Put Dividends to Work in Your Portfolio

During the dotcom boom of the late 1990s, the notion of dividend investing was increasingly seen as laughable. Back then, everything was going up in double-digit percentages, and nobody wanted to fool around with the meager 2-3% gain from dividends. After all, we were in the "new economy"—the rules had changed and companies that paid dividends were a relic of the "old economy."

After the bull market of the 90s ended, the fickle mob once again found dividends attractive. For many investors, dividend-paying stocks have come to make a lot of sense. Although we have seen several market surges since the 90s, more and more of the growth in stocks is attributable to private investors as venture capital continues to grow. This has made boring old dividend stocks one of the best games in town for investors. In this article, we will explain what dividends are and how you can make them work for you.

INVESTMENT ESSENTIALS

INCOME INVESTING

The What and Why of Dividends

A dividend is a cash payment from a company's earnings; it is announced by a company's board of directors and distributed among stockholders. In other words, dividends are an investor's share of a company's profits, given to them as a part-owner of the company. Aside from option strategies, dividends are the only way for investors to profit from ownership of stock without selling their stake in the company.

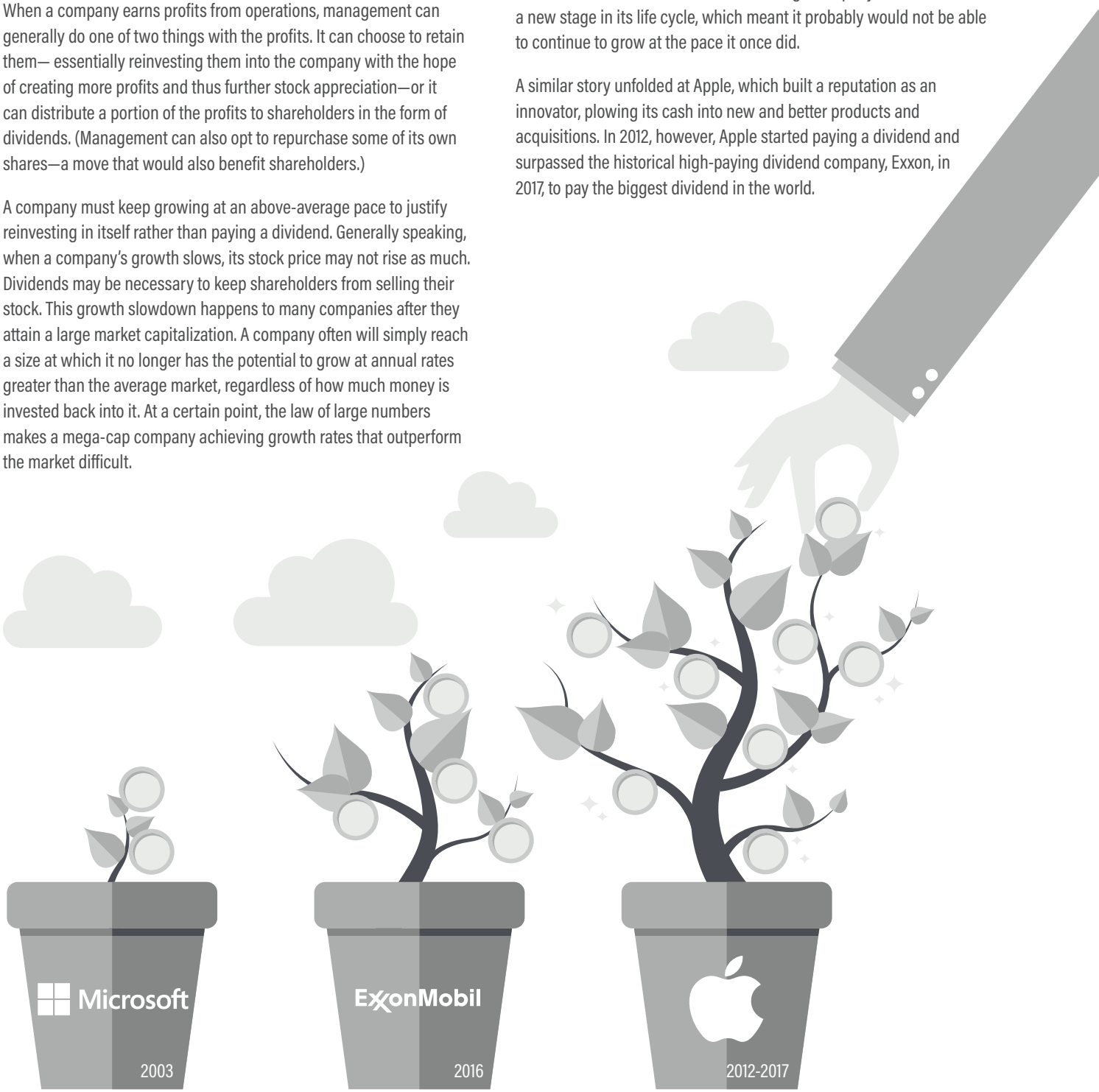
When a company earns profits from operations, management can generally do one of two things with the profits. It can choose to retain them— essentially reinvesting them into the company with the hope of creating more profits and thus further stock appreciation—or it can distribute a portion of the profits to shareholders in the form of dividends. (Management can also opt to repurchase some of its own shares—a move that would also benefit shareholders.)

A company must keep growing at an above-average pace to justify reinvesting in itself rather than paying a dividend. Generally speaking, when a company's growth slows, its stock price may not rise as much. Dividends may be necessary to keep shareholders from selling their stock. This growth slowdown happens to many companies after they attain a large market capitalization. A company often will simply reach a size at which it no longer has the potential to grow at annual rates greater than the average market, regardless of how much money is invested back into it. At a certain point, the law of large numbers makes a mega-cap company achieving growth rates that outperform the market difficult.

Together Again: Microsoft and Apple

The changes witnessed in Microsoft in 2003 are a perfect illustration of what can happen when a firm's growth levels off. In January 2003, the company finally announced that it would pay a dividend. Microsoft had so much cash in the bank that it simply could not find enough worthwhile projects on which to spend it. The fact that Microsoft started to pay dividends did not signal the company's demise; it simply indicated that Microsoft had become a huge company and had entered a new stage in its life cycle, which meant it probably would not be able to continue to grow at the pace it once did.

A similar story unfolded at Apple, which built a reputation as an innovator, plowing its cash into new and better products and acquisitions. In 2012, however, Apple started paying a dividend and surpassed the historical high-paying dividend company, Exxon, in 2017, to pay the biggest dividend in the world.



Mention of a specific security should not be considered a recommendation to buy or solicitation to sell that security.

Dividends Will Not Mislead You

By choosing to pay dividends, management is essentially conceding that a portion of profits from operations is better off being distributed to the shareholders than being invested or reinvested into the company. In other words, management feels that reinvesting all profits to achieve further growth may not offer the shareholder as high a return as a distribution in the form of dividends.

There is another motivation for a company to pay dividends: a steadily increasing dividend payout is viewed as a strong indication of a company's continuing success. The great thing about dividends is that they cannot be fabricated. They are either paid or not paid, increased or not increased.

Earnings are a different story. All too often, companies must restate their past reported earnings because of aggressive accounting practices. This may harm investors who purchased the stock and can cause considerable trouble for investors, who may have already based future stock price predictions on these (unreliable) historical earnings.

Expected growth rates may be unreliable. A company can promote wonderful growth opportunities that should pay off several years down the road, but there are no guarantees that it will make the most of its reinvested earnings. When a company's robust plans for the future (which impact its share price today) fail to materialize, the stock may very likely take a hit.

However, you can rest assured that no accountant can restate dividends and take back your dividend check. The dividends you receive from your stocks are 100% yours. You can use them to do anything you like: pay down your mortgage, spend it as discretionary income, buy the stock of a company you think has better growth prospects or purchase more of the company's stock through reinvested dividends.

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Who Determines Dividend Policy?

The company's board of directors decides what percentage of earnings will be paid out to shareholders, and then puts the remaining profits back into the company. Although dividends are usually disbursed quarterly, it is important to remember that the company is not obligated to pay a dividend every single quarter. In fact, the company can stop paying a dividend at any time. However, this is typically rare, especially for a firm with a long history of dividend payments.

If people were accustomed to getting their quarterly dividends from a mature company, a sudden stop in dividend payments to investors seems like a signal that something was amiss with the company. Unless the decision to discontinue dividend payments was backed by some kind of strategy shift (say, investing all retained earnings into robust expansion projects), it would indicate that something was fundamentally wrong with the company. For this reason, the board of directors will usually go to great lengths to continue paying the dividend.

How Stocks That Pay Dividends Resemble Bonds

When assessing the pros and cons of dividend-paying stocks, you will also want to consider their volatility and share price performance as compared to those of outright growth stocks that pay no dividends.

Because public companies generally face adverse reactions from the marketplace if they discontinue or reduce their dividend payments, investors can be reasonably certain they will likely receive dividend income on a regular basis for as long as they hold their shares. Therefore, some investors may rely on dividends in much the same way that they rely on interest payments from corporate bonds and debentures.

Dividend-paying stocks tend to exhibit pricing characteristics that are moderately different from those of growth stocks. This is because they provide regular income, similar to a bond, but still provide investors with the potential to benefit from share price appreciation if the company does well.

Stocks with high dividend yields may offer a good combination of exposure to the growth potential of the equity market and regular income. An investment portfolio with dividend-paying stocks may see less price volatility than a growth stock portfolio.

Conclusion

When a company reaches a certain size a dividend announcement may be a sign that a company's growth has slowed, but also may be evidence of a sustainable capacity to make money. This sustainable income will likely produce some price stability when paid out regularly as dividends. Best of all, you can reinvest or spend the dividends as you see fit.

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