



BY JOHN KINGHAM

## DIVIDEND HUNTER

# A BEGINNER'S GUIDE TO DIVIDEND INVESTING

**When you've been investing for decades, it's easy to forget just how confusing the whole thing can be for newcomers. It's easy to ramble on about things like capital intensity, acquisition rates or Common Equity Tier 1 ratios and sound like an expert. But to most people, and most investment newbies, it's just gobbledygook. So, this month, I thought I'd take a step back and write a meat-and-potatoes beginner's guide to dividend investing containing just a handful of the most important points.**

And if you're an old hand at the dividend game, then you might still want to read this guide. Why? Because it's always a good idea to revisit the basics.

### **Step 1: Invest in lots of very different companies**

The number one cause of most stock market horror stories is excessive risk taking. I've seen it many times in myself (many years ago), family members and other investors I talk to.

The investor puts their money into just a handful of companies. Those companies go up in value and the investor is happy. But, at some point,

several of those investments go dramatically south, falling by thirty, forty or fifty percent in a few months. The investor panics, terrified that the investments could go to zero, so they sell everything today to avoid further pain tomorrow.

However, in most cases, if the companies are fundamentally strong, then their share prices eventually recover, leaving the dazed and confused investor sitting on the sidelines with their losses locked in for eternity. In my case, I'm so daft I had to go through this process twice (in 2003 and 2008) before finally learning one of the world's oldest lessons: Don't put all your eggs in one basket. In practical terms, this means invest-

ing an equal amount into at least 20 different companies. It also means spreading your investments across many different sectors and investing in companies that generate profits from many different countries. For example, I hold 30 companies. No more than three of those companies come from any one sector, about half of the portfolio's revenues are generated outside the UK (from a wide variety of different countries) and no more than six percent of my portfolio is invested in any one company.

By following this step (or something similar), you'll be insulating your portfolio from any single



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bad event, such as a company going bust, a sector going into decline or a country going into a recession.

## Step 2: Invest in companies with long-term steady growth

Notice that I didn't say "long-term steady *dividend* growth". If you're looking to build a portfolio capable of generating long-term dividend growth, then yes, obviously you're going to be interested in companies with track records of long-term dividend growth. But dividend growth is nothing without earnings growth, and earnings growth is nothing without revenue growth. So, let's break down long-term steady growth in a bit more detail.

By long-term, I mean ten years, at least. Data covering this sort of timescale isn't usually free (premium offerings from Morningstar, SharePad and Sharelockholmes all have 10+ years data for all FTSE All-Share stocks), but there are workarounds.

For example, you can see a list of all UK stocks with 10+ years of dividend growth on the [dividendchampions.uk](http://dividendchampions.uk) website. And you can also download this data as a spreadsheet, which is very handy. Unfortunately, the spreadsheet doesn't tell you whether a given company is large, medium or small cap – or more importantly, which sec-

# “DIVIDEND GROWTH IS NOTHING WITHOUT EARNINGS GROWTH, AND EARNINGS GROWTH IS NOTHING WITHOUT REVENUE GROWTH.”

tor it operates in. However, the London Stock Exchange (LSE) website has a Statistics section with a Companies and Securities page, and there you can download a spreadsheet of all LSE-listed companies which includes Sector and Market Cap information.

With a bit of spreadsheet fiddling, you can create a spreadsheet which combines the list of UK dividend champions with their related sectors and market caps. That will certainly get you a long way down the road of choosing which companies to invest in.

The dividend champion spreadsheet includes each company's dividend history, so you'll still need revenue and earnings information, but you can get a lot of that for free too. Morningstar, for example, has a comprehensive five-year data-set for each listed company. A narrower but deeper dataset (i.e. covering only the key variables, but over ten years or more) is available from [investgate.co.uk](http://investgate.co.uk) under their "fundamentals" tab.

So, it's possible, with a bit of work, to build a list of FTSE All-Share companies with 10+ years of dividend growth, as well as their sector, market cap and ten-year revenue and earnings histories. There are easier alternatives to this, such as an investment newsletter and so on, but if you want to go the free route then this is what you need to do (at least if you want to follow this strategy).

As for a definition of steady growth, I mean consistent, repeated or not one-off. If you're selecting stocks from the list of dividend champions, then obviously their dividend growth is consistent because that's the definition of a dividend champion. You can also apply the same thinking to revenue and earnings growth. If revenues and earnings went up every year, that's good. If they went down every year, that's bad. And somewhere in the middle is somewhere in the middle between good and bad. Again, spreadsheets make this sort of analysis easy and if you want you can download a spreadsheet from my website which will do these calculations for you.

The final part of steady long-term growth is growth, and it's a good idea to measure this (using a spreadsheet) over a ten-year timespan across revenues, earnings and dividends.

So, in summary, you want companies with steady, long-term broad-based growth – and the steadier, longer, broader and faster the growth, the better.

## Step 3: Invest in low risk companies

It's all well and good for a company to have a long history of steady growth of dividends, profits and so on, but the past is not necessarily a good guide to the future.

For example, what if you have a min-





**“EVEN THE BEST COMPANIES IN THE WORLD CAN TURN INTO TERRIBLE INVESTMENTS IF THEY’RE BOUGHT AT THE WRONG PRICE.”**

ing company which has benefited from a very long commodity super-cycle, where copper prices and the company's profits and dividends have increased consistently and rapidly for more than a decade. Is this company likely to continue growing at rapid pace for another decade or more? Perhaps, but perhaps it's also likely that copper supply will eventually catch-up with demand, that the price of copper will then collapse, and that the company's profits and dividends will collapse along with it.

So, in addition to a good steady track record of growth, there are some additional factors you'll need to look out for.

Since I've already mentioned mining, I'll start with commodity companies. These companies have zero pricing power because (more or less) copper or oil from one company is identical to copper or oil from another company. They are price takers, not price makers. That isn't the real problem, though. The real problem is that supply is typically slow to react to increasing demand, because, to significantly increase the supply of copper, you have invest a lot of time and money into setting-up or expanding copper mines. Increasing demand and a slow response from supply creates price increases which, if the demand increase is sustained, can last for years. This is good for commodity companies because they make lots of money and some of that gets turned into increasing dividends. But this happy scenario rarely lasts forever. Eventually, demand falls or sup-

ply catches-up with demand and the result is rapidly falling prices, profits and dividends.

This sort of thing is notoriously difficult to predict, so I don't try to. I simply assume that a fast-growing commodity company is not going to be able to sustain that growth over the long term. Instead, I effectively assume that it won't be able to grow faster than about 5% per year (which is average for most companies) and value the company on that basis. What I have done in the past, but definitely won't do again, is pay a high price for a rapidly growing commodity company on the assump-

tion that it will continue to grow rapidly.

This cyclical risk also applies to oil-related stocks, housebuilders and most construction companies.

The second major risk is debt and pension obligations. Debt is a fairly obvious one. You might have a company that's been growing rapidly for years, but only because each year it takes on lots more debt to fund its expansion. This growth is externally funded rather than internally, and because of that, it's both unsustainable and risky. It's unsustainable because debt and the



related interest payments cannot grow faster than profits forever, and it's risky because it puts a lot of power into the hands of banks and other lenders whose interests are not necessarily aligned with shareholders.

For debts, I just look at the latest total borrowings figure (current borrowings plus non-current borrowings) and compare that to the company's average profits over the last few years. If debts are more than four or five-times average profits, I'll usually end my analysis there.

As for defined benefit pension obligations, these are similar to debts, although pension obligations tend to grow too large when companies overinvest in human assets (by offering pensions that were too generous) rather than overinvesting in the capital assets (such as new factories or stores) that debts are often used for.

With large pension obligations, the risk is that the pension scheme's assets won't cover its liabilities, and that the resulting pension deficit will have to be paid-off by the company. This draws valuable cash away from both the business and its shareholders and can put an almighty strain on companies which are often already weak and uncompetitive.

If a company has a defined benefit scheme, you'll find its related pension obligations in the notes to the accounts in the latest annual report. If a company's pension obligations are more than ten-times its recent average profits, my assumption is that the risks are simply too high.

The third major risk is a dependence on "big wins". These are companies where one big win today can lead to revenues and perhaps even profits for many years to come. Companies like **Serco (LON:SRP)** or **Capita (LON:CPI)** have to win big contracts with big clients and that can lead to an excessive focus on winning contract at any cost, rather than winning contracts only if they'll produce good returns for shareholders.

This often leads to suicide bidding, where contracts are signed which can only make a profit if everything goes exactly to plan. But in reality, few things go exactly to plan.

Other types of "big win" companies are pharmaceutical and biotechnology companies which need big wins from big blockbuster drugs and the big patents that come with them. If a pharmaceutical company has produced lots of profit for a long time by relying on a small number of big patents, it will almost inevitably run into major problems when those patents run out. **GlaxoSmithKline (LON:GSK)** (which I own shares in) and **AstraZeneca (LON:AZN)** have found this out over the last few years.

The final major risk is companies where rapid growth has been driven by multiple acquisitions. Acquisitions aren't always a bad thing, but they usually are when they're used to grow a business where the existing core business is stagnant or in decline. These acquisitions are often too numerous, too frequent and too big to be successfully integrated into a single, seamless business. In the end, they're



often a costly distraction at a time when management should really be focusing on and investing in the core business.

So, if you see a company where stagnant core growth is being boosted by large and/or multiple acquisitions (especially if the acquired business is not virtually identical to the company's core business), be especially careful.

#### Step 4: Invest in attractively valued companies

Even the best companies in the world can turn into terrible investments if they're bought at the wrong price. The poster-child for this is **Coca-Cola (NYSE:KO)**, undoubtedly one of the world's best businesses in terms of





long-term financial performance, but also a very bad investment if you bought the shares in 1998.

Why? Because if you bought Coca-Cola shares in 1998, you would have paid about 10-times revenues and 50-times earnings, and you'd have received a dividend yield of less than 1%. Since then, the business has continued to grow (albeit at a gradually slowing rate) and its dividend has gone up by around 150%. However, the share price is more-or-less where it was 20 years ago. That's 20 years with zero capital gains, and all because the starting price was way too high.

Avoiding overpaying for quality dividend companies is relatively easy, although that doesn't mean you won't make the odd mistake here or there. But really, this is Dividend Investing 101: Buy shares that have a yield which is above average, or at the very least,

not too far below average.

Another way to think about this is to look at the dividend growth rate which would be required to produce decent returns. Let's say you want a 10% total annual return over the long-term. If you look at a company and its yield is 1%, then it's going to have to grow that dividend by 9%, year after year, to give you your 10% target return.

I don't know about you, but I don't think there are many companies capable of producing long-term dividend growth of 9% per year or more. Certainly not enough to build a well-diversified portfolio.

Personally, I don't like to invest where the yield is below 2%, and I'd much rather invest where the yield is 4% or more. I also look at the share price relative to ten-year average dividends and earnings, just to make sure the

current yield isn't caused by an abnormally large one-off dividend. If the share price is more than 30-times the company's ten-year average earnings, or 60-times its average dividend, then that price is a bit too hot for my liking.

## Step 5: Sell companies when their growth, risk and price are no longer attractive

Companies change and share prices change, so when a company does well and its share price shoots up too far, I'll trim the position or sell it entirely. And at the less positive end of the spectrum, if a company's growth rate turns negative for too long, or if its debts go too high, I'll sell in order to reinvest in better companies at lower prices.

But don't become a hyperactive day trader. I typically make just six purchases each year and six sales, which is enough to steer a portfolio in the right direction, but not so much that your stock broker benefits more from your portfolio than you do.

## A basic plan to get you started

If you're a beginner, I think this guide should be enough to get you up and running in the right direction. Eventually, as you gain experience, you can tweak it and refine it as much as you like.

But, however advanced you become, make sure you never forget the basics of broad diversification, consistent growth, low risk and attractive price. If you stick with those basics for a decade or more, then it's likely that your investment returns will be more than satisfactory.

### About John

John Kingham is the managing editor of UK Value Investor, the investment newsletter for defensive value investors which he began publishing in 2011. With a professional background in insurance software analysis, John's approach to high yield, low risk investing is based on the Benjamin Graham tradition of being systematic and fact-based, rather than speculative.

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