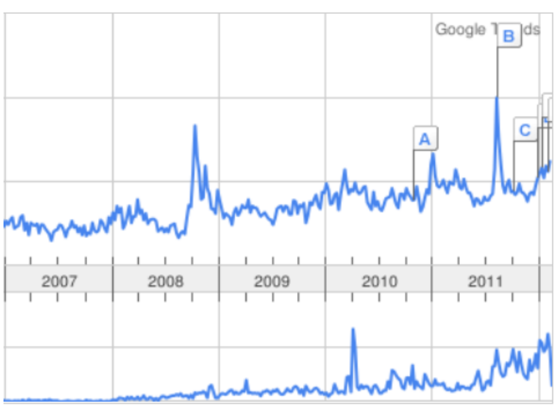
Passive Capital Management

Play of the Day – Dividend-Paying Stocks

In the third century BC, a popular rallying cry in Rome was ***"Carthago delenda est"*** – "Carthage must be destroyed." The politician Cato the Elder was particularly fond of this rather un-neighborly call to arms, and would conclude his speeches with the phrase. True to their word, the Romans would eventually sack the North African city of Carthage in 146 BC, selling the unfortunate population into slavery.

We begin with this dip into ancient history as a way to define a key word in this article – "dividend." Just as "del<u>endum</u>/del<u>enda</u>" means "must be destroyed," **so "divid<u>endum</u>/divid<u>enda</u>" means "must be shared or divided."** A dividend paid by a company is a **portion of the profits that must be paid to shareholders** of record, once it has been approved by the board of directors. The ability to pay a dividend is often seen as a **positive sign of a company's health.** If there is sufficient excess profit to pay out to investors rather than reinvesting in the business, the theory goes, all must be well.

Investor interest in dividend-paying stocks has increased substantially in recent years, in part because of the implicit stability of the companies in question, but **primarily as a potential source of steady income.** This has been especially true in the last several months, as **historically low bond yields** have made income from investment-grade bonds difficult to come by. The Google Trends chart below shows spikes in search volume for dividend stocks (top line) and related news volume (bottom line). Note the **spikes in search volume** in the fourth quarter of 2008 and the third quarter of 2011, as equities in general plunged into bear market territory:



A [Why you should be buying dividend stocks now](#)
The Province - Oct 29 2010

B [UBS's Tay Recommends High-Dividend Stocks, Asian Bonds](#)
Bloomberg - Aug 8 2011

C [Fan Likes `High-Quality' Bond Issuers, Dividend Stocks](#)
Washington Post - Oct 4 2011

D [When dividend stocks aren't a safe haven](#)
Globe and Mail - Dec 29 2011

E [HSBC's Pedley Favors Fixed Income Over Dividend Stocks](#)
Bloomberg - Jan 10 2012

F [9 dividend stocks insiders are bullish about](#)
MarketWatch - Feb 2 2012

A Google News search finds <u>399 news articles on this topic *in the past month alone*</u>. This has become the investment "play of the day."

So, why not join the crowd and concentrate a portfolio around dividend-paying stocks?

An initial objection might be the fear that such sudden and intense popularity **could cause a rapid increase in prices for these stocks**, which in turn would drive down yields. Investors who are late to the party could overpay for these popular names, and thus **experience underperformance when market conditions made them less attractive** – a bull market in growth stocks, or increasing fixed income yields, for example. **In seeking more, an investor can end up with less.**

The related and perhaps greater concern is that by concentrating a portfolio, an investor reduces diversification. **Diversification is a critical tool for investors,** helping to **reduce unsystematic risk** by spreading risk across companies, sectors, regions, countries and types of stocks – small, large, growth, value – **protecting the investor from sharply negative returns in any one area of the market.** It is often called the only "free lunch" in investing. **Focusing only on dividend-paying stocks limits an investor's options to approximately 20% of the total US stock market.** With hindsight, we also know that taking this approach 25 years ago would have eliminated some of the best-performing stocks in the period since, including Cisco, Starbucks and many others (source: DFA).

Most importantly, we feel that **this strategy is simply unnecessary.** As Dartmouth finance professor Kenneth French has observed, it doesn't matter to the investor **whether he or she earns income from dividends or from long-term capital gains**. Current tax law (February 2012) treats them much the same. Dividends are psychologically helpful, because they feel like an official payout, a tangible return on investment, and a steady income stream. But a thoughtful investor can take a **total return approach** to investing, and pay himself through so-called **"homemade dividends"** – disciplined, regular sales of long-term assets to generate income.

Such an investor can hold a globally diversified portfolio, with an appropriate asset allocation for his or her investment goals, time horizon and risk tolerance, and avoid the risk of concentrating in a particular sector or taking excessive risk in higher-yielding bonds. Clients at Passive Capital Management generally hold more than 10,000 stocks around the globe, including dividend-paying stocks. Avoiding concentration in this way means avoiding market-timing penalties and unsystematic risk, while capturing market returns in a low-cost, tax-efficient way.

The investment professionals at Passive Capital Management routinely help clients who are retired, or who are beneficiaries of a trust designed to produce income, to manage the process of trimming gains to provide regular income payments. Setting a spending policy using a fixed percentage of a three-year trailing average is a good way to avoid over-consuming in good years for the market, or facing a sharply reduced income level in weaker years. An appropriate asset allocation is also a key element in this process.

To see Professor French discuss this topic, you can click here. If you are reading this in hard copy, you can search the web for "Kenneth French homemade dividends" and easily find the video, or you can use your smartphone's QR code reader to scan the QR code at the bottom of this page.

The bottom line – we firmly believe that remaining committed to a thoughtful, disciplined **total return** approach is likely to deliver a better investment experience than joining the crowd in the "play of the day."

Also, don't ever build a city too close to Rome.

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Passive Capital Management, LLC
2328 West Joppa Road, Suite 120, Lutherville, MD 21093, 443-275-2703
Two Clinton Square, Suite 215, Syracuse, NY 13202, 315-478-3130
www.passivecapital.com

Scan this code to view Professor French's video.