THE 10 RULES OF DIVIDEND INVESTING

How to be succesful with dividend stocks

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THE 10 RULES OF DIVIDEND INVESTING

The rules of dividend investing are providing dividend investors some support on three important aspects to be successful with a dividend stocks portfolio.

Those three aspects are:

1. Ranking the best dividend growth stocks for long-term investors
2. When to buy dividend stocks
3. When to sell dividend stocks

RANKING AND SELECTING DIVIDEND STOCKS

Dividend portfolio's examples, ranking on fundamental data such as dividend yield, payout ratios are a great way to start exploring dividend stocks. In addition, technical price & performance data can help, when you are looking for good dividend stocks to buy and hold for the long-term.

Please keep in mind that a diversified dividend portfolio already benefits from diversification from owning just 10 to 20 individual dividend stocks. Research by Robert Hagstrom has shown that 15 individual dividend stocks are sufficient. However, when you want to start with smaller amounts a mutual fund or tracker can help to diversify.

Rule #1: Rank Stocks by dividend history and rising dividends

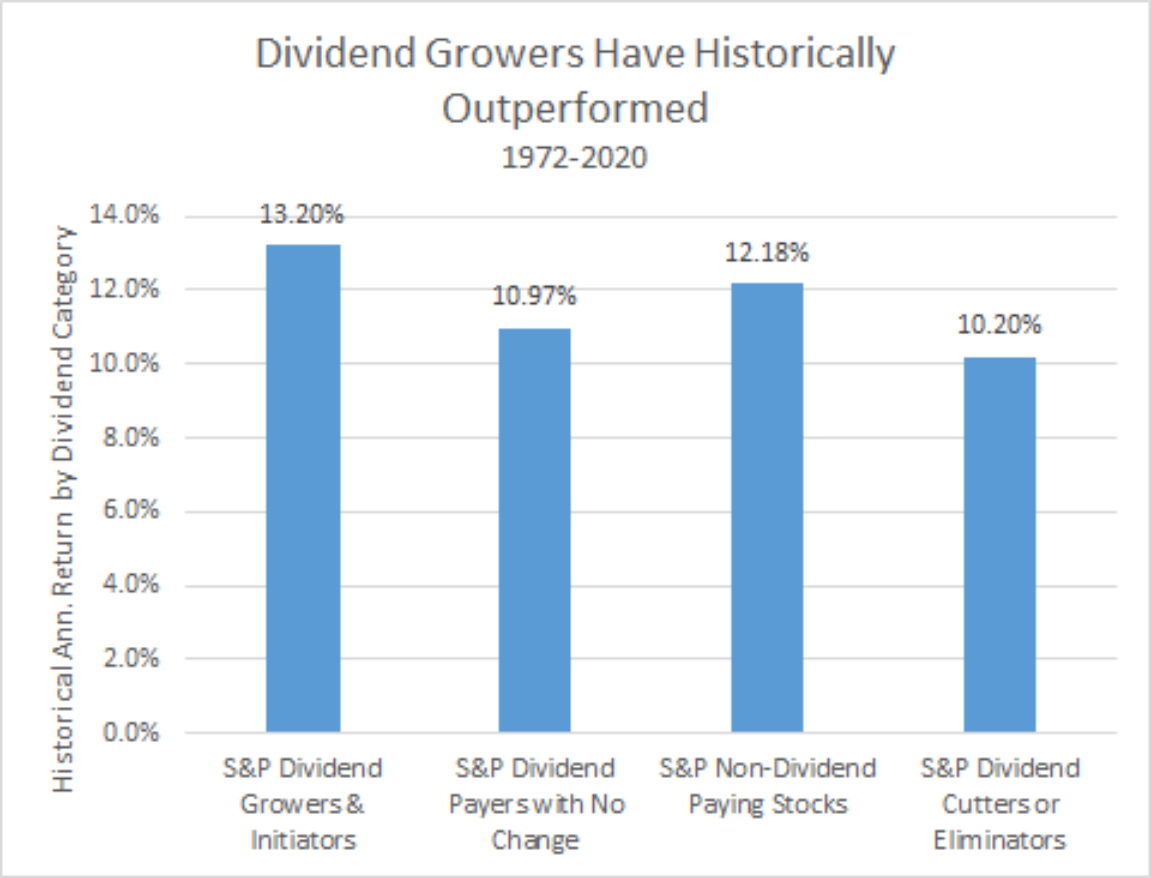
Stocks with rising dividends over several years tend to outperform stocks with stable or decreasing dividends.

Rising dividend history is an important measure of a company's financial health and that companies that not only pay but consistently grow their dividend, perform better across full market cycles.

Apply for example the 10-10 rules, which stands for a company that increases dividends for 10 consecutive years with an average of 10% or more growth in dividends per year.

Alternative select stocks from the Dividend Aristocrats lists. Those stocks, with 25+ years of rising dividends, have outperformed the S&P500 over the last 10 years by 2.3 percentage points per year.

The result is a focus on quality companies with sound balance sheets, strong earnings growth potential, and a commitment to paying shareholders while keeping the payout ratio in balance.



Rule #2: Pay Attention to the Payout Ratio

To determine the dividend payout ratio, divide the annual dividend by earnings per share (EPS). The payout ratio is a way to measure the sustainability of a company's dividend payment stream.

Use the following general guidelines to help measure how well various companies' payout ratios compare:

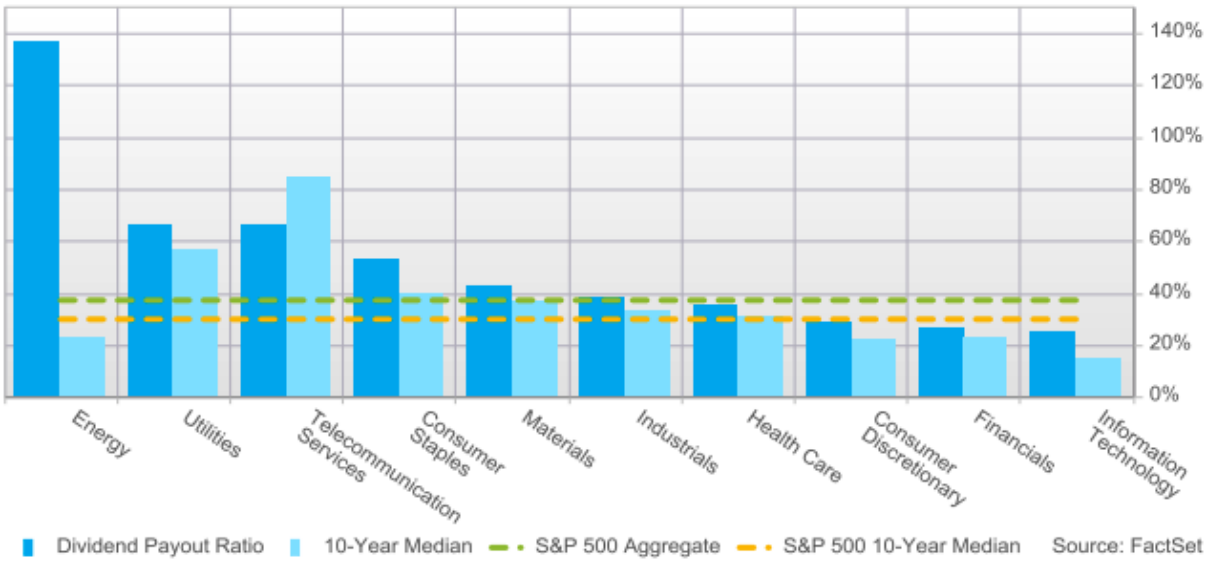
< 40%: Payout ratios below 40% are in the low range and a good reason to analyze this dividend stock further. Growth stocks have low payout ratios because they continue to reinvest in the business; these stocks offer the potential for increased dividend payments as well as capital appreciation in stock price.

Around 50%: 50 percent is the traditional payout ratio, meaning the company is paying 50 percent of its profits to the shareholders in the form of dividends.

50% to 70%: Payout ratios between 50 and 70 percent is an average range and should not generate any concern. Please keep in mind that the range may vary by sector. Utilities, for example, sometimes show payout ratios as high as 80 percent, which is okay for that sector.

>100%: A 100% or higher payout ratio means nothing is left to invest in the business. A dividend payout that exceeds the quarterly profit is a big red flag and usually indicates an inevitable dividend.
cut. Also, a high payout ratio leaves little room for error. If all of the earnings are paid out as dividends, a big drop in earnings one quarter may lead to the company taking on debt to make the (dividend) payments or an immediate dividend cut.

Exclude payout ratios above 100% from your ranking and analyze dividend stocks having a figure below 40%.

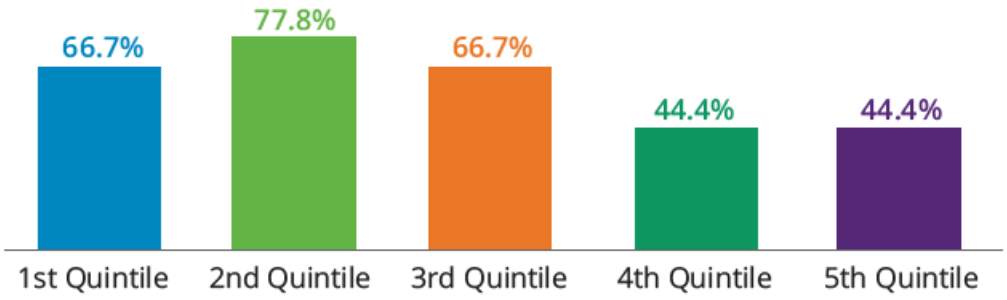

140%
120%
100%
80%
60%
40%
20%
0%
Energy
Utilities
Telecommunication Services
Consumer Staples
Materials
Industrials
Health Care
Consumer Discretionary
Financials
Information Technology
Dividend Payout Ratio
10-Year Median
S&P 500 Aggregate
S&P 500 10-Year Median
Source: FactSet

Rule #3: Rank stocks by dividend yield but be aware of the yield trap.

Generally, higher dividend-yielding quintiles outperformed lower-yielding quintiles. Worth noting is that the highest yielding quintile of stocks, containing the 20% top dividend payers, did not outperform the 2nd quintile. Meaning that the high yield dividend stocks are not always providing the highest total return.

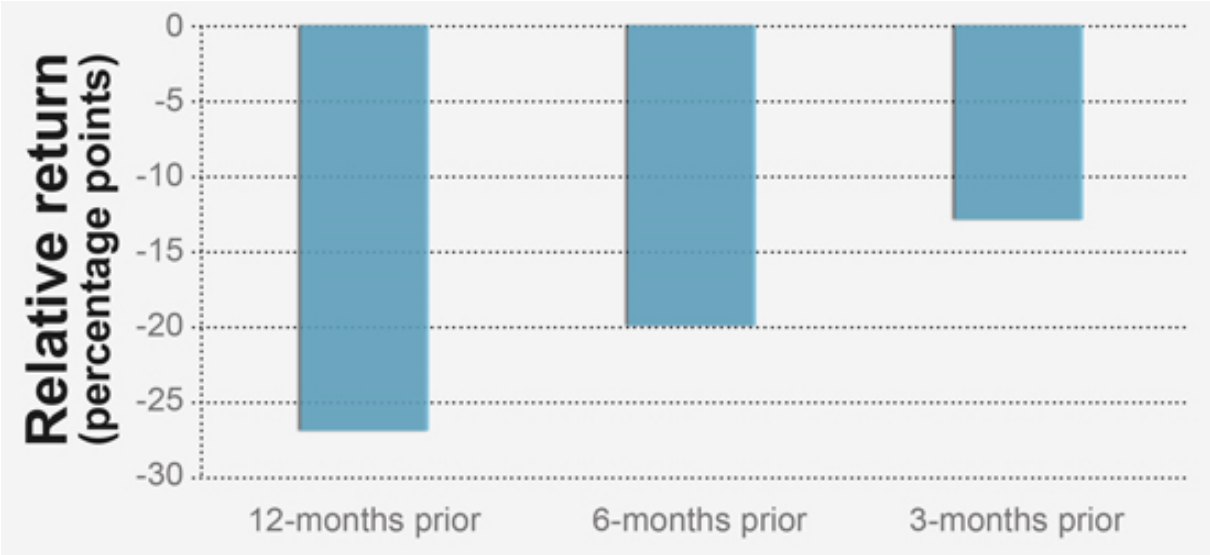
Second-Quintile Stocks Outperformed Most Often From 1930–2020

Percentage of Time Dividend Payers by Quintile Outperformed the S&P 500 Index (summary of data in **FIGURE 5**)

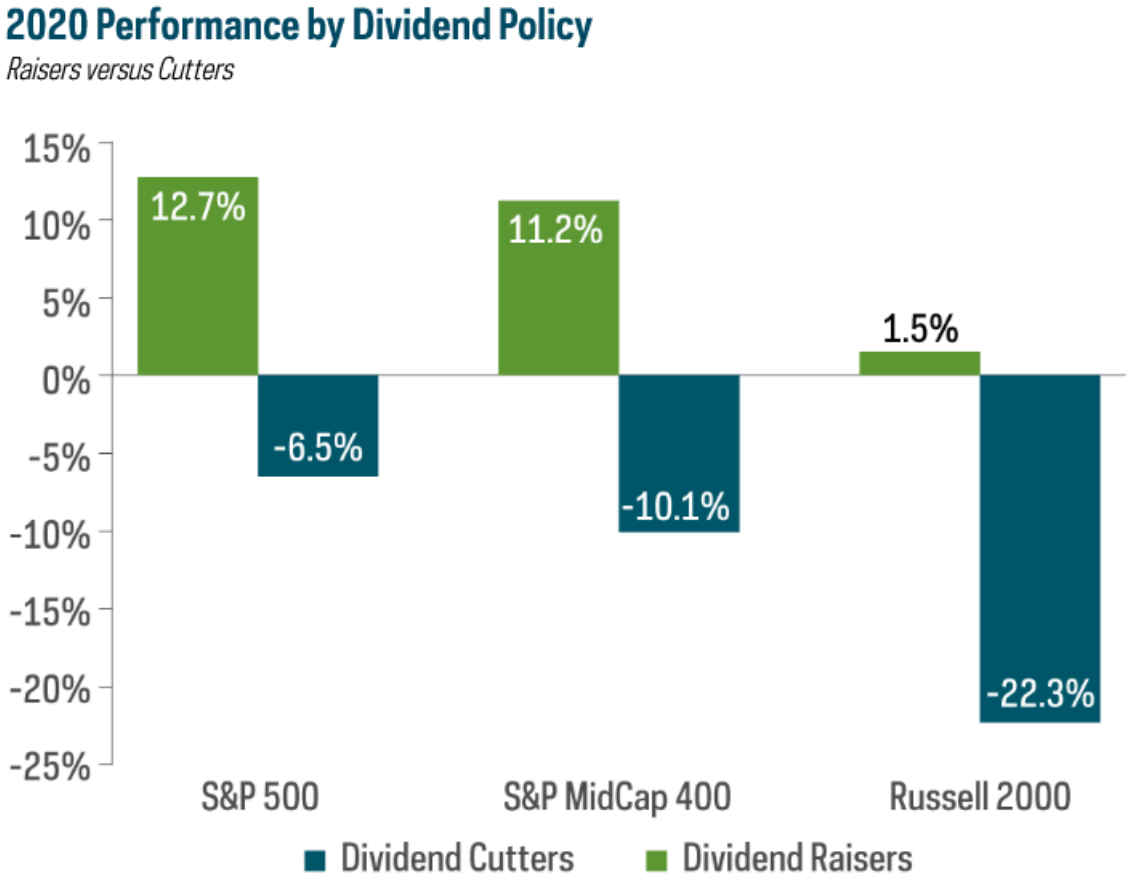


Data Sources: Wellington Management and Hartford Funds, 2/21. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment.

On average during the past two decades, 9% of S&P 500 stocks with the highest yields cut or suspended dividends within one year. Historically, the average dividend stock that cut or suspended its dividend underperformed the market by more than 25% in the 12 months preceding the announcement. (See the chart on the next page.)



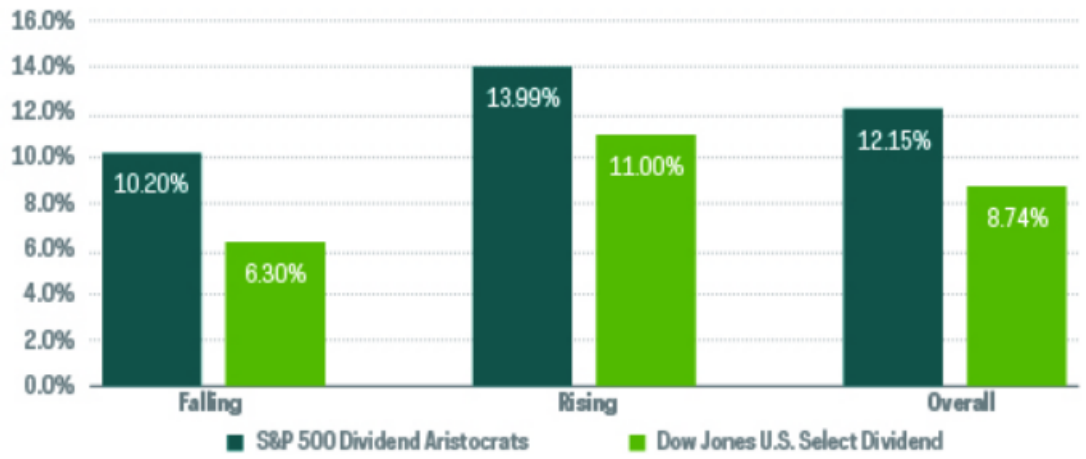
In 2020, there has been a performance difference of approximately 20% between dividend growers and dividend cutters. Q-1 2021 had far more dividend raises (124) than cuts (3) and is showing a similar performance difference; -3.26% for the dividend cutters versus +10.24% for the raisers.



Source: Bloomberg, ProShares. Based on dividend per share announcements from 1/1/20—12/31/20. Past performance is no guarantee of future results.

The history of stock market performance in various interest rate environments is mixed. High-dividend-paying sectors have struggled when rates have risen.

Dividend Growth Outperformed High Dividend Yield in Both Rising and Falling Rate Periods



Rule #4: Rank stocks using the modified PEG.

Using the PEG ratio ((Price/Earnings)/ Earnings Growth Rate), popularized by Peter Lynch, is a nice valuation metric that considers the growth potential and safety of the business.

A PEG around 1, is considered as a fair valued company. A PEG much higher than 1 (e.g. 2+) indicates an overvalued company, and a PEG lower than 1 indicates an undervalued company.

The PEG ratio should be adjusted slightly to work with dividend stocks – dividend yield should be added to the growth rate to come up with the G in the PEG ratio.

This modified PEG-ratio can be a useful indicator to rank dividend stocks, lowest PEG-ratios first. Preferably this ratio is combined with other ranking-selecting factors.

WHEN TO BUY DIVIDEND STOCKS?

Rule #5: Buy dividend stocks or ETF at predetermined intervals

"Buy low, sell high" must be the best-known investing advice in the universe, however it is easier said than done. Dollar-cost averaging can help you to build a diversified dividend portfolio for the long term. This strategy of investing a fixed dollar amount in a dividend stock or ETF at specific intervals. The idea is that you will end up buying more shares when prices are low, and fewer shares when prices are high. For long-term investors, this is a mathematically favorable way to buy stocks and required the investor to stick to a plan.

This approach is especially useful for investors to start to build a dividend portfolio.

Rule #6: Buy dividend stocks based on pricing data

When additional funds (lump sum) are available or dividends are received from an existing dividend portfolio, the question is often when to reinvesting. 2 simple rules can be used:

1. Use the 200 simple moving average (SMA) as an indicator when (not) to buy.
2. Invest after a negative monthly performance.

Rules 1 and 2 need to be combined in such a way that a positive cross of the SMA-200, meaning the closing price of the stock is above the average, it is a buy. If the monthly performance of a stock is negative and the closing price of the stock is above the SMA-200 it is a buy.

When the closing price is below the SMA-200, it is not a buy at all.

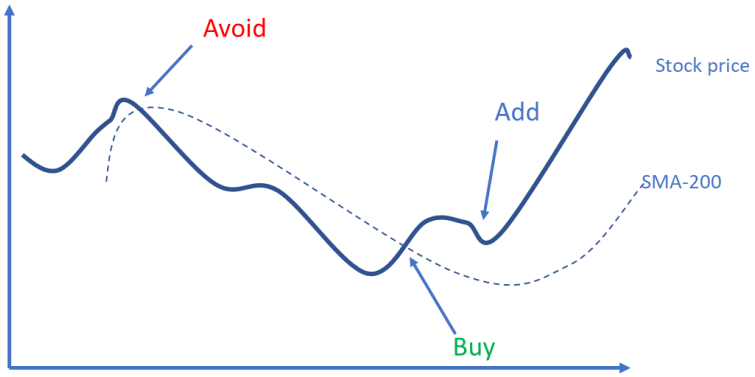


Figure 1: Schematic overview of trend timing

Alternatively, one can invest the received dividends by the end of every quarter.

WHEN TO SELL?

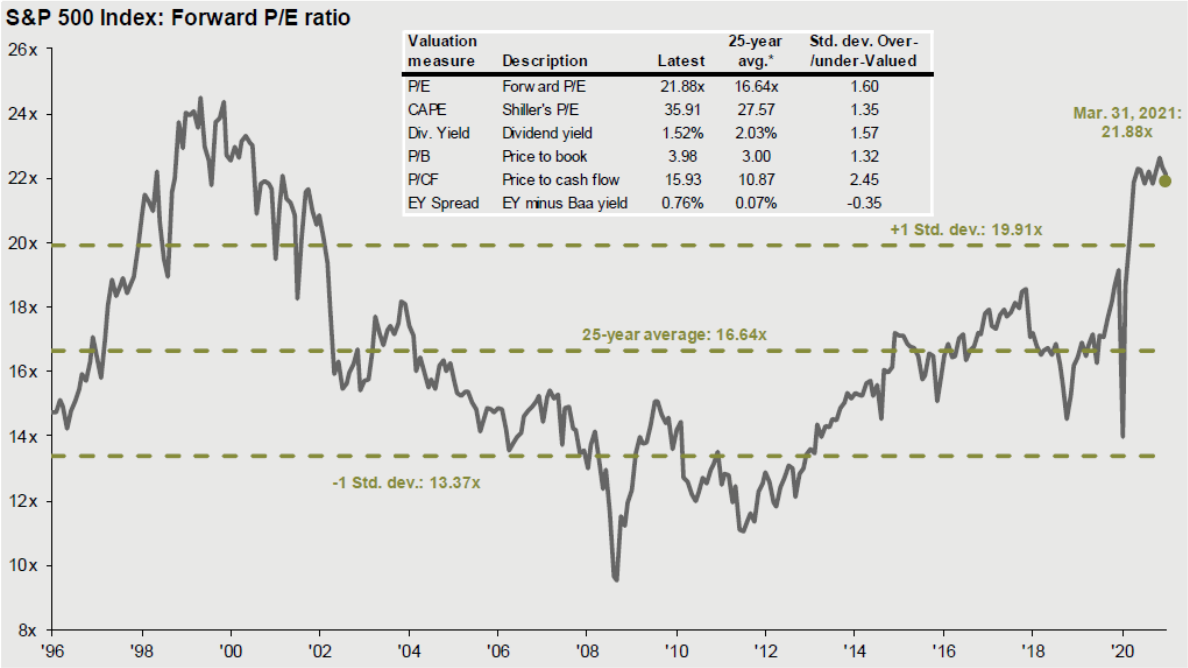
Rule #7: Sell when the dividend payment is reduced or eliminated.

Stocks that reduced or eliminated their dividends had a -0,37% return from 1972 through mid-2021.

Rule #8: Sell over-valued dividend stocks, meaning a P/E ratio over 35-40%

The price-to-earnings (P/E) ratio is a good benchmark for comparing any two dividend stocks, particularly if they are in the same sector. If the P/E ratio for a business sector averages 15, a stock with a P/E of 12 would be undervalued compared to its competitors. A stock with a P/E ratio of 20 would be overvalued.

A dividend stock with a ratio of 40 is extremely likely to be overvalued, especially if it is a dividend aristocrat. The P/E 10 years historical average is around 17, with a minimum of 9% and a maximum of 24%. In June 2020, the highest P/E ratio was 48.5 (West Pharmaceutical Services) while the average is 19.9 for the Healthcare sector.



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	21.88x	16.64x	1.60
CAPE	Shiller's P/E	35.91	27.57	1.35
Div. Yield	Dividend yield	1.52%	2.03%	1.57
P/B	Price to book	3.98	3.00	1.32
P/CF	Price to cash flow	15.93	10.87	2.45
EY Spread	EY minus Baa yield	0.76%	0.07%	-0.35

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.

Rule #9: If the company’s share price drops more than 10 percent but the dividend is maintained.

This situation is a judgment call. First, look at the rest of the market. Is the price down because of a sharp decline in the sector or broad market? Is this stock part of the sector causing all the trouble, like the banking sector in 2008?

Rule #10: Sell when the payout ratio is above 100%

Generally, a higher payout ratio indicates that a company is sharing more of its earnings with stockholders. A payout ratio of more than 100% means that a company's dividend payments are exceeding its net income. This isn't sustainable and should be taken as a sign that dividend payments will likely go down in the future. Companies with the strongest long-term dividend payment records tend to have stable payout ratios over time. Please note that average dividend payout ratios are different per sector (see chart in the dedicated section on payout ratio). The average payout ratio of the dividend aristocrats is around 50%.

Past performance is no guarantee of future results.

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