



Napa Wealth Management's The Sensible Investor

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Next Newsletter: **November 2011**
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The Income Story - for a Good Night's Sleep



If you have been around Napa Wealth Management for any length of time you are familiar with the concept of investing for income streams. A close examination of our investment management methodology would illuminate the types of securities we use to create income in our client accounts, most of which include dividend paying stocks. In this article I intend to highlight why dividend paying stocks offer attractive investment returns over long periods of time.

I'll begin by reviewing the stock market performance. As of October 10th the S&P 500 was down 5% year-to-date and the NASDAQ -3.3%. From the high point in the market this year at the end of April, the S&P 500 dropped 17.4% to its lowest point this year and the NASDAQ was down as much as 16.4% from this year's peak. Now, let me remind you, last year the S&P 500 dropped 16% from the end of April to the beginning of July, so we've seen back-to-back years of eye opening declines in the stock market.

In the quarter ending September 30, mutual funds experienced their worst quarterly investment performance since 2008. The average US stock mutual fund dropped 16.7% in the July to September period according to Lipper Inc. (a company that tracks and provides analytical data on mutual funds).

Given the fact that the stock market has had a very challenging time moving higher recently supports our rationale to own investments that pay dividends. Now, let's examine how these securities react during market declines.

A study from a database of 1500 largest publicly traded stocks called "*When the Bear Grows: Bear Market Returns 1970 - 1996*" was used to evaluate four strategies of stock investing. I'll spare you the analytical details and cut to the chase: for the full 27-year period, through both up and down quarters, the high dividend strategy produced an 8% better return than the stock market and outperformed the other three investment strategies.

Perhaps a more compelling endorsement for the dividend strategy is the fact that the declines were roughly half as much as the market. Consider the fact that if an investment drops 25% in value, it requires a 33% increase to arrive back to its value prior to the drop (a 50% decline requires a 100% increase). This simple math fact illustrates that the increase required to reach the value establish before the decrease becomes more challenging as the decline deepens.

You may be thinking, "What about bonds?" Stocks with dividends are competitive with bond yields, especially in the low-yield environment we currently find ourselves. In order to obtain competitive yields in the bond market, one must look for longer maturity (10+ years) and/or lower quality bonds (often referred to as junk bonds). It is difficult to reinvest bond interest unless you are invested in a mutual fund, which doesn't accurately compare to owning individual stocks or bonds. Bond mutual funds are a basket of bonds which don't carry a maturity date. For this analysis we're focused on individual bonds because you can peg a date the bond matures - when the principal is paid back to the investor - as well as how to evaluate the strength of the issuer (company).

Bonds are debt instruments; therefore bond investors (bond buyers) are lenders. If a company issuing bonds increases its earnings, the bond holders will not see an increase in the interest income the bond pays. The bond may be easier to sell to another investor, if needed, but in the end remember that a bond holder is simply a lender. Similar to an individual borrower; just because the borrower makes more money doesn't mean the lender gets more interest.

Stocks with high, consistent dividend yields tend to be more resistant to a decline in price than low or no dividend stocks. The reinvestment of dividends during stock market declines has also been shown to lessen the time necessary to recoup portfolio losses. Jeremy Siegel, acclaimed professor at the University of Pennsylvania's Wharton School coined the terms "bear market protector" and "return accelerator" to describe how dividend reinvestment during stock market declines can dramatically lessen the time necessary to recoup portfolio losses.

Dividends also provide a way to evaluate a company's strength. A company's ability to pay cash dividends is a positive factor in assessing the underlying health of a company. In most cases, dividend-oriented stocks come from companies that possess a predictable cash flow, have a strong balance sheet (not excessive debt) and typically provide a product or service that people need (we don't need a device that injects carbonation in our water but we do need clean water - see the difference?).

The tax code also favors dividends (at least through 2012 - hopefully longer). In 2003, the Jobs and Growth Tax Relief Reconciliation Act allowed individuals to pay a maximum of 15% tax on earnings on qualified dividends (dividends from stocks that are held for at least 61 days out of a 120-day period surrounding the ex-dividend date).

Dividends are a significant contributor to the total returns produced by stocks. The confluence

of capital appreciation and dividends are complimentary to the stock portfolio. But what if capital appreciation is missing from this duo like we've seen recently? In this case, the portfolio void from dividends requires the stock market to increase in order to provide a return on the investor's capital.

Dividends on the other hand, become an active component in the portfolio for investors- much like rental income received by a landlord who wasn't over leveraged on his real estate investment - he can cash the rent check and use the money as he wishes. When investments pay dividends a financial storm is much easier to weather. Conversely, when your portfolio is filled with growth-oriented stocks (typically no dividends), your reliance on the performance of the stock market becomes paramount. Even though growth stocks may create a better opportunity for increasing wealth, a decline in value becomes an albatross to the portfolio's performance.

An investor who buys stock is an owner. When a profitable company is paying a portion of its earnings to its shareholders in the form of dividends, that company's management team is motivated to keep its earnings high enough to support their dividend and have money to reinvest. When a dividend driven company increases its earnings, owners (shareholders) often participate in the increase by higher dividends and in some cases an increasing share price.

In a stock market that has not been friendly to growth investors, dividends can be the elixir that provides a good night's sleep. I have a list of stocks that have a 25+ year history of increasing their dividend. Names include 3M, Colgate-Palmolive, Becton Dickinson (medical instruments), Johnson & Johnson, Wal-Mart, and many others (this list of stocks is not a recommendation to buy or sell). These are not necessarily the darlings that capture the headlines and create exciting conversations on the golf course but they provide products that we use every day, in a hot economy and a cold one - maybe even freezing cold!

Sleep well and keep looking up - George