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# Quality Trumps Yield for Stock-Dividend Investors

## *Vanguard Dividend Growth popular for its focus on high-quality companies that can sustain payouts*

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Mutual-fund investors with an interest in dividend-paying stocks need to distinguish between those that offer higher yields and those that offer high quality, advisers say.

Dividend-paying stocks have grown so popular that their prices have been driven to rich levels by investors hungry for income in this period of very low interest rates.

But should rates rise and investors decide they can get more yield from Treasurys or other high-quality bonds without equity risk, dividend investors could be left exposed, financial advisers warn.

"You could almost end up with a sector-focused fund if you're just looking for dividend-focused funds or exchange-traded funds--one heavily weighted to utilities or tobacco stocks--and they could end up being much more sensitive to interest-rate changes than you think," says Stephen Biggs, partner at HC Financial Advisors in Lafayette, Calif.

Dan Culloton, associate director of active funds research at Morningstar Inc., says yields in general aren't really that generous--which could compel managers and investors to chase yield regardless of quality. Especially now, he says, investors should focus on funds that are buying only stocks of well-run companies.
"They may not have the highest yield out there," he says, "but they might offer a little bit more downside protection if we get a more sustained correction or a bear market."

Investors shouldn't assume that dividend-paying stocks will protect their portfolios in the next bear market just because they provided good protection in 2008, Mr. Culloton says. Valuations matter, and "they don't provide the valuation cushion they used to," he says.

Shannon Zimmerman, associate director of mutual fund analysis for Morningstar, says investors who are substituting dividend-paying stocks for bonds should remember that they can lose everything in stocks.

Mr. Biggs, whose firm manages $250 million, says he has invested in Vanguard Dividend Growth Fund for years for both its low fees and focus on high-quality companies that can sustain their dividends. As of

March 7, the fund offered a standardized 30-day yield of 1.98%, according to Morningstar. He also invests in the Vanguard Equity Income Fund, which focuses on higher-yielding companies. As of March 7, it offered a standardized 30-day yield of 2.73%.

Vanguard Dividend Growth is one of Morningstar's favorite dividend-focused funds, partly because with just 60 holdings, it tends to be more focused than some index funds, says Mr. Culloton: "It's a little bit more of a best ideas portfolio."

The fund's manager, Donald Kilbride, has done a good job of finding quality companies with sustainable dividends and dividend growth, Mr. Culloton says. In addition, the fund leads almost all dividend-focused equity funds with more than 60% of its assets held in wide-moat stocks--or companies that can defend their profits from competitors, he notes.

The fund has gained 8.6% in the five years through March 7 while its large-blend peers have risen about 6.7%, according to Morningstar.

The Vanguard Equity Income Fund's portfolio manager, W. Michael Reckmeyer III, buys stocks with higher-than-market yields, but he won't pay up for yield, says Mr. Culloton. The fund has gained nearly 8.2% over 10 years through March 7, while its large-value peers have risen about 6.6%, Morningstar says.

Brian Goodstadt, an investment adviser with Paragon Capital Management in Denver, also believes that investing in higher-quality dividend-payers is a relatively safer way to invest in stocks with less downside risk, particularly in an environment of lofty stock-market valuations. One of his clients' larger core holdings is Vanguard Dividend Appreciation ETF, which tends to hold high-quality, blue-chip, multinational companies that have consistently paid dividends over many years.

The ETF may account for about 20% of a clients' stock portfolio, depending on his risk profile, says Mr. Goodstadt, whose firm manages $700 million.

"We wanted some stability in our portfolio and it's made up of companies that have increased their dividends every year for 10 years in a row," he says. "Especially in a low-interest-rate world, we think getting consistent and stable growth is very important to a portfolio."

Another plus is the fund's 0.10% expense ratio. Fees will be important in the relatively low-return environment Mr. Goodstadt expects during the next few years. The ETF has gained 22.2% in the five years through March 7 while its large-blend peers are up about 24% on average, according to Morningstar.

Other dividend-focused funds that score high on portfolio quality with Morningstar are Amana Income and T. Rowe Price Dividend Growth, according to Morningstar. Because Amana Income invests according to

Islamic principles, it avoids companies with a lot of debt, Mr. Culloton points out: "That's a good shorthand for quality."

The fund has gained 10.9% in the 10 years through March 7, while its large-blend peers have gained about 6.7%, according to the investment-research firm.

As for T. Rowe Price Dividend Growth, while it focuses on dividend-paying stocks of companies that can sustain their payouts, it has also owned non-dividend payers, Mr. Culloton says. As a diversified portfolio, it tends to fare well in a variety of market conditions, he says. The large-blend fund has gained 7.6% in the 10 years through March 7, Morningstar says.

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