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The risky but necessary bet on dividends for income

Advisers should not forget overall portfolio construction objectives when chasing dividend yields

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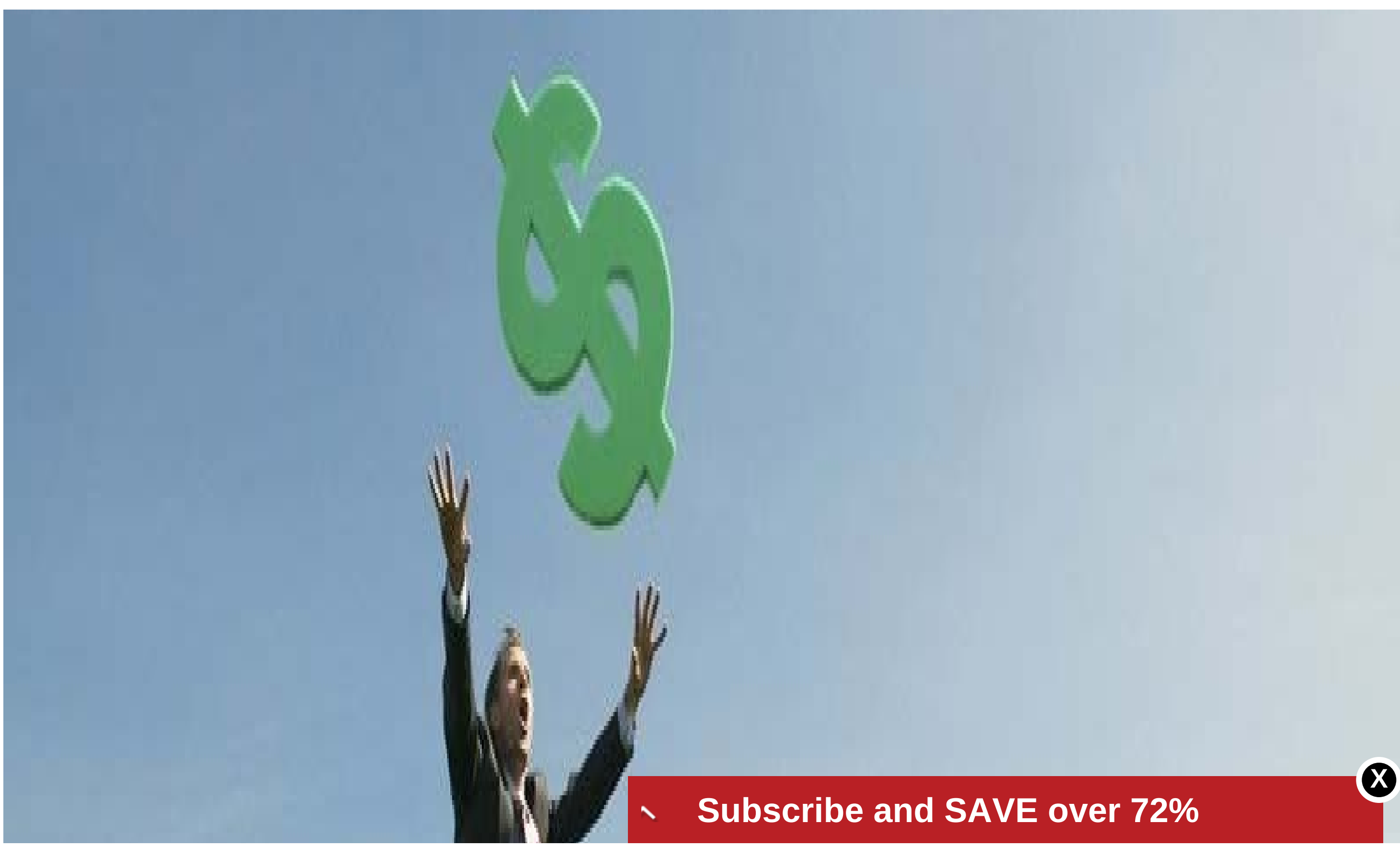
By **Jeff Benjamin**

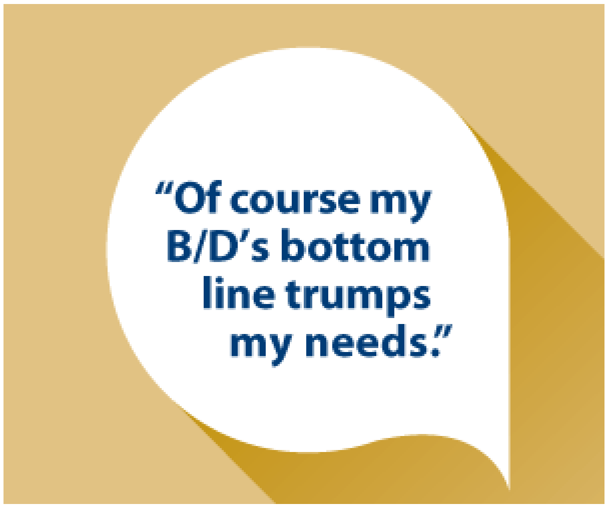


Dividend-yielding stocks have been praised as a replacement for bond income ever since the Fed started standing with both feet on interest rates, but that doesn't make the strategy an automatic home run for every client.

When it comes to portfolio construction, all income is not the same. Shifting from bonds to stocks might look like a shrewd income play, but it is replacing one kind of risk with another.

“This desperate hunt for yield that we're seeing is an extraordinarily unique environment,” said Doug Cote, chief market strategist at Voya Financial.

The **outperformance this year by value stocks** illustrates that desperate hunt. And whether advisers are chasing value over growth stocks for the perceived added bonus of income or shifting from bonds to dividend stocks for the yield, Mr.



Cote believes it is a risky line to walk.

"In this historically low-yield environment, investors are bidding up value stocks, and I think that could be a mistake because they're trading off current income for future income," he said. "Dividends come from earnings, but by focusing so much on the current income from dividend stocks you're missing out on future growth from companies that are going to be growing a lot faster."

In other words, loading up on slower-growing but **higher-yielding dividend strategies** might be juicing up your clients' income needs while also hampering their chances of benefitting from the growth that is expected from the equity side.

"I call it the folly of gaming diversification, which is creating ineffective portfolios by using equities for current income," Mr. Cote said. "The equity part of your portfolio should be focused on growth and the bond part should be focused on income."

FINANCIAL VOODOO

Kashif Ahmed, president of American Private Wealth, admits he is among those advisers migrating toward dividend stocks in a pursuit of better income strategies.

"In this environment, dividend stocks are a worthy alternative to bonds," he said. "However, you need to recognize that not all dividends are created equal, and there is a lot of financial voodoo going on at some companies that are trying to manufacture a dividend."

Mr. Ahmed holds his ground on loading income-seeking clients up with equity-market risk by pointing out that bonds might be in the same kind of bubble as stocks right now.

"Most people think bonds are safe and stocks are dangerous, but bonds have an inverse relationship with rates and rates have nowhere to go but up," he said. "If the Fed ever gets its act together and starts to raise rates, your bond holdings will lose value."

This is the kind of thing that keeps the actuaries at insurance companies and **pension funds up at night as they wrestle with** different ways to meet those pesky obligations.

"There is a scarcity of yield in the market right now, and you are seeing a steady drumbeat of pension fund shortfalls because of it," said Jim Russell, principal and portfolio manager at Bahl & Gaynor.

"The equity market risk profile and fixed-income market risk profile are different from each other and absolutely need to be considered, but until fixed-income yields get more attractive, some clients will want to replace bonds with dividend-paying stocks," he said. "If you own a bond or bond fund there is quite a bit of duration risk. And we think short term, short duration is probably the way to go for a safer experience for most fixed-income investors next the five to 10 years."

SHIFTING LANDSCAPE

In essence, if you can't beat 'em, join 'em. And with the 10-year Treasury bond yielding a lackluster 1.5%, it's pretty clear you can't beat 'em.

So, if you're going to trek down this path of dividend income for the sake of income, it's important to keep up to speed on the shifting nature of the landscape.

This is where chasing yield starts to become more like art than science, but still a lot of science.

"It is a very crowded trade to keep chasing the higher-yielding names and sectors," Mr. Russell said. "We prefer to pursue slightly higher dividend yields with a focus on patterns of consistent dividend growth. That's the gift that keeps on giving."

Across the portfolio, Mr. Russell said his target is a dividend yield of between 6% and 8%, which compares favorably to a 2% rate of inflation.

Mr. Russell's pursuit of dividend growers, as opposed to just the highest yielding stocks, has drawn him toward technology and financials, and away from some of the more richly valued sectors like telecommunications, utilities and consumer staples.

A clean and relatively simple way to allocate to dividend growers could be through a handful of exchange-traded funds.

The SPDR S&P Dividend (SPY), Vanguard Dividend Appreciation (VIG), ProShares S&P Dividend Aristocrats (NOBL) and WisdomTree US Quality Dividend Growth (DGRW) each provide exposure to companies that have met certain criteria for patterns of dividend growth.

The key is to resist the temptation to chase yield, keeping in mind that, like a bond, the yield is higher for a reason.

“The same way a bond investor seeing a 7% or 8% yield should be asking questions about whether payments can be made, if your yield is too high, either the dividend is at risk or the stock price has just fallen,” said Todd Rosenbluth, director of mutual fund and ETF research at S&P Global Market Intelligence.