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A Different Way to Play Dividend Stocks

By MURRAY COLEMAN

Yield-starved fund investors keep reaching for stocks that are paying high dividends, even as more under-appreciated parts of the market heat up.

That means investors are missing out on companies whose strong underlying fundamentals should drive future growth, say advisers who prefer a more even-handed approach to income investing.

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"The high-dividend theme has been getting long in the tooth, but there are still good income strategies that focus on the quality of a company's earnings," says Lane Jones, chief investment officer at Evensky & Katz Wealth Management in Coral Gables, Fla., which has $850 million in assets.

Funds investing in the highest yielding stocks typically are steeped in "value-styled" parts of the market such as financial services, utilities and industrials, says Michael Rawson, an analyst at Morningstar Inc.

Since May 22, when policymakers started tipping their hand about tapering of the U.S. Federal Reserve's massive bond-buying program, the Chicago-based investment research firm's data show a greater divergence in market behavior.

Mutual funds and exchange-traded funds leaning toward higher-flying growth companies have been outperforming traditional value-styled stock funds on average by more than a 2-1 margin in that period.

For example, the iShares Select Dividend ETF's (DVY) net asset value has barely moved into positive territory since late May. At the same time, the Guggenheim S&P 500 Pure Growth ETF (RPG) has gained close to 4%.

"In anticipation of less intervention by the Fed and a continued rally in stocks, we're starting to see more fund investors turn to companies with track records of delivering higher growth rates," says Matt Reiner, chief investment officer at Capital Investment Advisors in Atlanta, which has $1.2 billion in assets.

Over longer market cycles, investors typically can expect to pay a premium for more growth, notes Dan Suzuki, an equity strategist at Bank of America Merrill Lynch. As investors have crowded into the highest-dividend payers, those premiums have been dropping, he says.

In fact, the median price-to-earnings ratio for stocks that pay below-average dividends on the S&P 500 index now is running around 17.1, based on 12-month expected earnings, according to Mr. Suzuki. That is in line with median long-term averages since 1986.

At the other end of the spectrum are the blue-chip benchmark's top 50 dividend payers, which are trading at a forward PE multiple of about 14.8, higher than the group's 11.8 median historical level, Mr. Suzuki says.

"In a low interest rate environment, it's natural for investors to overcompensate by reaching for the highest yielding stocks. But we see that as a dangerous bet," says David Trainer, president of Nashville-based New Constructs, a research consultant to other advisers and institutional money managers.

Instead, he recommends funds that focus on stocks like PepsiCo Inc. (PEP), Wal-Mart Stores Inc. (WMT) and Abbott Laboratories (ABT). "These companies don't necessarily produce the highest dividends, but they do generate strong cash flows," Mr. Trainer says.

Such names are leading holdings in the $17.4 billion Vanguard Dividend Appreciation ETF (VIG). It screens for companies with histories of increasing dividends, but also considers measures of earnings quality. Not part of its portfolio are popular stocks like Microsoft (MSFT) and Apple (AAPL), which are mainstays in funds tracking the broader market.

"These companies are showing less ability to generate strong after-tax profits than in the past, which are red flags that their competitive advantages are on the decline," Mr. Trainer says.

He is advising clients that such "fundamental business concerns" should be foremost in their investment decisions, rather than "any debate over whether a company like Microsoft or Apple should be paying higher dividends."

Portfolio manager Mr. Reiner says he is favoring the $12.5 billion SPDR S&P Dividend ETF (SDY). It buys stocks that have raised their dividends in each of the past 20 years and dips into companies with smaller market capitalizations than the Vanguard ETF.

"Even in a rising rate environment, dividend investing can still make a lot of sense," Mr. Reiner says. "It's important to look for sound businesses that can keep generating dividends year after year."

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