Dividend-paying stocks coming back into vogue

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By Debbie Carlson, Special to Tribune Newspapers

With interest rates unlikely to rise from their rock-bottom levels any time soon, some people are looking for higher-yielding investments, and many are turning to dividend-paying stocks.

These types of stocks were out of favor for many years in lieu of growth-oriented shares, but in a more risk-averse investing climate, the old-fashioned idea that companies pay shareholders a small income has returned.

"You're seeing (the idea of) returning value to shareholders being reborn," said Damon Southward, chief market strategist at Briefing.com.

A dividend is a claim on a portion of the company's profits. Historically, publicly traded companies that paid a shareholder dividend were usually old-line companies like consumer staples or utilities that had consistent, if not glamorous, performance. With interest-bearing accounts like money market funds and some short-term certificates of deposit earning mostly less than 1 percent, investors are seeking other ways to get a slightly higher yield. Thus, dividend-paying stocks are back in favor as they offer income and potential appreciation.

The chase for yield has led many firms to start paying dividends, even those that are anything but the staid company that grandma and grandpa may have owned.

One example of a high-profile company jumping on the dividend bandwagon is Apple, which offered its first shareholder dividend last year.

Now that dividend-investing is trendy, experts warn that buyers need to be cautious and understand what they're doing.

A dividend-paying stock offers a yield to shareholders, payable at certain times of the year. That income can be reinvested to buy more shares or deposited in the shareholder's bank account. Stock dividend dates are set by the company and are a timeline of when the income will be distributed.

People looking to add dividend-paying stocks need to consider what's in their entire portfolio, said Joe Lucey, president of Minneapolis-based Secured Retirement Advisors.

"See how they fit in your portfolio. This should be money that you put in your long-term investments, money that you don't need," he said.

Shawn Hackett, president, Hackett Financial Advisors, in Boyton Beach, Fla., said one should start with companies that have a solid record of paying dividends. "You want to look for a business that endures. You want to make sure that it's around for 30, 40 years. Selling things like cereal and cheese has worked for a long time," he said.

He also said to seek a company that regularly raises its dividend. "Don't make the classic mistake of looking for a company with the highest yield. They can dramatically cut that yield. It's better to have one that has a 3 percent yield that consistently grows 5 to 8 percent for 30 years," he said.

Buying a stock just for its high yield is risky, and in this current environment, it's especially concerning, Southward said. "That's the No. 1 red flag. People are chasing yield in this environment like I've never seen. We've seen some extremely high yields surface," he said.

Southward said when researching companies, pay attention to a firm's peer group. If the yield is 2 percentage points higher than the rest in that sector, that's a bad sign. The company's quarterly reports should show strong earnings. "If financial net income is falling quarter after quarter, it's a concern," he said.

Lucey also said investors need to realize that since these are stocks, they can lose their principal. Investors who want to keep their principal are better off in Treasury bonds or highly rated municipal bonds. "There is credit risk, of course, but there's always going to be a trade-off between safety … and growth," he said.

Investors can choose from individual firms, mutual funds or exchange-traded funds. Hackett prefers building a portfolio by researching individual companies to avoid paying fund manager fees. Some companies offer a dividend reinvestment plan, where shares can be bought directly and income reinvested.

For those who don't have time to research individual firms and still want diversification, Lucey and Southward advocated buying exchange-traded funds and focusing on low fees.

There are two types of dividend-paying stocks, common and preferred. Both Hackett and Southward like preferred stocks for those who are focused on income. Preferred stocks usually have a guaranteed fixed dividend, whereas common stocks have variable dividends. Preferred stocks can be "callable," meaning the company has the option to repurchase the shares at any time for any reason.

"I'm high on a preferred-stock program. ... It's a type of security that doesn't tend to show a tremendous amount of volatility, unless there's a major market correction," Southward said, suggesting the Powershares Preferred ETF (ticker: PGX), as a top pick. It has a 6.4 percent yield and an expense ratio of 0.5 percent.

Hackett said when picking one preferred stock, start by looking at the company's credit rating and the stock's callable date and yield.

In common stock, Hackett said his No. 1 sector is water utilities, and then food. Southward said to focus on expense ratios in common-stock ETFs.

"Target a strategy and look for extremely low expenses, like Vanguard (High Dividend Yield ETF; VYM). It has a yield of 3.36 percent and an expense ratio of 0.13 percent," he said.

Finally, new investors need to know that dividend income is taxed. How much it is taxed depends on how long one holds the income and the person's tax bracket.

"Any income you get from dividends you have to pay taxes on, unless it's in an IRA," Hackett said.

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