Making Your Savings Work Harder for You

Dividend-paying stocks offer many advantages.

BY JON A. HULTMAN, DPM, MBA

In his book, *Secrets of the Millionaire Mind: Mastering the Inner Game of Wealth,* T. Harv Eker highlights seventeen things that wealthy people do differently. One of these is: "Rich people have their money working hard for them." Think about how hard you work for your money, and how difficult it is to put away money after paying monthly expenses. If you put those hard-earned savings into a traditional savings account delivering a return of less than one percent a year, they are clearly not working hard enough for you. At some point in your life, the money you have saved will need to produce an income stream reliable enough to enable you to "slow down" or even retire. You should even be striving to achieve savings that generate an income stream while you are still working full time—money that can be used to meet unexpected personal expenses or invested to build greater wealth without having to take as much money from your working income.

The upsides of bank savings accounts are that they are insured, and their return is guaranteed. The downside is that the return will be insufficient to create wealth or deliver an income stream that will grow at a rate greater than the rate of inflation. You can increase the "safe rate" of return slightly by tying up money for longer periods of time—through a vehicle such as an eighteen month CD that pays 1.18%, or a ten year Treasury Bill—currently paying only 1.81%. The problem with tying up money in this way is that over a prolonged time, the investment becomes less safe because the risk of inflation increases during the time you are holding it. Also, should you need to take cash out early, this type of investment is illiquid. The reality is that any attempts to increase the return of an investment typically increase risk.

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You might ask, "How does one generate a higher income stream from fixed investments without taking on undo risks?" While there are many investment vehicles that can produce income streams (such as annuities, real estate investment trusts-REITs, municipal bonds, corporate bonds, high-yield bonds, and master listed partnerships-MLPs, etc.), these are often complicated, have risks and fees that are difficult to understand, and may not be immediately liquid. Because of this, my preference for achieving acceptable safety, along with the potential for a better return, is investment of a portion of one's portfolio in dividend-paying stocks.

Because of their predictable, reliable income, dividend-paying stocks were once known as "widow-and-orphan stocks". These stocks are typically utilities and large, stable "blue chip" companies that regularly distribute a portion of their earnings to shareholders. About 25% of Standard & Poor's 500 companies offer a dividend yield higher than the current interest rate on 10-year Treasuries. The

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ten highest dividend-yielding stocks of the 30 listed on today's DOW have a dividend yield ranging from 3.16% (Coca-Cola) to 4.15% (Verizon Communications). There are 166 stocks on today's New York Stock Exchange paying even higher dividends. between 8% and 12%—with another 142 paying 6% to 8%. When safety and the continuation of a dividend are of significant concern, it is important to evaluate each stock individually to determine if it is under-or over-valued. You will, however, find at least 50 stocks on the S&P 500 that have paid dividends every year for the past 25 years *and* have increased their dividend each year—the proverbial win-win.

The terminology and math involved in understanding dividend-paying stocks are relatively simple. Companies list dividends as a dollar amount, per share. The stock's dividend yield is determined as a percentage of the stock's price. If the price of Company X's stock is $15.00 and it pays a dividend of $1.00 per share, the percentage yield on that investment is 6.67% ($1.00/15.00 = 6.67%). If you were to invest $15,000 to purchase 1,000 shares of Company X, the dividend amount paid to you over the year would be $1,000. If a "market correction" occurred and the price of this stock dropped 33.33% (from $15.00 to $10.00), your dividend payments each year would remain at $1,000 (unless the board voted to raise or lower the dividend). Note that there is an inverse relationship between yield and stock price.

If, when this stock dropped to $10.00, you bought 1,000 more shares during the downturn (which is always the best time to buy a quality stock paying a dividend), the dividend payment would still be $1.00 per share, but the yield on those shares would increase

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from 6.67% to 10% ($1/$10 = 10%). If the price were to return to $15.00 over the next five years, in addition to the $5,000 you would have received in dividend payments on this new investment over the five years, you would also capture a 50%, or $5,000, increase in the stock's value—creating a total return of $10,000 ($5,000 in dividends plus $5,000 in capital gains). The yield of $15 per share would drop back to 6.67% for any new investors, but similar to earning interest in a bank on the portion of your money invested at the lower share price of $10.000, you would still be earning a 10% return or, $1.00 per share.

There are no "sure things" in the world of investing, but given that most of us face the challenge of retiring without the benefit of a defined benefit plan that will provide a predictable income stream, we need our investments to grow as safely as possible and be able to produce a relatively predictable income stream under all market conditions. The reasons I prefer investing in a portfolio of dividend-paying stocks are 1) the relative safety (because a security's dividend yield is a sign of its stability, profitability, and tends to support the firm's share price), 2) the investments are liquid (they can be sold instantly), 3) dividend income is fairly predictable in spite of market price fluctuations, 4) quality companies have a history of increasing dividends, 5) growth in the underlying stock price can create return in addition to the dividends themselves, 6) market downturns offer buying opportunities because this is when dividend yields immediately increase, 7) you have direct control over your money and your investments, and 8) if you are taking annual distributions of 4% or 5% a year during retirement, you can cover that distribution in a down year without needing to sell any stocks. **PM**

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