5411 Commonwealth Ave | Western Springs, IL 60558 | 630-341-9090 | Brett.Suchy@csamg.com

Dividend Growth Investing: Boring but Wise
By: Brett E. Suchy
June 3rd, 2021

Dividend growth investing is often overlooked for the wrong reason. It is boring. Generally, inexperienced investors will try the get-rich-quick strategy and buy momentum stocks that are trending in the news for short term gain. However, the chase strategy often relies on hope that the share price will continue to rise, and oftentimes there is no sell strategy when the stock may be getting ahead of itself or becomes too expensive. Timing these investments is difficult.

Playing the chase game and trying to time momentum is a risky proposal and can lead to volatile returns. Therefore, it is important to consider dividend growth as a part of your portfolio to help pursue passive income over the long term. When you invest in dividend growth stocks, the growth rate of those dividends is one of the key drivers of return, rather than just the return on the stock price.

What is a dividend and dividend yield?

A dividend is the distribution of some of the company's earnings to its shareholders, which is determined by the company's board of directors. They are used to reward investors for putting money into their company and are usually paid quarterly or semi-annually. Shareholders of dividend-paying companies are typically eligible for the dividend if they own the stock before the ex-dividend date and they can be paid out as cash or in the form of additional stock (dividend reinvestment).

The current dividend yield is the amount of money a company pays its shareholders for owning a share of its stock, divided by its current stock price. So, if the company pays out a $1.00 annual dividend and the stock is trading at $40.00, the current yield is 2.5%.

Typically, more mature companies pay out higher dividend yields. In addition, certain sectors are known to pay higher yields, such as utilities, real estate, master limited partnerships, and consumer staples stocks. However, higher dividend yields do not always indicate attractive investment opportunities because the dividend yield of a stock may be elevated as the result of a declining stock price and could indicate the dividend is at risk of being cut.

How should I select dividend growth stocks?

First, it is important to research and assess the overall health of the company such as business model, earnings growth, valuation, industry, and outlook. If the company displays a compelling investment opportunity you would then want to assess the dividend yield, the years of dividend growth, the dividend growth rate, the payout ratio, and the likelihood of consistent dividend growth over the coming years.

High-quality dividend companies will consistently grow their dividend each year and the pace at which they grow their dividend is important. Typically, you can find the 5-year growth rate of the dividend, which represents the average year over year dividend growth over the last 5 years, to help you assess the magnitude of income growth. High growth rates are attractive if the dividend is sustainable because dividend raises represent more income and present a higher yield on the cost basis for the security. However, it is important to assess the road ahead and the likelihood that these dividend payers can keep up the growth rate.

A company may have an attractive dividend growth profile; however, it is important to assess the health of that dividend. This can be measured by looking at the dividend payout ratio, which is the proportion of earnings paid out as dividends to shareholders. If the dividend payout ratio is considerably high or the amount of the dividend is greater than earnings, the dividend could be at risk of being cut. When a company chooses to cut their dividend, the share price will usually fall, unless the cut was widely anticipated and factored into the current share price.

Some companies pay out all their earnings to shareholders, while some only pay out a portion of their earnings. If a company pays out some of its earnings as dividends, the remaining portion is retained by the business. The amount of retained earnings depends on the company's level of maturity. A new, growth-oriented company that aims to expand, develop new products, and move into new markets would be expected to reinvest most or all its earnings and would therefore have a low payout ratio.

Why should I have dividend growth stocks?

First, the market has, over the last several years, been rewarding growth stock investors. Since January 1, 2018, Wilshire reports that their large, mid and small growth indices have all outperformed their value counterparts. However, over the last several months, dividend and value-oriented stocks have been outperforming many growth segments.[1] Thus, it is wise to hold both growth and dividend-oriented stocks to enhance overall portfolio diversification and help mitigate volatility.

Second, imagine comparing dividend growth investing to owning a vineyard. The vines are the stocks, and the grapes are the dividends. The vines bear grapes, and the vineyard generates income. If the vineyard has strong vines and they are tended to appropriately, over time the vines will hopefully bear even more grapes, thereby generating even more income. If the vineyard uses that income to reinvest in good soil and maintenance, the vineyard's income will continue to climb, which is just like the concept of compounding dividends.

Lastly, investing in high-quality dividend growth stocks can provide a source of income that can be calculated and used to pay the bills and enjoy retirement with a heightened peace of mind.

As always, if we can provide a more comprehensive overview on dividend growth investing, please feel free to contact me at Brett.Suchy@csamg.com.

[1] https://www.longtermtrends.net/growth-stocks-vs-value-stocks/