Why Investing in High Dividend Paying Stocks Could Leave You Broke!

Abstract

I'm getting ready to retire. I don't want to take a lot of risk. But I have a lot of income that needs to be replaced and bonds won't do the trick. I'll just buy these high dividend stocks instead!

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"Do you know the only thing that gives me pleasure? It's to see my dividends coming in."

John D. Rockefeller

"When yields on corporate bonds are lower than dividends on stocks, that unnerves me."

Lloyd Blankfein

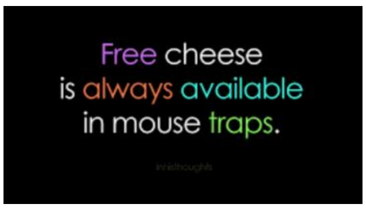
"The four most dangerous words in investing are: 'This time it's different'."

Sir John Templeton

Why Investing in High Dividend Stocks Could Leave You Broke!

The Temptation…

Spouse: "Honey, look at this. These high dividend stocks are paying 4,5,6, up to 8% per year. Wow, if I invest in these, I can just sit back and relax and not worry about the stock market ups and downs. I'll be able to completely replace my working income and our retirement will be secure! And who cares what happens to the stock values – as long as I keep getting my checks we will be fine."



You can read a lot of books about dividend investing. But as Albert Einstein said, "Any fool can know. The point is to understand." Books and knowledge alone won't get the job done.

The TRAP

To fully understand this mousetrap, you will have to suffer through a bit of a tediuous explanation. But hey, no problem, it's only the rest of your life we're talking about. If you don't have time to understand, and you would rather just go cut the lawn instead, then, like Einstein said, you can still be in the "know". It's not like these decisions will shape your future for the next 20 years or so.

First, it's important to understand how dividends are calculated and what happens to that calculation when markets fluctuate. What does it mean when you look up Apple on your favorite stock website and find that it pays a 2.5% dividend? It means that if you add up Apple's last 4 (1 year TRAILING) quarterly dividends and you get $8 dollars per share, then divide your 8 by the current stock price (in this example $320) you get the dividend yield: $8/$320 = 2.5%. Therefore, if I invest $100,000 in Apple stock today, I should receive 2.5% * $100,000 = $2,500 in annual payouts.

Simple right? While your math is correct, your assumptions may be incorrect.

1) The yield and the $8 dividend is based on the past. We added up the last 4 quarterly payments and we ASSUMED that the next 4 would be similar. But what if the next 4 quarterly dividends are not similar?
2) What happens when the stock price moves? Some might claim it doesn't matter. After all, I put in my $100k today, at a 2.5% yield, so that is exactly what I should get. The trick with this statement is that it's partially true. It's true that based on the assumption in #1 above, you should in fact receive your 2.5%.

If the stock price moves tomorrow to \$400/share, the dividend yield on that \$8 past payout drops to \$8/\$400 = 2%. So, the company itself is doing well, and investors are bidding up the stock price, but my dividend yield is going down? That seems wrong.

If the stock price moves tomorrow to \$200/share, the dividend yield on that \$8 past payout increases to \$8/200 = 4%. Wow, that seems juicy. But wait. The company in this case is doing poorly, and investors are selling down the stock price, but my dividend yield is going up? That seems wrong.

It turns out that dividend yields give an inverse signal about the strength of a company.

It also turns out that the LAST 4 dividends are not a great predictor of the NEXT 4 dividends. Basically, when you invest, all you care about is the future. It helps to look at the past to understand if the stock is relatively expensive or cheap, high or low, but the direction of the company is the key.

The Example:

GE is the best example of what can go wrong, because it was the stalwart of stocks. GE is the one stock you could depend on for more than 50 years. GE passed every investor test. Great company with great products and great management. And the dividend was fantastic, typically in the 2-3+% range for many years.

Until one day, GE wasn't. It wasn't a great company anymore. But during the tenure of Jeff Immelt, the management had been propping it up with opaque metrics that analysts and investors were struggling to understand. The lesson is that when someone on Wall Street (or any street for that matter) tells you that something is great, and you don't see it because you just don't understand – you can almost be certain, they are hiding something they don't want you to know.

In typical Wall Street fashion, after Jeff could no longer convince people to NOT look at Oz behind the curtain, when Jeff stepped down, John Flannery took over as CEO.

Dividend investors were not worried.

But uh-oh, here it comes. Flannery began to come clean, then to literally throw the kitchen sink of GE difficulties at investors. It became clear that GE had spent many of the previous years doing almost everything wrong.

GE bought two companies that caused endless troubles. Although in fairness to GE, it is true that GE Capital was created and then disposed of through at least 72 transactions if not more. But let's simplify and focus on the big name, blockbuster deals, not the smaller, no-name deals. First, in April 2008 GE bought CitiCapital – right, CitiGroup, the giant financial services company. As initially expected, the newly expanded and gigantic GE Capital was soon producing almost half of GE's total revenue as a whole company. Wow, what a great transaction!

But in truth it was quite the opposite. GE had "bought" at the height of the market in 2008, before the Great Recession which brought the value of all banks to their knees and caused two giants to close for good, Bear Stearns and Lehman Brothers. GE would then "sell" those assets in 2015 not far off the low.

The next troubling transaction was a big investment in oil service company Baker Hughs. Again, GE bought at the height of the market and sold at the low of the market.

As any good investor knows, buying high and selling low is the exact opposite of the goal for a good investor.

Regardless of whether you agree on the particulars of the GE transactions, our focus must return to the dividend payout. All those GE transactions were obviously not good because in 2018 GE began to cut its dividend. Prior to these cuts, the dividend yield on GE had always been above 3% for the past decade.

But Flannery was cleaning out the kitchen sink of bad news and dumping it all at once on investors.

GE was a company that dividend investors would love and adore. It always paid 3% and always would, right?

As CEO Flannery began to come clean the stock price plummeted temporarily making the dividend yield look high – because remember, the dividend yield is based on the PREVIOUS 4 quarters of payout.

Finally, in the 4th quarter of 2018, new CEO Larry Culp had to cut the dividend to just 1 cent and the dividend yield dropped from 3.8% in September to just 0.5% by December 2018.

The point is not about GE. The point is that a dividend is only as "sure" as the company that is behind it. And sometimes, when a company is having trouble, the stock price begins to fall, and the dividend yields looks temporarily juicy, but it's more a sign of trouble than an opportunity for dividend investors.

The lesson is that an investor can't just run a stock screener looking for a bunch of companies with dividend yields in the 5-8% range and buy those stocks – sit back and collect checks. If it were that easy, everyone would do it. It doesn't work. Companies with relatively high dividend yields often are struggling and dividend cuts are on the horizon as the company begins to hoard cash to ward off bankruptcy.

Are you listening, investors in Coke, Pepsi, Exxon, IBM, Chevron, Abbott, Starwood Prop, Arbor Realty, BP, Banco Santander, TGP, MO, Total SA, Prudential, Redwood Trust, Vornado, Kinder Morgan, AT&T, Vale, Rio, Cit, Wyndham, Valero, Key, Hess, Stanley Black & Decker, Regions Financial, etc.

It's not that easy. Don't sit on your laurels. When was the last time you truly evaluated those companies and read their financial reports? Take this opportunity to investigate. Those dividends are only as good as the companies that stand behind that dividend payout. You might be surprised at some of the names on this list. They are all big dividend paying companies. And probably not all of these companies should get your investment dollars, even if they are giant stalwarts with household names and high reputations.

Taxes

The other reason you shouldn't only consider dividends when investing is taxation. Dividends get taxed at your full marginal tax rate, which in 2020 is probably in the 15-30% range.

However, long term capital gains get taxed at lower, tax advantaged rates. If you are retired, you might even have an income less than $40k (single), $80k (married) and your capital gains would be tax free = 0%. Most people will fall into the middle category of a 15% tax on long term capital gains. Some people may pay the highest rate of 20% if their income is above $441,500 (single) and $496,600 (married).

In most of these cases, your long term capital gains tax rate will be less than the tax you will pay on your dividends.

The bottom line is that this is not an either/or situation. You want to look at TOTAL RETURN, not just at capital gains, and not just at dividends.

A full analysis of each stock is necessary. If you are not trained in accounting, then check out our white paper entitled: "Stock Investing: Are Accounting Statements Truly Important?".

Either way, you might want to get some help. Also check out our white paper entitled, "Top 10 Income Streams to boost your Retirement".

How can I get some help?

1) Talk to your Warren Financial advisor.
2) Read the white papers recommended throughout this document.
3) Talk on our website (warrenfinancial.com) using our Chat feature to get immediate access to a portfolio manager or relationship manager.
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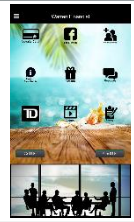

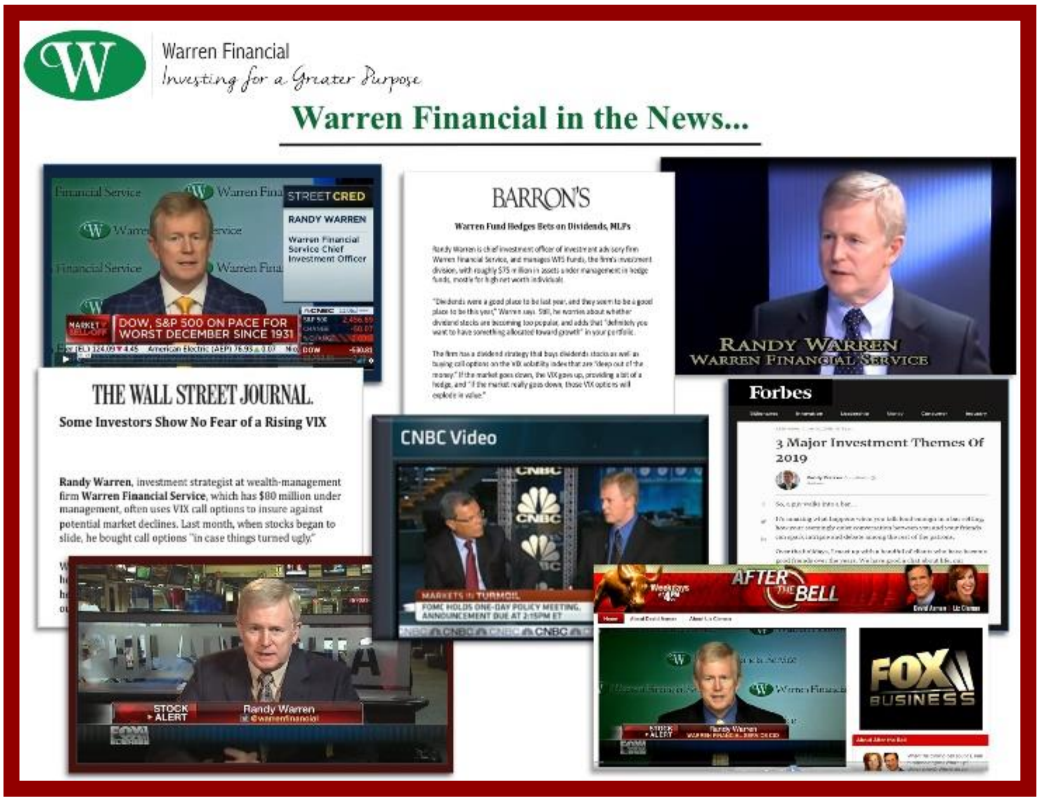

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