Chapter One

The Check Is in the Mail

Get Paid to Invest with Dividends

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THE CONTROLLER OF MY COMPANY IS NAMED PAM. Besides being a great controller, Pam has a great smile, one of those toothy ones that lights up a room. I always enjoy seeing Pam's smiling face, especially every other Friday. Everyone in my company loves to see Pam's smiling face every other Friday. That's when Pam hands us our paychecks.

Payday never gets old. I don't care if you've worked a week or a lifetime. Payday is always a great day, a day never to be taken for granted.

Why is payday great? Besides the obvious, payday represents that weekly, biweekly, or monthly validation that what we do matters, that we aren't simply wasting our time, that we are adding value.

Of course, you may feel other emotions on payday—perhaps jealousy, maybe a little resentment. Still, getting paid is really why we do *anything*. The pay may not always be in dollars. The currency may be that buzz you get when you volunteer your time, coach your daughter's softball team, hike your favorite trail, or send that check to your favorite charity.

Getting paid is why we get up every morning.

And getting paid is why we invest.

Investing may not always feel this way. I didn't exactly feel as if I was getting paid to invest in 2008. It felt as though I was doing the paying. Still, we invest to get paid. Otherwise, we wouldn't do it.

How do we get paid for investing? Two ways:

1. The value of our investment goes up. You buy a stock at $10, and it jumps to $20. You made $10 on your investment. That $10 profit is called a capital gain. If you sell and lock up the profit, you have

a realized capital gain. If you still hold on to the stock, you have an unrealized gain.

2. We receive a portion of the company profits on a regular basis. As a shareholder of a company, you're an owner. As an owner, you have a claim on the profits of the company in proportion to your ownership. The board of directors of your company may choose to keep those profits and reinvest them back in the company. On the other hand, the board may decide to distribute part or all of the profits to the owners. Let's say a company's board has made the decision to disburse 30 percent of its profits that year to shareholders. If profits are $2 million, shareholders receive $600,000. Your claim on that $600,000 depends on your percentage ownership. If you own 1 percent of the company, you'll receive $6,000. That $6,000 is commonly called a "dividend."

   Dividends are usually paid quarterly (every three months), although some companies (especially foreign firms) pay dividends only once or twice per year. Companies may differ in the months when they pay their dividends. Some companies pay dividends in March, June, September, and December; some pay in February, May, August, and November; others pay in January, April, July, and October.

> Knowing the dividend-payment dates can be useful when constructing a dividend portfolio to provide regular cash flows to meet financial obligations. I'll show you how to construct "dividends-every-month" portfolios in Chapter 7.

A stock's *total return*—the total amount you get paid for investing—is capital gains plus dividends. Let's say you own a stock that goes from $10 per share to $11 per share in a year. During the year, the stock paid $0.50 per share in dividends. The stock's total return for the year is 15 percent ($1 per share in price appreciation plus $0.50 per share in dividend divided by the starting value of $10 per share).

As you can see, dividends represent an important component of a stock's total-return potential. In fact, roughly 40 percent of the stock market's long-run total return comes from dividends.

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Why Dividends Matter

When you examine the two ways of getting paid to invest—capital gains and dividends—it's natural that dividends have special appeal. A stock's capital-gains potential is influenced

significantly by what the market does in a given year. Sure, stocks can buck a downward market. But most don't.

On the other hand, dividends are usually paid whether the broad market is up or down.

The dependability of dividends is a big reason why investors should consider dividends when buying stock. I'm not suggesting that every stock you own must pay a dividend. However, there's something to be said for the bird-in-hand theory of investing—that a steady, dependable dividend stream provides nice ballast to a portfolio's return. Procter & Gamble, the consumer-products giant, has paid a dividend every year since 1891. Procter & Gamble's stock price has not risen every year since 1891. But shareholders who owned the stock at least got paid a little during those down years. They weren't totally dependent on capital gains to get paid.

Another attraction of dividends is that they can grow. Johnson & Johnson, the health-care company, has raised its dividend every year for more than 45 years. Shareholders received those growing dividends regardless of what happened to the stock price in a given year. And the rising dividend stream not only hedged against inflation but also accelerated the payback on investment.

Here's an example of what I mean by payback on investment. If you had invested $5,000 in Johnson & Johnson at the beginning of 1985, held the stock until today, and

reinvested dividends along the way, your annual dividends from J&J stock would now be more than $7,100. In other words, your payback on your initial investment via dividends is more 100 percent *every year*.

Now *that's* the power of dividends in an investment program.

To Pay Dividends or Not To Pay Dividends

The stock market is really a market of a bunch of small companies. Probably 80 percent or more of all publicly traded stocks have market capitalizations—market capitalization is figured by multiplying outstanding shares by the per-share stock price—of less than $1 billion. In fact, a healthy chunk of all publicly traded companies have market caps that are less than $100 million. Fewer than 300 companies have market caps above $10 billion.

In short, the typical stock is not IBM or Microsoft or Exxon Mobil. The typical stock is one that you probably never heard of, one in which the firm is quite small and in its primary growth mode.

When you understand that the stock market is really a market of very small companies, you understand why the majority of publicly traded companies don't pay a dividend. A dividend represents an outflow of assets to shareholders. Once dividends are paid, the money is gone, and the firm can no longer use that money to fund growth. Small and

growing firms often choose to retain profits in order to have the cash to fund their growth.

Another reason why smaller companies may not pay a dividend is because of the variability of their profits. Small companies may be dependent on a few customers. If orders dry up from one customer, so too do revenues and profits. Implementing a dividend initiates an implicit contract with shareholders, a contract that says that you can depend on this dividend through thick and thin. True, this contract has been a bit frayed by the dividend cuts and omissions seen since late 2007. Historically, however, companies have been extremely reluctant to cut or omit a dividend. Therefore, if a firm is not confident in the stability and dependability of its profit stream, it is unlikely to initiate a dividend.

So what firms pay dividends? They are generally larger, more established companies. Dividend-paying companies have probably experienced their biggest growth spurt and don't require all of their cash flows to fund their operations. Such companies are reasonably confident that their future profitability will support a dividend payment.

Of course, there are exceptions to every rule, and plenty of smaller companies pay dividends. Still, out of the some 4,000 firms my firm tracks via our Quadrix stock-rating system (I'll tell you about Quadrix later in the book), less than 38 percent pay dividends. And those

dividend payers tend to have market capitalizations, on average, of $8.4 billion versus the average market cap of non–dividend-paying stocks of $1.5 billion.

No Profits, No Dividends

A stock's dividend represents the cash flows companies pay their common shareholders. These cash flows are ultimately paid out of profits or, technically, "retained earnings" of the company. That's pretty basic stuff, right? It's obvious that if a company doesn't generate profits, it probably isn't generating the cash flow that can be used to pay dividends. Yet you'd be surprised how many investors tend to ignore the relationship between profits and dividends when choosing dividend-paying stocks.

Dividends are ultimately paid out of a company's profits, so pay attention to the relationship between the two.

You may have owned companies that had a bad year but still paid their dividend, but that's not a game that can be played indefinitely. Companies can borrow money to pay their dividend. They can dip into cash reserves to pay their dividend. But at some point, a firm that isn't earning its dividend will not pay the dividend.

A useful tool for examining the relationship between profits and dividends is a stock's payout ratio. The payout ratio reflects the percentage of a company's earnings that are paid out in the form of dividends. A firm that has profits of $2 per share and pays $1 per share in dividends has a payout ratio of 0.5 (1 divided by 2).

The higher the payout ratio, the more danger the company is in of reducing or eliminating the dividend if problems develop. The payout ratio is the single most powerful factor in analyzing the health, stability, and growth potential of a stock's dividend. For that reason, the payout ratio carries the highest weighting in my Big, Safe Dividend (BSD) Formula discussed in Chapter 3.

What's My Yield?

Many investors like to compare dividends on stocks to the interest paid on bank CDs or money market accounts or the coupon payments paid on bonds. Although this is a bit of an apples-to-oranges comparison (the risks of stocks are decidedly greater than the risks of bank CDs or most bonds), the comparison is useful for understanding the concept of *yield*. The yield on your money market account is the same as the interest rate; that is, if you put $1,000 in a money market account that promises to pay you $20 in interest over the next year, the interest rate (or yield) is 2 percent ($20 divided by $1,000).

A stock's dividend yield is computed the same way. You take the amount of dividends paid over the last year and divide by the stock price. For example, a stock that trades at $10 per share and paid $0.50 per share in dividends over the last 12 months has a yield of 5 percent ($0.50 divided by 10).

Most investors use a stock's indicated dividend to compute yield. The indicated dividend is computed by taking the stock's most recent dividend payment and annualizing it. Thus, for a stock that paid $0.25 per share in its most recent quarter, the indicated annual dividend would be $1 per share ($0.25 multiplied by four quarters if the company pays quarterly dividends). And if the stock currently trades for $20, the indicated yield is 5 percent ($1 divided by $20).

While important, yield should not be the primary determinant for stock selection. Investors too often ignore the fact that yield is a pretty good proxy for risk. An unusually high yield can foreshadow big problems at a company. In fact, a high yield is an excellent predictor of dividend cuts or omissions. I'll discuss more about the relationship of yield and risk in Chapter 2.

No Free Lunch

While dividends are often referred to as an investor "free lunch," that's not exactly true. A dividend is not free money

for shareholders. A company cannot pay out dividends to shareholders without affecting its market value.

Think of your own finances. If you constantly paid out cash to family members, your net worth would decrease. It's no different for a company. Money that a company pays out to shareholders is money that is no longer part of the asset base of the corporation. It's money that can no longer be used to reinvest and grow the company. That reduction in the company's "wealth" has to be reflected in a downward adjustment in the stock price.

You may be surprised to learn that a stock price adjusts downward when a dividend is paid. The adjustment may not be easily observed amidst the daily price fluctuations of a typical stock. But the adjustment does happen.

This adjustment is much more obvious when a company pays a "special dividend." A good example is Microsoft's special $3-per-share dividend it paid to shareholders in 2004. Following the payment, the downward adjustment in Microsoft stock was readily apparent.

Dating My Ex

This downward adjustment in the stock price takes place on the ex-dividend date. Typically, the ex-dividend date is two business days prior to the record date. The key thing about the ex-dividend date is that it represents the cut-off point for receiving the dividend. You have to own a stock

prior to the ex-dividend date in order to receive the next dividend payment. If you buy a stock on or after the ex-dividend date, you are not entitled to the next paid dividend.

While this may sound unfair, remember that the stock price adjusts downward to reflect the dividend payment. Therefore, while you are not entitled to the dividend if you buy on or after the ex-dividend date, you are paying a lower price for the shares.

An example best shows the interworking of the ex-dividend date, record date, and payable date:

Declaration Date	Ex-Dividend Date	Record Date	Payable Date
11/10/09	11/27/09	12/1/09	12/30/09

On November 10, 2009, XYZ, Inc. declares a dividend payable on December 30, 2009, to its shareholders. XYZ also announces that shareholders of record on the company's books on or before December 1, 2009 are entitled to the dividend. The stock would then go ex-dividend two business days before the record date. In this example, the record date falls on a Tuesday. Excluding weekends and holidays, the ex-dividend is two business days before the record date—in this case on the preceding Friday, November 27. Anyone who bought the stock on Friday or after would not get the dividend (that dividend goes to the

seller of the shares). Those who purchase before the ex-dividend date receive the dividend.

I wish I had a dime every time an investor told me that he had been ripped off by a company because he didn't receive a dividend that he thought he was owed. Much of the confusion stems from the record date. Many investors believe that if they buy on the record date, they are entitled to the dividend. However, stock trades do not "settle" on the day you buy them. You need to be a shareholder on the record date, which means you have to buy *before* the record date. The ex-dividend date essentially reflects the settlement period.

I know this may sound a bit confusing, but the key date to know is the ex-dividend date. That is the date in which the stock price adjusts to reflect the next dividend payment. And if you want that dividend payment, you have to buy the stock prior to the ex-dividend date.

Capture the Dividend—Not!

At this point you may be thinking to yourself: If all I want is the dividend, why can't I just buy the stock just prior to the ex-dividend date and sell on the ex-dividend date? In that way, I can capture the dividend payment—free money.

Not quite. Remember that the stock price adjusts for the dividend payment. Say you buy 200 shares of stock at $24 per share on November 26, one day before

the ex-dividend date of November 27. And you sell the stock at the close of November 27. And the stock pays a quarterly dividend of $0.50 per share. The stock price will adjust downward on November 27 to reflect the $0.50 payment.

It's possible that, despite this adjustment, the stock could actually close on November 27 at a higher level. It's also possible that the stock price could close November 27 at a level lower than the $23.50 price suggested by the $0.50 adjustment to reflect the $0.50 dividend.

Let's assume for the sake of this example, the stock adjusts perfectly, and you sell at $23.50 per share. Are you better or worse off for capturing the dividend? Well, you'll receive $0.50 per share in the dividend. But you'll lose $0.50 per share because of the decline in the stock price. So it would appear to be a wash. But what about taxes? Aren't dividends currently taxed at a maximum 15 percent rate? I'll get into dividends and taxes a little later in this chapter, but for now the answer is "yes," but with a catch. In order to receive the preferred 15 percent tax rate on dividends, you must hold the stock for a minimum number of days. That minimum period is 61 days within the 121-day period surrounding the ex-dividend date. The 121-day period begins 60 days before the ex-dividend date. When counting the number

of days, the day that the stock is disposed is counted, but not the day the stock is acquired.

If the stock is not held at least 61 days in the 121-day period surrounding the ex-dividend date, the dividend does not receive the favorable 15 percent rate and is taxed at your ordinary tax rate.

To recap your dividend capture strategy:

1. You paid $4,800 (plus commission) to purchase 200 shares of stock.
2. Because you bought before the ex-dividend date, you're entitled to the dividend of $0.50 per share, or $100. But because you didn't hold the stock for 61 days, you'll pay taxes at your ordinary tax rate. Let's assume you are in the 28 percent tax bracket. That means your take after taxes is $72.
3. You sold 200 shares at $23.50 for $4,700, a loss of $100 (plus commissions). You now have a "realized" short-term loss, which you can offset against realized capital gains or, if you have no realized gains, up to $3,000 of ordinary income.

Was your dividend-capture strategy in this instance a winner? Not really. You're out the commissions to buy and sell the shares. You have a realized loss that you may

or may not be able to write off immediately (depending on the amount of realized gains and losses you already have). And you lose the preferred 15 percent tax rate on your dividends because you didn't hold the stock long enough.

I'm sure you could construct a hypothetical in which capturing the dividend provides a big windfall. But the key point is that there are no free lunches. Dividend-capture strategies don't have all upside and no downside. Between commissions, taxes, and downward adjustments for dividend payments, it's not easy to profit from dividend-capture strategies.

Dividends and Taxes

Qualified dividends are currently taxed at a maximum rate of 15 percent. The rate drops to 0 percent for lower-income individuals in the 10 percent to 15 percent tax brackets for ordinary income.

What constitutes a "qualified" dividend? Most dividends paid by domestic companies are qualified. And many dividends paid by foreign companies also qualify for the preferred tax rate. However, distributions paid by real estate investment trusts, master limited partnerships, and other similar "pass-through" entities may not qualify for favored tax status.

Also, as demonstrated in our dividend-capture example, dividends that are paid on shares that are not held at least

61 days in the 121-day period surrounding the ex-dividend date are not "qualified" dividends.

How dividends are taxed is very important when considering investments for cash flow. Interest on money markets and bank CDs is taxed at ordinary tax rates. So are interest payments on bonds. That means a person in the top tax bracket pays taxes on interest payments up to 35 percent. Compare that to the maximum 15 percent tax on dividends, and the "after-tax" returns are significantly better with dividends.

Say you put $100,000 into a bank CD paying 2 percent annual interest. You'll receive $2,000 in interest. If you are in the top tax bracket, your after-tax yield (assuming the investment is held outside of a retirement account) is 1.3 percent. (You arrive at that percentage by applying your tax rate of 35 percent to the $2,000 interest payment, leaving you with after-tax interest of $1,300, for an after-tax yield of 1.3 percent). If you invest the same $100,000 in a basket of stocks paying 2 percent annually in dividends, you'll receive $2,000 in dividends but only lose $300 to taxes (15 percent of $2,000), for an after-tax yield of 1.7 percent ($1,700 in after-tax dividends divided by $100,000 investment).

When comparing investments for cash flow, smart investors look at both pre-tax and after-tax yields. After all, it's not what you make. It's what you keep.

The bad news is that the preferred tax rate on dividends is in jeopardy. Unless an extension is granted or new rules enacted, the current tax rates on dividends expire at the end of 2010.

Obviously, the tax rate on dividends has huge implications for dividend-hungry investors. Will higher tax rates, if enacted, reduce the appeal of dividend-paying stocks? Will investors dump their dividend-paying stocks once the favored tax rate has expired? Perhaps, although tax rates on dividends cannot be viewed in a vacuum. What happens to the tax rates on capital gains (the current 15 percent maximum tax rate on realized long-term capital gains also expires at the end of 2010) will have a bearing on the relative attractiveness of dividend-paying stocks. And the type of stock-market environment we have after 2010 will impact interest in dividend-paying stocks. Finally, the graying of America will continue to drive a need for cash flow, which should be a plus for dividend-paying stocks.

In short, don't count out dividend-paying stocks because taxes on dividends may go higher. Plenty of reasons will still exist for investors to seek dividend-paying stocks.

Yield!

- *Dividends matter*. Nearly half of the stock market's long-term total return comes from dividends.
- *Less taxing*. When comparing yields on investments, remember to take into account the favorable tax rates (maximum 15 percent) on qualified dividends. After-tax yields are what really matter.
- *No free money*. Stock prices adjust downward for dividend payments. Don't let anyone tell you differently.
- *Bye-bye dividend*. A company that isn't making a profit is a company that isn't going to be paying a dividend for long.
- *Buy before the ex*. Want the dividend? Buy the stock before the ex-dividend date.