DRP STOCK CHARACTERISTICS AND A HIGH-YIELD CONTRARIAN SCREEN

By Kenneth J. Michal

Companies that offer dividend reinvestment plans tend to be larger, and more mature firms, with a heavy concentration of cyclicals. An individual who invests only in DRP companies would end up excluding firms in smaller, high-growth industries—including technology.

Every June, the *AAII Journal* publishes a guide that lists companies offering a dividend reinvestment plan (DRP).

Many individuals are attracted to companies with DRPs because these firms offer a low-cost approach to purchasing shares. This article explores the characteristics of stocks with DRPs and performs a basic screen for high dividend yields.

A SECTOR BREAKDOWN

This year's DRP survey covers 782 firms, 752 of which are tracked by and included in AAII's fundamental screening software program *Stock Investor Pro*.

Table 1 presents a sector breakdown of the firms that offer DRPs, as well as those without DRPs.

Dividend reinvestment plans have traditionally been offered to the shareholders of utilities and financial institutions because these firms have a steady need for equity capital, they pay an above-average dividend yield, and they benefit from the goodwill of turning their customers into owners. It is not surprising, then, to see that financials and utilities make up 23.1% and 13.2%, respectively, of the DRP stock universe. In contrast, financials make up 15.3% and utilities a mere 0.7% of the non-DRP universe.

Other segments that make up a larger percentage of the DRP stocks than non-DRP stocks include basic materials, conglomerates, and consumer non-cyclicals. While it is difficult to make any generalizations about conglomerates except that they obviously tend to be larger firms, the other two segments tend to be more stable, low relative growth sectors of the market.

In the non-DRP universe, the technology, services, and healthcare sectors have proportions significantly higher than the DRP universe. These are higher-growth sectors that often contain smaller firms that pay little, if any, dividends. An individual who invests only in companies with dividend reinvestment plans would end up excluding these sectors from his or her portfolio or would at least be limited to those companies within these sectors that are larger, more mature, and pay dividends. In the technology sector, only 46 firms out of a universe of 2,255 stocks offer DRPs.

COMPARING CHARACTERISTICS

Table 2 compares the investment characteristics of the DRP universe to the non-DRP universe. Medians (the midpoint of the complete range of numbers) are used instead of averages because they are not skewed by extreme values.

The companies offering DRPs are significantly larger, more mature firms than those without dividend reinvestment plans. Companies do not typically start paying cash dividends until they are past their rapid growth stage, when they are generating excess cash from operations and cannot find very profitable capital projects for the firm. This factor clearly shows up in the historical sales growth rate, as well as the earnings growth forecasts. The earnings growth rate for the DRP stocks, however, is higher than that of the non-

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TABLE 1. A SECTOR BREAKDOWN: DRPs vs. NON-DRPs

	DRPs		Non-DRPs	
Sector	No. of Firms	Percent of Total	No. of Firms	Percent of Total
Basic Materials	66	8.8	475	5.5
Capital Goods	40	5.3	465	5.4
Conglomerates	18	2.4	19	0.2
Consumer Cyclical	49	6.5	412	4.8
Consumer Non-Cyclical	49	6.5	281	3.2
Energy	19	2.5	349	4.0
Financial	174	23.1	1,325	15.3
Healthcare	21	2.8	916	10.6
Services	157	20.9	1,998	23.1
Technology	46	6.1	2,209	25.5
Transportation	14	1.9	148	1.7
Utilities	99	13.2	61	0.7
Total	752		8,658	

DRPs. This is due in large part to an unusual group of outliers—several small, new companies with very large negative five-year earnings growth figures that have skewed the non-DRP median and average. As you would expect, though, the DRP firms show a higher growth rate for dividends.

VALUATION COMPARISONS

Over the last five years, large-cap stocks have outperformed small-cap issues. However, in late 1999 and for the entirety of 2000, small-cap stocks displayed the stronger performance. During bear markets, dividend-paying value stocks tend to outperform smaller-cap, growth issues. The valuation measures reflect this large-cap trend. The price-earnings ratio of 16.2 for the large-cap DRP firms exceeds the non-DRP multiple of 14.4.

The dividend yield median for the roster of DRPs is greater than that of the non-DRP group—2.3% versus 0%. In fact, only 18% of the firms without DRPs pay any dividends at all.

The ratio of price-earnings to earnings growth (PEG ratio) is often used to measure the balance between value and growth. A firm with a low price-earnings ratio may not be a bargain if the company has poor earnings growth prospects. Firms with higher growth prospects are attractive if you do not pay too much for the earnings. Companies with a PEG ratio near 1.0 are considered to be fairly valued; a ratio at 0.5 or less is considered undervalued, while a ratio near or above 1.5 is considered overvalued.

While the stocks with DRPs have a slightly higher median price-earnings ratio compared to the non-DRPs, it appears that their median price-earnings ratio is not low enough given the earnings growth rates of these firms. The stocks of the non-DRP group have a more attractive PEG ratio median of 0.8, compared to 1.4 for the DRPs.

Many investors like to adjust the PEG ratio by adding the dividend yield to the growth rate. This adjustment acknowledges the contribution that dividends make to an investor's return. This adjusted ratio is calculated by dividing the price-earnings ratio by the sum of the earnings growth rate and the dividend yield. For the DRP group this brings the ratio down to a more attractive 1.1.

MANAGEMENT & OWNERSHIP

The DRP companies tend to have better profitability ratios than the non-DRP companies, but it is difficult to make any generalizations about these ratios since profit margins are very industry-specific. Given the difference in industry weightings for the two groups, the ratio differential may or may not be significant.

When it comes to measures of financial structure, some observations can be made. Large, established firms with proven track records have greater access to the debt markets than smaller firms. The differences in the ratio of long-term debt to total capital certainly bear this out. Smaller firms must rely more on equity financing, short-term bank loans, and growth in supplier-provided accounts payable as sources of external funding. The ratio of total liabilities to total assets considers the complete debt structure.

The companies with DRPs have attracted much more institutional coverage than the non-DRP group. More than half of the shares for this group are held by institutions, compared to just 13.2% for the non-DRP group. The median number of institutions that have a position in a DRP firm is 316, while the median number with an ownership position in a non-DRP company is only 26.

Managers and founders are more likely to own a higher portion of outstanding stock of smaller firms. It is not surprising, then, that the insider ownership statistics are much higher for the smaller, non-DRP companies than the larger DRP firms.

Lower prices are often associated with smaller-cap stocks, and the price statistics reflect this tendency—the prices of the non-DRP group tend to be significantly lower, $4.95 versus $27.26 for the DRP firms.

While both groups underperformed the S&P 500 (as measured by the 52-week relative strength) in our past few DRP screens, the DRP group in this screen is performing 33.0% above the S&P 500. On a relative basis, the larger-capitalization DRP stocks have been the

stronger performers, while the non-DRP firms are down over the same period.

A HIGH-YIELD SCREEN

An investor looking for an aggressive, high-growth portfolio must look beyond the DRP universe. However, applying a screen searching for out-of-favor, high relative yield stocks may highlight some companies that warrant further research and analysis.

For comparison purposes, the same screening criteria were applied separately to the DRP and the non-DRP universe. The screen searched for companies with high relative dividend yields and above-average dividend and earnings growth.

Traditionally, financials and utilities trade with higher dividend yields and require separate relative dividend yield screens; otherwise, a simple screen for high dividend yields would be heavily weighted with securities from these groups. Our first screen filtered out financial, utility, and real estate stocks. This requirement reduced the number of non-DRP firms from 8,658 to 7,084, and DRP firms from 752 to 414.

The next screen looked for companies that have paid a dividend for each of the last six years and have not reduced their dividend over the period. This screen cut our DRP list to 238 and the non-DRP list to 364.

It is important for a company to demonstrate the ability to increase dividend payments over time, and therefore the next screen looked for companies with a dividend growth rate greater than the growth rate for the firm’s industry. This screen dropped the totals to 193 DRP stocks and 304 non-DRP stocks.

The next filter required that the company’s current dividend yield be higher than its five-year average. This filter identifies companies whose dividends have increased faster than increases in share price, or whose current share price has dipped recently. This contrarian filter tries to identify stocks that are out-of-favor, hopefully due to a short-term overreaction to bad news. This criterion cut the list of DRP stocks to 105, while the non-DRP list was whittled down to 149.

The safety of the dividend is also important. A high dividend yield may be a signal that the market expects the dividend to be cut shortly and has pushed down the price of the stock accordingly. A high relative dividend yield is attractive only if the dividend level is expected to be sustained and even increased.

The payout ratio is the most common measure of dividend safety. It is computed by dividing the dividends per share by the earnings per share. The lower the ratio, the more secure the dividend. Any ratio above 50% is generally considered a warning flag, but some stable

TABLE 2. INVESTMENT CHARACTERISTICS: DRPS VS. NON-DRPS*

Size	DRPs	Non-DRPs
Market Capitalization ($ Mil.)	1,655.6	51.6
Sales—Latest 12 Months ($ Mil.)	1,814.2	75.4
Growth (Five-Year Annual)		
Sales (%)	9.4	14.4
Earnings per Share (%)	7.9	6.1
Estimated Earnings per Share (%)	10.9	20.0
Dividends (%)	4.9	0.0
Valuation		
Price-Earnings Ratio (X)	16.2	14.4
Dividend Yield (%)	2.3	0.0
Price-to-Book Ratio (X)	1.9	1.4
Price-Earnings to Growth Ratio (PEG Ratio) (X)	1.4	0.8
Price-Earnings to Growth—Dividend Adjusted (X)	1.1	0.8
Profitability		
Gross Margin (%)	34.4	37.8
Net Profit Margin (%)	6.8	1.1
Return on Equity (%)	12.8	4.9
Financial Structure		
Long-Term Debt to Total Capital (%)	39.4	6.7
Total Liabilities to Total Assets (%)	70.6	54.5
Shares/Ownership		
Institutional Ownership (%)	52.5	13.2
Number of Institutional Owners	316	26
Insider Ownership (%)	20.0	45.0
Shares Outstanding (Mil.)	62.2	15.5
Price		
Price ($)	27.26	4.95
Price as a % of 52-Week High (%)	89.0	50.0
52-Week Relative Strength (%)	33.0	–18.0
One-Year Price Change (%)	13.1	–40.5

All values are medians—the midpoint of the range.

industries, such as utilities, have higher payout ratios. The screen here looked for firms with payout ratios below 50%, which left 63 DRP stocks and 96 non-DRPs.

Our final screen required a minimum level of earnings growth. The criterion used here looked for firms with earnings growth rates in the upper half of their respective industries, which recognizes the growth differences between industries and tends to lead to more meaningful screening results.

Forty-seven stocks with DRPs and 61 stocks without DRPs passed all of the filters. The top 10 dividend-yielding stocks from each group are presented in Table 3.

PRICE MOMENTUM

Two data points included in Table 3 but not used as a screen are worth mentioning: the 52-week relative strength figure and the one-year price change.

Relative strength reflects the price performance of a stock over the last year relative to the performance of the S&P 500. The base figure, reflecting performance equal to the S&P 500, is 0%. Numbers above 0% reflect performance greater than that of the S&P 500, while negative numbers reflect underperformance. For example, in the DRP group at the top of Table 3, automobile manufacturer General Motors Corp. has a 52-week relative strength of –32%. This figure indicates that General Motors has underperformed the S&P 500 by 32% over the last 52 weeks. As you can see, just a few firms presented in these two lists have actually underperformed the S&P 500 relative strength benchmark—three rather significantly. In contrast, Modine Manufacturing Co.'s 52-week relative strength performance indicates it has performed 50% better than the S&P 500 for the same period.

It is also important to consider the performance of a company relative to its peer group. For the peer group comparisons, Table 3 includes medians for the complete 752-stock

TABLE 3. FIRMS WITH THE HIGHEST DIVIDEND YIELDS: DRPS VS. NON-DRPS

	Dividend Yield		Annual Growth Rates				52-Wk.	Price	
Company (Exchange: Ticker)	Current (%)	5-Yr. Avg. (%)	Dividends per Share (%)	EPS (%)	Est. EPS (%)	Payout Ratio (%)	Rel. Strgth. (%)	Change (1 Yr.) (%)	Description
Firms With DRPs									
Barnes Group Inc. (N: B)	4.1	3.3	8.3	6.5	na	41.1	34	16	Metal pieces & aerospace parts
Kelly Services, Inc. (M: KELYA)	4.1	3.2	4.9	5.9	13.0	40.6	19	3	Staffing servs
Bandag, Inc. (N: BDG)	4.0	2.7	7.5	–5.3	8.0	41.4	47	27	Tires
SUPERVALU, Inc. (N: SVU)	4.0	2.7	3.3	44.3	11.0	30.3	–24	–34	Wholesale food & nonfood prods
Cooper Industries, Inc. (N: CBE)	3.8	3.0	1.2	35.4	10.8	36.6	26	8	Electrical prods & tools/hardware
General Motors Corp. (N: GM)	3.6	3.0	12.7	–1.4	6.1	30.3	–32	–41	Autos, trucks & locomotives
Modine Manufacturing Co. (M: MODI)	3.5	2.7	12.1	–0.2	na	49.7	50	29	Heat exchangers & sys
Harsco Corporation (N: HSC)	3.4	2.8	4.8	4.6	12.7	39.5	10	–6	Mill servs, gas & infrastructure
Westvaco Corporation (N: W)	3.4	3.0	2.7	–2.5	6.0	38.8	–2	–16	Paper, lumber & specialty chems
Snap-On Incorporated (N: SNA)	3.3	2.6	5.5	6.7	10.3	39.1	29	11	Tools, storage prods & diag equip
Median for Top Ten Yielders	**3.7**	**2.9**	**5.2**	**5.3**	**10.6**	**39.3**	**23**	**5**	
Median All DRP Firms	**2.3**	**2.5**	**4.9**	**7.9**	**10.9**	**39.0**	**33**	**15**	
Firms Without DRPs									
Knape/Vogt Manufacturing (M: KNAP)	5.1	4.0	0.7	7.1	na	48.9	0	–14	Storage prods
Selas Corp. of America (A: SLS)	4.8	2.3	3.7	5.3	na	35.1	–29	–39	Industrial heat sys
Quaker Chemical Corp. (N: KWR)	4.7	4.6	3.3	20.6	10.0	42.3	21	4	Specialty chem prods for manufac'g
Flexsteel Industries, Inc. (M: FLXS)	4.5	4.0	1.6	20.4	9.0	44.1	0	–13	Upholstered furniture
Oxford Industries, Inc. (N: OXM)	4.2	3.5	2.0	20.0	na	36.5	36	17	Consumer apparel prods
Alexander & Baldwin (M: ALEX)	4.0	3.6	0.5	12.5	5.0	41.6	25	8	Ocean transport & prop develop
Russ Berrie & Company (N: RUS)	4.0	3.5	8.0	25.2	na	37.0	50	29	Retail gift prods
Craftmade International (M: CRFT)	3.8	0.7	38.0	20.3	22.0	25.4	77	53	Ceiling fans & light kits
Ampco-Pittsburgh Corp. (N: AP)	3.7	2.6	21.7	12.2	na	23.8	9	–6	Heat exch coils, air sys & power
Riviana Foods Inc. (M: RVFD)	3.7	2.3	16.2	12.6	9.0	31.8	26	9	Rice & other food prods
Median for Top Ten Yielders	**4.1**	**3.5**	**3.5**	**16.3**	**9.0**	**36.8**	**23.0**	**6.0**	
Median All Non-DRP Firms	**0.0**	**2.3**	**0.0**	**6.1**	**20.0**	**0.0**	**–18**	**–29.0**	

Statistics are based upon figures as of April 27, 2001.
Source: AAII's Stock Investor Pro/Market Guide Inc. and I/B/E/S.

DRP segment as well as the 8,658 stocks that make up the non-DRP group. Industry relative strength numbers can be found on the Web at popular investment-related sites such as MarketGuide.com (www.marketguide.com). Industry data can also be found within databases included with fundamental stock screening software packages, like the one included in AAII's *Stock Investor Pro* software.

Many investors also like to look at both the long-term performance figures as well as the firm's more recent, shorter-term performance. To do this, consult both the 52-week and 13-week data for relative strength. This type of momentum check will test a stock's strength and determine whether its performance prowess is sustainable.

Almost half of the passing stocks—four in each group—have been beaten down as of late, evident by the one-year price changes. One-year price change is simply the percentage change, in a company's stock price over the last 52 weeks. The high yields are the result of these price drops, but the drops themselves are most likely due to the cyclical nature of their industries.

CONCLUSION

The list of DRP stocks passing the high-yield screen is not a diversified portfolio, nor is it a recommended list of companies. There is a heavy concentration of cyclical firms, which carry more risk late in an economic cycle.

And, as with all contrarian screens, your analysis should focus on whether or not the market is too pessimistic in its assessment of the future of these stocks.

This initial screen for high-yielding DRP and non-DRP firms is meant only to be a starting point toward further analysis. Throughout the year, the *AAII Journal* and the AAII Web site (www.aaii.com) present articles to illustrate how individual investors can analyze the prospects of specific stocks by applying a variety of secondary screens and demonstrating how these techniques might be useful.

Before making any investment decision, you should gather all pertinent information and understand the investment thoroughly. Also, keep in mind that no one investment technique will be best in all market environments.

Diversifying your investments, minimizing taxes and transactions costs, maintaining a portfolio of investments at a level of risk that you are comfortable with, and taking a longer-term perspective are investment approaches that will prove the most valuable over time.

Firms with dividend reinvestment plans offer investors advantages, but remember to buy them because you are optimistic about performance, and not simply because the company offers a DRP plan. ✦

Definitions

The following is a short description of the screens and terms used in Table 3.

Dividend Yield—Current: Indicated dividend divided by current price. Provides a relative valuation measure when compared against historical average dividend yield.

Dividend Yield—Five-Year Average: Average company dividend yield during the last five years.

Growth Rate—Dividends per Share: Annual growth rate in dividends per share over the last five years. An indication of the past company strength and dividend payment policy.

Growth Rate—EPS: Annual growth rate in earnings per share over the last five years. A measure of how successful the firm has been in generating the bottom line, net profit.

Growth Rate—Est. EPS: Consensus estimate of the long-term (five years) growth rate in earnings as tracked by I/B/E/S.

Payout Ratio: Dividends per share for the last 12 months divided by earnings per share for the last 12 months. Provides an indication of the safety of the dividend. Figures between 0% and 50% are considered safer. Figures ranging between 50% and 100% are considered early warning flags. Negative values and values above 100% are considered red flags for a dividend cut if the levels persist. Beyond examining a single year, look for trends.

52-Week Relative Strength: The price performance of a stock during the last year relative to the performance of the S&P 500. A figure of 0% indicates the stock had the same percentage price performance as the market over the last 52 weeks. A figure of 5% indicates that the stock outperformed the market by 5% over the last 52 weeks.

Price Change (1 Yr.): The percentage change in stock price over the last 52 weeks.