Dividend-Paying Stocks: A Look Beyond Income

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The current low-interest-rate environment has caused many investors to become thirsty for yields from alternative sources to support their portfolio income needs. In 2011, many investors were seduced by the allure of dividend-paying stocks, tempted by their high yields relative to what they earn on safe bonds.

Reviewing last year, yields on stocks as measured by the S&P 500 Index of 2% surpassed the 10-year U.S. Treasury yield of only 1.89%. To represent high-dividend stocks, the yield of the S&P High Yield Dividend Aristocrats Index[1] was 2.88%. The S&P 500 Dividend Aristocrats Index outperformed the broader index in 2011, with a return of 8.33% vs. 2.11% for the S&P 500 Index reflecting the investor appetite for dividend-paying stocks.

	2011	**YTD** (as of 3/21/12)
S&P 500 High Yield Dividend* Aristocrats Index	8.33	7.24
S&P 500 Index**	2.11	12.09

*http://www.standardandpoors.com/indices/sp-500-dividend-aristocrats/en/us/?indexId=spusa-500dusdff--p-us----
**http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usduf--p-us-l--
Past performance is not indicative of future results. Indexes are unmanaged baskets of securities in which investors cannot directly invest; they do not reflect the payment of advisory fees or other expenses associated with specific investments or the management of an actual portfolio.

In addition, investors may use stable and increasing dividends as an indication of confidence in their firms' prospects, corporate maturity and strength. Dividend-paying stocks are often considered to be big, stable companies that are better equipped to weather these uncertain and volatile times.

We would caution investors to be careful when focusing solely on dividends (or any single attribute) when making investment decisions. Investors may draw more income from dividend-paying stocks but expose themselves to other risks that may undermine portfolio returns. It is important for investors to understand that to the extent stocks paying generous dividends exhibit lower beta or volatility, it seems likely they may also exhibit lower expected returns over the long term.

First of all, it is important for investors to remember that when the market rebounds and riskier assets do better, dividend-paying stocks may lag behind. For example, during the 2008 financial crisis there was much attention focused on the importance of dividends — and when stocks rebounded in 2009, non-dividend-paying stocks trounced the dividend payers.

Similarly, since the start of 2012, investors have turned away from dividend-paying stocks and have assumed more risk. So far this year, the S&P 500 Index has eclipsed the Dividend Index with a return of 12.09% vs. 7.24%, respectively (year-to date as of March 21, 2012).

In addition, an isolated or solitary focus on dividends may distort a long-term investment approach and undermine other important considerations for a prudent portfolio strategy — such as lack of diversification, tax-efficiency and the need for portfolio growth to meet long-term investment objectives.

Diversification

Buying a dividend-paying stock is essentially placing a bet on a certain type of stock, which could result in a concentrated strategy. The S&P 500 Dividend Aristocrats Index holds only 51 of the S&P 500 index constituents, which represents only 10% of the index.

When we exclude firms from our portfolio that pay no dividends today, we may deprive ourselves of the returns associated with the biggest dividend generators of tomorrow. A broadly diversified strategy that includes both dividend payers and non-dividend payers ensures we enjoy the potential rewards of both.

Tax Efficiency

Tax-efficiency is another important consideration when making investment decisions. One element of President Obama's budget proposal which is beginning to attract attention is the proposed tax treatment of dividends. In recent budgets, dividend tax rates have run at 20% for the top income earners, but Obama proposes that those rates go up to marginal levels, where the top rate would be 39.6%. With the so-called Bush tax cuts due to expire on December 31, Congress must pass legislation to extend all or part of them, but this is far from a sure thing. Still, on the face of it, tax rates on dividends for wealthier individuals have a real chance of going up significantly. This may undermine the attractiveness of dividend-paying stocks.

Portfolio Growth

Psychologically, investors seek higher yields for comfort to support their portfolio income needs. We should not care whether we draw income from dividends or capital growth. Money is money, whether it comes from a stock dividend, bond income payment or from capital growth. There's no reason to prefer one above the other for spending needs.

In reality, the form of your cash flow is less important than the size of your wealth. Financial security is about total wealth — the present value of net worth, not marginal income generated from the portfolio.

We believe there is no need to employ a focused strategy on dividend-paying stocks. Dividend-paying stocks are an important component of a globally diversified portfolio — and in most cases you already own them in a well-diversified portfolio.

Note: *Past performance does not guarantee future results and the principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Diversification neither assures a profit nor guarantees against loss in a declining market. Implementing a total return income portfolio cannot guarantee a gain or protect against a loss.*

[1]The S&P 500 Dividend Aristocrats Index is designed to measure the performance of S&P 500 index constituents that have followed a policy of consistently increasing dividends every year for at least 25 consecutive years.

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