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Guest Column by Steve Wenstrup

Returns to be found by Investing in Dividend Stocks

While some investors have begun to return to US Equity (funds) there is still a large amount of money on the sidelines. End of year 2012 data shows investors have trillions in money markets and savings accounts. While there is no guarantee all that money will make its way back into the market the matriculation has begun.

For two years ended December 2012 net domestic equity flows out of mutual funds total -$288 Billion!! During 2012 domestic equity ETF's began to show positive inflows but not enough to overcome the huge flow out of mutual funds.

Good news! Since December of 2012, according to The Investment Company Institute (ICI) and Lipper US Fund Flows, domestic equity funds and ETFs have shown net inflows of nearly $70 Billion. There is no guarantee we will end the year with positive flows, but they are consistently moving in the right direction.

HOW SHOULD AN INVESTOR APPROACH A RETURN TO THE MARKETS?

After the confidence destroying financial crises, investors have been slow to return to the equity markets and many are resistant to leave their seemingly safe low yielding instruments. Market volatility and memories of the past have kept many an investor away. If investors are to get back in they must develop a credible plan they are comfortable with in terms of risk exposure (allocation) and types of securities purchased. Dividend paying stocks may be an area to consider.

As I discussed in my previous Business Journal article, bonds contain their own potential for risk once the economy improves and interest rates rise. While dividend paying stocks cannot be considered as a replacement for bonds which many hold as a way to preserve capital they do offer a cash return like bonds. For investors who can consider a venture back into equities it will be helpful for you to get a better understanding of the relationship of various factors that may drive stock returns over time.

In most of the past three decades investors focused on stock price growth paying little attention to cash return from dividends and dividend growth. Numerous studies have compared the risk and return performance of stocks and portfolios focused on various dividend and earnings characteristics. In this low yield environment dividends are now much more attractive, can grow and potentially create a total return for the patient investor who needs to stay ahead of future inflation.

A study from Ned Davis Research*, showed stocks with growing dividends not only were less volatile but provided greater returns in a study of the period from 1972 to 2010. It was also enlightening to learn that dividend strategies tended to outperform in periods of moderate economic growth as we are likely to experience going forward. For companies, deciding to make dividends declarations is a serious business and normally signals that a company has a competitive advantage and really solid cash flow. Dividends are cash, not just accounting profits and increases are generally a good sign of business improvement. No company wants to be seen cutting a dividend they granted or increased.

For research purposes, we performed a search to cull dividend oriented stocks using information from several sources. Our parameters were:

- Companies over $10 Billion in size,
- A qualified brokerage firm rating of at least Neutral, and
- Stocks carrying a Morningstar rating.

Each stock yields more than the S&P500 Index, while earnings grew more in the current year than in the previous and is expected to be surpassed again in 2013. Not every stock on this list has a growing dividend but the average dividend growth rate of the list is almost a 10%. For our own purposes we will look for additional characteristics of growth, value, cash flow, as well as other qualitative factors. Our current preference is for stocks with attractive yields that can grow in difficult markets.

There is no guarantee that any of these stocks will outperform the market, but they carry factors consistent with the aforementioned study that proved to be a winning strategy.

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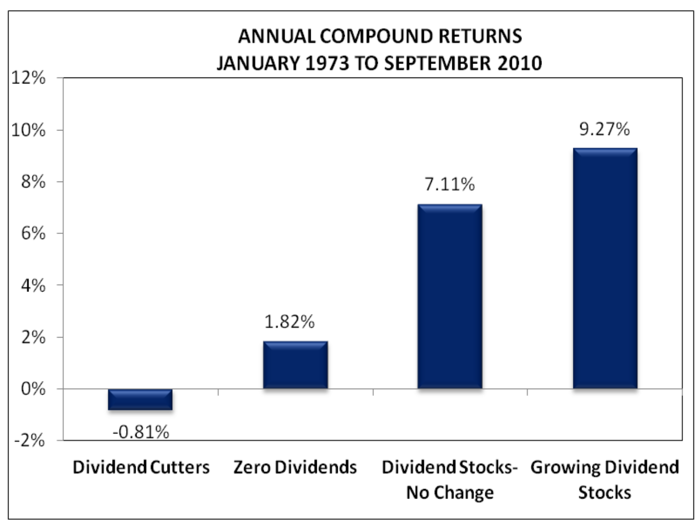

*Based on equally weighted compound total returns of dividend and non-dividend paying S&P500 stocks. Each of the portfolios were reconstituted at the beginning of each year based on actual dividends paid in the previous year. Performance does not guarantee future performance. Source: Neil McCarthy and Emanuele Bergagnini from data provided by Ned Davis Research.