

# EQUITY-INCOME INVESTING:

## BEWARE OF YIELD OVERREACHING

By Donald Cassidy

An income-oriented equity paying a no-growth dividend carries the downside of a bond—no inflation protection—but without a bond's income or principal guarantees. A steady dividend rate is not good enough; steady dividend growth should be your standard.

More investors are becoming attracted to equity-income investing—owning equity securities rather than bonds alone as sources of income. Their major reasons include concerns over valuation levels for growth stocks and a hope of using dividend “cushions” to reduce downside risk.

However, equity-income investing is not what it used to be. Until 1959, common stocks (being viewed as more risky) actually offered investors higher yields than bonds. As memories of the Great Depression faded, growing acceptance of the growth/total-return thesis regarding stocks came to justify a reversal of historical norms. Today, most stocks provide considerably lower yields than bonds.

The stocks of steels, railroads, autos, integrated oil companies, utilities, and real estate investment trusts (REITs) have historically provided above-average yields within the equity universe. However, steels and railroads have suffered major structural changes, rendering them no longer dependable as income vehicles. Since 1981, major rises in the price-earnings ratios for large industrial stocks have pushed yields on oils and autos below passbook savings rates. Today, utilities and REITs are the primary survivors as equity-income candidates.

### A PROPER INCOME OUTLOOK

When buying equities for income, investors tend to carry over their bank-CD shopping habits—they reach for the highest yield, all too often to their later dismay. Buying a stock is not at all like buying a CD. Dividends are voluntary quarterly decisions made by a board of directors. Interest payments and principal are guaranteed by the CD contract, and principal is insured by a federal agency. A common stock sits lowest on the corporate ladder in terms of security: all other claims come ahead of it, including chances for any income stream. In exchange, common stockholders receive exclusive rights to upside possibilities: growth of earnings and dividends and therefore (one hopes) a resulting rise in stock price.

This trade-off implies a decision criterion investors should consider absolute: If you want *guaranteed* income, buy bonds, preferably of high quality. In doing so, you accept a fixed nominal income stream that's virtually guaranteed. However, with no chance of a growing income stream, future inflation will erode your purchasing power.

Buying stocks means you give up the guarantees of bond indentures (especially those associated with U.S. government securities), so you must insist on receiving the only justifying trade-off—rising income. That implies another rule: If you invest in equities for income, you absolutely should insist on regular annual increases in the dividend rate. An income-oriented equity paying a no-growth dividend carries the downside of a bond (no inflation protection) but without a bond's income or principal guarantees. In effect you have a weaker instrument than a junk bond. A steady dividend rate is not good enough; steady *growth* in dividends must be your

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*Donald Cassidy, of Denver, Colorado, is the author of three books on personal investing: "It's When You Sell That Counts: Understanding and Overcoming Your Self-Imposed Barriers to Investment Success" (McGraw-Hill); "30 Strategies for High-Profit Investment Success" (Dearborn Financial Publishing), and "Plugging Into Utilities: A Safe and Sound Way to Superior Returns in the Stock Market" (Irwin/McGraw-Hill). A fourth book is due out in July 1999. He is also a senior research analyst for Lipper Inc. (E-mail: dcassidy@lasc.com).*

standard.

When this article was written in April, the 30-year T-bond yield had ticked up to 5.5%. Numerous utility stocks were actually providing lower yields than that important measure, and some offered zero or just minuscule dividend growth. Some electric companies that had not raised dividends for multiple years were priced to provide yields in the 5.5%–6.0% range. Yield-oriented investors should think like risk-averse insurance actuaries: In accepting a given yield for a higher-risk investment choice (compared with the Treasury rate), ask whether you are getting enough in additional “premium” (added yield) to pay you for taking a higher risk (common stocks versus bonds). An extra couple of percentage points in yield will pale against your capital impairment if today’s higher yield turns out to signal a deep dividend cut or omission pending.

## OVERREACHING FOR YIELD

Yield-oriented investors have a natural tendency to reach for the highest available yields. After all, if one invests primarily for current income, it might seem logical that stocks with the highest yields would be best. The popularity of the “Dogs of the Dow” approach would seem to support that assumption.

However, the Dow Dogs approach is designed to beat major averages through price appreciation; the high yield under that approach is merely an indicator of possible undervaluation.

In actual practice, high yield often presages dividend cuts—distasteful actions taken in trying to turn a company around. The “dogs” approach should not be applied to stocks bought mainly for income. Instead, shoppers for equity-income securities should avoid the high-yielding stocks and gravitate to lower-yielding choices. The market correctly perceives these as least risky and therefore does not demand a higher yield as a risk premium.

In addition, you will almost always find a higher rate of growth in the annual dividend level associated with low current yield.

The dividend-discount model is based on the assumption that dividends ultimately drive share price. If a firm doubles its dividend over a certain time, its stock price should also double if interest rates do not change.

Thus, the percentage rate of dividend growth drives and equals the expected rate of increase in share price. From that equivalence, we can derive this formula for expected percentage total return:

$$\begin{aligned} \text{Expected Total Return} = \\ \text{Expected Dividend Growth Rate} + \\ \text{Current Dividend Yield} \end{aligned}$$

## KEY FINANCIAL MEASURES

In choosing among numerous equity-income stocks, investors should also consider several important financial measures.

- *Common shareholder’s equity as a percentage of total capital:* I prefer this to the simpler debt-equity ratio as a measure of corporate staying power (and an assurance that dividends will continue to be paid), since the former counts preferred stock as a prior obligation whereas the latter counts preferred as if it were the same as common stock. Track a company’s common equity ratio as a time series for five or more years; also compare its level and trend with those for similar companies in its business.
- *Short-term debt as a percentage of total debt (or of total capital):* Another important indicator of corporate staying power that will help ensure dividend payments. Management is often tempted, by typically lower short-term interest rates, to “borrow short and invest long.” Properly, long-term assets should be financed with long-term debt or with equity. Danger arises from heavy short-term debt under several scenarios. First, a general credit crunch might cut off the ability to roll over the short-term paper, possibly causing a default. Second, short-term debt could

unluckily come due in a period of high interest rates, forcing your company to accept a much higher cost of capital going forward. In some cases, high short-term debt may signal a very aggressive management eager to expand rapidly and do the permanent financing later. Companies in many industries are most optimistic at just the wrong times—late in economic expansions when things look rosy and costs of capital seem acceptably low. Finally, your company or the whole economy might hit a downturn at renewal time, raising chances of denied credit or an onerously high interest cost for renewal.

- *Dividend payout ratio:* In its simplest formulation, common dividends divided by earnings per share. Lower ratios mean dividends are better covered in case of a period of flat or lower business fortunes. More sophisticated calculations of the same concept look at all dividends (including on preferred stock) as a percentage of income after taxes, or perhaps of cash flow. I’m a minority voice on this subject for not liking or emphasizing payout ratios. Earnings are subject to unforeseen write-offs or one-time gains, and in the gas and electric utilities, earnings are greatly influenced by weather. Corporate directors’ informed decisions on raising the dividend are the best indicators of future prospects. Earnings (the ratio’s denominator) fluctuate in response to capital expansion cycles, and also because of FASB (Federal Accounting Standards Board) rulings on non-cash charges from things such as the stock price versus option exercise levels. The resulting reported “earnings” form a potentially sharply fluctuating portion of the payout-ratio calculation. My advice: keep your eye fixed on the dividend-growth rate.
- *Price-to-book-value ratio:* Another popular measure, but one I find

**TABLE 1. CHECKLIST FOR INCOME STOCK'S ANNUAL REVIEW****Basic Information Recorded Upon Purchase**

- Your Stock's Name & Ticker
- Date of Purchase
- Number of Units
- Total and Unit Cost
- Where Shares Are Being Held
- Quarterly Declaration Dates
- Ex-Dividend Date Cycle
- Payment Date Cycle
- Percent Rise in Dividend Rate
- When Dividend Last Changed
- Date of Last Dividend Increase
- Dividend/Share at Purchase Date
- Cash Yield at Purchase Date
- 30-Year Treasury's Yield to Maturity at Same Date

**Annual Check-Up Items for Your Stocks and Comparables**

- Name & Ticker of Stock
- Current Dividend Rate per Share
- Current Cash Yield
- Yield as Percentage of 30-Yr. U.S. Treasury Yield-to-Maturity
- Date Dividend Last Raised
- Most Recent Percentage Increase in Dividends
- Implied Action (Hold vs. Sell)

that has less virtue than formerly. Like a price-earnings ratio, the price-to-book-value ratio is greatly driven by the overall level of interest rates. Low interest rates mean low dividend yields and low earnings yields (the inverse of price-earnings ratios) and therefore higher price-to-book ratios than in the past. The price-to-book-value ratio can highlight undervalued companies that might become takeover targets, but even then it must be viewed in tandem with debt/equity levels—investors pay a lower premium on book for firms at higher risk due to their heavy debt loads.

You can troll the data waters endlessly in search of a perfect company with all the right ratios. But in the final analysis, there is no perfect mathematical formula in investing. Market prices move even while your computer calculates—and you are judging via a rear-view data mirror. Better to have past data than no data, but the future will not be a perfectly projected trendline.

to massive price busts if quarterly earnings miss the consensus estimates by a penny.

And, corporate directors are the most informed dozen or so people on the planet about your company's present status and future prospects, and they signal changes in their views when changes are made in the dividend policies. Do you dare ignore a change in dividend-growth signals when directors flash one?

**MONITORING YOUR HOLDINGS**

Equity-income investors must remain vigilant and flexible. That's because no instrument short of U.S. Treasury debt can safely be made one-decision (buy and hold to maturity) in nature. When investing for income, investors are especially prone to the dangerous effects of mental inertia. An income investment is chosen with careful attention to safety features and past history. So, after making the purchase decision, many investors subconsciously assume all will remain in good order into the

Few analysts' reports ever publish adverse analyses or "sell" recommendations. When they do, run for the hills! Otherwise, your equity-income investments must eventually be bought and held or sold on the best available but imperfect information.

Two fortunate factors can help reduce your risk in equity-income investing. One is that in the present cult period of growth/momentum investing, few institutional investors like (or can tolerate) these slow-but-steady companies. Therefore these stocks are less prone

indefinite future. Such tacit assumptions are now increasingly dangerous in a world where change is accelerating and where new types of change have appeared. A good example is in the utility arena: Pipelines saw revolutionary new regulation in the 1980s; electric and telephone companies can now compete (and be competed *against*) in the late 1990s. In short, investors must review their positions regularly.

It's important to focus on the patterns of dividend increases by your chosen companies. Value Line, various online databases, and required earnings/dividend tables in companies' annual reports disclose the size and timing of latest dividend increases. Corporate boards typically follow predictable annual cycles and will consider another increase at 12-month intervals. Perform your annual review for each stock right after its increase is scheduled.

Regular reviews will let you monitor changes in corporate health and prospects; Treasury bond and comparable company yields provide a necessary context. While few pure parallels are likely, using near-equivalent companies is important. Select functionally and geographically similar firms—for example, a local gas distributor versus other distributors rather than interstate pipelines; apartment versus other apartment REITs.

Yield comparisons must be in context. Watching the 30-year T-bond yield will give you an idea of the net direction of interest rates between checkups. Viewing your stock's yield change against those of comparable companies will highlight changing investor perceptions of attractiveness and risks. A rising yield (relative to comparables) indicates increased perceived risk. The market is seldom grossly wrong regarding large-cap stocks, which are well-followed by analysts. Higher yield signifies risk for the income investor, rather than opportunity.

With REITs and utility stocks, you should focus on one simple factor: the dividend growth rate. Changes there are major signals of pending shifts in corporate health. Directors are highly informed on the outlook for their com-

pany, and any change in their dividend-growth decisions, even if seemingly small, is extremely valuable "legal inside information." You'll never know all the underlying reasons, but acting promptly on revised bottom-line signals directors give will serve you well. If dividends are usually raised \$0.03 per share every fourth quarter, a \$0.02 per share increase (or less) means those most in the know believe prospects are now less rosy. Conversely, acceleration or a resumption of dividend growth

means something important has turned more positive. Unless the company is raising capital and might be trying to increase its share price in the short term, you do not need to know the details. Thus, a failure to increase dividends on time or by the established percentage by your company or by geographically close comparables should be a red flag.

Zero dividend growth is a very strong negative signal; immediate sale is warranted. Almost as often as not, a flat dividend precedes a reduced dividend.

That nasty news will cut both your income and your capital (as the stock falls). Dividend cuts can be followed by further cuts or actual omissions. You simply do not want to be anywhere near a utility stock as it suffers through such events.

Properly reviewing equity-income holdings requires using a checklist covering key information, including comparisons with relevant alternate securities. Suggested items to record and track are included in Table 1. ♦

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