I

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.

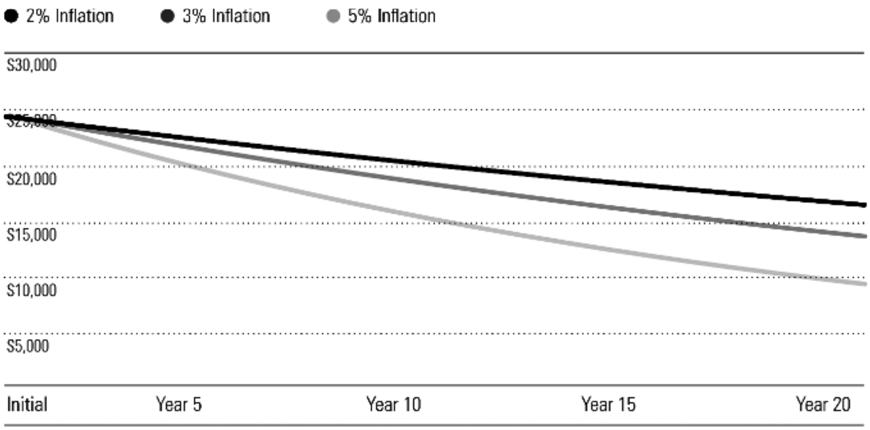

Figure 1.4 Fixed Income: Purchasing Power of $25,000 over Time

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.

Where the Dividends Are

I figure that American corporations are dishing out some $250 to $300 billion worth of dividends annually, a gargantuan sum by any standard. This estimate only pales in comparison with the aggregate market value of the stock market: $15 trillion or thereabouts. As large as this dividend stream is, it's still less than 2 percent of the market's total value.

In fact, dividend yields have been so low (less than 3 percent) for so long (continuously since 1994) that it's little wonder that stock investors as a group have all but forgotten their contribution to overall returns. This was not always the case: Historically, dividends have been a much more significant contributor to total return—a comprehensive measure of investor profits that takes both dividend income and capital appreciation into account. Only in the 1990s did dividends fall from favor, and even a recent comeback hasn't come close to offering the yields of the past (see Figure 1.6).

The good news is that today's dividends are not equally distributed. Many stocks pay no dividends at all, and hundreds more make only token payments of cash (such as United Healthcare's 0.1 percent yield). This leaves a relative minority of firms paying the bulk of the market's cash dividends. Certain fields—which just happen to be less volatile and more profitable than American business in general—turn up as providing the best prospecting grounds for dividend income.

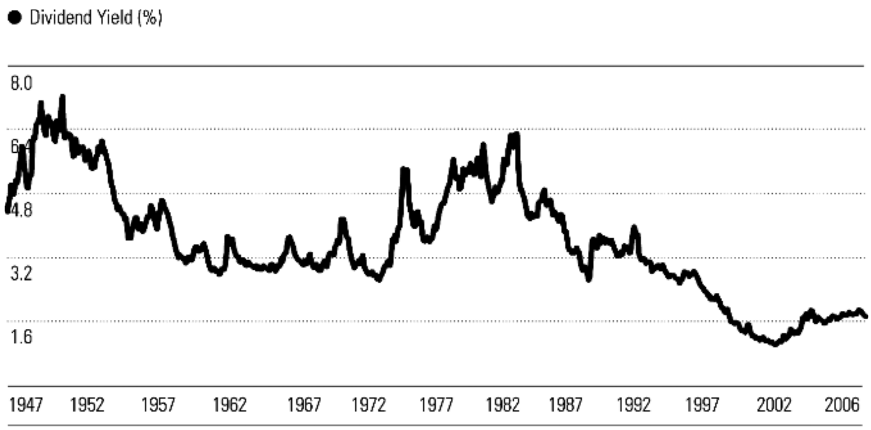

Figure 1.6 Dividend Yield of the S&P 500, 1947–2006

- *Banks.* While other segments of the U.S. market let their dividends lag, banks have continued to dish out cash, making them the market's leader in terms of total dividends paid. Bank stocks frequently offer yields between 3 and 5 percent with generally excellent dividend growth as a group—double the rate of inflation or higher. The record of Associated Banc-Corp, which I mentioned in the Introduction, is fairly typical, but much larger banks have superb records as well. (See Figure 1.7.)
- *Utilities.* Ever since electric and natural gas utilities ceased being growth stocks back in the 1950s, the basic appeal of these stocks has been high current income. The industry is not nearly as profitable as banking, which has made it tough for many utilities to increase their dividends as fast as inflation. Still, well-chosen utilities have historically been able to supply current yields of 4 percent or more while keeping pace with inflation. (See Figure 1.8.)
- *Consumer staples.* People still eat during recessions. They also continue to buy beer, soap, and razor blades. This group encompasses food, beverages, household products, and the like, and as a group these enterprises are enormously profitable. Sales growth is relatively slow—there's a limit to how much overall gains in household wealth will translate into higher consumption of detergent and toothpaste—but these firms also provide decent, above-average yields with growth prospects double or triple the rate of inflation. (See Figure 1.9.)

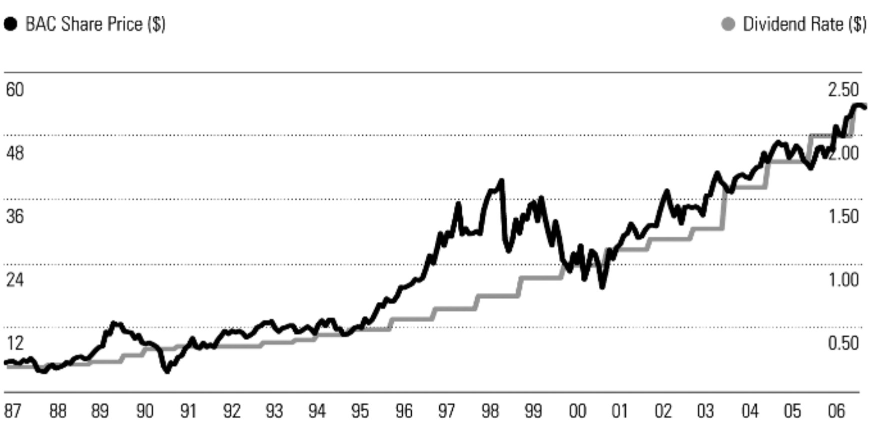

Figure 1.7 Bank of America (BAC): Share Price and Dividend History

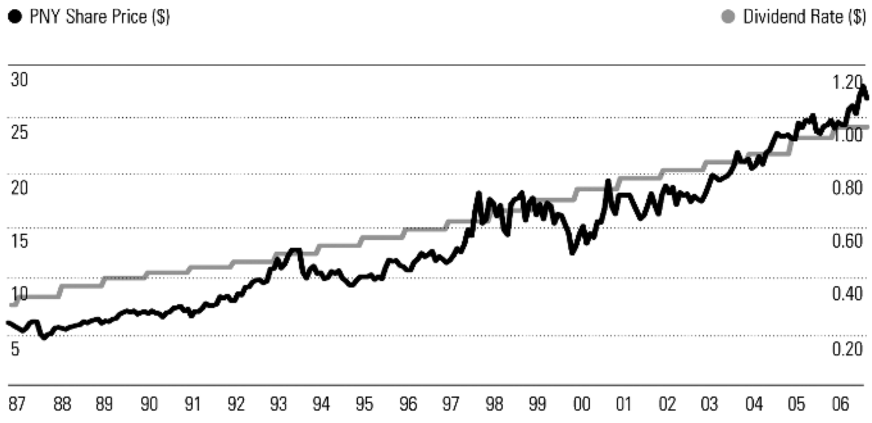

Figure 1.8 Piedmont Natural Gas (PNY): Share Price and Dividend History

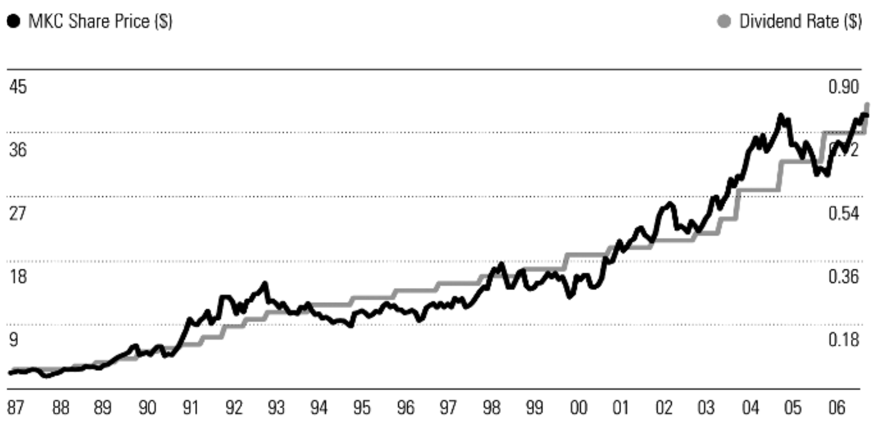

Figure 1.9 McCormick & Company (MKC): Share Price and Dividend History

- *Real estate investment trusts.* These firms make an interesting trade-off: In exchange for not paying federal income taxes at the corporate level, they agree to pay out at least 90 percent of their taxable income to shareholders as dividends so (as you might expect) the government can tax it. The bulk of this industry is simply in the landlord business: owning office buildings, malls, warehouses, and hospitals; collecting the rent; and mailing most of it out to investors. Like utilities, growth prospects in general are relatively mod-est; unlike utilities, no regulator places a ceiling on profitability, so effective

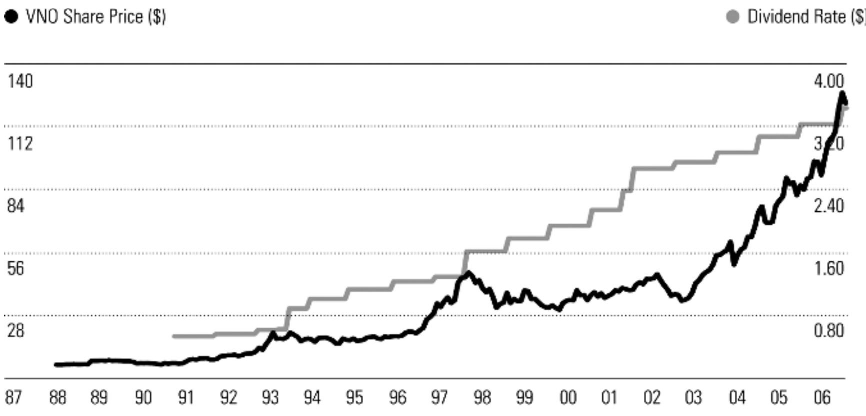

Figure 1.10 Vornado Realty Trust (VNO): Share Price and Dividend History

capital allocators can generate growth well above the industry average. Historically, dividend yields have run at 6 percent or better. (See Figure 1.10.)

- *Energy.* There are two kinds of action in the energy industry. First, you've got Big Oil—ExxonMobil (XOM), Chevron (CVX), British Petroleum (BP), and the like. By virtue of sheer size, these firms dole tremendous quantities of cash out to their shareholders. When oil prices are high, their share prices rise in tandem, resulting in lower dividend yields. Nevertheless, these major oil producers have usually been able to deliver yields in the 3 to 5 percent range.

  Second, and even more interesting, are energy transportation businesses held in master limited partnerships (MLPs). These firms generally have little or no exposure to oil and natural gas prices; instead, they own the pipes and terminals that move the stuff around the country. These are as cash-rich businesses as you're likely to find, and like the REIT structure, MLPs typically hand almost all of their cash flow back to investors, creating yields of 6 percent and up. (See Figure 1.11.) Not only that, but the industry has demonstrated excellent income growth for investors. (The only hitch is that MLPs carry certain tax characteristics that make them more complicated to own than ordinary common stocks and REITs; more on this in Appendix 6.)

The industries I've mentioned are well known for rich dividend yields and at least decent dividend growth, but even these are not alone. For example, few industrial manufacturers provide decent current yields, but General Electric

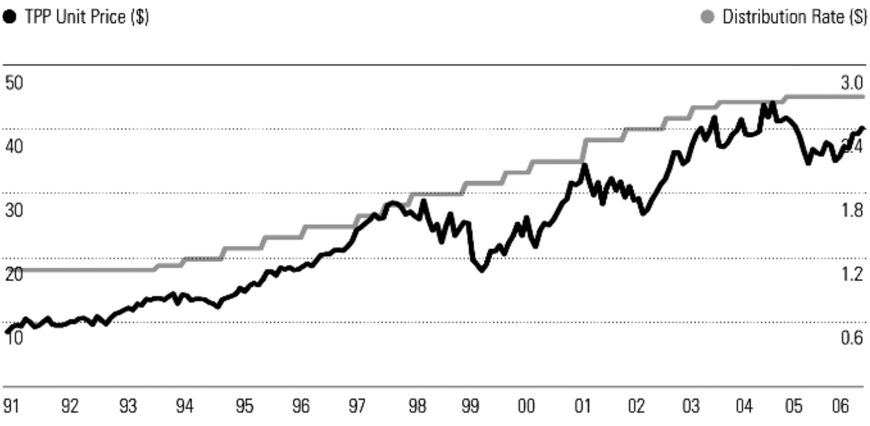

Figure 1.11 TEPPCO Partners (TPP): Unit Price and Cash Distribution History

(GE) has often been priced to yield 3 percent or more since the bottom of the 2000–2002 bear market—*and* has been increasing its dividend at a 12.3 percent annualized rate over the past 20 years (see Figure 1.12).

I don't cite these examples to make recommendations; whether a particular stock, regardless of yield or growth, is worth buying is a topic for later chapters. I merely mean to demonstrate that the equity investor is not limited to the dismal yield of the market averages or fixed-income investments with low real returns. Individual stocks, chosen for their dividend characteristics, can bridge the gap between fixed-income yields and equitylike growth prospects.

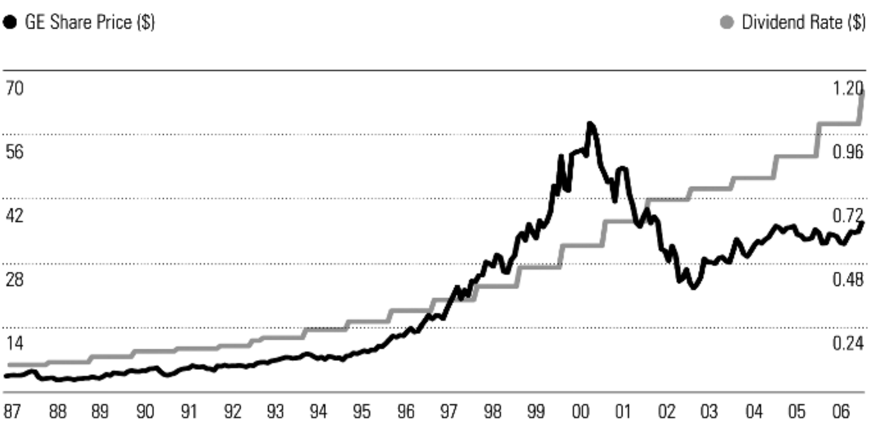

Figure 1.12 General Electric (GE): Share Price and Dividend History

The Ultimate Example

There are no perfect stocks out there, but some come closer than others, and one stock in particular—California-based real estate investment trust Realty Income (O)—comes closer to being perfect than any other I know of.

This landlord specializes in freestanding, single-tenant retail properties. But if its business is predominantly collecting rent, it treats shareholders—not just tenants—as customers. It bills itself as "the Monthly Dividend Company," and I have yet to find any company so devoted to large, consistent, and rising dividend payments as this one. CEO Tom Lewis and his lieutenants routinely invoke the expectations of "the 75-year-old lady in Dubuque for whom dividends aren't a luxury, but a necessity"—not only when pitching their stock to investors, but also when making business decisions. Far from being the lip service this line might otherwise represent, this deep sense of responsibility to shareholders is evident in the firm's long-term performance. (See Figure 1.13.)

Realty Income is not a buy at any price (no stock is; see General Electric's stock price chart if you doubt me), but its basic characteristics are exactly those meant to meet the real-world needs of income seekers. Between 1994 and 2006, its annual dividend payments to shareholders rose an average of 3.7 percent per year. That may not sound like a lot of growth, but the stock also provided an average dividend yield of 7.5 percent during this time.

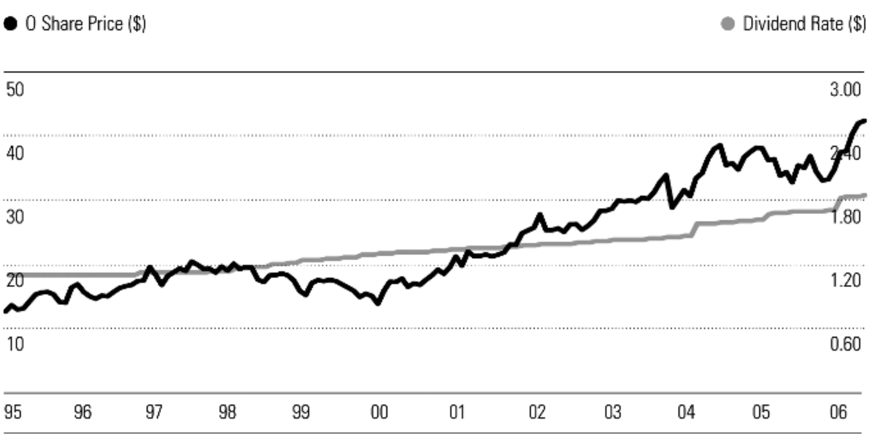

Figure 1.13 Realty Income (O): Share Price and Dividend History

Note that Realty Income's stock price does not always go up. Mr. Market is at work here, too: The market price of these shares fell 30 percent between August 1997 and March 2000. Without the dividend, it would have been tough to hang on to Realty Income shares during that stretch of almost three years of decline.

But even as Realty Income's yield rose and fell inversely to its market price, its monthly dividend rate never declined. Through thick and thin, bear and bull, those cash payments to shareholders kept right on rising. The investor holding Realty Income shares for the dividend didn't need to panic, nor was there any need to trade back and forth to generate a worthwhile return. Realty Income, not the shareholders, did all the work.

Realty Income is exactly the kind of stock that can meet Sally's needs. Bought at a reasonable price, it can provide a yield of 6 percent or more, filling Sally's need for cash. This dividend should also grow at least as fast as inflation, keeping the purchasing power of Sally's income stable. I wouldn't recommend investing Sally's entire portfolio in this one company—no stock's dividend is safe enough for that—but a mix of stocks with similarly attractive dividend characteristics seems to me to offer the best way to meet real-world financial goals.

Dividend Reinvestment

Maybe you don't need current income from stocks—you're far from retirement, and what you want is for your money to grow. I have wonderful news: Dividend reinvestment is just as good a way (or better) to build wealth and future earning power as the pursuit of capital gains.

Take Realty Income, for example. Between the end of 1994 and the end of 2006, its market price rose from $8.56 a share to $27.70. You could have paid $856 for 100 shares and earned a capital gain of $1,914, an increase of 10.3 percent per year on average.

That's not at all bad on its own, but a rising stock price was only half of the story:

- Realty Income also paid out $13.57 a share in dividends over those dozen years. That same $856 investment kicked out $1,357 in cash payments. The total return on those 100 shares was not $1,914, but $3,271.

(continued)

► Not only that, but the shareholder who used those monthly dividends to buy additional shares saw his ownership stake grow from an initial 100 shares to 249 shares over those dozen years. The final gain of that strategy—$6,039—was almost double the sum of the return with dividends taken in cash (see Figure 1.14).

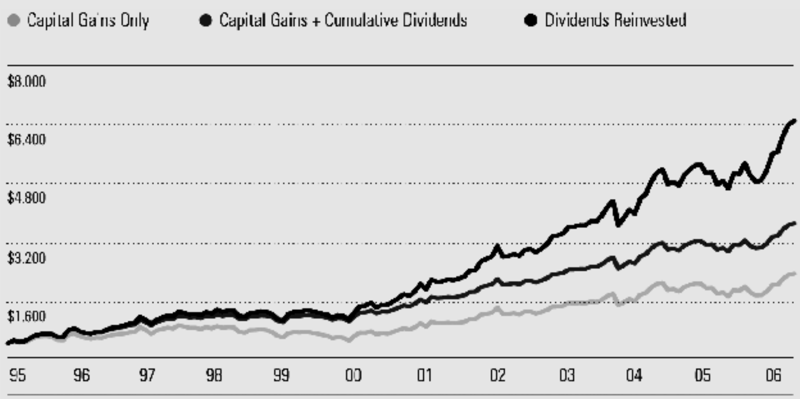

Figure 1.14 Realty Income: Hypothetical Dividend Reinvestment

Having accumulated earning power with reinvested dividends, you're free to stop anytime and start taking your dividends in cash. In this case, the 100 shares that once provided $90 worth of dividend income per year has become 249 shares paying some $378 annually—the investment's earning power has multiplied more than fourfold. Given the right group of well-chosen dividend payers, with high yields, rising dividend rates, and reinvestment compounding to your benefit, you might never need to sell in search of higher-yielding investments—even at retirement.

Many brokerage firms and even individual dividend-paying companies make it easy to reinvest dividends through automatic dividend reinvestment plans—also known (regrettably) as DRIPs. I'll describe how DRIPs work in more detail in Appendix 1.

(My sole knock on Realty Income is the fact that it doesn't sponsor a DRIP. Doing so would cost the firm a meaningful amount of money, and it would rather pay those funds out as dividends. Fortunately, most brokerage firms also offer low-cost dividend reinvestment programs, even for stocks that don't offer DRIPs of their own.)

What Do You Want to Own?

While the current income provided by high-yield stocks is attractive, the single best side effect of the dividend harvest strategy is that it helps shift the investor's attention away from ever-fluctuating stock prices. Instead, the income stream—sound, large, and growing—becomes the ultimate source of reward and the benchmark of success.

Let's try a little experiment. Imagine that it's noon on a Wednesday, the markets are open, and you've got some cash to invest. Then you receive word that when the stock market closes today, it's going to stay closed indefinitely—at least five years, maybe a decade or two. There's nothing wrong with the economy: Corporate profits are strong, dividends are safe, and nobody has repealed capitalism. But whatever you own when that closing bell rings, you're stuck with for the foreseeable future. What do you want to hold?

Were this to happen in the real world, I have no doubt that Mr. Market would have a full-blown seizure. Investors who own stocks in anticipation of capital gains would flee and prices would crash.

As for me, I'd be loading up on Realty Income and other high-yield stocks like it. With enough dividend income and dividend growth to justify my investment, what do I need the market for? I'm not a seller on this day; I'm a buyer with both hands. Assuming Realty Income can keep up a 4.5 percent growth rate in annual dividends (it's been growing even faster than this recently), I stand to get all of my money back in less than 14 years, and even then I expect the firm will continue to pay ever-rising dividends to shareholders. (See Figure 1.15.)

Fortunately, I know of no plans on the part of the government, the stock exchanges, or anyone else to shut down the stock market. I wouldn't want this to happen; I like being able to buy stocks when I have money to invest, including the money that comes in through dividends I don't need for living expenses. And it is valuable to have a place to sell shares when good reasons arise; maybe I decide I need a new pickup truck, and selling a few shares of Realty Income makes more sense than borrowing from a bank. Maybe I discover that Realty Income is headed for trouble, or some other dividend-paying stock is positioned to provide even more income, faster income growth, or a combination of the two. But the underlying principle remains the same: Up, down, or closed, I'm not relying on the market to deliver my return.

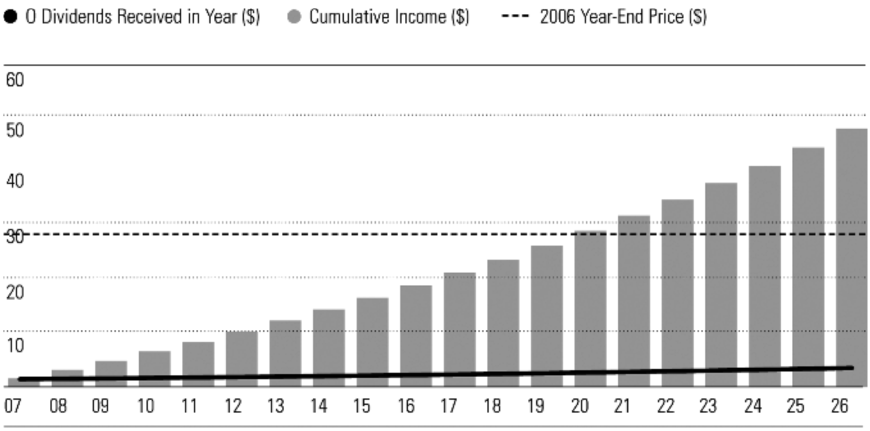

Figure 1.15 Realty Income: Cumulative Dividend Projections

This approach, which works well for any individual stock, stands to be even more effective when managing a portfolio. The focus is on the dividend stream: How large is it, how safe is it, and how fast is it growing? In *Morningstar DividendInvestor*, I look at myself not so much as a portfolio manager but as a manager of two streams of income—one as large as safely possible, the other smaller but rapidly growing. I suggest the same approach to Sally: Use your $500,000 to pick yourself a basket of stocks that collectively provide $30,000 worth of income, and then watch that income grow. Having arranged for your portfolio paychecks up front, you can let your statement value flop all over the place—as it surely will—without having to rely on Mr. Market.

The Case for Individual Stocks

Most of the stock held by American investors is held through intermediaries of one kind or another, primarily mutual funds. Some funds, as well as the new crop of dividend-oriented exchange-traded funds (ETFs), talk about dividends as being part of their strategy. Many are called equity-income funds; some even throw the word *dividend* into their names. With dividends becoming more popular in recent years, a lot of new money has flowed into these funds.

If you outsource your stock picking to others, however, you're obliged to make several trade-offs.

- *Fees*. If you own a stock like Realty Income directly, you'll collect 100 percent of the dividend income it provides. By contrast, if you own Realty Income through a mutual fund, the management fees and other expenses of the fund will be deducted from its dividend income before the fund itself distributes cash to investors. The average equity-income mutual fund covered by Morningstar offered a yield of 1.7 percent in mid-2007, even though the underlying portfolios provide yields of 2.3 percent on average. Not only are these equity-income funds failing to seek much income, but fees and expenses are claiming at least a quarter of what little there is.
- *Strategy.* While there's no shortage of dividend fund and ETF choices, their strategies seem to fall into one of two camps. One group will buy stocks with the highest yields possible to generate maximum income, though often without much regard to growth or sustainability. The dividend ETFs generally fall into this camp, while some actively managed funds go so far as to manufacture dividend income by buying stocks in advance of one-time special payouts or simply in advance of the ex-dividend date. The other, larger group of equity-income funds will buy stocks *with* dividends, but not necessarily *for* or *because* of those dividends. These funds are, like their dividend-indifferent peers, more interested in capital gains and beating the indexes. I have yet to find a fund with a true and consistent dividend strategy, where the emphasis is on a rising stream of income. (And unlike a stock, whose dividend rate is a predictable dollar amount, the actual quarterly or annual dividend distribution of a mutual fund can vary as the portfolio changes.)
- *Need matching.* With so many choices available, it's possible you may find a fund that throws off the kind of income you seek. But the bulk of these funds' yields are so modest that the investors looking to withdraw 3 to 4 percent or more of their portfolio values annually will wind up selling shares. They'll be right back to living off the pile.

There's nothing necessarily wrong with opting for a mutual fund or ETF that emphasizes dividends, as long as these trade-offs seem reasonable to you. However, I think the case for owning individual dividend-paying stocks directly is stronger: You can match your need for income with the stocks that can provide it, and then you'll get 100 percent of the income they generate.

Naturally you (or your adviser) will have to do some homework; the companies, not the market, provide the returns in a true dividend strategy, but not all dividend streams are worth owning. Fortunately, a research approach centered on dividends (the one in this book) is not at all complicated—and the kinds of stocks this process involves are more attractive to own than the market in general.

The Bottom Line

Establish, nurture, and harvest a stream of income: What a liberating concept! But perhaps I've gotten a bit ahead of myself. Later in this book I'll have much more to say on the task of managing a portfolio from the income stream perspective. Next on the docket, however, is a journey through the land of dividends—why they matter, where they come from, and what they have to tell us.

Chapter 1: Rules and Plays

- ► Even though portfolio withdrawals made up with capital gains may look like income, they are a very poor substitute for dividend and interest payments.
- ► Fixed-income returns are much more predictable than the total returns from stocks. Predictably low, that is, after inflation is taken into account.
- ► High-yield stocks combine the best of both worlds: the steady income of fixed-income securities and the growth only stocks can offer.