

The Sound Investor Series #63

Talking Dividends

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August 30, 2006

Some investors love to receive dividends - nothing wrong with that – but there are pitfalls to watch out for.

One confusing point is that dividends do not generally constitute any extra return. The market knows and expects some companies to pay dividends and it is built into the price of a stock. For example let's take a look at two portfolios, similar in all respects except one pays no dividends and the other pays substantial ones.

Let's assume that investors expect the price of the "No Dividend Portfolio" to increase at 10 percent a year. If the price of the "Dividend Portfolio" is also expected to increase 10 percent, and it has a dividend yield of 5 percent, it is obviously more attractive. Savvy investors would sell the "No Dividend Portfolio" and buy the "Dividend Portfolio." This action would drive down the "No Dividend Portfolio's" price and raise the "Dividend Portfolio's" price until expected returns for both would be the same.

O.K. - even if you understand there is ultimately no extra gain from high dividends, you still might like them. The next problem is that in our real world it is very difficult to find two portfolios identical except for dividend yields. Generally speaking, young, growing companies want to reinvest cash flow and pay little or no dividends. On the other hand older, more mature companies have fewer perceived investment opportunities and are more willing to pay dividends. Technology and bio-tech companies are good examples of the first group while banks, utilities and automobile firms represent the second.

This creates a problem for investors who wish to hold only high dividend paying stocks as they will be over-weighted in some market sectors and ignore others.

For instance, take a look at the iShares Dow Jones Select Dividend Index Fund (DVY), an Exchange-Traded Fund investing in stocks that pay high dividends. Right now this fund has a dividend yield of 3.4 percent, double the S&P 500's yield of 1.7 percent, and outstripping the Russell 3000's yield of 1.5 percent.

But by concentrating on dividend paying firms, DVY has 20.6 percent of its assets in utility companies compared with an overall market weighting of 3.3 percent for utilities. This overweighting in utilities has worked out well over the past few years, as utility stocks recovered from their near-death experience in 2002, but that will not always be the case.

DVY is correspondingly heavily weighted in financial stocks at 41 percent versus 23 percent for the overall market.

On the flip side, DVY has almost nothing invested in the consumer discretionary and technology sectors; and has less than half the market weight committed to industrial and health care companies.

Investors who buy these types of funds need to ask themselves if the higher dividend payments they are receiving justify the risks they are taking.

Many investors, especially retirees, need a steady cash flow but there are other ways to generate income. One way is to simply sell a few shares every quarter. The tax treatment of both dividends and capital gains is the same. An added benefit of this method is that you will sell stocks over a long period of time and get the benefits of dollar-cost averaging. But, if you chose to do this, make sure to use a broker that charges little or no commission!

For investors in the savings mode, there is another argument not to chase dividends – and his name is Uncle Sam! If you receive a dividend and reinvest it, Uncle Sam will take his cut. It might only be 15 percent, but with most of us scrimping and scraping to save for retirement, why give away anything? Over 20 years, depending on the returns and dividends, taxes paid by reaching for dividends could lower your portfolio by 3-5 percent.

One other point investors should be aware of is the new trend toward “fundamental” indexing. Companies such as WisdomTree have constructed what they call “fundamental indexes” primarily based on dividends. They are also marketing a set of Exchange-Traded Funds that will track these indexes.

Like other “dividend indexes” they significantly overweight financial stocks and underweight technology (although not to the degree of the iShares Dow Jones Select Dividend Index Fund).

WisdomTree argues that these indexes are better suited for passive investing than more traditional “capitalization weighted indexes” which are influenced by market psychology. They point out that during the technology bubble in the late 90s when prices were pushed higher, capitalization weighted indexes automatically gave tech stocks greater weight in the index and this would not happen with a “fundamental index.” The other side of the argument is that “fundamental indexes” might hold on to film companies like Kodak and ignore new technology like digital cameras.

I believe WisdomTree’s approach is interesting, but investors should evaluate it just like any other active investment strategy. It may or may not beat the market. Most passive investors choose funds following capitalization weighted indexes because these indexes measure all the money invested in a group of stocks and how the “average” dollar performs.

All in all, dividends may be nice, but they are no free lunch. Be careful of the lurking risks when pursuing any investment strategy. Please contact me if you have any questions about this article or ideas for future ones.

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