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Investing in Dividends

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- Diversify your portfolio with dividends
- Minimize risk and maximize rewards
- Start trading and making informed decisions

Lawrence Carrel

Investing in Dividends

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Investing in Dividends For Dummies®

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by Lawrence Carrel

For Dummies®
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Investing in Dividends For Dummies®

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Introduction

The purpose of the stock market is to enable companies to raise the capital they need to start or grow their businesses. Instead of borrowing money from a bank and paying interest on it, a company can sell shares of itself to investors. Over the years, the stock market has gone from being a respectable venue for investors to purchase partial ownership in companies to something more akin to a casino. Seduced by reports of individuals earning millions nearly overnight by investing in high-growth stocks, speculative investors poured money into many companies that offered nothing more than a promise of sales and profits, further inflating share prices. When the needle point of reality finally popped the bubble, the poor unfortunates who failed to cash out their chips early enough were blown away like dust.

Fortunately, the deflated bubble (along with some dividend-friendly tax legislation) brought many investors down to earth and back to the basics — investing in companies with a proven track record of earning profits and paying dividends. As they return to the fold, investors are beginning to realize what their parents, grandparents, and great-grandparents already knew — dividend investing offers a host of benefits that provide a safer and often more profitable way to invest in the stock market.

Dividend investing is nothing new. In fact, since 1602, when the Dutch East India Company became the first corporation to issue stock, dividends have been the primary way for investors to receive profits from their investments without dissolving the company or selling the investment. However, following a dividend-investment strategy is new to many modern investors who've been focused solely on growth investing. If you count yourself among this crowd or are just starting out and plan on investing in dividend stocks, you've come to the right place. *Investing in Dividends For Dummies* contains all you need to know to develop your strategy, find and evaluate potentially good dividend stocks, manage your portfolio, and avoid the most common and critical mistakes.

About This Book

I'd love to be able to hand you a list of stocks and send you off with instructions to buy each one, but investing doesn't work that way. Every investor is different. You have a unique personality, specific goals, and a tolerance for risk that's different from your neighbors next door or across the street. Every company is different, too, operating in a specific industry, offering unique products and services, and being managed to varying levels of success. As an investor, your goal is to pair yourself up with investment opportunities that are a suitable match. That's what this book is all about.

In *Investing in Dividends For Dummies*, I present the idea of dividend investing and lead you through a process of self-examination to determine the type of investor you are, identify your goals, and develop an overall strategy that can move you most efficiently (and safely) from point A to point B. I show you how to find promising candidates and how to then evaluate them by using time-tested criteria so that you choose the best stocks to meet your needs. I mention some historically well-performing stocks you may want to check out, show you various ways to buy and sell shares, and offer guidance on managing your portfolio after you've purchased some shares.

The best part about this reference book is that *you* decide where to start and what to read. I've written every chapter to stand on its own, so you can start at the beginning of the book or pick any chapter from the table of contents and dig in.

As you read, keep one important point in mind: Past performance of a stock is no guarantee of future returns. I know, I know — you've heard that one before. But it's worth repeating. What it boils down to is this: If I mention a company in this book that I think is a potentially good dividend stock, don't assume I'm telling you to buy it. You may want to look into it, but I'm not necessarily recommending it. After all, by the time you read this book, that stallion of a stock may be a bust. Whatever you invest your money in or spend your money on is entirely your choice. I provide some guidance in picking stocks that may be likely to outperform other stocks, but I provide no specific recommendations. Take all the credit for your good investment decisions, but take all the blame for bad ones, too.

Foolish Assumptions

While writing this book, I made a few foolish assumptions, mainly about you and how much you know about investing:

- You have a general understanding of investing and your investment options, including CDs (certificates of deposit), money market funds, stocks, bonds, mutual funds, real estate, and so on.
- You grasp the basics of stock market investing.
- You realize that investing always carries some risk, that some risks are greater than others, and that *not* investing can also be risky.
- You have some money (capital) to invest. It doesn't need to be stuffed in your pocket or sitting in a bank account. It can be money you already have invested, perhaps sitting in an IRA or 401(k).
- You want a safer way to invest your hard-earned dollars, so you're interested in introducing or adding more dividend stocks to your portfolio.

Icons Used in This Book

Throughout this book, you can spot icons in the margins that call your attention to different types of information. Here are the icons I use and a brief description of each:

Everything in this book is important, but some of it's more important. When you see this icon, read the text next to it not once but two or three times to brand it on your brain cells.

Tips provide insider insight from behind the scenes. When you're looking for a better, faster, safer, and/or cheaper way to do something, check out these tips.

This icon appears when you need to be extra vigilant or seek professional help before moving forward.

Investing has its fair share of highly specialized language and concepts that typically fly above the heads of mere mortals. Whenever I explain something highly technical, I flag it with this icon so that you know what's coming.

Beyond the Book

In addition to all the material you can find in the book you're reading right now, this product also comes with some access-anywhere goodies on the web. Check out the Cheat Sheet at `www.dummies.com/cheatsheet/investingindividends` for helpful insights and details about whether you should hire a financial advisor and considerations for building a nest egg. You can also find interesting companion articles at `www.dummies.com/extras/investingindividends`.

Where to Go From Here

Investing in Dividend For Dummies is designed to appeal to a universal audience of intermediate and experienced investors at all stages of developing and managing their investment portfolios.

For the new dividend stock investor, I recommend you read the book from cover to cover starting with Chapter 1. More experienced divided stock investors who already know themselves and their goals and have an effective strategy in place to reach those goals may want to skip to Chapter 7, where I show you how to track down income-generating, dividend paying stocks, or Chapter 8, where I show you how to evaluate them.

Regardless of your experience, however, feel free to skip around and read whatever catches your interest. Each and every tidbit of knowledge and insight you acquire can only serve to make you a more astute investor.

Part I

Getting Started with Dividends

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In this part . . .

- Get the basics on the risks and rewards of dividend stocks as you prepare to become a savvy investor.
- Find out what to look for as you invest and how to adapt as the holdings in your portfolio develop.
- Discover stock market indexes and the interplay between dividends and market.
- Understand what to look for when you're looking for sound companies to invest in.
- Delve into some of the reasons that the popularity of dividend investing tends to rise and fall.

Chapter 1

Wrapping Your Brain Around Dividend Investing

In This Chapter

- Understanding dividend stocks and their benefits and risks
- Preparing to become a savvy dividend stock investor
- Knowing what to look for as you shop for dividend stocks
- Monitoring and adjusting the holdings in your portfolio

For many investors, dividend stocks offer the best of two worlds: a healthy balance of risk and return. Investors receive the benefits of both share price appreciation and the ability to realize profits through *dividends* (cash payments) without having to sell shares. (Later in this chapter, I list more of the many benefits of dividend stocks, and in Chapter 3, I explain them in greater detail.)

In this chapter, I pack the essentials of dividend investing into a nutshell, starting with the bare basics, such as defining what a dividend is, and taking you to the very end — managing your portfolio after you populate it with promising dividend stocks. Along the way, I reference other chapters in this book where you can find additional information and guidance on each topic.

Coming to Terms with Dividend Stocks

Dividend stocks are stocks that pay dividends — payments in cash (usually) or shares (sometimes) to stockholders. Through dividend payments, a company distributes a portion of its profits to its shareholders, typically every quarter or every month, and pumps the remaining profits back into the company to fuel its growth.

REMEMBER

The percentage of total profits a company pays out in dividends to shareholders is called the *payout ratio*. For more about payout ratios and how to use the number in evaluating dividend stocks, check out Chapter 9.

Why companies pay dividends

Successful companies are profitable companies. They earn money, and they can use that money in several ways:

- **Reinvest it:** Companies usually invest a good chunk of their profits, if not all of them, into growing the business.
- **Pay down debt:** If, in addition to selling shares, companies borrowed money to raise capital, they may use profits to pay down the debt, thereby reducing the expense of their interest payments.
- **Buy back shares:** Companies may use profits to buy back shares that they feel are undervalued, or for other reasons. In some cases, they initiate buybacks to artificially inflate the share price and improve investor confidence in the company.
- **Pay dividends:** Paying dividends is a form of *profit sharing* — spreading the wealth among the company's owners, the shareholders.

A company's dividend policy generally reflects the board of directors' and shareholders' preferences in how to use profits. Two schools of thought govern their decision:

- **Pro growth:** This school believes a company is better off reinvesting its profits or using profits to pay down debt or buy back shares. This strategy makes the company more valuable, and the share price rises accordingly. Shareholders benefit when they sell their shares for more than they paid for them.
- **Pro profit-sharing:** This philosophy stems from the belief that shareholders own the company and should share in its profits.

Other factors can also influence dividend policies. For example, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), which lowered the maximum tax rate on dividends from 39.6 percent to 15 percent, led companies making up the S&P 500 Index to boost their dividend payments. For more about how tax legislation can affect dividends, check out Chapters 3 and 11.

The advantages of dividend investing

Receiving dividends is like collecting interest on money in a bank account. It's very nice but not exciting. Betting on the rise and fall of share prices is much more exhilarating, especially when your share prices soar. Placing excitement to the side, however, dividend stocks offer several advantages over non-dividend stocks:

- **Passive income:** Dividends provide a steady flow of passive income, which you can choose to spend or reinvest. This attribute makes dividend stocks particularly attractive to retirees looking for supplemental income.
- **More stable companies:** Companies that pay dividends tend to be more mature and stable than companies that don't. Startups rarely pay dividends because they plow back all the profits to fuel their growth. Only when the company has attained a sustainable level of success does its board of directors vote to pay dividends. In addition, the need to pay dividends tends to make the management more accountable to shareholders and less prone to taking foolish risks.

- **Reduced risk:** Because dividends give investors two ways to realize a return on their investment, they tend to have a lower risk-to-reward ratio, which you can see in less volatility in the share price. A stock with lower volatility sees smaller share price declines when the market falls. Low volatility may also temper share price appreciation on the way up.
- **Two ways to profit:** With dividend stocks, your return on investment (ROI) increases when share prices rise and when the company pays dividends. With non-dividend stocks, the only way you can earn a positive return is through share price appreciation — buying low and selling high.
- **Continued ownership while collecting profits:** One of the most frustrating aspects of owning shares in a company that doesn't pay dividends is that all profits are locked in your stock. The only way to access those profits is to sell shares. With dividend stocks, you retain ownership of the company while collecting a share of its profits.
- **Cash to buy more shares:** When you buy X number of shares of a company that doesn't pay dividends, you get X number of shares. If you want more shares, you have to reach into your purse or pocket to pay for them. With dividend stocks, you can purchase additional shares by reinvesting all or some of your dividends. You don't have to reach into your pocket a second or third time. In most cases, you can even enroll in special programs that automatically reinvest your dividends.
- **Hedge against inflation:** Even a modest inflation rate can take a chunk out of earnings. Earn a 10-percent return, subtract 3 percent for inflation, and you're down to 7 percent. Dividends may offset that loss. As companies charge more for their products (contributing to inflation), they also tend to earn more and pay higher dividends as a result.
- **Positive returns in bear markets:** In a bear market, when share prices are flat or dropping, companies that pay dividends typically continue paying dividends. These dividend payments can help offset any loss from a drop in share price and may even result in a positive return.

- **Potential boost from the baby boomers:** As more baby boomers reach retirement age and seek sources of supplemental income, they're likely to increase demand for dividend stocks, driving up the price. Nobody can predict with any certainty that this will happen, but it's something to remain aware of in the coming decades.

The risks

There's no such thing as safe investing, only safer investing. You can lose money in any of the following ways:

- **Share prices can drop.** This situation is possible regardless of whether the company pays dividends. Worst-case scenario is that the company goes belly up before you have the chance to sell your shares.
- **Companies can trim or slash dividend payments at any time.** Companies aren't legally required to pay dividends or increase payments. Unlike bonds, where failure to pay interest can put a company into default, a company can cut or eliminate a dividend any time. If you're counting on a stock to pay dividends, you may view a dividend cut or elimination as losing money.

  Most companies try their best to avoid these moves because cutting the dividend may cause shareholders to sell, lowering the share price.
- **Inflation can nibble away at your savings.** Not investing your money or investing in something that doesn't keep pace with inflation causes your investment capital to lose purchase power. With inflation at work, every dollar you scrimped and saved is worth less (but not worthless).

Potential risk is proportional to potential return. Locking your money up in an FDIC-insured bank that pays an interest rate higher than the rate of inflation is safe (at least the first $100,000 that the FDIC insures), but it's not going to make you rich. On the other hand, taking a gamble on a high-growth company can earn you handsome returns in a short period of time, but it's also a high-risk venture.

Prepping Yourself for the Journey Ahead

People often invest more time and effort planning for a weekend vacation than they do preparing to become an investor. They catch a commercial for one of those online brokerages that makes investing look so easy, transfer some of their savings to the brokerage or roll over their IRA (individual retirement account), and try to ride the waves of rising investment sentiment to the land of riches.

A more effective approach is to carefully prepare for the journey before taking the first step. The following sections serve as a checklist to make sure you have everything in place before you purchase your first dividend stock.

Gauging your risk tolerance

Every investor has a different comfort zone. The thrill-seekers crave risk. They want big returns and are willing to take big risks to get them. Riding the rollercoaster of the stock market doesn't bother them, as long as they have some hope they'll end up on top. On the other end of the spectrum are conservative investors willing to trade high returns for stability. Prior to investing in anything, you can benefit by determining whether you're more of a thrill-seeker, a conservative investor, or someone in between.

In Chapter 7, I offer several methods for gauging risk tolerance, but regardless of which method you choose, you should account for the following factors:

- **Age:** Younger investors can generally take bigger risks because they have less money to lose and more time to recover from lousy investment decisions.
- **Wealth:** "Never bet money you can't afford to lose" is good advice for both gamblers and investors. If you're relying on the money you're investing to pay your bills, send Johnny to college, or retire soon, you're probably better off playing it safe.

- **Personality:** Some people are naturally more risk-tolerant than others. If you tend to get worried sick over money, a low-risk approach is probably more suitable.
- **Goals:** If your goal is to reap big rewards quickly, you may conclude that the risk is worth it. If your goal is to build wealth over a long period of time with less chance of losing your initial investment, a slow, steady approach is probably best.

REMEMBER

Only you can determine the right balance of risk and reward for you and your goals. You can obtain valuable guidance from a financial advisor, but how you choose to invest your money is entirely up to you (at least it should be).

Choosing the right approach

Tossing a bunch of ticker symbols into a hat and drawing out the names of the companies you want to invest in is no way to pick a dividend stock. Better approaches are available, as presented in the following sections.

Value

The value approach is like shopping at garage sales. Investors hope to spot undervalued stocks — stocks with share prices that appear to be significantly lower than what the company is really worth. When hunting for values in dividend stocks, investors look for the following:

- **Strong earnings growth:** Companies that earn bigger profits with each passing year demonstrate they're growing and thriving. A shrinking profit usually means trouble — bad management decisions, increasing competition, or other factors chipping away at the company's success.
- **High yields:** *Yield* is the ratio of annual dividends per share to the share price. If shares are selling for $50 each and dividends are $2.50 per share (annually), the yield is $2.50/$50.00 = .05 or 5 percent. Stocks with higher yields deliver higher dividends per dollar invested. For example, a dividend stock with a yield of 5 percent generates a nickel for every dollar invested, whereas a yield of 25 percent generates a quarter per dollar.

- **Low price-to-earnings ratio (P/E):** *P/E* tells you how many dollars you're paying to receive a share of the company's profits. If a company earns an annual profit of $3.25 for each share of its common stock and the shares sell for $50, the P/E is $50/$3.25 = 15.39. In other words, you're paying $15.39 for every dollar of profit the company earns. The P/E ratio provides a barometer by which to compare a company's relative value to other companies and the market in general. (Head to Chapter 2 for more on common stock.)

  A good P/E ratio is one that's lower than the P/E ratios of comparable companies. As a general rule, investors look for P/E ratios that are lower than the average for a particular index, such as the S&P 500 or the Dow Jones Industrial Average (DJIA). See Chapter 2 for more about these stock market indexes; Chapter 9 explores P/E ratios in greater depth.

- **Solid history of raising dividend payments:** Like strong earnings growth, covered earlier in this list, a solid history of raising dividend payments demonstrates that the company is thriving. Every year it has more wealth to share with investors.

- **Solid balance sheet:** A *balance sheet* is a net worth statement for a company, listing the cost of everything it owns and subtracting the cost of everything it owes. Ultimately, a healthy balance sheet shows that the company has enough assets to cover its liabilities and then some. The remainder is called *shareholder equity.* For more about balance sheets, flip to Chapter 9.

- **Sufficient free cash flow:** Ideally, a company's cash flow statement shows that the company brings in enough actual cash each quarter to more than cover its expenses as well as the dividend distributions.

Growth

The growth approach to investing in the stock market focuses on a company's prospects for generating future earnings. These companies are expected to see their revenues and profits grow at a pace faster than the rest of the market. As such, this approach tends to be more speculative than the value approach. Growth investors may pay more for shares than their past results or actual performance justifies.