

Are Dividend Stocks the Answer to Today's Low Yield Environment?

Happy New Year! We hope that you had a joyous holiday season, surrounded by friends and family.

Despite nonstop reporting on Europe's ongoing financial and political difficulties, equity markets around the world rallied smartly in the fourth quarter. After dismal returns in August and September, stocks were arguably oversold and due for a rebound. Improving economic data in the U.S. provided the impetus for the rally. The unemployment rate dropped under 9%, fears of a double-dip recession receded, and the consensus view emerged that the U.S. economy will continue to grow over the next 12 to 24 months, albeit at a substandard rate compared with historical norms. Inflation remains well under control.

After strong returns in 2009 and 2010, 2011 was a relatively poor year for stock markets worldwide. Here are asset class returns for the quarter and full year 2011:

Index	Asset Class	Fourth Quarter 2011	Year-to-Date 2011
Short/Intermediate-Term Bonds	Fixed Income	0.8%	5.8%
S&P 500	Large U.S. Stock	11.8%	2.1%
Russell 2000	Small U.S. Stock	15.5%	-4.2%
MSCI EAFE	Foreign Stock	3.3%	-12.1%
Dow Jones REIT	Real Estate Securities	15.4%	9.4%

It is no surprise that interest rates remain at extremely low levels compared with historical averages. The benchmark 10-year U.S. Treasury bond yields just 2%, and the Federal Reserve has said that it fully intends to keep short-term rates near zero until mid-2013—and possibly longer. While these low rates are a boon for borrowers, they penalize savers and those living on fixed incomes. Retirees, and those

OUR PROFESSIONAL ADVISERS

Mark Dowling, CFA, CFP®

MARK.DOWLING@DYWEALTH.COM

Dale Yahnke, CFA, CFP®

DALE.YAHNKE@DYWEALTH.COM

Paul Temby, CFA, CFP®

PAUL.TEMBY@DYWEALTH.COM

Will Beamer, CFA, CFP®

WILL.BEAMER@DYWEALTH.COM

Alana Asmussen, CFA, CFP®

ALANA.ASMUSSEN@DYWEALTH.COM

Jacqueline Bell, CFA, CFP®

JACQUELINE.BELL@DYWEALTH.COM

Questions?

Please e-mail or call us at (858) 509-9500.

Adviser Corner



MARK E. DOWLING, CFA, CFP®
PARTNER

Mark holds the designations Chartered Financial Analyst (CFA), CERTIFIED FINANCIAL PLANNER™ (CFP®), and has a Master's Degree in Business, Finance (MBA) from San Diego State University. He completed his undergraduate work at San Diego State University with a degree in Industrial Arts. Mark has taught financial planning and investments at the adult education, community college, and university levels. He has been instrumental in the development and review of competency tests for financial planning professional organizations.

Mark is a member of the National Association of Personal Financial Advisors (NAPFA), the Financial Planning Association (FPA), the CFA Society of San Diego, Inc., and the CFA Institute. He is currently serving on the Board of Directors of the Coastal Community Foundation. Mark has worked on committees for the Board of Examiners of the Certified Financial Planner Board of Standards to develop and maintain the comprehensive examination required of all CFP candidates. Mark was born and raised in Southern California, is married, and has two children.

nearing retirement, are especially concerned about their portfolios' ability to generate sustainable income at tolerable risk levels. From a behavioral standpoint, this situation has been further complicated by the stomach-churning ups and downs that have roiled the stock market since 2007. Many individual investors, frightened by ongoing stock market volatility, have retreated to the shelter of interest-earning assets at the precise time that these "safe" securities are most unlikely to satisfy their income requirements.

For any investment predicament, the financial services industry, and the media that covers it, has always been happy to serve up a so-called "solution." This time around, we are told that dividend stock investing is the answer to our investment problems. Investors can still participate in the long-term capital appreciation of the stock market, but do so with a less-volatile portfolio that will throw off substantial dividend income. At first glance, it is a fairly compelling story. The stocks of many blue chip companies, including ConocoPhillips, Johnson & Johnson, Intel, Abbott Laboratories, Microsoft, and Procter & Gamble, have dividend yields (dividend payments divided by stock price) over 3%, well in excess of the 10-year U.S. Treasury bond. Who would not want to own a portfolio of such high quality names?

We are not about to suggest that investors should avoid dividend-paying stocks. Indeed, all of the individual stocks listed above, and many other dividend-payers, are contained within our client portfolios. Our objection is to the concept of constructing stock portfolios using the dividend payout rate as the primary, and in some cases only, consideration for selection. By building portfolios using this methodology, investors could be creating new, unintended risks.

One concern is that some investors might consider replacing low yielding, high-quality bond holdings with dividend-paying stocks. Let us be very clear: dividend-paying stocks are not bonds. If an investor views them as substitutes for one another to boost portfolio income, his or her portfolio will contain a more aggressive and volatile asset allocation than may be appropriate. High-dividend-paying common stocks can incur significant price declines, just like any other risky equity asset, and can reduce their dividend payout, with board approval, at any time. In fact, excessively high dividend yields are often a sign of financial distress. At the market peak of 2007, bank stocks were among the highest dividend-yielding equities; they were subsequently pummeled during the global financial crisis. Today, bank stocks remain at much lower prices, plus these firms have massively curtailed their dividend payouts. Investors lost on both fronts.

A second potential pitfall facing dividend chasers is neglecting the positive attributes of the non-dividend paying stocks they are excluding from their portfolio. The decision to pay a dividend is effectively an admission by corporate management that reinvestment in the business is unlikely to earn a return in excess of the company's cost of capital, and shareholders will therefore be better off by having money returned to them in cash.

Typically, high-dividend stocks are those of companies in relatively mature industries (oil and gas, packaged goods, utilities). Conversely, many companies with attractive growth opportunities do not pay dividends, reinvesting their earnings into their businesses instead. Many of the best performing stocks of the last 20 to 30 years still do not pay dividends (such as Berkshire Hathaway, Amazon.com, Google, and Apple). These companies use the earnings they generate to expand product lines, increase production capacity, and hire workers. These investments, in turn, further increase the companies' market share, revenue, and net income. To return that capital to investors in the form of dividends would reduce future growth prospects and likely lower the stock price appreciation enjoyed by these corporations. By excluding stocks of companies with the most attractive reinvestment opportunities, investors will generate more current income, but will fail to capture much of the upside inherent to a growing, dynamic capitalist economy.

“Our objection is to the concept of constructing stock portfolios using the dividend payout rate as the primary, and in some cases only, consideration for selection.”

Finally, some investors ignore the tax implications of focusing on dividend-paying stocks. Dividends are a tax-inefficient type of income, taxed at both the corporate and individual levels. While qualified dividend income is currently taxed at the 15% long-term capital gain rate, this favorable tax treatment is scheduled to expire along with the Bush-era tax cuts at the end of 2012. Unless new legislation is adopted, dividends will once again be taxed at ordinary income rates starting in 2013, as they were during much of the bull market in the 1980s and 1990s. Indeed, the prices of dividend-paying stocks may already be priced lower in anticipation of more punitive dividend taxation.

We always encourage our clients to view their portfolio in terms of total return, not just the cash income generated. Total return encompasses not only the income derived from stock dividends and bond interest, but also the capital gains and losses realized on these assets. Without a doubt, dividends are an important component of overall return, representing approximately 44% of total return for the S&P 500 over the past 80 years. But focusing solely on income generation comes at a cost. Studies conducted by Credit Suisse and Bank of America found that the highest-yielding stocks produced lower total returns than those with lower dividend yields. (These studies ignored the impact of taxation, which likely would have further increased the advantage of the lower-yielding stocks.) We believe a superior approach is to have a blend of dividend-yielding stocks (for current income) and stocks of companies with attractive growth prospects (for capital appreciation). This more diversified approach is likely to have a superior risk/return profile over long periods of time than a dividend focused strategy.