5 RULES OF WINNING DIVIDEND STOCK INVESTING

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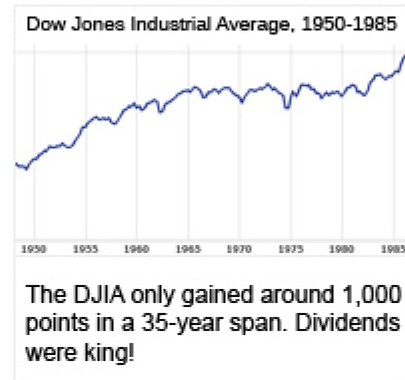
Once upon a time, dividend stock investing was the *only* way to invest in the stock market. Before the days of computers, automated trading systems, discount brokerages, and all the other technologies that have made stock investing accessible to almost everyone, stock prices just plain didn't move very much.



The DJIA only gained around 1,000 points in a 35-year span. Dividends were king!

Without the hope of big price appreciation, investors had no choice but to buy stock in solid, name-brand companies that paid steadily increasing dividends.

Well, the "Days of the Dividend" are back (and likely here to stay for good!). Investors are flocking in droves to big-name dividend-payers these days, and for good reason – **dividend stocks offer a level of protection from market turmoil that non-dividend-payers can never equal**.

So, now that dividend stocks are back in the spotlight as the best investment vehicle for the vast majority of the investing public, we at Dividend.com would like to share with you our tried-and-true rules for dividend stock investing. We've broken down the most important practices that all dividend investors should know and follow, and narrowed down a list of five rules designed to help you grow your dividend portfolio.

Rule #1 – Avoid Dividend Traps by Looking for High Yields that are Sustainable

The Dividend Yield Approach

There are several hundred stocks out there right now offering annual dividend yields of 10%, 20%, 30%, and even more. The problem with the vast majority of these yields is that they are simply *too high*. We call these types of stocks **Dividend Traps**, meaning that their high yields are nothing more than temporary bait to lure in investors seeking high yields. Typically, companies can

rarely, if ever, make ends meet while paying out more than 10% of their stock prices in dividends. It just doesn't happen.

Normally, stocks with abnormally high dividend yields will require cutting their dividend payouts down to more appropriate levels. What is an "appropriate" level? **Generally speaking, dividend investors should be looking for yields between 3% and 9%** (and 9% is probably still too high).

A good question to ask yourself when considering investment in a stock with an abnormally high dividend yield is "How did this yield get so high in the first place?" The answer usually points to eroding share value – the stock's share price has fallen greatly in the recent past, and what used to be a more normal-looking dividend yield now sticks out like a sore thumb. Eroding share price almost always indicates eroding fundamentals, and if a company doesn't earn what it used to, it won't pay out what it used to, either.

The Payout Ratio Approach

Another way to gauge the viability and sustainability of a particular dividend is to look at the stock's **Payout Ratio**, which refers to the percentage of its net income the company pays out in dividends. If Company XYZ earned $2 per diluted share last quarter, and paid out $1 per share in dividends, it would have a Payout Ratio of 50%, since it paid out half of its income as dividends to shareholders.

A Payout Ratio of 50% is respectable – the company is issuing a good amount of its income to its shareholders, while banking the other half to use to grow its business (and hopefully its share price).

So, at what point should a company's Payout Ratio be considered "too high?" That's a matter of opinion, but we feel that a Payout Ratio of 75% or above should raise some red flags for investors, since, at the very least, the company will probably not be seeing much growth in the near future. A ratio of 100% or higher is an almost sure sign that a dividend cut is forthcoming. Why? Because a Payout Ratio of over 100% indicates that the company is actually *losing money* by paying out more funds to shareholders than it is bringing in.

Of course, there are a few notable exceptions to the Payout Ratio rules. During certain economic down-cycles, for instance, a company's profits can take a temporary hit, which pushes their Payout Ratio unexpectedly higher. As long as a company has enough cash in its coffers to avoid these kinds of hits, and its core business remains strong, it shouldn't have too much trouble maintaining its current dividend payout level.

Please Note: These guidelines regarding Payout Ratios do not apply to **REITs** (Real Estate Investment Trusts), who are federally required to pay out a minimum of 90% of their taxable profits in the form of dividends. **MLPs** (Master Limited Partnerships) also have a similar tax-advantaged structure which requires a high Payout Ratio.

Rule #2 – Dividend Growth Should be a Requirement, not a Bonus

Just as important as a stock's current dividend payout is its **dividend history**. Historical dividend data can sometimes tell you all you need to know about a company – where it came from, where it's going, and how long it will take to get there. Simply put, the best dividend-paying stocks combine a solid current dividend payout with a strong history of steadily increasing their dividends.

Before investing in any dividend-paying stock, be sure to check its dividend history first. Make sure that the company has not cut its dividend payouts recently, as such an action is almost always an indicator that the company is in financial peril. Another shortfall to watch out for is **stagnant dividend payouts** – these are payouts that have either not increased, or have increased by only a small margin over time.

Do your portfolio a favor, and scan for stocks whose dividend payouts increase year after year. **In general, dividend investors should look for dividend stocks with a recent history of increasing dividend payouts by an average of at least 5% annually for the past five years.**

Just because a certain stock *hasn't* augmented its dividend payouts much recently doesn't necessarily mean you should avoid it – what it does mean, however, is that there are certainly other stocks out there that could offer you better returns over the long run.

Rule #3 – Forget Value Plays: Cheap Stocks are Cheap for a Reason

Dividend.com Founder and CEO Paul Rubillo always says that "cheap stocks aren't good, because good stocks aren't cheap." That prophetic quote pretty much says it all. **Don't ever get suckered into buying a stock simply because it**

looks cheap. The market is extremely good at determining stock values, and 99.9% of the time, there are several good reasons why a stock's value is lower that you may think it "should" be.

Take a look at U.S. automakers Ford and General Motors. These two names were heralded by value investing "experts" for years because of their relatively high dividend yields and the supposed fact that they were "undervalued." Despite eroding fundamentals, sluggish sales, dominant labor unions, and sharply increasing dividend payout ratios (which we covered in the second part of Rule #1), many fund managers and individual investors foolishly clung to these names.

The market landscape is littered with many other value plays that simply continued to crash and burn – Eastman Kodak, Corning, Xerox, and Nortel Networks are just a few more examples of cheap stocks that are now even cheaper.

Value stock managers tend to hide under the cloak of the buzzword "value" in order to pass big losses off as buying opportunities. "Value" stocks differ from other stocks only by their label – these names can fall just as far and just as fast as "growth" or "momentum" stocks.

Rule #4 – Invest in Sectors with Good Future Growth Prospects, while Avoiding Dinosaurs and Cyclical Downturns

Past Performance does not Indicate Future Results

This one may seem like common sense, but you'd be surprised how many investors forget this rule. Simply put, **don't get caught up in the past performance of a stock or sector.** A stock's ten or twenty year price performance has little to no bearing on how it will perform for the next ten or twenty years.

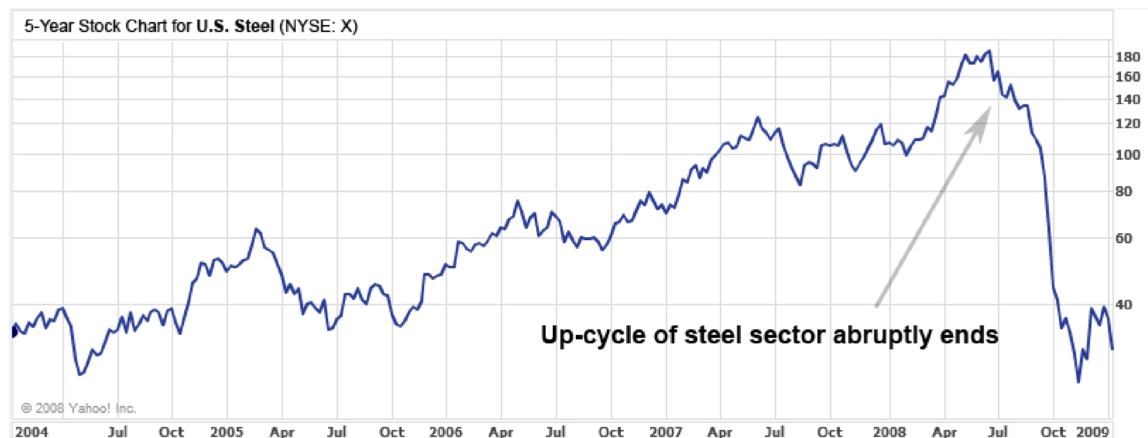
Always avoid **dinosaurs** – stocks whose business models are slowly but surely dying out. Some examples of current dinosaurs include traditional publishing companies (most notably newspapers), brick-and-mortar book retailers, and companies who produce "fad" products (remember the big highs that Crocs and Krispy Kreme hit before plummeting all the way under $2 per share?).

Instead, focus your efforts on finding stocks that pay good dividends and have plenty of room to grow. Some examples of sectors with strong growth prospects right now include technology, health care, and energy.

Up-cycles and Down-cycles

Investors should also step back from time to time and scan the current market landscape, paying attention to current state of "cyclical" plays like commodity and energy names. Are we at the beginning of a big swing higher, or has the sector already peaked? **The most money is usually lost when investors mistime their investments in cyclical sectors.**

Take a look at U.S. Steel's five-year stock chart below for a prime example of a dividend-payer that had a big multi-year run, only to see **five years of phenomenal gains erased in a single three-month period**:



As you can see, U.S. Steel had a great five-year run during a huge up-cycle for the entire steel industry. Several related stocks also enjoyed big runs during the period, such as AK Steel, Nucor Corporation, and Reliance Steel – and all of them subsequently experienced the exact same meteoric fall. You could substitute any of these major steel stocks' charts for the one above, and it would look almost exactly the same.

So, what lesson can dividend investors learn from this recent major fall from grace in the steel sector? In summary, cyclical sectors can turn on a dime. When you own stocks in commodity, energy, and certain aspects of technology, be sure to watch the names you own (as well as related names) very closely for signs of an impending down-cycle.

Rule #5 – Develop a Sell Strategy and Stick to It

This rule is quite possibly the most important one of all. Dividend investors always need to keep in mind that "buy and hold" doesn't mean "buy and hold, regardless of how far the stock falls." Dividend investors, like all other types of investors, must develop a **sell strategy** in order to protect profits and minimize losses.

A **sell strategy** refers to a predetermined set of rules that an investor establishes *before* investing in a specific security. Before adding any shares to your portfolio, make sure you ask yourself the following question: **What type of losses (percentage-wise) am I willing to absorb before selling?** We always suggest investors look at the 15% mark as a starting point, but each investor must ultimately make his or her own decision about when to sell.

Once a stock you own reaches the -15% to -20% level, we suggest taking a close look at the company's key statistics to ensure that its fundamentals haven't changed. Sometimes, a drop of 15 or 20% is simply a part of an overall market correction, where even the best companies lose share value. Usually, however, such a decline indicates that the company has encountered some tough times, so be vigilant and investigate the potential causes of the share price decline.

Conclusion

The five rules we've outlined in this report are a good foundation upon which to develop a solid dividend stock investing strategy. Although this is by no means a complete list, all dividend investors should keep these rules in mind when building and editing their portfolios.

We hope you find this report interesting and useful, and we welcome all comments and feedback via e-mail to contact@dividend.com.

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