INVESTOR PROFESSOR

Three Pillars for Successful Dividend Investing

AAII's Dividend Investing service is based on a total-return strategy that seeks stocks that have the potential to rise in price and make larger dividend payments in the future.

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Since 1926, dividends have accounted for more than 40% of the return realized by investing in large-cap stocks. The frequently cited 9.9% historical annual return for stocks is significantly impacted by the payment of dividends. Ibbotson Associates, which tracks long-term historical returns, says that if dividends were taken out of the equation, the long-term annual return for stocks would fall to a more modest 5.5%

How do you become a successful dividend investor? For our *AAII Dividend Investing* (DI) newsletter, we seek stocks that have the potential to rise in price and make larger dividend payments in the future—a total-return strategy. To achieve these goals, our approach focuses on three pillars for dividend investment decisions.

Our three pillars of dividend investing are a firm's growth trends, financial strength/quality and valuation. Successful dividend-paying stocks must possess good business models, strong balance sheets, growth in sales and earnings, positive free cash flow, attractive valuations and a history of rising dividend payments. In this article, we explain each of the three pillars.

Pillar I: Growth Trends

There are several characteristics to consider when assessing the growth trends of dividend-paying stocks. The DI approach analyzes a company's record of growth in revenue, earnings and cash flow. Also examined are profit margins, earnings surprises and estimates, dividend history and dividend growth trends. These growth trends are used because a company's success is driven by its ability to generate sales and convert the revenue into earnings and cash flow.

A version of this article originally appeared in the June 14, 2019, AAII Dividend Investing Weekly Update.

Strong sales growth is meaningless if management allows costs and expenses to grow disproportionately. Therefore, it is useful to analyze the profitability of a company by calculating and tracking various profit margin ratios—gross margin, operating margin and net margin. Net margin is the "bottom line" profit that is generated from all phases of the business, including interest and taxes. The net margin compares net income to sales.

Profit margins are expressed as percentage ratios to facilitate the comparison of a wide range of companies that vary in size. The term for comparing a company to other firms is cross-sectional analysis, and ratios such as profit margins make comparisons across companies meaningful. However, it is important to note that margins can differ from industry to industry, so it is vital to compare firms in similar lines of business. Profit margins provide a great window into company and industry trends, the competitive environment and management's ability to manage costs.

Pillar II: Financial Strength/Quality

In order to determine the financial strength and quality of a company, you need to understand its underlying financials and its ability to generate cash flow, pay its obligations and return capital to shareholders. The DI approach looks at a company's leverage ratios, cash flows, payout ratios (earnings and cash flow) and capital returned to shareholders through dividends and share buybacks. These items are monitored to ensure that a company can continue raising its dividends.

One of the key characteristics that dividend investors look for in a company is free cash flow. Free cash flow is calculated by deducting capital expenditures (capex) from cash from operations (both are listed on the cash flow statement). Free cash flow indicates whether a company is generating enough cash from its normal business operations to fund its capex and still have money available to pay a dividend, buy back shares or make acquisitions.

One way to evaluate the safety of a company's dividend is by examining its free cash flow relative to its

TABLE 1

Measures Used to Evaluate Dividend Stocks

Pillar I: Growth Trends

Profit Margin Ratios

Gross profit margin = (sales – cost of goods sold) ÷ sales

Operating profit margin = [sales – cost of goods sold – selling, general & administrative (SG&A) costs] ÷ sales

Net profit margin = net income after taxes ÷ sales

Pillar II: Financial Strength/Quality

Leverage (Debt) Ratios

Debt-to-assets ratio = total liabilities ÷ total assets

Debt-to-equity ratio = long-term debt ÷ total shareholder's equity

Debt-to-total-capital ratio = long-term debt ÷ (long-term debt + shareholder's equity)

Interest coverage ratio = earnings before interest and taxes ÷ interest expense

Cash Flow

Free cash flow = cash from operations – capital expenditures (capex)

Payout Ratios

Earnings payout ratio = dividends per share ÷ earnings per share

Free-cash-flow payout ratio = dividends per share ÷ free cash flow per share

Pillar III: Valuation

Relative dividend yield = annual indicated dividend per share ÷ current price per share

Trailing price-earnings ratio = current price per share ÷ earnings per share for recent four quarters

dividend—its free-cash-flow payout ratio. This ratio analyzes how much cash a company is paying in dividends as a percentage of free cash flow. Investors should look to the free-cash-flow payout ratio to understand if a company is generating enough cash to cover its dividends year to year. If it is not, the dividend payment may not be sustainable.

Pillar III: Valuation

Valuation is another key component in seeking attractive dividend-paying stocks. Stock prices tend to fluctuate between high and low extreme valuation levels; these relationships can be used to determine a stock's value range. The DI approach looks at two valuation metrics: dividend yield and the trailing price-earnings ratio (P/E).

The primary valuation measure is relative dividend yield (annual indicated dividend per share divided by price per share). The dividend yield can be used to calculate a valuation estimate, indicating if a stock is expensive relative to its historical norm. The DI approach seeks out undervalued dividend-paying stocks with current yields above their five-year historical average, yet that are expanding their dividend payments at a greater-than-average rate. Overvalued stocks whose current yields are below their five-year averages are avoided.

The price-earnings ratio is another cornerstone measure of value used in dividend investing. The price-earnings ratio is determined by dividing a stock's price by its earnings per share reported over the most recent four quarters. It is called a trailing price-earnings ratio when historical earnings are used in the calculation. It is important to see how trailing price-earnings ratios compare with historical averages. A price-earnings ratio lower than its historical average would be a potential sign that the stock is undervalued and vice versa.

Formulas for calculating the measures mentioned here are given in Table 1. ■

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Profit Margin Analysis, July 2011

Analyzing Debt Ratios, July 2010

A Dividend Approach to Judging the Value of Stocks by John Bajkowski and Jaclyn N. McClellan, CFA, May 2017