

Lowell Miller's Best Dividend Screen

By John Bajkowski

Article Highlights

- High dividend-paying stocks with increasing dividends offer rising income streams and higher price valuations.
- “Best stocks” have above market yields, dividend growth, financial strength and a reasonable valuation.
- Miller also considers price momentum and the quality of management.

A low interest rate environment has helped to fuel a run-up in the prices of dividend-paying stocks.

Equity-income investing is once again fashionable, but some investment advisers have always preached the long-term benefits of investing in dividend-paying stocks. Lowell Miller is known for his disciplined, dividend-focused investment strategies. He founded Miller/Howard Investments Inc. (www.mhinvest.com) in 1984 and manages a number of portfolios constructed of financially strong firms with the ability to pay and consistently raise dividends.



their investment decisions. In the information age, it is too easy to come across investment ideas that turn individuals into traders reacting to the continuous market noise. Individual investors will have a tough time succeeding if they trade a lot and select 10 different stocks for 10 different reasons. Miller feels that individuals should stop “playing the market” and instead become investors. Like Warren

Buffett, we should consider our stock investment as a partnership interest in a real and ongoing business. The ownership perspective frees investors from trying to guess the next hot sector or investment style, provided they invest in financially sound companies with reasonable long-term growth prospects.

A long-term perspective does not free a portfolio from the market up and down swings, but confidence in one's approach provides a vision and understanding of why the market is down and its ability to rebound. An investor must stick with a plan. Successfully jumping from strategy to strategy is very difficult to do. If you are comfortable with your approach, you will be able to maintain a cool head, not panic and not let emotions take over your decision making. Cars don't crash, the driver behind the wheel crashes. A good investment strategy must acknowledge the human operator and protect the investor from himself. The marketplace is unpredictable, often forcing investors into emotional decisions.

Miller advocates that investors establish a strategy that relies on common sense, with reasonable, achievable goals. Of course the strategy should be supported by evidence that the approach works over the long run. Investors should also avoid swinging for the fences: Investors will not succeed over the long term if they try to get higher returns than the market normally allows for a given level of risk. While it is

The Philosophy

Lowell Miller lays out his strategy in his book “The Single Best Investment: Creating Wealth with Dividend Growth” (Print Project, second edition, 2006). We first featured a screen based upon his approach in a June 2009 *AALJ Journal* First Cut article titled “High Quality + High Yield + High Growth Stocks.” At the time, Miller argued that high-dividend-yielding stocks have performed extremely well after past bear markets, especially bear markets induced by a recession—a prediction that proved to be very accurate. With the run-up in dividend-paying stocks, it is important to have a system in place to keep your emotions in check and have an analytical framework to select and manage your portfolio. In this article, we provide a more detailed examination of the investment approach presented by Lowell Miller in his book.

Miller argues that too many investors have a hodgepodge of holdings that lack any overall strategy or philosophy behind

important to spread your risk among a number of investments, you should not lose control of your portfolio by investing in too many stocks.

Dividend Income

An advantage that a stock dividend has over interest income from a bond is the potential for the stock dividend payout to increase over time. Bonds do not offer growth of income, which is why they are called fixed-income investments. A fixed-income investment may not be able to overcome the loss of purchasing power due to inflation. Miller equates investing in dividend-paying stocks to building a structure out of bricks in which the bricks themselves make more bricks. Equity income offers long-term growth of principal and income. A good stock investment must overcome inflation and justify its risks.

Miller reminds investors that investments such as stocks do not have the same rate of return each year. To compare investments, you must also consider the volatility of the return and seek out the highest level of return for a given level of risk. The stock dividend payment helps to smooth out the return over time, and you do not need to hit a home run every time to build wealth. An investment with a 10% annual return will grow 600% in 20 years. Investors just need to find a business with reliable growth willing to share its profit with its owners. A long-term viewpoint is important, as an obsession with monthly and even quarterly returns may “gum up the gears.”

Stock dividends make it easier to hold onto investments through price fluctuations of individual stocks and the market as a whole. The compounding principal of equity income success remains in play whatever the market is doing. Income-producing securities are priced based upon the amount of income they produce. If the income output of a security increases, its price will rise. Miller looks for high-dividend-paying stocks with increasing dividends because investors will get the rising stream of income and the higher income

level should eventually result in higher price valuations as well. Of course this assumes relatively normal price-earnings ratios and interest rates.

Miller points out that dividends tell the truth. A meaningful dividend and a growing dividend payment are signals that the company has the wherewithal to pay its dividend. With a rising dividend, investors have some evidence that they are partnering with a real company that is doing well enough to pay and increase its dividend on a regular basis. Dividends are paid from earnings once a company is mature and stable enough in its life cycle to distribute excess cash. There may be a number of ways a company can make its earnings look good during its quarterly release, but dividends don't lie. They are an acid test of a firm's finances.

Dividends have a signaling attribute of the state of the firm's business to investors. Boards of directors never want to cut the dividend, and they will only raise the payout after considering the business strength and capital needs of the firm. Miller highlights a 2004 study published in the *Journal of Finance* by Adam Koch and Amy Sun that revealed investors buy dividend growth stocks to confirm the quality of reported earnings.

Miller acknowledges that dividend strategies fall out favor at times, but he reminds us that investors will continue to be rewarded with the income portion of the approach until the market comes around to appreciating these stocks again. Long term, Miller feels that you should see the stock price rise by an equal percentage to the dividend increase for stocks trading with above-average dividend yields. If you purchase stocks with low current dividend yields, the market is looking at other factors to value the stocks.

The 12 Rules

Miller seeks out high-quality stocks trading with high current dividend yields that offer high growth of dividends. He refers to a company with these qualities as a Single Best Investment (SBI) stock. Miller lays out 12 rules to follow in buying and holding a Single Best Investment

stock and cautions that investors need to be somewhat adaptable rather than rigid when following the rules. However, for all but the most sophisticated investors, the rules should be treated as rules and not guidelines. Under normal market conditions, if a stock does not meet one of the 12 rules, there should be another stock that manages to meet all of the requirements. Miller cautions investors not to try to be too clever or a hero.

1) The company must be financially strong.

High-quality stocks have superior financial strength: low debt, strong cash flow and good overall creditworthiness. While some debt is good, too much debt puts the company at risk during a slowdown. Dividend payments are optional, but interest obligations from debt must be paid. Failure to do so will result in default if the lender is not willing to restructure debt obligations. A temporary sales slowdown may leave a company scrambling to conserve cash by cutting marketing, research and development, employee salaries and even dividends. These types of moves may help a company stay solvent at the cost of future growth. It's far better to have financial flexibility to buy assets at fire-sale prices during economic downturns. A high need to borrow may also force a company to take on debt when interest rates are high.

While companies with very stable and predictable cash flow may be able to take on higher levels of debt, Miller indicates that investors should avoid companies that have a debt-to-capital ratio greater than 50%. Capital is the long-term source of funding for the firm and consists of the sum of long-term debt and owner's equity (book value). Debt to capital is calculated by dividing long-term debt by capital. Half debt and half equity results in a ratio of 50%. The higher the ratio, the greater the proportion of debt.

We used AII's fundamental screening and stock database program *Stock Investor Pro* to construct a screen that follows the Miller Single Best Investment strategy laid out in his book.

The program's dataset covered 7,452 companies as of May 10, 2013. Just over 5,000 companies had a debt-to-capital ratio less than or equal to 50%, eliminating around 2,500 companies from consideration.

Beyond the level of debt carried on the company's books, investors should also examine the ability to pay interest obligations from the company's cash flow. The times interest earned figure, sometimes referred to as the interest coverage ratio, is a traditional measure of a company's ability to meet its interest payments. A custom calculation within *Stock Investor Pro* looks at earnings before interest, depreciation and taxes divided by the income expense. It indicates if a company is able to generate pre-dividend earnings to pay interest on its debt. The larger and more stable the ratio, the lower the risk of the company defaulting. Miller looks for a coverage ratio of at least 3 to 1. Just over 5,000 companies in the *Stock Investor Pro* universe have a times interest earned ratio of 3 or better. Adding this filter to the debt-to-capital filter left us with 3,792 passing stocks.

Miller looks for overall cash flow to be strong for his Single Best Investment candidates. Strong cash flow provides financial flexibility for companies in good times and bad. It allows firms to expand, run marketing campaigns, develop new products, etc. Miller wants cash flow to be strong enough to fund the dividend and the investment need to keep the company growing. We created a custom field in *Stock Investor Pro* that took the cash flow from operations and subtracted capital expenditures and divided the total by the number of shares outstanding to create a per share figure. We then required that this cash flow per share figure be greater than the indicated dividend. Around 3,500 firms passed this filter independently. Adding the filter to our Miller SBI screen reduced the cumulative number of passing companies to 1,817.

As a final quality check, we excluded stocks that were not listed on the New York, American or NASDAQ stock exchanges. This reduced the cumulative number of passing companies to 1,517.

2) The company must offer a relatively high current yield.

Miller requires that the dividend yield (indicated annual dividend divided by stock price) be high enough at the time of investment to be meaningful, even if high dividend growth is anticipated. The goal is to locate stocks with high current yields and high expected growth. It is important for the yield to be high enough to be a "compounding machine." High-yielding stocks attract income-seeking investors who will put pressure on management and the board of directors to continue paying an attractive dividend.

Miller compares the current stock yield to the market yield (S&P 500 index) and requires that the yield be at least 1.5 times the market. Two times the market yield is even better. Screening for a dividend yield relative to a market benchmark automatically adjusts the filter to the market valuation levels. Barron's publishes a number of valuation ratios for the popular market indexes and averages every week in its Market Lab section. The current yield of the S&P 500 is 2.1% ($\$35.02 \text{ dividend} \div 1667.47 \text{ index value}$). The yield is down from 2.4% one year ago, even as the dividend for the index has increased by 12.2%. Our Miller SBI screen is looking for companies with a dividend yield of 3.1% or higher ($2.1\% \times 1.5$). Only 1,025 stocks out of a universe of 7,452 companies trade with a yield of 3.1% or greater. Adding the requirement to our financial strength filters reduces the number of passing companies to 172.

3) The yield must be expected to grow substantially in the future.

Miller looks for a combination of high quality, high current yield and high dividend growth. These are firms with the financial strength and willingness to raise dividends. Just screening for high yield may leave investors with high current yield, but little prospect of future dividend growth. The dividend growth rate should be at least as high as inflation. Examining the past pattern and records of dividend increases should help to gain an understanding of dividend growth

patterns. Miller looks for expected dividend growth of 5% or greater to assure growth in excess of inflation. *Stock Investor Pro* does not have consensus dividend growth estimates. Our Miller screen required a compound annual growth rate of 5% or greater over the past three years. Around 1,000 stocks in the database had a historical growth rate of 5% or higher, and adding this requirement to our Miller SBI screen reduced the number of passing companies to 62. Miller notes that investors should not just mindlessly extrapolate the historical growth rate into the future, but it helps to provide a feel for the dividend growth policy of the firm.

Dividends are paid from earnings, so many investors look at the dividend payout ratio to measure the flexibility of the firm to continue paying and increase its dividend payout. The payout ratio is the annual dividend divided by annual earnings per share. The lower the ratio, the more secure the dividend and the greater the chance for a dividend increase. The acceptable payout ratio varies by industry, with companies in more stable industries often having higher payout ratios. Our Miller SBI screen looks for utilities with a payout ratio of 85% or lower and for all other firms to have a payout ratio of 60% or below. Around 3,400 firms met this filter. Adding the requirement to our Miller SBI screen reduced the number of passing companies to 29.

4) The company should offer at least moderate consistent historical and prospective earnings growth.

Miller looks for stocks in which earnings are expanding on a steady uptrend. Dividends are paid from the income stream, so earnings must also be expected to expand. The earnings growth does not need to be humongous, but it should be at least as strong as the dividend growth you are expecting. Annual earnings growth that is consistent and in the 5% to 10% range is required. Our Miller screen looks for companies with an expected compound annual growth rate in earnings of 5% or greater over the next three to five

years. We also added simple filters that required positive expected earnings per share for the current and next fiscal year. About 2,000 stocks possess these characteristics. Adding the positive earnings requirements along with the minimum expected long-term earnings growth rate of 5% reduced the number of passing companies to 10.

5) Management must be excellent.

Miller considers a long record of success as one measure of good management. A record of expanding during an economic or industry slowdown is a good sign. Ownership of shares by management is another good sign. Share ownership reflecting one-year's worth of salary is a reasonable requirement.

Miller examines how well management has been able to absorb and integrate acquisitions. Miller recommends identifying management with integrity by examining if public statements turn out to be true. "A funny odor in the basement might well be the first hint of corpses buried there." These are primarily qualitative measures that should be reflected in good quantitative results.

6) Give weight to the valuation measures.

It is natural to seek out bargains when selecting stocks, but investors should remember the old maxim that "quality is always a bargain." Even Warren Buffett is quoted as saying that it is far better to buy a wonderful company at a fair price than a fair company at a wonderful price. However, Miller acknowledges that many studies have shown that stocks that are priced lower based on traditional valuation measures outperform more expensive stocks in the long run. Many investors overpay for high expected growth and underpay for assets.

Miller highlights the use of price-to-sales ratios, price-earnings ratios and price-to-book-value ratios in his book. When a stock trades with a low price-to-sales ratio, the multiple likely reflects investor pessimism about the company's ability to maintain or improve its profit margins. A low price-to-sales

ratio is attractive, especially if you notice an improving trend in profit margins. Miller references James O'Shaughnessy's ("What Works on Wall Street: A Guide to the Best-Performing Investment Strategies of All Time," McGraw-Hill, fourth edition, 2011) research on desired price-to-sales ratios and notes that seeking stocks with price-to-sales ratios of 1.5 or lower is a good start. If desired, you can refine the rule to consider the norm for the industry. Our Miller SBI screen looks for companies with a price-to-sales ratio of 1.5 or lower. Around 3,000 stocks passed this filter independently.

Much research also supports the benefit of seeking stocks with low price-earnings ratios. It provides a quick measure of how expensive or cheap a given stock is priced currently. Higher-growth stocks deserve to trade with higher price-earnings multiples, but other factors such as interest rates also impact the earnings multiple. Lower market interest rates can support higher price-earnings ratios. Miller recommends stocks with a price-earnings ratio less than the market price-earnings ratio. The S&P 500 has a price-earnings ratio of 19.3 currently, so our Miller SBI screen looks for stocks with a price-earnings ratio of 19.3 or lower. Around 2,200 stocks have price-earnings ratio of 19.3 or lower.

Book value is a very rough measure of the accounting value of a company. It represents the accounting value of firm assets less all liabilities. Comparing the price of a stock to its book value per share highlights how closely the market value of the company is trading to its accounting value. Unfortunately, many company intangibles will not show up on the company's books, so book value will often understate the true economic value of the firm. Nevertheless, stocks with low prices to book values have historically outperformed the market. The lower the ratio, the better. Miller prefers to compare the company's value to the market level. The S&P 500 index is currently trading with a price-to-book-value ratio of 2.5. Just over 4,000 stocks have price-to-book-value ratios of 2.5 or lower.

All three of our valuation filters reduced the number of passing companies from 10 to 5.

7) Consider the "story."

In many ways, Miller feels the story or belief behind the company is as important as the valuation of the stock. An undervalued stock has some proposed story or expectation, and the investor needs to believe the story will come true when they buy the stock. The story must be about the future of the stock, the market or even the economy. It might be a simple story that projects a rebound in earnings over the next few years and a stock's return to its normal valuation level. A tailwind of favorable industry growth is good. Optimally, there is a "growth kicker" built on a base of reliable earnings and cash flow. Miller believes that "in the end investors make their buying decision more or less holistically, looking at the whole picture of a company, the whole story."

8) Use charts to help your buying.

While technical analysis can be complex and difficult to interpret, there is a great deal of support in the use of relative strength to highlight stocks on the upswing. Miller indicates that underperformance followed by notably rising relative price strength is a positive sign. A high-volume selling climax may point to stock ready for an upturn. Miller states that technicals are not too useful for selling, but can help investors select among their candidates and trim some positions. Our Miller screen simply looks for stocks that have outperformed the S&P 500 index over the last 52 weeks. About 2,600 stocks have had stronger price performance than the S&P 500, and the filter reduced the number of passing companies to four.

9) Picture the future.

Miller is trying to build a long-term compounding machine by investing in businesses with long-term prospects. When performing their qualitative analysis, investors should ask if the company provides items that are a necessity of life: Will the goods produced by the

Table 1. High Quality + High Yield + High Growth Single Best Investment Stocks

Company (Ticker)	Div Yield		LT Debt to Capital (%)	Payout Ratio (%)	Annual Growth Rate			P/E Ratio (X)	Current Price (5/10) (\$)	Rel Strgth Index (S&P=0)	Industry
	Current (%)	7-Yr Avg (%)			Past (3 Yrs) Div (%)	EPS (%)	Expct EPS (%)				
Meredith Corp. (MDP)	3.8	2.7	26.8	57.8	16.8	43.9	15.0	16.1	42.7	26.6	Printing & Publishing
Siemens AG "ADR" (SI)	3.7	2.8	35.7	49.1	23.3	24.2	64.8	14.3	106.7	1.3	Electronic Instr & Cont
Sunoco Logistics (SXL)	3.6	6.7	22.2	46.0	10.5	25.2	12.0	15.0	63.4	37.7	Oil Well Servs & Equip
Raytheon Co. (RTN)	3.4	2.7	36.3	35.2	17.3	4.6	6.2	11.0	64.3	2.0	Aerospace & Defense

Source: AAIL's Stock Investor Pro, Thomson Reuters and I/B/E/S. Data as of 5/10/2013.

company be required years from now? Are profit margins improving? How has the company responded to competition in the past? Is it a dominant market player and is the size of the market for its goods or services growing?

10) Hold with equanimity.

Miller feels that successful investing requires a long-term perspective of an investor. We should focus on the unfolding story of the company, its industry and the marketplace. Investors should stop playing the market and focusing too much on quarterly reports. Avoid checking prices too often. We should do everything possible to keep from "holding anxiety." The ownership perspective is a long-term perspective. Emotions and unnecessary decisions are the undoing of most investors.

11) Sell when the dividend is in jeopardy, when the dividend has not been increased in the past 12 months without an excuse or when the story has changed.

Dividends are the key to the Single Best Investment strategy, so investors need to be alert to the state of the dividend. Stocks should be sold if the dividend is in jeopardy. A rise in the

payout ratio may highlight a risk to the dividend payment. In many ways, the reverse of the factors used to select SBI stocks are concerns: Declining cash flow, growing levels of debt and earnings declines are issues that should be explored. A change in the company dividend policy may signal a change in the payout philosophy of the firm. Unless there is a reasonable excuse, failure to raise the dividend annually is a red flag. A company that has increased its dividend annually and suddenly stops doing so should be sold, unless there are clear and articulated mitigating circumstances. SBI stocks are purchased for their financial strength, high current dividend and high dividend growth; once the story changes, the stock should be sold.

12) Diversify among as many stocks as qualify for Single Best Investment.

Miller states that if your account is large enough, you should hold around 30 stocks, with equal dollar investments in each holding. If you hold fewer stocks, it is better to focus on the more conservative stocks of the universe. The high-income stocks of the Single Best Investment universe should be able to

produce long-term income and growth of capital.

Conclusion

Only four securities passed our interpretation of the Miller Single Best Investment strategy, and they are shown in Table 1 ranked by current dividend yield. The influx of money into dividend-paying stocks has lowered the yield of most stocks and pushed up the stocks' prices. Our screen focused on the quantitative elements of the strategy, the first step in the process. Miller lays out a helpful framework in building and managing an equity-income portfolio. The next step would be to examine the qualitative factors of the company, its management and the industry.

Individual investors have the advantage of time on their side. Investing in dividend-paying stocks with growing dividends represents a great way for investors to harness the power of time and the compound growth of dividend reinvestment. Miller even quotes Baron Rothschild when emphasizing the benefit of reinvesting dividends: "I don't know what the Seven Wonders of the World are, but I do know the eighth: compound interest." ▲

John Bajkowski is president of AAIL. Find out more at www.aail.com/authors/john-bajkowski.