

THE FINANCIAL PLANNER

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Investing for Dividends

Many investors have long relied upon dividend-paying stocks. Retirees felt secure that they had a dependable source of regular income. Conservative investors found them a safe way, relatively speaking, to generate growth by reinvesting their dividends.

Historically, dividend-paying stocks were an excellent place to turn to in a recession. Wharton professor Jeremy Siegel has calculated that from 1872 to 2003—a period that encompassed numerous recessions—97% of the market's return came from reinvesting dividends. Just 3% came from capital gain on the original principal.

But now...

It probably comes as little surprise that the current news about dividends isn't as good as before. Standard & Poor's Dividend Record reported in January that the fourth quarter of 2008 was the worst for dividends since 1956, the first year that the S&P began keeping dividend records.

Out of approximately 7,000 publicly owned companies, 288 decreased their dividends, a 444% jump from the issues decreasing their dividends in the fourth quarter of 2007. On the other hand, some companies still were able to increase their dividends. The number of increases fell 40%, to 475, from the 792 reported in the year-earlier period.

Obviously, dividend-paying stocks haven't disappeared. Looking at just the S&P 500, in 2008, 241 companies increased dividends (62 cut them), and 369 companies still were paying dividends, versus 390 in 2007. Overall, for both 2008 and 2007, the percentage of publicly traded companies making payouts was approximately the same, 48% (with a very slight edge in favor of 2008).

A little less gloom

The continued falling of earnings may mean yet more dividend cuts, suggests Howard Silverblatt, Senior Index Analyst at S&P. He believes, however, that the worst may be over or, at least, may be near. Cuts during the end of 2008 make it "easier to generate better numbers in 2009."

Dividend yields by all common stock issuers in the S&P were up from 2007, 6.7% against 4.4%. But those percentages need to be put in perspective. A higher yield is due, for the most part, to the depressed value of a company's stock. The lower the stock's price, the higher the yield for a given dividend. A company with a drastically reduced share price could be a good candidate to cut or eliminate its dividends, as the lower price indicates lack of investor confidence.

Signposts

Investors looking for companies with the best history of paying dividends sometimes turn to the S&P 500 Dividend Aristocrats listing as part of their research. The list reports the performance of S&P 500 index constituents that have followed a policy of consistently increasing dividends every year for at least 25 consecutive years. There are 52 companies in the latest compilation, released in December 2008.

As everyone should know, however, past performance does not predict future performance. Some of those companies on the S&P list may not be experiencing growth or profit sufficient to allow them to continue their stellar record. And investors need to exercise caution with companies with high debt-to-capital ratios or that pay a substantial percentage of their earnings in dividends—a percentage that may not be sustainable should earnings drop.

When looking for stocks that are on safe ground—with strong potential to maintain or increase dividends—a review of payout ratios may shed some light. It's simple to figure: Just divide the company's annual dividends per share by its earnings per share. For example, say Company X was paying 88 cents in annual dividends per share and earning \$3.13. That's a payout of 28% and a fairly attractive number. (The average payout for U.S. stocks is 40%.) Some might argue that a higher ratio is a better sign because it suggests that a company is willing to share a significant amount of its profits. But a high percentage could put the pressure on to cut dividends should there be a later drop in earnings.

A bigger tax bite ahead?

The current tax rates on qualified dividend income have been in place since 2003. As of right now, for taxpayers in the 10% and 15% brackets, there's a 0% rate; for all others, 15%. In 2011 the rates are scheduled to jump back to earlier levels (for taxpayers in the 15% bracket, 10%; all others, 20%).

Many observers expect that the tax on dividends will rise. A top rate of 20% has been bandied about. The timetable is a bit unclear, too. Earlier it seemed that the increases might come this year. Some analysts now are saying that next year is more likely.

A chance to avoid traps & pitfalls

All of these factors, and others, make picking the right dividend-paying stocks especially tricky today and, clearly, not a job for the amateur investor. The guidance offered by an experienced and knowledgeable investment advisor can prove very valuable.

That's why you should turn to us. If you are interested in finding out more about investing with an eye toward dividends, or have questions about any other investment issue, we would be glad to be of assistance. Please contact us at any time. © 2009 M.A. Co. All rights reserved.

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