Cabot’s Complete Retirement Income Guide

How to Secure a Lifetime of Income

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Cabot Dividend Investor
Safe Income and Dividend Growth
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There are two ways for retirees to live off their investments. One is to sell stocks or assets when you need cash. This can work with any investing strategy, whether you own small-caps, options, growth stocks or mutual funds. But it will leave you very susceptible to the vagaries of the market. You’ll sometimes be required to sell assets at disadvantageous prices, just because you need the cash.

That’s why many retired investors focus instead on investing for income: owning investments that generate a steady income stream, without ever having to sell anything.

There are several advantages to income investing. For one, your income stream is reliable, and not price-dependent. The best income-generating investments keep paying investors to own them regardless of what’s happening to their price.

Second, if you invest right, your income stream can actually grow... sometimes while your portfolio is growing too! If you’re selling assets whenever you need cash, your portfolio will be shrinking over time. But if you own investments with growing income streams, and rising prices, your income and your portfolio value can both increase over time.

Income investing can also become less work as you get older. After a few years of building up your income portfolio, you may find that you can just sit back and watch the dividend checks roll in as you enjoy your golden years.

Lastly, income investments’ reliable returns make them less volatile than the market. A recent study found that U.S. stock funds with yields over 2% (meaning they hold mostly dividend-paying stocks) had an average three-year annualized standard deviation (a measure of volatility) of three percentage points less than stock funds yielding less than 2%. In addition, many income investments actually become more popular when the market is weak—or when the environment is “risk-off” in Street parlance—so they can be great buy-and-hold assets for investors who don’t want to have to trade a lot.

So you think income investing is for you?

Great! Income investing is fundamentally different from investing for capital appreciation though. If you’re accustomed to buying stocks for their appreciation potential and selling after their prices rise, then you may have to start thinking differently about your investing strategy.

You’ll be buying investments for different reasons, and likely holding for different time periods, and then selling for different reasons (or not selling at all).

But don’t worry: this guide, and our two accompanying reports on MLPs and using IRIS, contain all the knowledge you need to get ready to transform your portfolio into an income-generating machine.

Getting Started

The first step to income investing is to consider your income needs or wants, and your risk tolerance. There are some income investments that return as much as 10% of your investment as income each year—but they’re generally going to be much higher-risk than an investment that returns 2% or 3% each year.
That amount—the percentage of your investment that is returned as income each year—is called **yield**. If you’re looking at a dividend-paying stock and see that it has a 3% yield, that means that at the current dividend rate, an investor who puts $1,000 in that stock will get paid $30, or 3% of his investment, each year in dividends. Those dividends are on top of any price appreciation from the stock, and don’t reduce the amount of your original investment. The investment is just paying you to own it.

Here’s how you determine the yield of an investment:

\[ \text{Yield} = \frac{\text{Annual Dividend Amount}}{\text{Price}} \]

When you’re considering buying a new investment, you will use the current indicated annual dividend amount (how much the company has declared it will pay in dividends that year) and the current price in that calculation. That will tell you what percentage of your investment you’ll receive as income each year, as long as the company maintains its current dividend rate. This number is widely available on many quote services.

The other part of the equation is risk. Obviously you’d like to maximize your income, but simply buying all the highest-yielding investments you can find is a sure recipe for disaster. For one thing, there aren’t that many (about 100 stocks in the S&P 1500 currently yield over 4%). And you don’t want to be buying sub-par stocks just for the yield—if the company is struggling, they won’t be able to maintain that yield for long.

So you need to balance yield against the other factors that matter to you in your investments: things like volatility, diversification, capital appreciation potential and income growth potential. (That last one is very powerful, and I’ll talk more about it a little later in this report.) Luckily, there are a wide variety of different investments that pay you to own them, so every investor should be able to create a mix of holdings that fulfill both their income needs and other criteria.

### Types of Income Investments

**Equities**

The backbone of our *Cabot Dividend Investor* income portfolio is a diverse group of income-generating equities. Income-generating equities include ordinary dividend-paying common stocks, income-paying foreign stocks and ADRs, and stocks of special types of income-focused companies like Master Limited Partnerships and Real Estate Investment Trusts.

**Dividend-Paying Common Stocks**

Dividend-paying stocks make up the core of our income portfolio. That’s because these stocks have many qualities that make them “the best of all worlds” as far as income investments go.

For one thing, there are thousands of dividend-paying stocks. That means there are plenty of high-quality options you might want to own. There are also dividend-paying stocks that will appeal to almost every type of investor: you can create a dividend-and-value strategy, or a dividend-and-growth strategy, or focus on international dividend stocks, or low-priced dividend stocks, or minimum-volatility dividend stocks.
Dividend stocks also have infinite capital appreciation potential, like any other stocks. Other income investments, and especially fixed income investments, have minimal or limited appreciation potential.

Dividend paying stocks can also make taxes easy. If you’re a U.S. investor investing primarily in U.S.-listed stocks, most common stock dividends will qualify for the reduced dividend tax rate of 15%. These are called **qualified dividends**.

In order for your dividends to qualify for the capital gains tax rate, you must have held the stock for more than 60 days including the ex-dividend date. That gives you a 121-day window in which your 60-day holding period can fall.

Many foreign stocks pay qualified dividends too. Stocks of foreign companies that are “readily tradable” on U.S. exchanges, including ADRs, can be qualified. In addition, stocks of companies may be based in one of the 60 or so countries with which the U.S. has a “comprehensive income tax treaty,” including Australia, Canada, China, Denmark, France, Germany, India, Israel, Japan, Mexico, South Africa, Switzerland and the United Kingdom. The complete list is available on the IRS website.

Lastly, the best thing about dividend-paying stocks is that their dividends can grow.

Companies that pay dividends can, and often do, increase their dividends year after year, paying existing investors more each year to hold the stock. A growing income stream is a pretty nice retirement benefit! At the end of this report, I’ll explain why dividend growth is so great, and how to secure it for your own portfolio.

**Real Estate Investment Trusts**

Real estate investment trusts, or **REITs**, are special purpose entities, with special tax status, that own real estate and pass along most of the income from the real estate (rents or mortgage payments) to shareholders. They can own any type of real estate, and many specialize in one type, like apartment buildings, malls, office buildings, self-storage facilities or hotels. A REIT that owns property directly and gets most of its income from its tenants’ rents is called an Equity REIT.

A mortgage REIT, on the other hand, is a REIT that doesn’t own property directly. Instead, they own property mortgages and mortgage-backed securities. Their income comes from the interest they’re paid on the mortgages. They’re sometimes called mREITs.

There are also hybrid REITs that own assets both ways.

Both types of REITs are exempt from taxation at the trust level as long as they pay out at least 90% of their income to investors. That means that while any retained income will be subject to regular corporate-rate taxes, the REIT doesn’t have to pay taxes on current income (rents or interest payments from the current period) that is distributed to unitholders (the trust version of shareholders). Essentially, the REIT is treated as a “pass through” entity, collecting the rents or interest payments and then passing them on to investors. It’s as if you own a sliver of the properties or mortgages themselves.

But that doesn’t mean REITs have no growth potential. While they don’t retain much money to reinvest in their business, REITs often borrow money to make new acquisitions or improve properties. They can also earn more by raising rents or improving occupancy rates.
REIT performance tends to be more correlated to the real estate market than the overall stock market (and mortgage REITs are strongly affected by interest rates and credit conditions), so keep this in mind when deciding how much of your portfolio to allocate to them.

Owning REITs does have some tax consequences. Most of your REIT distributions will be classified as **ordinary income**, because you are treated as a part owner of the assets the REIT owns, and thus income from those assets is treated as your income. However, when some portion of a REIT’s distribution did not come directly from that quarter’s real estate ownership activities—for example, if it sold a building and distributed part of the proceeds to investors—you may be taxed differently on that portion of the distribution. The REIT will tell you after the year-end how that year’s dividends should be treated. Options include ordinary income, qualified dividend income, long-term capital gains and **return of capital**. Any portion of the distribution that is treated as return of capital will reduce your cost basis in the REIT, and then you’ll be taxed on the difference between your purchase price and your adjusted cost basis when you sell the REIT.

On average though, about 70% of REIT distributions are taxable as ordinary income. This can be a good reason to own REITs in a tax-advantaged account like an IRA.

**Business Development Companies**

**BDCs** are kind of like venture capital funds, but they’re publicly traded on stock exchanges so that anyone—not just millionaires—can invest in them. They provide financing to small and mid-size companies that are often underserved by banks and other traditional lenders. Often this financing includes “mezzanine loans” that pay high interest rates and come with or can be converted into equity in the target company. BDCs typically borrow funds at much lower interest rates than those paid by the smaller companies, so investors reap the rewards of the spread—although it does make these investments fairly interest rate-sensitive.

BDCs can have very high yields—frequently in the double-digits—but those payouts often reflect the high risk of lending to speculative, development-stage companies. BDCs that make loans to primarily more mature businesses with positive cash flows will be safer, while BDCs that make more speculative loans to smaller businesses will be riskier—but they may also have more growth potential, especially if they take equity positions in a lot of their portfolio companies.

Looking at a BDC’s filings should give you a sense of how risky or safe their loan portfolio is. Some BDCs mostly make higher quality loans that have a better chance of getting paid back, while others will make more speculative loans that have higher interest rates but also carry a greater chance of default. You can check the interest rates on the loans for a sense of the borrower’s creditworthiness. If the BDC is able to charge higher interest rates than its peers, it’s probably making riskier investments.

BDCs also have to take on a lot of debt themselves, so they can then lend that capital at higher rates. Luckily for you, that means bankers have already looked at this company’s balance sheet and assessed their financial health, so you can take a shortcut by looking at what kind of interest rates the BDC is paying on their own debt. That will give you a general idea of how risky bankers think this company is. Also find out if the rates are fixed at that level or if they’re floating rate, which can expose the BDC to more interest rate risk. You may also want to compare the BDC’s debt-to-equity ratio to the industry average to see if this BDC has more or less financial flexibility than its peers. Some BDCs may even be rated by one of the big ratings agencies.
Since BDCs aren’t taxed at the corporate level, their dividends are usually composed mostly of ordinary income—meaning you have to pay taxes on them at your ordinary income tax rate.

**Master Limited Partnerships**

Master Limited Partnerships, or **MLPs**, are another unique kind of tax-advantaged investment designed primarily to pass income along to investors. They can be a great source of high yields, but are also somewhat complicated, so I’ve created a whole separate guide on why you might want to own them, what to look for in a good MLP, and how to pay taxes on them.

Refer to the *Ultimate MLP Investors Guide* for the answers to all your MLP questions.

**Utilities**

Utilities have long been considered “widow and orphan stocks” for their slow, steady returns and low volatility. While they’re never going to grow fast enough to be hot stocks, utility companies usually operate legal monopolies in their market area, and don’t have to worry about losing customers. Utilities in faster-growing regions may grow faster than average, while utilities in slower-growing regions may struggle. And economic conditions can temporarily affect demand levels for electricity and other utilities. But long-term, utilities usually mange to achieve annual earnings and revenue growth in the mid-single digit range.

This reliability makes utilities good dividend payers. They have predictable cash flows, so they can easily predict how much they’ll be able to afford to make in dividend payments. And they rarely cut their dividends during tough times, because utility demand will usually rebound long-term. The average utility’s yield is good too, around 4% per year.

Analyzing utilities is similar to analyzing dividend-paying stocks, although they often have higher debt levels because they rely on borrowing to maintain and improve their significant infrastructure. Having more liabilities than assets is okay for a utility, as long as the ratio isn’t too high. You can look at the total debt to capital ratio, which should probably be under 60%, or just check to see that short-term debt (debt maturing in the next two years) is manageable. You can also check the utility’s credit rating, which will indicate the utility’s ability to mange its current debt and secure future financing. Investment-grade-rated utilities (BBB-/Baa3) are generally safe.

Also, utilities with more unregulated operations will have more unpredictable cash flows that utilities with primarily regulated operations (where rates are set by regional laws or rules). Utilities with large exposure to commodity prices (coal, oil, natural gas) will also have less consistent cash flows.

Lastly, geographic diversification can make utilities more reliable by cushioning them against regional economic slowdowns.
Funds

Exchange-Traded Funds

There is a wide range of income-oriented exchange-traded funds. Your most important consideration when adding an ETF to your income portfolio will probably be how the ETF generates its income. ETFs that hold mostly fixed-income assets, like bonds or preferred stocks, will be very sensitive to interest rate changes and have lower upside potential than equity ETFs. But equity ETFs will be highly correlated to the stock market, or whatever sector of it they focus on.

Many income ETFs also pay less predictable dividends than individual dividend-paying stocks. Look at the ETF’s distribution policy, if it has one, and distribution history to get an idea of its distribution schedule and how much its distributions vary. Many ETFs will pay variable quarterly dividends from their regular income plus an extra dividend at the end of the year made up of capital gains.

ETF distributions are taxed based on their original source—i.e., how the fund earned them. When ETF dividends come from common stock dividends, they’re taxed just as they would be if you owned the stock yourself. They can be eligible for the lower dividend tax rate if they’re paid by a qualified corporation. Most dividends paid by U.S. corporations will qualify for the lower rate, and some dividends paid by foreign corporations will too. Dividends from businesses organized in some structure other than a corporation—like REITs—will usually not be qualified.

However, just as when you own an individual stock, you need to have held the ETF for over sixty days, including the ex-dividend date, in order to qualify for the lower dividend tax rate. In addition, the fund needs to have held the stock long enough for them to qualify for the lower rate too. So even if a fund only holds stocks of companies that pay qualified dividends, you may receive some non-qualified dividend income.

Any portion of a fund’s distribution that comes from interest on fixed income investments will be taxed as ordinary income, just like interest paid by individual bonds. (Income from municipal bonds will be exempt from federal income taxes and income from Treasury bonds will be exempt from state and local income taxes.)

And capital gains distributions, which are often made at the end of the year (but include any portion of a distribution generated by price appreciation and sale of assets), will be taxed at either long-term or short-term capital gains rates, depending on how long you held the ETF and how long the ETF held the assets.

Closed-End Funds

Closed-end funds or CEFs are exchange-traded funds. However, they’re different from other funds because they issue a limited number of shares. So the size of the fund doesn’t change when new investors buy in. That actually makes them resemble ordinary publicly-listed companies more than other funds: when a new investor buys into a CEF, they have to buy from someone else who is selling their shares, like with a stock. ETFs and mutual funds, by contrast, regularly issue new shares and buy back old ones (through bank intermediaries). That means they’re sometimes forced to buy more assets just because the fund is getting bigger, and sometimes they get too big to maintain their performance.
Many CEFs are designed to generate income, either by owning income-generating investments like bonds, dividend stocks or preferred stocks, or by employing leverage, covered calls or other strategies to extract a consistent income stream from their holdings. It’s important to know how a CEF generates its income before buying it, so you know what kind of market conditions would affect its performance (the source of your distributions can also change what kind of taxes you owe on them).

CEFs trade at a market-determined price like common stocks, not at their net asset value (NAV) like mutual funds. This makes trading easier and should impact your decision to buy a CEF. The gap between the current share price and the NAV is referred to as the CEF’s discount or premium.

If a CEF is currently trading at $19.00, but its NAV is $20.00, then the CEF’s discount is -5.0%. You can find a CEF’s discount or premium with this equation:

Discount or Premium = (Share price ÷ NAV) – 1

Here’s one more example:

Share price = 12.00  
NAV = 10.00  
Premium = (12.00 ÷ 10.00) – 1 = 1.20 – 1 = +0.20 = +20.0%

You can also look up a CEF’s current discount or premium on the fund manager’s website, or on Morningstar. Usually, premiums are denoted with a plus sign, as above, and discounts with a minus sign.

The fact that discounts and premiums exist gives CEF investors one more piece of information when considering their investment. However, it’s not just as easy as buying any CEF that’s trading at a discount. Some investors think so, and will argue that by buying at, say, a 10% discount, they’re “getting $1 worth of assets for 90 cents.” But that’s an oversimplification.

For one thing, you can’t assume that a CEF’s price will always return to its NAV. CEFs can trade at a discount or premium to their NAV for years.

Second, there may be a reason a particular CEF is trading at a discount to its NAV. It may have made negative changes in its distribution policy, or may own assets that are out of favor.

Third, and most important: a CEF’s NAV is not fixed. The NAV can change just as easily as the fund’s price. If you buy a CEF at a 10% discount to its NAV, but then the value of the fund’s assets declines by 10%, the discount will have been erased, but you won’t have made any money. (In fact, you’ll probably lose money as the price declines to reflect the loss of worth.)

So while it’s important to check a CEF’s discount or premium prior to purchasing it, a big discount is not in itself a reason to buy the fund.

That said, it’s important to be careful when buying shares at too high a premium. While shares currently trading at a premium can certainly stay at a premium for a long time, their upside may be limited. Unless the NAV increases commensurately, any increase in the share price will also widen the premium gap, which may limit how far the share price can rise.

You can also compare a CEF’s current discount or premium to its average historic discount or premium, as you might compare a stocks’ current P/E to its average historical P/E, a common strategy among value investors.
To find a CEF’s relative discount or relative premium in a historical range, use this equation:

\[
\frac{\text{current discount} - \text{average discount}}{\text{standard deviation of the discount}} = z
\]

If \( z \) is negative, the CEF’s current discount is lower than its average, and this might be a good time to buy the fund. If \( z \) is positive, the current premium is higher than average, and the fund might be somewhat overvalued right now.

So, the important things to remember when investing in closed-end funds are:

- Check the discount or premium of any CEF you are considering buying.
- Premiums add risk to a CEF investment because unless the NAV rises to meet your purchase price, you will likely lose money on your investment in the long run. Avoid premiums above 10%.
- While buying a CEF at a discount can increase your chances of making money, always check to see if there is a reason why they fund is trading at a discount, and remember that the NAV can also decline.
- A fund’s relative discount is more important than its discount to the current NAV, because CEFs are more likely to return to their average historical discount than to their NAV.

**Fixed Income**

**Preferred Stocks**

Preferred stocks are a special class of shares that are traded like stocks but actually represent debt, like a bond or loan. They do not represent or confer ownership, and the distributions rarely go up. So you’d only buy a preferred for steady income, not capital gains.

That said, preferred stock can generate a very steady income. The yields are usually between 4% and 8%. And preferred shareholders are usually better protected—both in and out of bankruptcy—than common stock holders.

Preferred stock is usually issued at a par value of $25.00, although shares are sometimes issued for different amounts, including $50 and $100. When the shares are issued, the company announces the shares’ coupon rate and consequent annual dividend (which is the par value times the coupon rate). Although the coupon rate determines the annual dividend at the outset (because preferred shares are debt, so prevailing interest rates and credit conditions will determine what rate the company can issue preferreds at) the annual dividend is actually the number that won’t change over time. The “coupon rate” or yield may.

For example, a company that wants to issue preferreds yielding about 8% would declare an annual dividend for the shares of $2 (because \( $2/$25 = 0.08 \)). Once the preferreds are trading, the annual dividend won’t change, so the yield may vary slightly. Most preferreds issued at $25 will trade in a range between $23 and $27, depending on market conditions and investor sentiment about the company and the preferreds. If the preferreds are trading at $26, then the current yield on the shares will be 7.69% ($2/$26 = 0.0769).
While preferred stock dividends still have to be “declared” by a company’s board quarter-to-quarter or year-to-year (unlike bond distributions, which are mandated), they usually won’t change. In addition, preferred stock dividends are very safe because they are paid before dividends on the common stock. And preferreds are above the common stock in the capital structure, so in bankruptcy, preferred shareholders’ claims over the company’s assets are superior to ordinary stockholders’ (although in practice, both usually get nothing).

Preferred stock dividends are also usually cumulative, meaning that if the company doesn’t pay some (or all) of its promised distributions, investors will receive them at a later date. The unpaid portion is considered “dividends in arrears” and must be paid before any other dividends. Check to make sure your preferred is “cumulative” to see if it has this feature. If it’s “non-cumulative,” skipped dividends don’t have to be made up.

Most preferreds are also callable. Callable preferreds will have a call price (usually also $25) and a call date. On or after the call date, the company has the right to buy back the preferreds from investors for the call price. The company has no obligation to call its preferreds, and many preferreds are not called for years after their call dates. A company is most likely to call its preferreds if interest rates have dropped and the company can now issue less-expensive debt.

If your preferreds are called, you’ll receive the call price of the shares plus any unpaid dividends. Having your preferred called can be a good thing if you bought it below the call price, and a bad thing if you paid too much for it.

If you’re considering buying a preferred above its call value, you should first figure out your potential yield to call. For example, let’s say you’re considering paying $26 per share for a preferred that pays $2 a year in dividends but is callable at $25 in two years. If the preferred is called, you’ll lose $1 per share. But you’ll earn $4 in dividends in the meantime. Thus, your yield to call (average annual return until the call date) would be 5.82%, quite a bit lower than the current yield of 7.69% (= $2/$26) but still decent. You can figure out your yield to call using a calculator like the one at www.moneychimp.com/calculator/bond_yield_calculator.htm.

Some preferreds also have maturity dates, which is a date, between 30 and 100 years after the issue date, when the preferreds must be called.

And some preferred stock is convertible, meaning it can be converted into ordinary stock on or after a given date. This option gives preferred stockholders more potential upside.

One downside to preferred stock is that preferred holders usually don’t have voting rights as common stockholders do.

Finally, while preferred stock is theoretically as easy to buy and sell as common stock, some preferred stocks are very lightly traded and may be difficult to buy or, more importantly, sell, at a desirable price. In general it’s a good idea to avoid preferred stocks trading less than 4,000 shares daily, on average.

Quantumonline.com is a good source of information on specific preferred stocks, including their annual dividends, call and maturity dates, whether they’re cumulative or convertible, and whether their dividends qualify for the 15% dividend tax rate.
Bonds

Bonds have historically been recommended for investors who wanted to preserve their capital above all else. However, the low interest rates that have prevailed since the financial crisis have driven yields down across the board, so that many bonds now yield barely enough to keep up with inflation. In general, the safer and shorter-duration a bond, the less it yields. Today, the safest treasury bonds aren’t even yielding enough to cover inflation. Many investors and institutions are responding by taking on greater risk, buying lower-quality bonds in search of decent yields. You should be cautious about this strategy, which can get you in a lot of trouble.

In addition, bond prices are likely to decline sharply in the years ahead, as interest rates rise. Standard bond funds will not be a good store of value, because they’re particularly susceptible to yield curve risk in a rising rate environment (they’re forced to regularly unload bonds at the shorter end of the yield curve while buying bonds at the longer end of the curve—for example, a bond ETF that tracks a three-to-seven-year bond index will constantly be selling bonds once they fall below three years to maturity and replacing them with bonds that don’t mature for seven years.)

If you’re going to hold bonds, be sure you are investing in them in a way that preserves your principal guarantee—which refers to the fact that, regardless of what happens to the bond price, you always get your principal back when the bond matures. For this to work, you have to hold individual bonds with a principal date you’ll be around for. If you’re holding a 30-year bond, you will be able to redeem it for full value in 30 years, but a lot can happen in the interim, including the bond losing much of its value for a time. If something unexpected happens, you or your heirs may be forced to sell it at a disadvantageous price.

The principal guarantee also only works if you buy the bond at or below face value. If you buy the bond for above-redemption value, you’ll lose some of your investment when you redeem it. (This might be worth it for the yield in the meantime; use a calculator like the one at www.moneychimp.com/calculator/bond_yield_calculator.htm to decide.)

Also, if safety is important to you, you should only invest in investment-grade bonds.

If you decide to hold some of your portfolio in bonds, you can either buy individual bonds (I suggest bonds with maturities no further than 10 years out; you can also try laddering them), or a bond fund with a maturity date.

Putting It All Together

To learn how to combine these investments into a portfolio that generates the yield and growth you want at a risk level you’re comfortable with, read the third report in this series, *Tips, Tricks and Strategies for Making IRIS Work for You: Guide To Creating the Perfect Portfolio*. It will walk you through the steps of creating a cohesive portfolio out of a variety of different income investments. There are also practical tips on things like buying the right number of stocks and when to buy in your *Guide to Cabot Dividend Investor*.

All About Dividend Growth

As promised above, I’m going to close this guide by sharing the dividend investor’s number one secret: the power of dividend growth.

Above, I introduced the concept of current yield, which is equal to an investment’s current annual dividend rate dividend by today’s price. It’s the yield you see listed on Yahoo! Finance and other quote
services. However, the really powerful fact about income investments is that that current yield only really applies to new investors.

Once you own an income investment, the more relevant number to you is your **yield on cost**.

Your yield on cost is a number unique to you. That’s because it’s equal to the investment’s current annual dividend per share divided by the price you bought the investment at.

\[
\text{Yield on Cost} = \frac{\text{Annual Dividend Amount}}{\text{Your Price Paid}}
\]

So even if *Yahoo! Finance* says a stock you own is currently yielding 2%, you may be earning a much higher yield on your investment.

Let’s say that five years ago, you bought a $20 that was yielding 2%—so paying a 40-cent dividend every year. Since then, the stock has continued paying its 40-cent dividend per year, but its price has risen to $35. The stock’s current yield is:

\[
\frac{0.40}{35.00} = 1.14\%
\]

However, you’re still earning a 2% yield on your position purchased five years ago.

Where this concept becomes really powerful is when you buy a stock that increases its dividend every year.

Let’s say you bought Target (TGT) when it was trading at 35. At the time, TGT paid a quarterly dividend of $0.16, for a total annual payout of $0.64. So when you bought the stock, the yield was:

\[
\frac{0.64}{35.00} = 0.018 = 1.8\%
\]

Over next five years, TGT rose from 35 to 61. But TGT also increased its dividend every year over this time period, from 64 cents per year to $1.72 per year. So the stock’s current yield changed to:

\[
\frac{1.72}{61.00} = 2.8\%
\]

But you bought at a lower price, so your yield on cost is even better. It’s equal to the current annual dividend amount, divided by your purchase price. That works out to:

\[
\frac{1.72}{35.00} = 4.91\%
\]

So even though quote services like *Yahoo! Finance* will say that Target is a 2.8%-yielding stock, you’re getting a nearly 5% yield from your investment.

Over longer time periods, this effect becomes even more powerful. It’s estimated that Warren Buffet’s Berkshire Hathaway now earns more in dividends from Coca-Cola (KO) every year than they originally paid for the stock... that’s a yield of over 100%.

That’s why I said at the beginning that your investment portfolio can actually become *less* work as you get older. If you choose the best, highest-quality dividend growth stocks today, you can sit back, relax, and watch the dividend checks roll in tomorrow.

I think dividend growth is the most powerful force in a retirement investor’s tool kit. But, there are other considerations to make when building your overall portfolio, like safety of principal and current income.

I’ll explain how to balance these three elements in my third and final report in this series: *Creating the Perfect Portfolio.*
Dividend Glossary

CAGR: Stands for compound annual growth rate and is a way of annualizing growth over a multi-year period. If I say a dividend grew at a 16% CAGR, that means it grew 16% per year on average. In reality, it may have grown more or less than 16% in each individual year.

Dividend Reinvestment: If you don’t need income from your investments right now, you can automatically reinvest the dividends. Reinvested dividends will be used to buy more shares at the market rate. This is an easy way to increase the value of your position while doing nothing. Most brokers will reinvest dividends for you at no cost, or you can use a DRIP.

DRIP: Stands for Dividend Reinvestment Plan and is an alternative way to reinvest your dividends. Companies with DRIPs allow you to buy shares directly from the company, and then reinvest the dividends in new shares automatically, usually at below-market prices. They’re a good way to increase the value of your investment quickly, although you do have to buy directly from the company, so you lose the ability to manage your investments all in one place.

Ex-Dividend Date: The ex-dividend date is the date by which you need to own a stock in order to receive the next dividend payment. It’s called the ex-dividend date because anyone who buys the stock on that date or after is buying it without the dividend, or ex-dividend. (Even though they now own the stock, the person who sold it to them will receive the dividend.) Ex-dividend dates are shown in red and italics on our Dividend Calendar. If you’re thinking about buying a new position and want to collect its next dividend, make sure you buy before that red date ... not on it.

FCF: Stands for free cash flow. Free cash flow is a more direct measure of cash available to the company than EPS, and since dividends are paid out of cash, I use it sometimes when talking about payout ratios or whether a company can “afford” its dividends. While EPS can give you a good idea of how a business is doing, FCF is usually a better measure of how much cold hard cash the business has on hand for activities like paying dividends and buying back stock.

Payment Date: The Dividend Payment Date is the day the dividend will actually be paid and show up in your brokerage account. You have to buy the stock before the ex-dividend date to receive the payment. Dividend payment dates are shown in green on our Dividend Calendar, so stockholders will know when they’re getting their dividend checks (or deposits).

Payout Ratio: The payout ratio is the percentage of earnings paid out as dividends, calculated by dividing the stock’s dividend per share by EPS. A low payout ratio is good; it shows that the company’s dividend payments are well covered by its earnings, so they’re not in danger. In addition, it means the company is holding plenty of cash back to reinvest in the business, ensuring the security of future dividend payments. On the other hand, a high payout ratio can be a red flag that a company is having a hard time affording its dividend payments, especially if the payout ratio is historically high for that company. Companies that pay out a large percentage of their cash also have less cash to reinvest in growing their business.

Some companies can maintain higher payout ratios than others, so we also consider company’s historical payout ratios and the trend of a company’s payout ratio. And some types of businesses, like MLPs and REITs, will always have very high payout ratios (often over 100%) and need to be evaluated differently.

Qualified Dividends: The U.S. government taxes dividends at a lower rate than regular income (currently 15%). However, the dividends have to be qualified. Most regular dividends paid by regular companies (U.S. or foreign) will be qualified, but most distributions paid by tax-advantaged entities like MLPs, REITs, BDCs and some CEFs will not.
Record Date: The Record Date is the day, usually about four weeks before the payment date, when a company pulls the list of current shareholders who are eligible to receive their next dividend, called “shareholders of record.” However, you need to buy the stock before the ex-dividend date in order to be counted as a shareholder of record.

ROC or Return of Capital: Distributions that are considered a return of capital reduce your cost basis in an investment. You don’t have to pay taxes when you receive them, but when you sell the investment, you have to pay regular income taxes on the difference between your original cost basis and your adjusted cost basis. See your MLP guide for some examples of how this can work. While most MLP distributions and some BDC distributions are considered return of capital, it’s often a red flag if a regular company or a CEF makes a distribution that’s partially return of capital. This can signal that the company or fund didn’t make enough cash to cover its distribution, so they’re covering the difference by “returning” some of your capital.

Total Return: I report total return in our portfolio overview, rather than just price appreciation, because it includes dividends earned. It’s equal to the total appreciation of your investment, including price appreciation and dividend payments.

Yield: Yield is the percentage of its value an investment generates every year. It is equal to an investment’s annual dividend per share divided by its price per share. If you own a $1,000 investment that pays you $20 per year in dividends, your yield is 2%.

Yield on Cost: Yield on Cost is the yield you’re receiving from your income-generating investments. It’s equal to the annual dividend per share divided by your average cost basis per share. If you’ve held an investment a while and its price has gone up, your yield on cost is likely significantly higher than the current yield.

About the Expert

Tom Hutchinson is Chief Analyst of Cabot Dividend Investor and Cabot Income Advisor and a Wall Street veteran with extensive experience in multiple areas within the financial world. His experience includes specialized work in mortgage banking, commodity trading and as a financial advisor to the nation’s largest investment banks.

Tom has created and actively managed investment portfolios for private investors, corporate clients, pension plans and 401Ks. He has a long track record of successfully building wealth as well as providing a high income while maintaining and growing principal. Tom has written extensively on various industries, individual companies and most every kind of investment for Motley Fool, StreetAuthority, NewsMax, and several of the nation’s largest online publications.