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A Steadier Way to Play Dividends

By MURRAY COLEMAN

Investing in high-dividend paying stocks can prove to be a winning long-term strategy. But new research suggests that an even better bet might be to include some lower-yielding stocks into the mix.

Portfolios with a healthy dose of attractively valued stocks plucked from the market's bargain bins have outperformed over time those focused just on income-oriented fare, according to New York-based investment adviser Gerstein Fisher.

The firm, which has $1.5 billion in assets under management, recently completed a study that was published in April's Journal of Financial Planning. It found that over a 33-year period through July 2012, a portfolio tilted toward the highest-yielding U.S. stocks returned an average of 12.4% a year.

At the same time, a basket that included high-dividend payers but leaned to broader value-oriented stocks produced an average yearly gain of 14.1%.

"Dividend investing isn't a bad way to go. But our research indicates that over the longer-term, combing a broader value strategy with higher dividend-paying stocks reduces portfolio volatility and minimizes risk--without sacrificing returns," says Gregg Fisher, the advisory shop's chief investment officer.

The Gerstein Fisher model looked at metrics such as price-to-book ratios, an accounting mechanism to figure how much a company's assets are worth, and price-to-earnings data. It found that both served as bigger contributors to a portfolio's long-term outperformance than simply reaching for yield.

"The appeal of high dividend paying stocks during a period of historically low interest rates is obvious," Mr. Fisher says. "But over time, a healthy investment diet needs a broader menu."

A large amount of academic research supports the latest research piece's findings, observes Frank Armstrong, president at Investor Solutions, an advisory firm in Miami with about $600 million in assets.
"Most investors are chasing yield when they buy into a dividend strategy. That's misguided and wasteful," Mr. Armstrong says.

Funds with a focus on dividends are the second-most popular type of diversified U.S. stock group so far this year, according to Lipper data. Net inflows topped $6.5 billion through Wednesday, trailing only a much larger multi-cap core category. It had $15.1 billion in positive 2013 flows.

Mr. Armstrong says a more effective long-term approach is to focus on a portfolio's total returns, which include dividends and price appreciation. In that manner, investors can "carve out income opportunities" from whatever sources are available, he points out.

"Unfortunately, I've observed that many investors would choose a 4% income stream over a total return of 6%," Mr. Armstrong says. "Somehow, those dividend and interest payments seem more real to many people than unrealized gains. It's just another case where we humans are not as rational as we would like to believe."

A key to building a portfolio that combines value appreciation with steady income streams is to keep investment strategies simple, says Brian Goodstadt, an adviser at Paragon Capital Management. The Denver-based firm manages about $600 million in assets.

"A lot of big institutions are coming up with more complicated models to exploit market mispricing and squeeze out more in yield," Mr. Goodstadt says. "We have some complicated models ourselves, but we keep bringing our clients back to a more basic process."

As a result, many of his investors use the Vanguard Dividend Appreciation ETF (VIG). In the past five years, its yield has risen by an annual average of around 14%, estimates Mr. Goodstadt.

Even broader-based value funds--which emphasize stocks selling at bargain-bin prices--tend to provide investors with exposure to higher income streams, says Matt Goff, chief investment officer at the Goff Financial Group in Houston, which manages $140 million in assets.

In client portfolios, he's using the Vanguard Mega Cap 300 Value ETF (MGV). "It focuses on the more steady Eddie type of value stocks, but still pays a yield comparable to sector funds that track parts of the market that traditionally pay higher income streams."