dividends reinvested into additional shares along the way—that same \$10,000 investment compounds into a stake worth \$161,000, nearly twice as much as from capital gains alone. The total return on the stock over these two decades was not just the 11.3 percent average annual capital gain, and not just the 3.2 percent average yield, but an average total return of 14.9 percent annually.

I chose Associated not because it is a spectacular example of success, though in its own way it certainly has been. Instead, Associated is noteworthy precisely because it is so ordinary. This bank may not be well known across the country, but it certainly is to hundreds of thousands of depositors and loan customers in Wisconsin. Dozens of seemingly humdrum banks in other corners of the country have generated similar performances, as have hundreds of firms in other industries. The unifying factors are growing dividends and the patience to collect them.

A Role Model

Dividend investors have few heroes, at least as far as you can discover by browsing the bookshelves at Barnes & Noble or reviewing a year's worth of cover stories in *Fortune* or *BusinessWeek*. Indeed, dividends may be the most misunderstood aspect of investing in stocks, to the extent people bother to understand dividends at all. Most professionals are indifferent to dividends, and a surprisingly large minority are downright hostile. Even the fans of dividends you might see on TV or read about in a magazine are usually on their way somewhere else, collecting dividends just to kill time while waiting for other opportunities to crop up. True fans, those who understand the critical role of dividends over the long run, are very rare in the professional ranks.

As editor of a monthly newsletter devoted to the topic, *Morningstar DividendInvestor*, I am one of those rare professionals. And while I admire Warren Buffett, Peter Lynch, Marty Whitman, and many other famously successful and articulate investors as much as anyone, my true hero is—drum roll, please—Marjorie Bradt.

Don't spend too much time trying to place her name; she's never been featured on CNBC or mentioned in the *Wall Street Journal*. She's never written a book about investing or managed a mutual fund. Indeed, the stock market has never even been a hobby of hers. Yet I'm willing to bet that Marjorie's long-term investment record beats the vast majority of investors over the past half century.

I became familiar with Marjorie's remarkable record while working as an assistant to a stockbroker in 1999. Marjorie and her husband, Don, were getting their ample estate in order, and they needed cost basis information for their seven-figure portfolio. Given this task, I was handed a folder six inches

thick with old statements, some dating back to the 1950s. The best information I had was their current portfolio, almost all of which consisted of the various corporate descendants of AT&T, the original Ma Bell.

Working backward from what they owned in 1999, I noticed that Marjorie's account was marked by a distinct lack of active management. All she did, it seemed, was reinvest her dividends—quarter after quarter, year after year, decade after decade. When AT&T broke up into a long distance-only carrier and the seven baby Bells, Marjorie held on to all eight stocks. When Southwestern Bell bought Pacific Telesis and Ameritech, she held on. When AT&T went on to spin out Lucent, and US West spun out MediaOne, she held on to those, too.

After more than a day's worth of work, I finally found the root of Marjorie's wealth: a handful of gifts of AT&T stock given to her by her father between 1955 and 1962. Their original value totaled \$6,626. Very early on, she signed up for AT&T's dividend reinvestment plan. Instead of getting penny-ante dividend checks every three months, she turned those payments into additional shares, which led to more dividends, and so on. As AT&T prospered and raised its dividend rate, the value of each share rose as well—as did the Baby Bells' dividends and share prices. By 1999, this investment had blossomed into a portfolio of ten separate stocks worth more than \$1 million—all of them descendants of the original Ma Bell.

I was astounded. Here was all this wealth, but Marjorie hadn't lifted a finger to earn it. She hadn't foreseen the raging inflation of the 1970s, the surge in gold, the run of small caps, then large caps, then small caps again. She didn't predict anything—and she didn't have to. She just held and held, reinvesting every dividend, letting these rising dividend payments do all of the work.

The beauty of Marjorie's experience is its simplicity: Anyone could have done the same, even if virtually no other investors did. No PhD, MBA, or CFA was required; math skills learned in junior high school could suffice. Marjorie didn't have to trouble herself with a market-timing strategy or the pursuit of the next Microsoft. And it isn't as though AT&T was a diamond in the rough in the 1950s; back then the company owned almost every telephone in America. Other companies were growing faster, but millions of investors held stock in Ma Bell, drawn in by the same thing that made AT&T attractive to Marjorie's parents: large, steady, and growing dividends.

Marjorie thus traded the usual investor attempts at prescience for a combination of dividends and patience—and rarely does one find an example of such a richly rewarding investment strategy.

The Ultimate Dividend Playbook

This book is devoted to putting the three dividend plays of income, insight, and independence into practice. These are the tactics I've used to make investment recommendations in *Morningstar DividendInvestor*, and in the aggregate, these stocks are providing exactly the kind of income and income growth I've set out to earn. Prices rise and prices fall; dividend growth may exceed my expectations or disappoint. But the well-rounded model portfolios I manage are delivering the cash to meet real-world investor needs.

As this book unfolds, I'll take you through the insides of a corporation and the factors that allow it to pay and raise dividends; I'll show you how to separate safe dividends from risky ones, and how to construct a portfolio of dividend-paying stocks to meet your financial needs. Along the way I hope to share a little business acumen and a lot about dividends, and to frame an approach—emotional as much as intellectual or financial—that will equip you for a rewarding investing career.

Income? From Stocks?

CONGRATULATIONS ARE IN order! If you've picked up this book, you probably have some money to invest. Perhaps you've just retired with a couple of hundred thousand dollars, maybe even a million or two. Funny thing about money, though: It doesn't come with instructions. Television commercials for the *Wall Street Journal* in the 1980s used this line to suggest that the *Journal* was the next best thing. I appreciate the *Journal's* insightful missives as much as anyone. For the most part, though, you and your money are largely on your own.

Whether your accumulated savings are large or small, we can begin by asking what you want from the money. "To get rich" is a straightforward and honest answer, but it may not quite get to the heart of the matter. Fortunes have been and will be made by investors who can outguess the market, especially with large quantities of other people's money. It's also true that very few of us will reach the ranks of the superrich. Even on Wall Street, there's only so much dough to go around.

Then again, it's not necessary for one's investments to generate fantastic fortunes. Buying groceries, paying the gas bill, taking a vacation now and again—these are the bread-and-butter activities of Main Street, both before retirement and after. The goal of saving and investing, then, is to replace the paychecks earned by the sweat of your brow with paychecks from your investment portfolio. Income—steady, reliable, predictable, and rising income—is the objective.

Portfolios: Piles and Flows

There was a time, a generation ago or thereabouts, when the average working stiff didn't have to think too hard about retirement. We were thriftier back then, with a lot fewer financial choices. Savings went into passbook accounts that paid 5 percent interest. Paying off the mortgage was a well-earned cause for celebration. The boss took care of retirement income, through defined-benefit pension plans. And whatever the pension couldn't cover, Social Security and a modest accumulation of savings would.

Though held in derision and contempt today, defined-benefit pensions plan were reasonably well suited to the needs of the average worker and retiree of the time. Only a tiny proportion of the American public is trained in investment analysis and portfolio management. We all memorized the state capitals and learned how to dissect frogs, but they didn't teach much (if anything) about personal finance in school. Having employers and their investment managers take responsibility for investment decisions made a lot of sense. Leaving asset-allocation and security-selection decisions to the professionals allowed ordinary folks to concentrate on their jobs and personal lives.

Of course, defined-benefit pensions had significant drawbacks; this is why they've all but disappeared from the private sector. When an employee changed jobs—a phenomenon that became much more frequent in the 1980s and 1990s—accumulated pension benefits would stay with the original employer, usually at a sharply diminished value. The monthly pension benefit in retirement was typically fixed, meaning its purchasing power would shrink over time because of inflation. And if the employer went bankrupt, retirees could find their monthly pension checks slashed.

In the early 1980s, a new vehicle came along to replace defined-benefit pensions: the defined-contribution plan, most frequently in the form of a 401(k) account. *Defined contribution* describes these plans perfectly: The only known

factor is how much money is put in; no one guarantees any particular amount of money the beneficiary will one day take out. Employees, not employers, are responsible for saving. Employees, not employers, determine how these savings are invested. And retirees, not the former employers, have to figure out how to turn accumulated assets into income. In fact, 401(k) plans are often lauded for providing employees with the freedom to choose their own investments. But no freedom exists without responsibility—a responsibility few people are adequately trained to shoulder.

In addition to shifting the responsibility for saving and investing from boss to worker, 401(k) plans changed the focal point of retirement planning. The defined-benefit plan was all about *flows* of cash—the pensioner's monthly check. The worker might receive a statement of benefits showing how much he was eligible to collect; translating this into a budget was easy. The value of the assets in the plan that would provide these payments was not terribly relevant and was rarely of interest to the beneficiary. The 401(k) plan, by contrast, shows you every three months how much you've accumulated—the emphasis is on the size of the *pile*. Someone close to retirement might have a statement balance of \$500,000, but how much of the pile can be safely extracted each month is a matter of guesswork.

Living Off the Pile

Let's all say hello to Sally, who has just retired with \$500,000 worth of savings in her 401(k) account. Her situation is not too different from millions of newly retired Americans, possibly even you. Sally's expenses are manageable, especially after taking Social Security income into account, but she still figures to draw \$30,000 worth of cash from her portfolio every year.

Sally's account is invested in a handful of stock mutual funds. Over the past 20 years, these funds have done a wonderful job helping her accumulate this \$500,000 balance. Assuming that her mix of funds mirrors the industry average, they provide very little dividend income: a yield of about 1 percent, or \$5,000 annually. Not much more than a rounding error in the big scheme of things, these dividends have always been reinvested automatically. To generate income—or at least cash flows that look like income—Sally plans to sell off \$30,000 worth of mutual fund shares every year.

This is a strategy we might call living off the pile. Sally is implicitly assuming that her portfolio will grow more valuable over time, enough that

drawing \$30,000 a year out of the account won't actually cause its value to fall. If her savings were simply dollar bills stuffed in a mattress (earning an investment return of zero), she'd run out of money in less than 17 years. But Sally knows, or thinks she knows, that the stock market returns 10 percent a year on average. A 10 percent gain for a \$500,000 portfolio means an annual dollar increase of \$50,000. Even after taking out \$30,000, Sally figures she'll still be \$20,000 ahead at year-end.

This rising balance is important to Sally because she's counting on being able to draw more money out of the account next year and still more the year after that. Like anyone, she's feeling the effects of inflation—at the grocery store, the gas pump, the car dealership, you name it. As the cost of living rises, her portfolio withdrawals will have to grow. If inflation runs at 3 percent annually, that \$30,000 withdrawal in year one will have to rise to \$30,900 in year two, \$31,827 the year after that, and so on.

Fooling around with a spreadsheet, she makes five-year projections based on 10 percent portfolio returns and a \$30,000 withdrawal that grows 3 percent annually, as shown in Figure 1.1.

	Year 1	Year 2	Year 3	Year 10	Year 25
Beginning Balance	500,000	520,000	541,100	727,615	1,574,767
Asset Return (10%)	50,000	52,000	54,110	72,762	157,477
Withdrawal	−30,000	−30,900	−31,827	−39,143	−60,982
Ending Balance	520,000	541,100	563,383	761,234	1,671,262

Figure 1.1 Living Off a \$500,000 Pile: Projected Balances and Withdrawals

On the surface, this doesn't seem like a bad strategy. It does assume a 10 percent return from stocks—a bit higher than I think the market is capable of over the long run, as I show in Chapter 5. But even though Sally's withdrawals rise with each passing year, her account balance is rising faster. Maybe she can take even more than \$30,000 annually out of the account and add exotic travel to her plans. At the very least, it provides a bit of room for the market to fall short of a 10 percent return without blowing up her portfolio.

Hearing of Sally's strategy, I should introduce her to this fellow I know. His name is Mr. Market.

Meet Mr. Market

Even though the market is made up of millions of individual buyers and sellers, it forms something of a collective consciousness of its own. Ben Graham, the father of value investing, understood this when he suggested the character of the mythical Mr. Market. He's the guy on the other end of your stock trades. When you buy, it's his shares you're buying. When you sell, you're selling to him. Every moment of every trading day, Mr. Market can be found quoting prices for publicly traded stocks.

To understand Mr. Market, we must begin with the premise that price and value are distinct concepts. On Wall Street—as with any economic transaction—price is simply what you pay, but value is what you get in return. The value of a stock is a function of its capacity and propensity to return cash to its owner. Were Mr. Market a steady, reasonable man, his price offers would reflect these future cash returns perfectly. A \$1,000 investment today would provide \$1,000 worth of value, no more and no less.

But Mr. Market is not what you'd call a steady business partner. An incurable manic-depressive whose actions define the words *fear* and *greed*, Mr. Market will offer ridiculously high prices for a given stock at one point and insanely low prices the next. Mr. Market is the guy who does most of the obsessing about quarterly earnings, economic reports, and so-called technical trends in stock prices. Does anyone really believe that the value of large, well-established, profitable businesses should change 50 percent or more over the course of a year? But Mr. Market's prices fluctuate that widely all the time.

So who's in charge of your money, you or Mr. Market? No one wants to admit to being in Mr. Market's thrall, but the observed collective behavior says otherwise. Rather than buying low and selling high, we see the market's individual participants doing the opposite: buying high and selling low. These are the ancient and ineradicable emotions of greed and fear in action. And if you're interested in seeing what this Mr. Market fellow looks like, you might want to check a mirror. There's at least a bit of him in all of us.

I'm not sure that most of us are prepared to engage Mr. Market, even if the odds can—through great effort—be tipped in the investor's favor. As with any active strategy, the onus of the buy-high-and-sell-low approach is on the stockholder, not the stock. The investor does the bulk of the work to

earn his expected return; whatever the underlying business may be up to is of secondary importance. And at the end of the day, success or failure will be measured when the stock is sold: that is, success or failure depends on Mr. Market's attitude shifting from gloom to glee.

Sally and Mr. Market

This volatility is not necessarily a problem. This year's drop leads to next year's rebound; those who hang on to investments in good companies will be fine. Indeed, the investor who has the ability to add money consistently—whether stock prices are high or low—will wind up with more shares, lower purchase prices, and higher returns than a portfolio without inflows. This is a financial phenomenon known as *dollar-cost averaging*, and it's a terrific tool for growing and compounding wealth. (See accompanying box.)

But Sally's investment strategy is about to change dramatically. Every year, Sally will have to sell shares to generate cash. If prices are high, she'll have the luxury of selling fewer shares and leaving more money working for her financial future. If prices are low, she'll have to sell many more shares at lower prices to generate the same amount of cash. As a result, her selling prices will be lower than the average level of the market. She's still going to be dollar-cost averaging, all right—dollar-cost averaging in reverse.

Dollar-Cost Averaging

Stock prices fluctuate. Even watching a stock for a couple of minutes will tell you that much. However, for the investor who is steadily adding to a position in a stock (or portfolio), this volatility actually reduces average cost and increases subsequent profits.

How can this be? Let's check the math. You're hoping to build a nice-size position in a particular stock, but you don't have all the money right now. You can invest \$12,000 now, another \$12,000 in three months, and another \$12,000 three months after that. Initially, your investment buys you 200 shares at \$60 apiece. Later, the stock has dropped—but at a lower price of \$50, your \$12,000 buys you 240 shares instead of 200. By the time of your final purchase, the stock has shot up to \$80, and you're only able to buy 150 shares. Figure 1.2 depicts this sequence.

	Dollars Invested (\$)	Stock Price (\$)	Shares Bought
First Purchase	12,000	60.00	200
Second Purchase	12,000	50.00	240
Final Purchase	12,000	80.00	150
Totals	36,000	—	590
Average Price of Stock	—	63.33	—
Average Cost per Share	—	61.02	—

Figure 1.2 Dollar-Cost Averaging in Practice

The average price of the stock over this period is \$63.33, the simple average of the three purchase prices. But because you're able to buy disproportionately more shares at lower prices, your average cost per share (the \$36,000 invested divided by the 590 shares your money purchased) is \$61.02, about 3.7 percent lower than the simple average price. Simply by buying in equal dollar amounts, you'll wind up paying less per share and earning higher profits in the future. And if this discount of 3.7 percent doesn't look like that big of a deal, just try adding it up and compounding it over a long stretch of time.

This math works with equal force when selling shares in fixed dollar amounts. Had these three transactions been sales instead, the average selling price would have been at the 3.7 percent discount—and your returns would suffer as a result.

A little tinkering with her previous projections shows just how damaging this reliance on market prices can be. Just a couple of bad years in a row, especially early on, can turn what looks like a sustainable investment strategy into a problematic one. So let's throw some bad years at the spreadsheet: a 25 percent drop in the stock market in year one followed by a 20 percent drop in year two. Then let's bake in a rebound, enough to bring the stock market's cumulative return into positive territory by the end of year five. (If this sounds draconian, I can only say it's not quite as bad as the 2000–2005 bear market and subsequent rebound was.)

By the end of year two, Sally's account has lost more than half of its value (see Figure 1.3). The biggest risk here is probably that Sally panics and sells out at the bottom, locking in those losses forever. For the purposes of this example, though, we'll assume Sally hangs on for the recovery. But even if she

	Year 1	Year 2	Year 3	Year 4	Year 5
Beginning Balance	500,000	345,000	245,100	286,803	311,382
Asset Return	−125,000	−69,000	73,530	57,361	31,138
Withdrawal	−30,000	−30,900	−31,827	−32,782	−33,765
Ending Balance	345,000	245,100	286,803	311,382	308,755
Asset Return (%)	−25.0	−20.0	30.0	20.0	10.0
Cumulative Annual Return (%)	−25.0	−22.5	−7.9	−1.6	0.6

Figure 1.3 Living Off a \$500,000 Pile: Projected Balances and Withdrawals after a Bear Market

does, her account has been permanently damaged. Over this five-year stretch, the stock market’s cumulative return is slightly positive, yet her cumulative returns are a negative \$31,971. By selling to fund her withdrawals, she wouldn’t have those funds working for her in the rebound.

Worse yet, her year five withdrawal exceeds 10 percent of the account’s balance. A 10 percent annual return won’t be enough to maintain Sally’s spending level. If she doesn’t change her withdrawals, and the market returns a perfect 10 percent in all the years thereafter, her account will run out of money in less than 20 years. Alternately, she could slash her annual withdrawal rate by \$10,000, but what’s the consolation in that?

I’m not laying out this negative scenario to scare you away from stocks altogether—far from it. But the lesson here is simple: *Mr. Market cannot be relied upon to provide dependable income.* This clown will force you to sell shares of stock precisely when selling is the worst thing to do. Will Sally want to cancel her vacation plans just because the Dow Jones drops a thousand points? And can she really afford the 20 percent or 30 percent cut in income that a bear market might require? Some economies can be had, but let’s be realistic: Income that is subject to market price risk is not the stuff of a sustainable retirement strategy.

Are Fixed-Income Investments the Solution?

After Sally sees my bear market scenario, she’s ready to dump her stocks and buy bonds. A bond offers the investor a fairly straightforward relationship: You give a government, corporation, or some other institution your money

for a predetermined period of time, during which you'll receive a fixed rate of interest. At the end of that stretch, you get your money back. Case closed, more or less.

The primary trouble with bonds, at least in recent years, is that the yields they offer are substantially lower than the long-term returns provided by stocks. The yields on bonds and their close cousins, bank certificates of deposit, change all the time, but these days you can't get a government-guaranteed yield greater than 5 percent, even if you're willing to part with your principal (the original investment) for 30 years.

Looking at rates available on long-term Treasuries, Sally figures she could pour her 401(k) into 30-year bonds and generate a 5 percent yield, or \$25,000 worth of income a year. That would require her to trim her budget by \$5,000 annually, but the extra security alone would make this trade-off worthwhile.

Unfortunately, there's another problem with fixed-income investments, and it's right there in the name: The income they provide is fixed; it doesn't grow. There are a variety of ways to tinker with a bond portfolio and increase its yield, but from a big-picture point of view, the only way to get a bond portfolio's income to grow is to reinvest a portion of its income in additional bonds. Of course, those reinvested dollars aren't available for living expenses.

So now Sally faces a very difficult choice. She can either spend all \$25,000 of her interest income, knowing this figure will never rise, or she'll have to live on even less so that this income can grow.

Choice 1

Let's say Sally withdraws all of her interest income every year, and, as a consequence, her income doesn't grow. Figure 1.4 illustrates how the purchasing power of her income will change under several inflation scenarios.

At even a 2 percent rate of inflation, the purchasing power of this income stream will drop 9 percent in 5 years, 18 percent in a decade, and 33 percent in 20 years. At a steeper 5 percent rate of inflation, the purchasing power erosion is significantly faster—Sally's effective income would drop 22 percent after 5 years and a whopping 62 percent after 20. Spending all of one's earnings from a fixed income portfolio points the way to a steadily eroding standard of living.

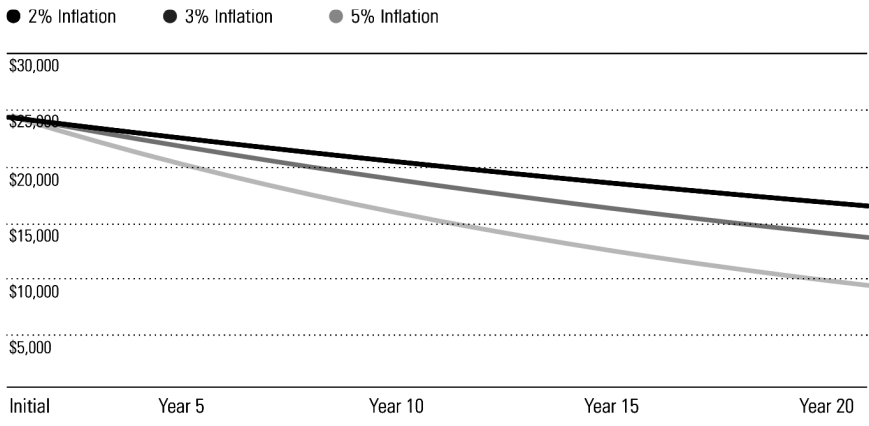


Figure 1.4 Fixed Income: Purchasing Power of \$25,000 over Time

Choice 2

Sally could withdraw less than \$25,000, leaving some of her interest income available to buy additional bonds. How much? That depends again on the rate of inflation.

Here we can call on a useful concept known as *real return*. Investment returns are usually expressed in nominal terms—percentages of dollars and cents—but nominal returns fail to take inflation into account. By subtracting the inflation rate from a nominal return, we can see what the real return is—that is, the net gain in purchasing power.

A good rule of thumb is that an investor should withdraw no more than the real return on a fixed-income portfolio. Withdrawals in excess of this figure will deplete the future purchasing power of the portfolio’s income and value. Instead, the portion of the nominal return that represents inflation should be held back and reinvested, to keep the portfolio’s real value stable.

For Sally’s bond portfolio, Figure 1.5 demonstrates the (ugly) figures.

If inflation manages to hold to a 2 percent rate, Sally should withdraw no more than \$15,000—just half of her original target. If inflation runs even higher, her allowable withdrawal drops further. At a 5 percent inflation rate, she technically shouldn’t withdraw anything at all; at even higher rates of inflation, she’d have to add dollars to the account just to keep its real value stable.

Nominal Return	Less: Inflation	Real Return	Nominal Income	Real Income
5%	2%	3%	\$25,000	\$15,000
5%	3%	2%	\$25,000	\$10,000
5%	5%	0%	\$25,000	\$0

Figure 1.5 Fixed Income: Nominal Income versus Real Income

The Third Way: Income from Stocks

Maybe I'm being a bit harsh with these examples. Fixed-income investments like bonds and certificates of deposit, as well as what you might call general stocks (those chosen without respect to dividends), may well have a part to play in your portfolio. Immediate annuities, investments where you turn over your funds to an insurance company in exchange for fixed monthly payments for life, could have a role as well. (You can't get your money back—as soon as you buy the annuity, the funds belong to the insurance company—but the yields tend to be quite a bit higher to compensate.) At any rate, the broader topic of asset allocation isn't the main focus of this book.

But what if there was a class of investments that could offer good current income that would grow as fast as or faster than inflation without any need for the investor to hold back part of this income for reinvestment? There is: stocks with large dividends.

To illustrate this phenomenon, I'll begin by drawing on an unconventional example.

Foremost among those who have made tons of money off Mr. Market over the years is Warren Buffett, a billionaire whose eminent wisdom and down-home charm have made him a household word. You might wonder how Buffett merits mention in a book about dividends, since his Berkshire Hathaway holding company has declared only one dividend on his watch—in 1966. (He has since suggested, perhaps only half jokingly, that he must have been in the bathroom when Berkshire's board voted to pay out that 10 cents a share.) The fact that Berkshire Hathaway hasn't paid a dividend in 40 years hasn't hurt the price of a Class A share, which has risen from \$15 to more than \$100,000. Buffett figures he can do a better job investing Berkshire's cash than shareholders can on their own, and just

about anyone—even someone devoted to dividends like me—would have to grant him that.

Early in his investment career, back when the assets at his disposal could be expressed in six or seven figures rather than eleven or twelve, Buffett focused his attention squarely on Mr. Market. Beginning in the 1970s, however, his emphasis started to change. He started buying entire companies—in essence, buying every single share of stock those companies had. The penny-ante investors under Mr. Market’s spell might be willing to sell their little bits of ownership at wildly undervalued prices, but knowledgeable businesspeople who control entire corporations are not. And once a company is off the public markets, there is no more Mr. Market to play games with. You won’t find the value of See’s Candies, Nebraska Furniture Mart, or Dairy Queen quoted in the papers or on the Internet. Because Buffett has bought these companies wholesale, these businesses do not even exist as far as Mr. Market is concerned.

If Buffett has given up the ability to trade these businesses on the stock exchanges, he must be obtaining an attractive return in some other way. That way, I have no doubt, is through dividends—large and growing ones, at that. Outside shareholders don’t see these payments since they are conducted entirely underneath the larger Berkshire umbrella. But the earnings of Dairy Queen are not simply piling up inside that subsidiary’s checking account; much, if not most, of the cash Dairy Queen and its Berkshire siblings generate is being returned to Berkshire. These returns aren’t being delivered by Mr. Market; they come from the operations of the businesses themselves with only the lightest touch from Buffett himself.

Very few of us are in a position to acquire entire corporations and set dividend policies that suit our personal needs. Yet that does not mean that investors of ordinary means must simply take whatever Mr. Market dishes out, for good or for ill. To the extent that a corporation chooses to pay out part of its earnings as dividends, its shareholders find themselves in a position similar to the controlling owner of a business. The larger the dividends relative to the size of the investment, the more shareholders can control their own fate. Dividends allow the investor to harvest cash returns that are fully and completely independent of market prices. It isn’t Mr. Market who pays dividends; only the underlying corporations can do that, and they can do it very well indeed.