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Leap of faith or misstep? 18 September 2011

Whipsawing markets. Slow economic growth. Low interest rates. It is little wonder that investors around the world are favouring high-dividend paying stocks. But a big dividend yield is not a panacea and neither is it an excuse not to do your homework.

In the first eight months of this year, more than \$US12 billion flowed into US managed funds that invest in high dividend stocks. That is four times more than such funds attracted in the whole of 2010, and it compares with \$US25 billion that flowed out of traditional equity funds in the same period.

Understandably, US investors have chosen to switch out of share market funds that are volatile and unpredictable and into share market funds that at least have some predictability – they pay regular dividends.

Over time, half of the return achieved from share market investments comes from dividends, and the other half comes from capital growth. In the recent past though, we haven't seen a lot of capital growth – well, we see it for a week or two, and then it disappears!

However, a number of businesses around the world, with predictable cashflows, have continued to pay healthy dividends and will likely continue to do so, irrespective of whether Europe gets its act together or the US figures out how to reduce its debt.

The predictable cashflows of such businesses arguably make them a better safe haven than say gold or US government bonds. The only problem is that despite an attractive dividend yield, such stocks are not entirely immune to share market volatility, and an economic slowdown can hinder their ability to keep paying dividends.

Just because a stock has a dividend yield of say 9%, it is not automatically a screaming buy. You may be better to settle for a stock with a 6.5% yield, if there is a greater likelihood that its dividend will continue to be paid.

As well as looking at the dividend yield, you should pay attention to a company's payout ratio. The lower the percentage of the company's earnings being paid out in dividends, the greater the buffer. If a company pays less than 50% of its earnings out in dividends, it will be less likely to reduce its dividend, even in a slow year.

You should also look at a company's earnings history. If a high dividend is being paid in a good year, but earnings have fallen in the previous three years, it could be a leap of faith that future dividends will be as good, or better.



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And a good dividend yield does not absolve you from doing some basic company analysis. A 9% dividend yield won't seem so flash if the company's share price falls 20% because it fails to meet expectations.

Bottom line, dividend stocks are a good addition to any diversified portfolio as they are typically less volatile and they give you an income while you are waiting for capital growth to emerge.

But as we are reminded every day, there is no such thing as a risk-free investment.