



Farm Creek Securities, LLC
Farmcreeksecurities.com
fc@farmcreeksecurities.com
89 Roton Avenue, Rowayton, CT 06853
(203) 838-1025

The Sound Investor Series #17

Dividends – A Good Thing, but Don't Overreach

by Ed Hynes, CFA

September 28, 2005

Since the tax laws changed a few years ago, dividends are gaining popularity with investors. Prior to the revisions, dividends were generally taxed at higher rates but now most are taxed at a preferential rate of 5% or 15% depending on the holder's marginal tax rate.

This change, along with several other factors, has led some investors to seek stocks with large dividend yields. However, I caution investors from being too aggressive in this pursuit of dividend income.

To start, let us frame how dividends fit into a stock's return. The total return of a stock is composed of both its dividend and its capital appreciation (the amount it goes up or down). Most participants in the market are interested in the total return of their stocks and do not care if the return comes from dividends or capital appreciation.

So in theory, stock prices get adjusted so if you receive more dividend income your capital appreciation will be lower. If this thinking is correct, and I believe it is; investors who emphasize dividend income will receive lower capital gains, unless they take on other risks. Put another way, dividends are not a free lunch.

But even without being a free lunch, dividend income is attractive for investors who are living off their savings. First, dividends are desirable due to their predictability. In the U.S., companies like to pay steady dividends. And since they are loath to cut them, they are very careful before raising them too much in the first place.

Another attraction of dividend income for retirees is that it insulates them from some of the market's volatility. This is because dividends remove money from the market in a consistent and disciplined manner. The gradual removal of money, without selling shares, helps shield investors from the ravages of volatility.

The benefits of dividends are quiet powerful, but I offer two cautions. First, until investors move from their savings phase to the spending phase, taxes will hurt investors who emphasize dividend income.

While in the saving mode, investors do not need the cash flow from dividends and therefore reinvest the cash. The problem is Uncle Sam taxes your dividends resulting in only part of it being reinvested. This causes a “dividend tax drag” on your portfolio.

This dividend tax drag is not large, but every speck of performance counts. The amount of drag is dependent on a few factors including the overall performance of the market and the time invested. I estimate that assuming a 10% return over 20 years, that each 1% of dividend income penalizes an investor’s performance by around 8 or 9 basis points (bps) a year. (A basis point is a hundredth of a percentage point.)

So if the market’s current dividend is 2% and you emphasize dividend paying stocks and get a yield of 5%; the dividend tax drag of the additional 3 percentage points of yield is about 25 bps a year.

The second pitfall for investors pursuing a high dividend strategy can be the makeup of their portfolios at the end of the day. Unless you are very careful, choosing stocks with high dividends will skew your portfolio toward financial, utility and material stocks and away from health care, consumer discretionary and technology.

A good example is the iShares Dow Jones Select Dividend Index Fund (DVY) exchange-traded fund. This fund sports a dividend yield of 3%. But the stocks it buys make the fund very different from the overall market. For instance, financial stocks make up about 39% of the fund compared to 23% in the overall market. Technology stocks are almost non-existent in the fund, but they make up 14% of the market. These differences may or may not turn out to be a good thing in the long run, but investors need to know and think about the risks they are taking.

The bottom line is that dividends can provide a nice, steady stream of cash for retirees. But investors reaching for higher dividend stocks should be careful of how they are tilting their portfolios relative to the overall market. In addition, investors still in their savings years need to be aware of the dividend tax drag and its effect on their portfolios.

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. This series of articles is available at farmcreeksecurities.com. Before putting money in any investment, you should carefully consider your investment objectives; and the risks, charges and expenses of any investment. Past performance is not an indication of future performance and there are risks to investing including the loss of principal. Please contact Farm Creek for a prospectus on any of the funds mentioned.

© Copyright 2005