Dividends Are Back

04/29/2010

We are just months removed from one of the worst years for corporate dividends on record. Uncle Sam is expected to take another big bite out of that income in 2011 in the form of sharply higher taxes.

And yet dividend investing has rarely looked better.

This year through mid-June, there were at least 135 dividend increases or initiations among the companies in the Standard & Poor's 500-stock index, up roughly 55% from the first six months of last year.

Dividend Surge

Across the economy, companies are boosting their payouts at a record rate this year.
View chart

And the gains are coming across a broad swath of industries. Chip maker Analog Devices Inc. in May said it would increase its quarterly payout 10%, to 22 cents a share. Dental-products provider Patterson Cos. in March announced it would initiate a quarterly payout of 10 cents a share. And on Thursday, Best Buy Co. announced it will raise its dividend by 7%, to 15 cents a share.

If the economy continues to gather strength, analysts say, many more companies will likely gain the confidence to boost dividends this year.

So what has changed? Corporate balance sheets, which were squeezed during the recession, are once again brimming with cash. S&P 500 nonfinancial companies had a record $837 billion in cash at the end of the first quarter, up from $665 billion a year earlier, according to S&P.

Of course, there are plenty of headwinds. The tax rate on qualified dividend payments, capped in 2003 at 15%, is set to expire at the end of this year along with some other Bush-era tax cuts. Absent congressional action, the top dividend tax rate will jump to 39.6% next year. It also could end up somewhere in between.

And BP PLC's June 16 announcement that it was suspending its payout was only the latest reminder that a seemingly fat dividend doesn't always pan out. Last year, there were 78 dividend reductions or suspensions among the S&P 500, slicing a record $52.6 billion in payments, all told.

But for investors looking to generate steady income, the alternatives to dividends don't stack up well. With the Federal Reserve keeping its key interest rate at a historic low, the roughly 2% average dividend yield of the S&P 500 looks attractive relative to many bond

and cash-like investments. The average taxable money-market fund, for example, offers a paltry seven-day yield of 0.04%, according to iMoneyNet, which tracks the funds. Bonds carry risks of their own, and must be rolled over and reinvested when they mature.

The long-term case for dividend investing, meanwhile, remains sound. Some research suggests that companies tend to boost these payments ahead of significant increases in cash flow. And dividends often provide a cushion when stock returns sag. That can be especially valuable for income-focused investors like those looking to cover regular living expenses during retirement.

Such investors shouldn't rely on stock-price appreciation to pay the bills, says Josh Peters, editor of Morningstar DividendInvestor newsletter, since "those capital gains won't always materialize when you need them." He says now is "a good time to look for good dividend yields."

With the payout picture brightening, some investors are following that advice. F. Courtney Mallinson Jr., 63 years old, of Alexandria, Va., a few weeks ago boosted his position in the iShares Dow Jones Select Dividend Index exchange-traded fund, which holds about 100 dividend-paying stocks.

Thinking about retirement in a few years, he says, "I'm looking to augment my pension and Social Security with investment income, and don't want to depend on bonds." With a broadly diversified dividend-focused fund, says Mr. Mallinson, a marketing manager for a telecom firm, "I just hold on forever."

With some careful decision making, investors can exploit today's favorable dividend climate without getting burned. Here are some key considerations.

Sector Rotation

Dividend investors have traditionally favored certain sectors—such as utilities and financials—that offered consistent payouts. But today, people looking for steady income, potential dividend growth and stock-price appreciation need to broaden their horizons, money managers and analysts say.

Consider the precipitous decline of financial-sector payouts. In precrisis days, financial companies accounted for a whopping 30% of S&P 500 dividends. Now, they contribute less than 9% of index payouts, says Howard Silverblatt, senior index analyst at Standard & Poor's.

"Most of the banks cut their dividends substantially, so there's very few of those that we even look at anymore," says Don Taylor, manager of the Franklin Rising Dividends Fund. The fund, which looks for companies that have raised dividends in eight of the past 10 years and doubled their dividend over that period, has beaten more than 90% of rivals in the large-cap blend category over the past 15 years, according to Morningstar.

While big banks may restore some of their payouts later this year, they will need more clarity from regulators on capital requirements before making that commitment, analysts say.

So what is today's best dividend hunting ground? Many managers favor the consumer-staples sector, which largely avoided big payout reductions last year and is now the biggest contributor to S&P 500 dividends. Morningstar's Mr. Peters says Clorox Co., for example, should be able to raise its dividend by 8% to 10% annually.

Health-care stocks, which also are contributing a growing share of S&P 500 dividends, are attracting managers' attention as well. In its Rising Dividend Growth Fund, money manager Dividend Growth Advisors LLC over the past 18 months has roughly doubled its health-care allocation to about 21%, says Troy Shaver, the firm's president and chief executive.

View Full Image

Associated Press
Senate Finance Committee Chairman Max Baucus (D., Mont.) is likely to be a key player in the upcoming debate over taxation of dividends.

Even the technology sector, traditionally the domain of go-go growth investors, sports some attractive payouts. The sector now contributes 9% of S&P 500 dividends, up from 7% in 2008. Robert Turner, chief investment officer of Turner Investment Partners, notes that Intel Corp.'s roughly 3% yield offers investors the rough equivalent of a 10-year Treasury, but with the potential for stock-price appreciation. He says he believes the stock could double in the next five years or so, to about $40.

Tax Consequences
When it comes to the tax rate on all those payouts, uncertainty reigns. "This is politics," S&P's Mr. Silverblatt says. "It could end up anywhere."

If the top dividend tax rate shoots up to 39.6%, stocks of companies with fat dividends could get crushed. But the rate could wind up somewhere between that and the current 15%. A provision in President Obama's budget limits the top dividend tax rate to 20%, though Congress can set its own limit.

Yet some money managers are sanguine about the looming tax increase, saying the stalwart dividend-paying companies they favor didn't change their behavior when the rate was cut in 2003 by President Bush, and therefore shouldn't change their approach when it rises, either.

There may even be a silver lining: Given the potential tax increase, there is reason to believe some companies will pay special dividends before the end of the year, Franklin's Mr. Taylor says.

In light of the tax uncertainty, Bank of America-Merrill Lynch in an April report screened for companies that it believes could use surplus cash to pay a special dividend. Looking for factors like low debt levels and strong cash positions, the firm came up with companies like Microsoft Corp., Gap Inc. and Estee Lauder Cos.

"We don't comment on speculation," says a Gap spokeswoman. Microsoft and Estee Lauder declined to comment.

Avoiding the Traps

There is a simple rule dividend investors should heed: Don't get greedy. A company with a fat dividend "yield," which is annual dividends per share divided by the share price, may have trouble covering its payout or boosting it consistently in the future. What's more, "there may be an artificially inflated level of [demand for] some of the higher-yielding stocks because interest rates are so low," Morningstar's Mr. Peters says.

He is skeptical of stocks like real-estate investment trust Annaly Capital Management Inc., which has a roughly 15% yield, since its dividend tends to bounce up and down a lot.

Many dividend-focused managers look for companies with a history of stable and rising dividends, and potential for more of the same. Mr. Shaver, for example, invests 80% of his fund's assets in companies that have boosted dividends an average 10% a year for the past decade.