Sure Dividend

HIGH QUALITY DIVIDEND STOCKS, LONG-TERM PLAN

3,000+ Word How-To
Dividend Growth Investing Guide

By Ben Reynolds

Dividend growth investing is the process of identifying, purchasing, and benefiting from businesses that increase their dividend payments year after year. Dividend growth investing focuses on *producing income streams* from your investments that grow over time. Increasing your passive income stream year after year is an excellent way to generate long term wealth.

When you purchase a stock, you are buying a small percentage of ownership in a business. Publicly traded businesses produce returns for investors in two ways:

1. They can pay their profits out to shareholders in the form of dividends. This means when the company you invested in makes money, you do as well.

2. Alternatively, publicly traded businesses can reinvest the money they make back into the business in hopes that it will grow quicker and create capital gains.

When a business grows, its stock price increases. This money is not paid out to shareholders. You must sell some or all of your holdings to realize capital gains.

Dividend growth investing looks for publicly traded businesses to invest in that take a portion of their profits and pay them out to shareholders, while reinvesting the rest in order to grow the business. In this way, dividend growth businesses can pay *rising dividends year after year*. If you like the idea of a passive income stream that increases yearly then you will benefit from learning how to implement and execute your dividend growth portfolio.

Why Dividend Stocks Outperform

It may come as no surprise to you that dividend paying stocks have historically outperformed stocks that do not pay dividends.

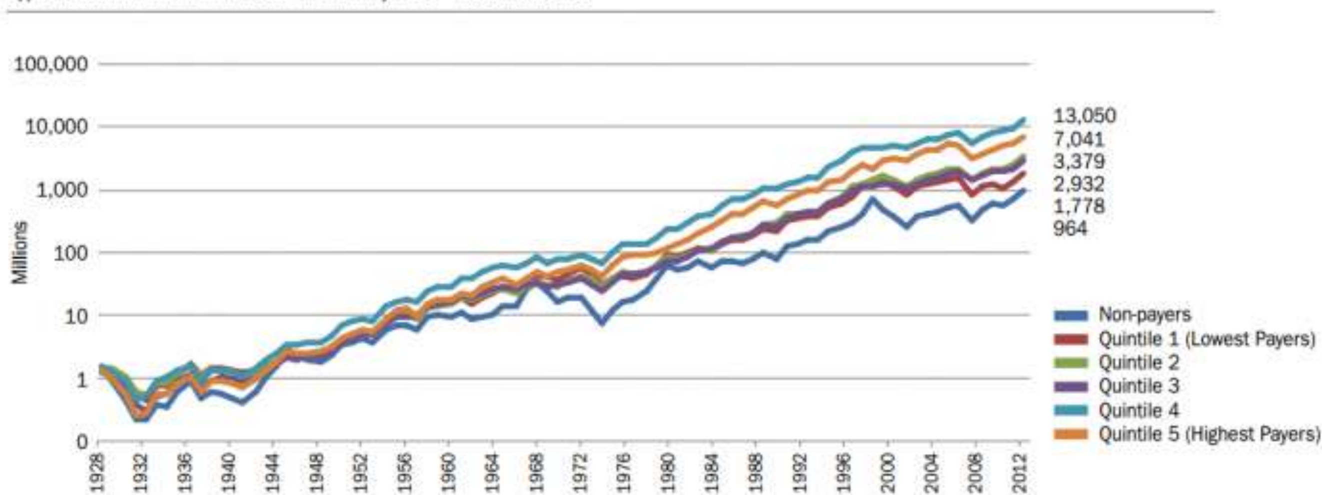


Table 1	Non-Payers	Quintile 1	Quintile 2	Quintile 3	Quintile 4	Quintile 5
Average Annual Total Return	8.32%	9.09%	9.91%	9.73%	11.65%	10.85%
Annualized Standard Deviation	33.78	23.03	19.51	20.79	21.42	24.26
Sharpe Ratio	0.14	0.24	0.32	0.30	0.38	0.30

Source: Kenneth R. French© and CRSP, 1/1/1928 - 12/31/2013

Source: [Dividends: A Review of Historical Returns by Heartland Funds]

The extent to which dividend paying stocks have outperformed non dividend paying stocks over a several decade period shows that dividend stocks have historically made better investments than stocks that don't pay dividends. There are several reasons for dividend stocks outperforming non-dividend paying stocks.

Reason 1: Stable Cash Flows

If a company pays a dividend it must have, or expect to have in the very near future, consistent cash flows. Businesses that don't pay dividends may not have the ability to consistently return money to shareholders. By investing only in dividend stocks you are investing only in businesses that are profitable or expect to be soon and can therefore return money to shareholders.

Reason 2: Forced Capital Allocation Enhancement

Dividend stocks also outperform non dividend paying stocks because it forces the management of a business to focus on the highest returning growth projects it has while excluding mediocre projects. The idea that giving management less cash to work with may seem paridoxical at first, but the example below shows why.

Example

Imagine there are two businesses that sell hamburgers. Each business is identical in every way, except that one pays out 60% of its profits to shareholders, while the other reinvests all its earnings into growth projects. Each business generates $1 million in profits. Both businesses have limited investment opportunities. They can invest $400,000 into a robotic hamburger flipper which is expected to yield a 20% return on investment. Any money beyond the $400,000 robotic hamburger flipper can be put into incrementally building out the store which is expected to provide a 3% return on investment.

The business that distributes money to shareholders would invest only in the 20% growth project and pay its remaining money out to shareholders in the form of a dividend. If you could reinvest the dividend at more than 3% a year, you would be better off owning the dividend paying company. Alternatively, you could use the dividend to buy *more shares* in the company that pays a dividend, as its management has shown excellent capital allocation skills.

The business that does not pay a dividend will invest its profits first into the 20% expected return robotic hamburger flipper, and then the remaining proceeds into building out the store which is expected to return 3% a year.

This hypothetical example shows that businesses that pay dividends must be more selective about which investment opportunities they take. Businesses that pay dividends can be more efficient with their capital allocation as they have less cash to invest in low growth ideas.

Reason 3: No Gambling On The Future

Dividends give you *current income*. Businesses that invest exclusively in growth may never reward you as they are betting on the future. Dividend payments are real cash flows now versus potential capital gains later. As Aesop said over 2,500 years ago:

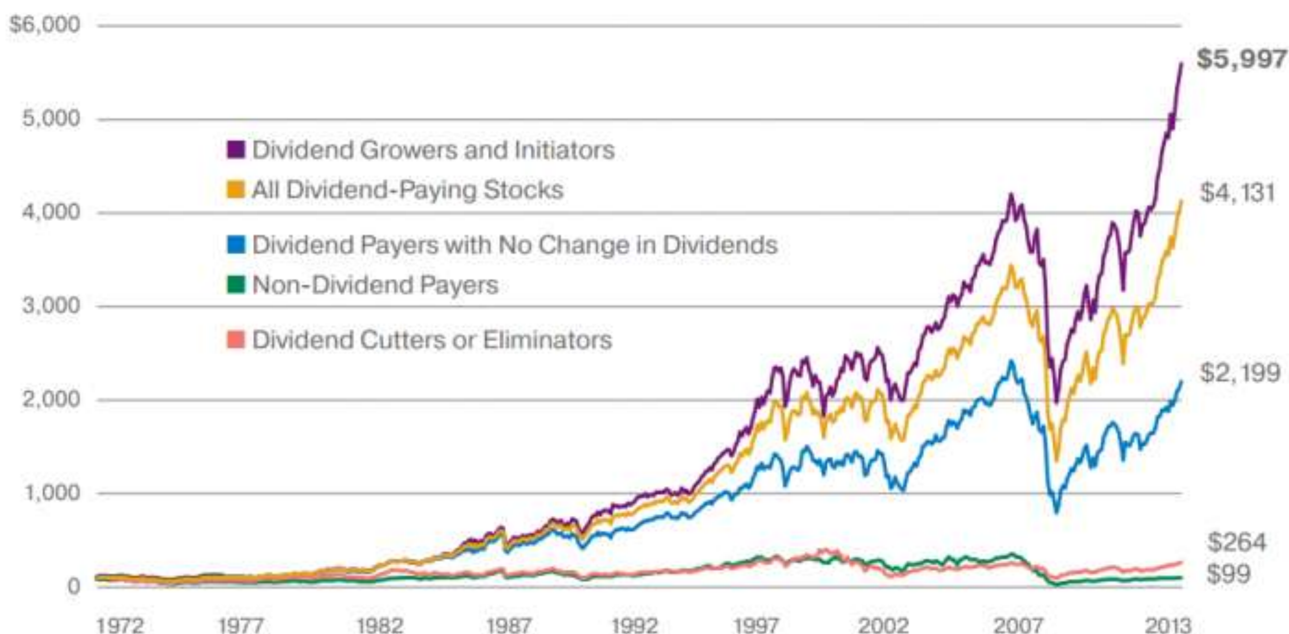
"A Bird In The Hand Is Worth Two In The Bush"

- Aesop, ancient Greek slave renowned for his fables

Dividend stocks in general have an excellent track record of success. Their outperformance makes intuitive sense. Dividend stocks that pay growing dividends have historically done even better than stocks that do not pay rising dividends.

Why Dividend *Growth* Stocks Outperform

Dividend stocks have historically outperformed the market. Dividend stocks that pay growing dividends have significantly outperformed dividends stocks over a long period.



Source: Rising Dividends Fund, Oppenheimer, page 4

Dividend growth stocks outperform dividend stocks because they tend to possess a strong competitive advantage. Businesses that are able to raise their dividend payments year after year must be able to consistently grow their earnings. For a business to experience a long period of consistent growth it needs a strong, durable competitive advantage.

Competitive Advantages

There are many types of durable competitive advantages, one of which is a competitive advantage derived from excellent branding. Coca-Cola and PepsiCo are examples of businesses who can sell their product at a premium due to the competitive advantage they have garnered from their strong brand names.

"We like a business with enduring competitive advantages that is run by able and owner-oriented people. When these attributes exist, and when we can make purchases at sensible prices, it is hard to go wrong."

- Warren Buffett, 3rd wealthiest person in the world

Another type of durable competitive advantage arises from businesses that grow stronger as they get larger. These are businesses that experience positive economies of scale. Wal-Mart is an example of a business that enhances its scale advantage the larger it becomes. As the company grows, it can better pressure suppliers and pass the price savings on to its customers which in turn creates more customers allowing Wal-Mart to put more pressure on supplier prices.

Strong network effects are another type of competitive advantage. A business that grows stronger as more people join the network has a lasting competitive advantage. Examples of businesses that exhibit the network effect are Facebook and eBay.

Businesses can gain a lasting advantage over their competitors through legal means as well. Businesses that own patents on a particular product or pharmaceutical drug can produce it without competition for around 20 years. Businesses with a strong research, development, and patenting operation are able to continually release innovative new products that they can sell without competition while their patent remains. Many healthcare businesses operate in this manner, such as Johnson & Johnson and Abbott Laboratories.

The government can create artificial competitive advantages for businesses as well by modifying the competitive landscape in an industry. An example of this is the government auctions of various spectrums in the wireless telecommunications industry. Businesses that act in highly regulated environments and have a more favorable relationship with the government than their peers have a competitive advantage. Examples of these types of businesses are large telecommunications companies like AT&T and Verizon.

Shareholder Focus

Businesses that increase their dividend year after year are focused on shareholder return rather than only growing the business. If a company is paying out dividends instead of reinvesting profits to grow the company larger it is a sign that the company has shareholder interests at heart rather than growing a larger corporate empire. Of course, dividend paying businesses can abuse shareholders, but they are, on average more focused on shareholders.

Dividend Growth Stock Examples

Perhaps the greatest argument for dividend growth investing is not its excellent historical record or how it makes sense conceptually. Simply put, the world's richest investor *is a dividend growth investor*. Warren Buffett has historically been known as a value investor, but one glance at his portfolio will show you he is interested in high quality businesses that pay increasing dividends year after year.

All of Warren Buffett's Top 7 stocks pay increasing dividends. In addition, four of his top seven stocks are Dividend Aristocrats; stocks that have paid increasing dividends for 25+ consecutive years without a reduction. Warren Buffett's four dividend aristocrat stocks are shown below, along with how many consecutive years they have increased their respective dividends.

- Wal-Mart – 41 consecutive years of dividend increases
- Procter & Gamble – 58 consecutive years of dividend increases
- ExxonMobil – 32 years of consecutive dividend increases
- Coca-Cola – 51 years of consecutive dividend increases

Sure Dividend created The 8 Rules of Dividend investing to find high quality dividend growth stocks with a long history of dividend increases that are suitable for long-term investing. Each of the 8 Rules of Dividend Investing has been historically shown to increase returns and/or reduce portfolio volatility. The 8 Rules of Dividend Investing aim to find high quality businesses trading at fair or better prices that are suitable for long-term investing. The idea is to create a low risk portfolio that pays you rising dividend income year after year.

Sure Dividend has discovered 132 businesses with 25+ years of dividend payments without a reduction. Of Warren Buffett's dividend growth portfolio, Wal-Mart, Coca-Cola, and ExxonMobil are in the Top 10 based on The 8 Rules of Dividend Investing. Procter & Gamble is in the Top 25. You can learn more about the Sure Dividend system by reviewing our old newsletters before you subscribe to receive current updates.

How To Build Your Dividend Growth Stock Portfolio

As you may already know, you cannot walk up to your local supermarket and purchase stocks. There are two ways to purchase stocks that make sense; through an online discount broker (easiest), or through a direct purchase plan (cheapest and safest).

Online Discount Brokers
The internet has revolutionized the way stocks are traded. Online discount brokerages allow investors to buy or sell stocks for under $10 a trade. This revolution has made it feasible for individual investors to build positions in single stocks without paying exorbitant fees. Not all discount brokerages are created equally. There are several different solid options available. An ideal discount brokerage will have a solid reputation, a long history of success, excellent customer service, and low fees. The list below shows several discount brokerages that are worthy of your consideration.

- Charles Schwab
- Fidelity
- Scotts Trade
- E Trade
- Interactive Brokers
- Trade King

Direct Stock Purchase Plans
Direct stock purchase plans allow an investor to purchase stock in a business directly from the business. You hold the stock *in your name*, not the street name of your brokerage. If something catastrophic where to happen to a discount broker and your funds were above the SIPC protection limit (which is $250,000) then you could lose all your investments.

Direct stock purchase plans have no counterparty risk. It is simply your money, invested in a corporation *by that corporation*. Not all publicly traded companies offer direct purchase plans, but many do. Direct purchase plans are not homogenous. Some charge set up fees and transaction fees, while others are completely free. Some direct purchase plans allow you to*automatically reinvest your dividends* back into the company, building large positions in dividend paying stocks over time.

You can find whether or not a business has direct stock purchase plan by visiting the company's investor relations. If the company has a direct stock purchase plan, minimum purchase amounts and fees (if applicable) will be provided by investor

relations. The company's investor relations will also have information regarding whether or not the company has a dividend reinvestment plan as well.

How Much to Buy of Each Stock

It would be very unwise to invest all your money into your favorite dividend growth stock. If the company suffers a business down turn or goes bankrupt, your savings will be wiped out. Owning a diversified portfolio of high quality dividend growth stocks limits your risk to any one investment. At the same time, you do not want to spread your investments over so many positions that the quality of your portfolio is diluted. The 8th and final rule of the 8 Rules of Dividend investing discusses the optimal amount of diversification. You can garner the bulk of diversification benefits from about 12 to 18 positions. A portfolio constructed of around 20 of the highest quality dividend growth stocks will be reasonably diversified against business failure from any one business.

When To Purchase

The market crash of 2009 saw a market decline of nearly 50%; almost half the value of the stock market was destroyed in a two year period. Purchasing all your holdings at the very top of a bull market can negatively impact your returns for years (or even decades). Alternatively, purchasing stocks in March of 2009 would have given you massive gains as the market has been on a strong 5 year rally since that time. Hindsight is always 20/20.

Timing the market is virtually impossible. If you wait for markets to crash, you could put off investing for 5 or 10 years and miss the chance to participate in strong gains. Alternatively, if you put all your money in at one time, you run the chance of seeing an immediate decline in wealth and missing the chance to buy businesses at a low price in the resulting crash. So what is an investor to do? It all depends on where you are in life.

For Investors in the Accumulation Phase

If you are still in the accumulation phase and are adding to your savings every month, then ***buy the highest ranked stock of which you own the least each month.*** Sure Dividend ranks 132 businesses with 25+ years of dividend payments without a reduction using the 8 Rules of Dividend Investing, which greatly simplifies the process of knowing which businesses to invest in each month. Alternatively, you could follow a 'Dogs of the Dividend Aristocrats' strategy, where you invest in one of the Top 10 highest yielding Dividend Aristocrats (whichever one you own least) each month. Over time, you will build a diversified portfolio of high quality businesses trading at fair or better prices. As an example, consider the Top 10 stocks based on The 8 Rules of Dividend Investing (from May 2014, not current) below:

1. Wal-Mart
2. PepsiCo
3. Coca-Cola
4. McDonald's
5. Chubb
6. ExxonMobil
7. Kimberley-Clark
8. Genuine Parts Company
9. 3M
10. AFLAC

If you didn't own any of these companies, you would buy Wal-Mart on your first month of investing with the amount you save each month. It should be noted that you should not pay more than 1% in transaction cost when you purchase a stock. If your discount broker charged $7 a trade, you would want to invest $700 or more each time you buy a stock as an example. Now consider you have been investing for several years and hold the following dollar amounts of the Top 10 stocks:

1.	Wal-Mart	$8,000
2.	PepsiCo	$7,000
3.	Coca-Cola	**$3,000**
4.	McDonald's	$9,000
5.	Chubb	$6,500
6.	ExxonMobil	$8,200
7.	Kimberley-Clark	$7,900
8.	Genuine Parts Company	$6,000
9.	3M	**$3,000**
10.	AFLAC	$5,600

Notice that you own Coca-Cola and 3M the least. In this example, you would purchase Coca-Cola next because it is the highest ranked stock of which you own the least.

<u>For Investors in Retirement</u>
If you are past the accumulation phase of investing and are now enjoying retirement (congratulations!), then you will naturally build your portfolio in a different manner than someone who is in the accumulation phase of investing. You will want to dollar cost average your purchases over a period of several months. I believe a 20 month period is sufficient to reap gains from fluctuations in market price while building your portfolio.

Divide the amount of your portfolio you are allocating into dividend growth stocks into 20 equal dollar amounts. Each month, purchase the highest ranked stock of which you

own the least. You can follow the Sure Dividend system which looks for high quality businesses, or a 'Dogs of the Dividend Aristocrats' strategy (or any other dividend growth strategy for that matter). The idea is to purchase the highest ranked stock of which you own the least each month so you build a diversified portfolio of high quality dividend stocks over time. Each stock is purchased at a time when it is relatively more attractive than other investment options available to you if you buy the highest ranked stock of which you own the least. Please see the example in the 'Accumulation Phase' section just above this section for a case example of how to purchase the highest ranked stock of which you own the least.

There is an alternative to equal weighting your positions. You can weight your positions based on *their correlation to other assets and their relative merit*. The Sure Dividend 20 stock model portfolio does just this. The portfolio is built with high quality dividend growth stocks that are weighted to provide more exposure to the best investment options available while simultaneously minimizing risk by maximizing correlation gains. This type of portfolio *is not equal weighted by position*. Instead of purchasing an equal dollar amount of stock each month, purchase the highest ranked position you don't own each month. Purchase a dollar amount equal to the percentage specified. An example of how much to purchase, and at what time to purchase, with a $1,000,000 portfolio is below. The positions and weights are taken from July's model portfolio *and are not current*:

Company	Target Weight	Month	Cash Amount
Abbott Laboratories	9%	1	$ 90,000
Wal-Mart	8%	2	$ 80,000
General Mills	8%	3	$ 80,000
Hormel	8%	4	$ 80,000
McDonald's	7%	5	$ 70,000
PepsiCo	7%	6	$ 70,000
CR Bard	7%	7	$ 70,000
J.M. Smucker's	7%	8	$ 70,000
Clorox	5%	9	$ 50,000
Coca-Cola	5%	10	$ 50,000
Becton, Dickinson	5%	11	$ 50,000
ExxonMobil	4%	12	$ 40,000
Philip Morris	3%	13	$ 30,000
Kimberley-Clark	3%	14	$ 30,000
Chubb	3%	15	$ 30,000
W.W. Grainger	3%	16	$ 30,000
McCormick & Co.	3%	17	$ 30,000
AT&T	2%	18	$ 20,000
EcoLab	2%	19	$ 20,000
3M	1%	20	$ 10,000

Final Thoughts

Dividend growth investing has proven to be a successful way to build wealth over time as evidenced by the research in this guide. Dividend growth investing puts the focus on *income/dividends* rather than *share price fluctuations*. This gives dividend growth investors a psychological advantage as they view market downturns as *opportunities to buy high quality businesses for higher yields*, rather than times of panic because stock prices are declining.

Additionally, dividend growth investing minimizes capital gains taxes and frictional costs such as brokerage fees caused by trading. This is because a dividend growth investor generally does not sell their holdings unless the business is deteriorating and the dividend payments are in danger.

"My favorite holding period is forever"
- Warren Buffett

The key ingredients for success as a dividend growth investor are discipline in your strategy, confidence in your decisions, and the patience to let high quality businesses compound your wealth over time. With these strengths, you will very likely see strong returns with very little risk of long term losses.

"Investing is most intelligent when it is most businesslike"
- Benjamin Graham, value investing pioneer

Bonus: Dividend Growth Investing Resources

Dividend Growth Investing Blogs

- Roadmap 2 Retire
- Dividend Mantra
- Dividend Growth machine
- Dividend Growth Investor
- The Financial Blogger
- Old School Value (this is a value site, but also an excellent resource)

Dividend Growth Investing Resources

- Seeking Alpha (many great articles on dividend growth companies)
- DRIP Investing Resource Center (check out David Fish's *excellent* spreadsheets)
- Finviz (powerful free stock screener)

If you have any questions at all, please contact me at ben@suredividend.com