The Stan Clark Financial Team's

# PERSPECTIVES

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Investing

## Dividends above everything?

*By Michael Chu, Investment Advisor*

**Everyone seems to like dividends. After all, we like getting paid. But is it true that the more dividends we have, the better?**

First, let's look at a stock's *dividend yield*, the annual dividend divided by its price. For example, if a $50 stock pays $1 in dividends per year, then the yield is 1/50 or 2%. A dividend yield is often used as a measure of value. Typically, a higher dividend yield means a cheaper valuation. High-dividend-yielding stocks are typically viewed as out-of-favour stocks, since they are trading at low prices relative to their dividends. Numerous academic studies suggest that using only dividend yield to pick out-of-favour stocks results in higher-than-average returns.

We've previously discussed other value measures that we also use to pick stocks, e.g., price to earnings or price to book. But dividends have a special feature over the others: They are highly objective. And the reason they're considered highly objective is that they are either paid or they're not. Dividends are not subject to being manipulated like other variables can be.

So, are high-dividend-paying stocks always good stocks to have? Unfortunately, it's not that simple. Some companies that have unusually high dividends can't actually afford them. High-dividend yields are usually the result of falling stock prices. Now, sometimes a falling stock price is temporary, which makes it a good investment. But other times, a falling share price is more permanent because of deteriorating earnings or business fundamentals. These may inevitably lead to a reduction in dividends – and these are the companies you want to avoid.

How do we avoid the bad-dividend-paying companies? We look at earnings momentum to help us pare down the list of companies. Then, by avoiding companies with poor momentum, we stay within a list of companies that have good dividends, as well as a higher chance of recovering and coming back into favour. We exclude companies with really poor momentum, as these companies will have a tougher chance of recovering.

We also look at the *dividend* payout ratio. This ratio compares the amount of dividends to the company's earnings. For example, a company might pay half its earnings as dividends. In this case, the payout ratio would be 50%. When using dividend yields, we prefer companies that have a reasonable cushion of earnings to pay their dividends. Believe it or not, there are many companies that pay out more than they earn. Of course, this isn't sustainable. Either earnings have to grow, or the dividend will eventually be cut.

In conclusion, along with everyone else we like dividends too. But we make sure we consider other factors, as well. ■

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