NEW EDITION

TOP 30 DIVIDEND GROWTH STOCKS FOR 2021

A SENSIBLE GUIDE TO DIVIDEND GROWTH INVESTING

David Van Knapp

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TABLE OF CONTENTS

CHAPTER	CONTENTS	PAGE
1	Introduction	4
2	How and Why Dividend Growth Investing Works	7
3	The "Big Five" Definitions	16
4	17 Reasons That I Like Dividend Growth Investing	32
5	Drawbacks and Oddities of Dividend Growth Investing	59
6	Selecting Stocks – Overview	81
7	Selecting Companies: Dividends	89
8	Selecting Companies: Quality	101
9	Selecting Companies: Financials	107
10	Valuing Stocks	126
11	Selecting Stocks – Review and Summary	146
12	Planning Your Investment Journey	150
13	Getting Started – Portfolio Construction	173
14	Managing Your Portfolio and Yourself	184
15	Top 30 Dividend Growth Stocks for 2021	205
16	Real-Life Investing: My Dividend Growth Portfolio	434
17	Guide to Further Reading	452
18	Glossary	458
19	Disclaimer, Disclosures, and Acknowledgements	488

CHAPTER 1

INTRODUCTION

Welcome to my eighth e-book on dividend growth investing. The first seven were published annually between 2008-2014. Then I took seven years off. It's good to be back.

I prepared this e-book not only to convey timeless investment information, but also to focus on the special circumstances of the times we live in. It contains two categories of information:

- **Top 30 dividend growth stocks.** This is a curated list prepared especially for this e-book. You will find analyses of 30 top dividend growth stocks. I will explain clearly how and why each stock was selected. Each stock is analyzed in detail.

- **Sensible investment guide.** This is as important as the Top 30. In these chapters we discuss what dividend growth investing is, how it works, whether it's right for you, and how to do it.

The principal goal of dividend growth investing is simple: To build a stream of dividends from stocks that is:

- sufficient,
- reliable, and
- rising.

Each of the three characteristics is important.

- **Sufficient:** You want your income stream to be enough to meet your needs.

- **Reliable:** You want your income to be consistently coming your way. You do not want to spend sleepless nights worrying about it.

- **Rising:** You want your income to rise consistently, not only to overcome the effects of inflation, but also to allow you to gradually raise your standard of living (if you choose to do so).

The dividend growth (DG) strategy is a proven way to generate income that grows faster than inflation. Once you reach the point that you can live on that income (when added to other income such as a pension or Social Security), you can consider yourself financially independent.

Living off income alone is attractive to many people. The main reason is that if you live off your income, you won't need to sell your assets for spending money, so your assets will never run out.

The DG strategy takes full advantage of compounding, which is one of the surprisingly powerful forces in the universe. Compounding lets you build wealth and income faster.

During your pre-retirement career, while you are in your so-called "accumulation" phase of life, you don't need to spend the income that your assets are generating. That lets you add a layer of compounding to the first layer that is happening naturally as companies increase their dividends.

The additional compounding that you add during your accumulation years results from reinvesting the dividends as they come in. You can do that, because you don't need to spend them. The reinvestments result in a second layer of compounding through which you add more shares to your growing collection.

The two layers of compounding reinforce each other: You own shares with rising dividends, and you accumulate more shares by reinvesting the dividends. The combination is very powerful. You can realistically generate double-digit income growth every year.

Even after you retire and begin *spending* the dividends rather than *reinvesting* them, you still have the first layer of compounding working for you. Those annual dividend increases from the companies you own will help you beat inflation during retirement.

Dividend growth investing is not a get-rich-quick scheme. It is a relentless, methodical, long-term process. But it is a time-tested investment strategy that can produce large rewards, including sufficient income to live off once you are no longer working and receiving a paycheck.

People require income — personal cash inflows — to pay for the necessities and luxuries of life. Capital tied up in stocks (or any investment) must be converted to cash to be of any use. The unique thing about dividend growth stocks is that they provide cash flow organically. Therefore, you don't need to sell the stocks to receive some cash.

There are three phases to executing the dividend growth strategy.

- Phase one is to identify the best dividend growth companies.
- Phase two is to obtain shares at good prices.
- The final phase is portfolio management.

This book will discuss all three phases of successful DG investing. Let's get started by examining the underlying realities and conceptual foundations for DG investing.

CHAPTER 2

HOW AND WHY DIVIDEND GROWTH INVESTING WORKS

Dividend growth (DG) investing is a strategy and methodology for profiting in the stock market. The purpose of this chapter is to explain the fundamental concepts upon which it is built.

This chapter assumes that you know the basic mechanics about stock investing, such as what a share of stock *is.* The focus here is on the *dividend growth* aspects of stock ownership.

This chapter is just an overview. Most of the concepts here will be expanded upon later in the book.

What is Dividend Growth Investing?

Dividend growth investing is a business model by which to run your personal investing. It focuses primarily upon receiving income from your stocks rather than on stock prices.

The DG strategy is to accumulate dividend-growth stocks that provide reliable rising cash from dividends. During your accumulation years, you reinvest the dividends to speed up the accumulation process.

When you retire, you can stop reinvesting the dividends and simply use them as personal income. The dividend income replaces your paycheck. Depending on your total income (from dividends, a pension, Social Security, etc.), you may not have to sell any of your stock shares to have sufficient retirement income. Or you may sell shares only for special reasons, such as a nice vacation each year.

Studies show that in most years, the rising dividends grow faster than inflation. That means that your income will not decline in purchasing power – even over decades – as a result of inflation. As the cost of living rises, so will your income. In fact, it is likely that your income growth will outpace inflation, allowing you to increase your standard of living during retirement.

Some investors and advisors dismiss DG investing as a pipe dream or magical thinking by people looking for a free lunch. But dividend growth investing is very real.

DG investing is a rational strategy for accumulating assets that, in retirement, will — without selling — generate income that is sufficient, reliable, and grows faster than inflation. It is a clear-eyed, data-driven approach to investing.

What Are Dividends?

Dividends are distributions of cash by a corporation to its owners. Dividends come out of each company's excess cash.

Dividends are a way for a company to distribute some of its returns to shareholders without forcing them to sell shares in the market. Dividends are declared when management determines that it does not need to retain all of its cash to fund capital and operational projects.

I will present a more complete description of dividends in the next chapter, but for the purposes of this overview chapter, just remember that dividends are cash that the company sends to its shareholders.

How Stocks Deliver Returns

There are two — and only two — ways that stocks deliver returns to shareholders. The historical (decades-long) average 9-11% annual total return from stocks consists of these two elements: price changes and dividends.

1. Price changes

In the stock market, prices change constantly. Prices go both up and down, so the price component of total return can be either positive or negative over a particular time frame.

The long-term market trend has been up since the Great Depression. Over shorter periods, of course, there have been stretches where overall market prices went down or stayed flat.

2. Dividends

The second component of stock returns is dividends. Dividends are cash distributions paid directly to shareholders by corporations. The market plays no role in the dividend component of total return.

While price return can be positive or negative, the return from dividends is always zero to positive, as dividends cannot drop below zero.

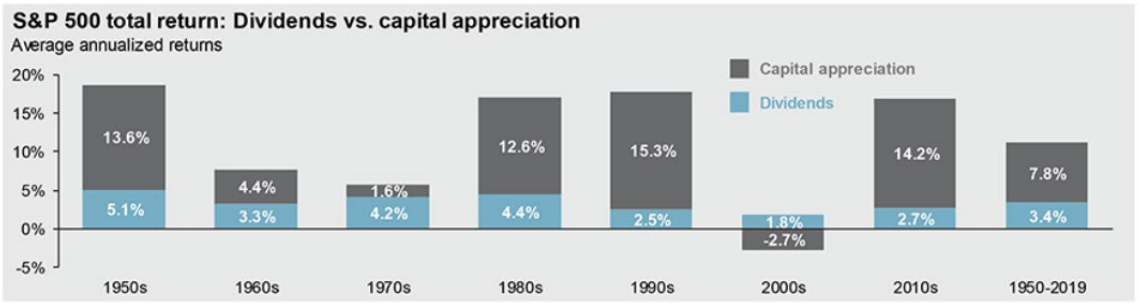
3. Total return

The total return from a share of stock over any time is the sum of the two components just described, leading to this most fundamental of equations:

Price Change + Dividends = Total Return

Total return is normally computed on an annual basis. Since 1950, dividends have contributed about 30% of annual total stock market returns. Price changes contributed the rest.

The following chart shows the contribution of dividends and capital appreciation to total stock-market returns since 1950.



(Source)

The bar on the far right shows total return over the 70-year period. Dividends provided 3.4% return and price changes provided 7.8%. The dividend portion was 30% of the total.

Compounding: When Money Goes Viral

Compounding means earning money on money previously earned. Compounding causes your money to grow at a geometric (or exponential) rate instead of a linear rate. In plain English, the growth line curves upward.

The most common example of compounding is compound interest. That occurs when a certain percentage rate of interest is periodically added to the principal in the account.

Over long periods, compounding creates a rolling snowball effect: As the accumulated total grows, it grows faster each time interest is credited to it. Each year's growth differs from the prior year's not by a constant *amount*, but by a constant *rate*. So as the snowball gets bigger, it gets bigger faster as it rolls down the hill.

Compounding happens in two layers in dividend growth investing.

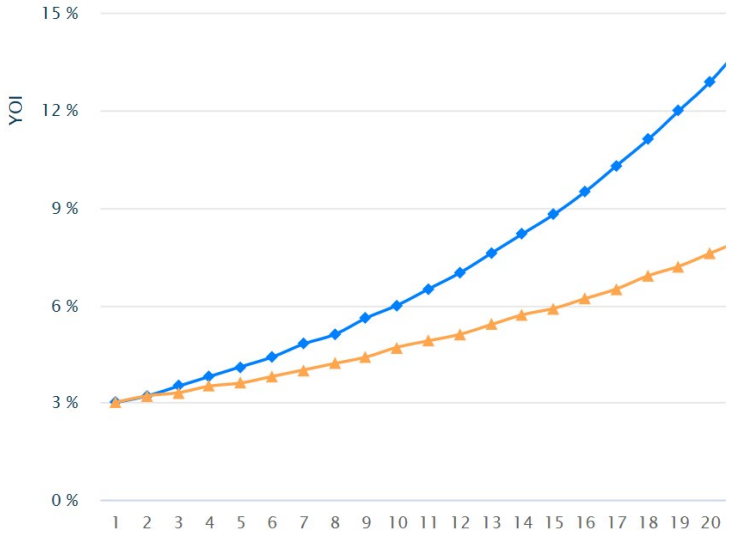
The **first layer** is the growth of the dividend itself. When a company raises its dividend, the increase is added to the former dividend payout, creating a new dividend amount.

Thus, if a company paying a dividend of $1.00 per share increases its dividend 10 percent, the dividend becomes $1.10 per share. Next year, if the company again increases its dividend by 10 percent, that increase is calculated on the expanded base amount ($1.10) rather than the original base ($1.00). The new dividend becomes $1.10 plus 10 percent, or $1.21.

Had the dividend not compounded, you would have two independent increases of 10 percent on the original $1.00, or $1.20. The difference sounds slight, but when repeated over many years, it becomes significant.

The **second layer** of compounding occurs if the investor reinvests the dividends. The reinvested dividends purchase more shares. Those additional shares, added to the snowball, generate their own dividends, so the total dividend payout increases not only from the underlying dividend increases from the stocks already in the portfolio, but also from the new dividends on the new shares.

The impact of reinvestment grows over time as more shares are added each year. To give an example of the power of reinvesting dividends, check out this graph.



I generated the graph using the calculator at Miller/Howard Investments. It illustrates a simple example: A stock that pays a 3% dividend and increases it 5% per year. The blue line shows the resulting income if those dividends are reinvested each year, and the orange line shows the income if the dividends are not reinvested.

After 20 years, the income with dividends reinvested has grown to 12.9% of the original amount, whereas the income without dividends reinvested has grown to 7.6%. Note that those are the payouts *in the single Year 20,* not cumulative amounts over multiple years.

Not only that, you can see the snowball effect: The blue line is curving upward, meaning that it is growing faster each year.

You Don't Have to Sell the Stock to Get the Dividend

No sale of anything is required to receive a dividend. Sometimes you will see statements that receiving a dividend is like selling a share, or that you can create your own dividend by just selling a share or two. These notions are incorrect.

The truth is that dividends are distributed by the company directly to you as a shareholder. No sale of a share is required to receive dividends.

After receiving a dividend, the recipient still owns all of his or her shares, and thus they still retain all of the rights that come with such ownership, *including the right to receive future dividends.* Indeed, if the recipient reinvests the dividends, he or she will own *more* shares at the end of the cycle than before the dividend was issued.

In contrast, if you sell shares to convert your capital into "income," you will *reduce* the number of shares you own, and conceivably you could eventually run out of shares to sell. This self-evident point is often simply missed by some pundits.

Equating the receipt of a dividend to the selling of a share is incorrect and fraught with pitfalls. I urge you not to think that selling shares and receiving dividends are equivalent ways to get money out of your investments. They are not.

Dividend Growth Stocks Are Unique

In his bestseller *Outliers: The Story of Success*, Malcolm Gladwell explained that success in many fields comes from factors that may be unusual in the population at large, but that are quite common among the outliers themselves. For example, the best hitters in baseball tend to have excellent eyesight. That helps them pick up the spin on the ball.

The best dividend growth stocks tend to share certain unique characteristics. In fact, I think of the best DG stocks as truly extraordinary investment opportunities whose achievements fall outside the normal performance of stocks generally.

There are about 15,400 stocks in the Morningstar database. Most of them do not pay a dividend at all; only about 5200, or 34%, pay a dividend. By using dividend payments as a simple screen, we eliminate two-thirds of all stocks.

Of those, about 775 have dividend-growth streaks of 5 years or more (source). That's about 5% of the Morningstar database. If we increase the streak requirement to 25 years, the number of stocks drops to about 140, or less than 1% of stocks.

The point is that dividend-growth stocks are quite uncommon creatures. While many of them are well-known companies, such as Johnson & Johnson or McDonald's, I think that many investors fail to appreciate just how special they are as *investments*. We will explore their special characteristics throughout this book.

The Dividend-Growth Investor's Business Model

I strongly suggest that all investors treat their investing as a business. By that, I mean to approach investing the way corporations approach their activities: With goals, strategies, and plans.

You are the CEO of your investing business. The buck stops with you.

The business model for a dividend-growth operation is that of a conglomerate. Whereas a corporate conglomerate owns entire businesses that fit together in some logical fashion, as an investor you will identify, purchase, and own *parts of* businesses that fit together logically and complement each other.

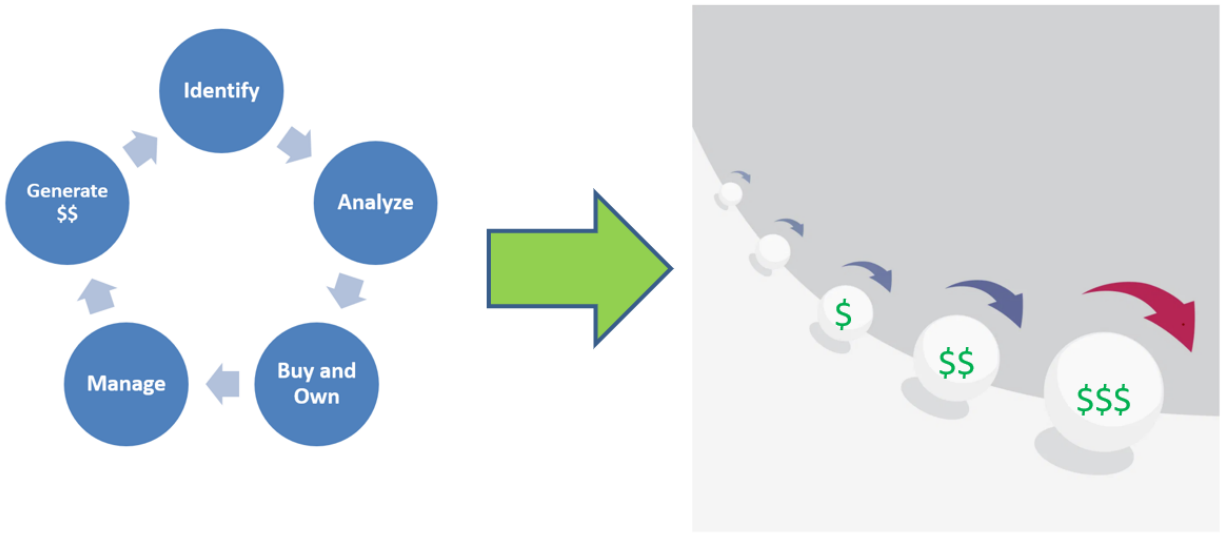
Later in this book, when we are analyzing stocks, we will talk about each company's "Story" that explains the company's business model. The Story tells you what the company does and how it makes money.

As the CEO of your investing operation, you have a Story too. Here is the short version of my DG Story – in other words, how I make money:

> **Identify, accumulate, and manage a portfolio of stocks, of high-quality companies, that reliably send growing amounts of cash to headquarters.**

"Headquarters" is my upstairs office. Here's what happens in practice:

Dividend Growth Investing Business Model



Now, with that foundation established, we're going to move on and begin to get into the details of how to be a DG investor. We start by digging further into five basic concepts.

CHAPTER 3

THE "BIG FIVE" DEFINITIONS

I have found that learning terms of art is a good way to learn a subject. In dividend growth (DG) investing, I believe that a few terms are essential to getting a grasp of the subject.

This chapter is an explanation of what I think are the five most important terms in dividend growth investing. They are a good way to get started in understanding how DG works. Other terms and definitions will be explained as we encounter them in the text, and they can all be found in the Glossary (Chapter 18).

I've arranged the terms here in logical rather than alphabetical order, so that you can build your foundation of understanding naturally by moving from definition to definition.

Here are the Big Five DGI terms:

1. Dividend
2. Yield
3. Compound
4. Compound annual growth rate (CAGR)
5. Dividend reinvestment

Big Five Definition #1: Dividend

We already saw the basic definition of "dividend" in the last chapter: **Dividends are voluntary distributions of cash by a corporation to its shareholders.**

Dividends are proposed by management, approved by the board of directors, publicly declared, and credited to shareholders at a later date. Example: If a company announces a dividend of $1.00 per share, and you own 100 shares, they will send you $100.

Why does a company declare dividends? Dividends come out of corporate profits, more specifically out of the company's cash flow.

Every company must decide what to do with its cash. It has many choices. It can *retain* the money for purposes like these:

- Invest in the company's growth
- Amass a war chest or rainy-day fund for future needs
- Pay down debt
- Fund internal projects to improve efficiency, upgrade systems, or develop new products
- Make capital investments in equipment or buildings
- Acquire other companies

In addition to the above, which essentially all companies do to a greater or lesser extent, the company can *distribute* some of its cash:

- Buy back some of its own shares
- Send dollars directly to shareholders via dividends

Dividends are discretionary

No company has to pay dividends. With a couple exceptions based on tax laws, the payment of dividends (or not) is a corporate choice.

Dividend programs reflect the company's policy and practice on what to do with its profits: Dividends represent a decision to send some profits directly to shareholders *now* versus retaining that money within the company for other purposes.

Companies do not "owe" their investors dividends. Most companies strive to make the best use of their cash for the company's owners. Some botch that task and waste money, while others manage their cash very well. Paying dividends sometimes is the best use of capital from the owners' viewpoint, but sometimes it is not.

When you buy a DG stock, you are putting your trust in management and the board to make good decisions about its cash.

Some companies raise their dividend every year

Some companies are so good at what they do, and so good at managing their finances, that they are able not only to pay a dividend here and there, but to pay dividends every year *and increase them* each year. There are several hundred such companies, and they are the ones that DG investors seek.

We will talk about how to find such stocks later in the book.

Dividends are different from market gains or losses

Investors sometimes confuse dividends with the outcomes of the market. But the latter are the result of share trading, whereas dividends are the result of company decisions.

These two mechanisms are independent from each other, and indeed they often go in opposite directions. It is not unusual for a company to raise its dividend even though its share price is declining. Indeed, more than 400 companies raised their dividends during the market crash of 2008, at the same time that most of their stock prices were going down.

Over the very long term, market prices rise, as do dividends, because both ultimately are outcomes of companies growing their earnings. But over short terms, there is no correlation between market price and dividends. Market prices certainly do not "cause" dividends.

Big Five Definition #2: Yield

Yield is the one-year percentage return on your investment from a dividend.

The formula is:

Yield = 12 Months' Dividends / Price

Depending on the specific 12 months chosen for the numerator, and also on the price chosen for the denominator, different yield calculations can present different answers.

The most common calculation is **current yield** (also sometimes called *forward yield* or *indicated yield*). In this book, when I say "yield," I mean current yield unless I state otherwise.

The formula for the current yield of a DG stock is:

Annualized value of the most recent dividend / Today's price

For example, if you own a share of stock worth $10, and the stock's most recent quarterly dividend was $0.25, that means that you can expect to receive dividend payments totaling $1 in the next 12 months. Therefore, your yield is $1 / $10, or 0.10, which equals 10%. The company's current yield is 10%.

The reason that current yield is the most common method of calculating yield is that it tells you what your annual percentage rate of dividend return is as of the current moment. It is akin to a bank stating the interest rate on a savings account.

By projecting the current dividend forward – that is, annualizing it – the yield becomes a forward-looking number, like a prediction. That's why it is also called *forward yield* or *indicated yield.*

Assuming that a company's dividend is neither cut nor raised over the next 12 months, current yield tells you what your rate of dividend return will be on your investment over the next 12 months.

Another flavor of yield that we will see is Yield on Cost (YOC). YOC tells you what your yield is on the original amount you spent for a stock.

The formula for YOC is:

Annualized value of the most recent dividend / Amount you spent

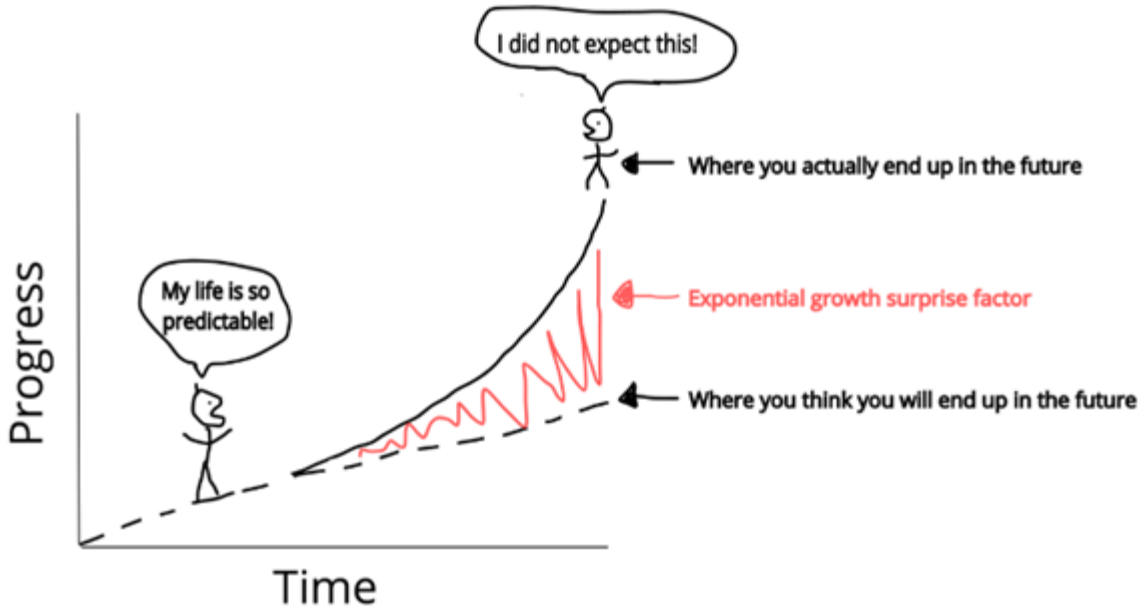
You can see that the numerator is the same as for current yield, but the denominator is your original cost rather than today's price of the stock.

In my investing life, YOC has served as an inspiration. For example, the idea that over a few years, a stock's dividend might grow to the point that it would be sending me 8% or 10% of its original cost *every year* has proved to be quite an incentive to invest in the first place, and also to stick with the plan when market prices are tumbling.

Big Five Definition #3: Compound

To compound means to earn money on money previously earned.

Compounding is one of the most powerful concepts in investing. Compounding occurs when your money grows at a geometric or exponential rate rather than a linear rate. When graphed over time, the line of how much money you are getting curves upward.



In dividend growth investing, compounding happens at two levels.

First level of compounding: Companies compound their own value by reinvesting earnings back into themselves. That enables them to grow their revenue, earnings, and dividends as the years pass.

Second level of compounding: Investors can reinvest the dividends they receive back into their own portfolio, buy more shares, and thereby gain the right to receive even more dividends next time around.

Let's look at each of the two levels of compounding.

Compounding within the company

Great companies compound money within their businesses by taking some of the money they earn and investing it back into the company to fuel growth. Thus they earn more money on money already earned, which satisfies the definition of compounding.

If things work out, company growth allows the company to increase its dividend. For example, if a company has been paying $1.00 per quarter as a dividend, and it increases the amount to $1.10, that's a 10% increase.

The investor's dividend stream benefits from the company's compounding. He or she receives larger dividends each year as the company's earnings grow.

Say that a successful company raises its dividend by 10% per year. In the first year, its dividend is $10.00 per share. Let's see how it grows when it is increased by 10% per year for 10 years.

Look at the blue columns in the following table. They show how the company's dividend would compound each year as it is raised by a consistent 10% each year.

For comparison, the red column shows how the dividend grows if it is raised by the same *amount* each year. Such a dividend is not compounding, it is simply growing in a straight line.

Year	Dividend Growth Rate	Dollar Amount of Increase	Dividend Amount with Compound Growth	Dividend Amount with Straight-Line Growth
2020	NA	NA	10.00	$10.00
2021	10%	$1.00	$11.00	$11.00
2022	"	$1.10	$12.10	$12.00
2023	"	$1.21	$13.31	$13.00
2024	"	$1.33	$14.64	$14.00
2025	"	$1.47	$16.11	$15.00
2026	"	$1.61	$17.22	$16.00
2027	"	$1.77	$19.49	$17.00
2028	"	$1.95	$21.44	$18.00
2029	"	$2.14	$23.58	$19.00
2030	"	$2.36	$25.94	$20.00

The table shows how powerful compounding is. **In 10 years, the compounded dividend increases to almost 2.6 times the amount of the first year's dividend.**

At first, this might seem impossible. After all, each year's increase was just 10%. If you add up 10 years' worth of 10% increases, shouldn't that give you a 100% total increase? *Shouldn't the amount after 10 years be 2.0 times the beginning amount?*

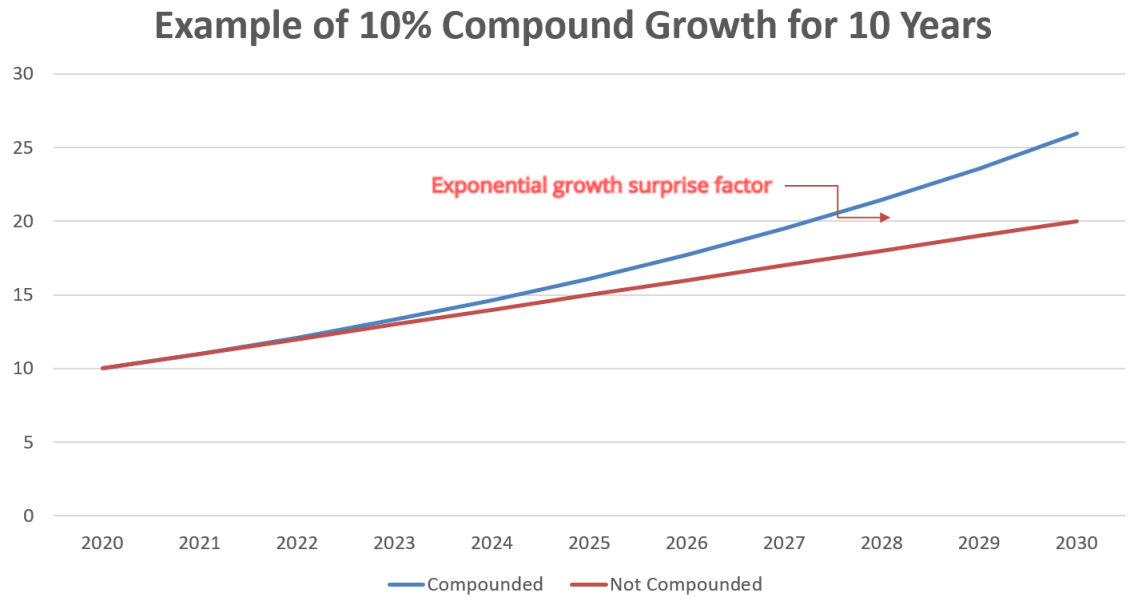
No! The reason is that compound growth is not linear. Each year's 10% increase is calculated on last year's amount, which grew from the year before. That means that *each year's increase is more* – in dollars and cents – than the year before. That's shown in the middle column.

So while the dividend growth *rate* stays constant at 10% per year, the *dollar amount* of each increase grows every year. That's the power of compounding.

The intuitive doubling of the dividend amount – to 200% of the original – instead becomes 260% as a result of compounding. That is a 30% *additional* boost in dollars (260 / 200 = 1.3, or 30% more).

For comparison, the red column shows the same dividend increasing by a constant *amount* of $1.00 per year. That represents straight-line growth. It matches the intuitive result of 100% total increase. In the 10th year, you receive twice the amount as in the first year.

Let's see how the numbers in the table look on a chart. The colors on the next chart match the colors in the table and in the cartoon at the beginning of this section: Blue means compounding, red means linear.



The first year's dividends are the same, but by 2030, the compounded dividend is 30% more. The compounding line curves upward, while the non-compounding line stays straight.

Over a long term, the difference between straight-line growth and compound growth can be startling. An initial amount will grow much faster, and at an increasing rate, if it is compounding rather than simply growing in a straight line.

Big Five Definition #4: Compound Annual Growth Rate (CAGR)

Compound annual growth rate (CAGR) is the consistent annual percentage increase that gets you from amount A to amount B over a specified time period.

In other words, if you know two amounts – $A and a later $B – CAGR shows you what unvarying annual rate of return would get you from $A to $B.

If you are comparing two investments, the one with the higher CAGR tells you which one has the higher rate of return.

I don't want to get into the mathematical formula for CAGR, but the concept is not hard to understand.

Here is a simple example. If you started out with $10 ten years ago and have $25.94 now, what was the CAGR?

The answer is in the table in the previous subsection. The numbers and length of time were taken from that table. We know from the prior discussion how we got to the final amount: The company compounded its dividend 10% per year for 10 years.

Online, there are calculators that will compute CAGR if you give them the beginning amount, the ending amount, and the number of years. I like the calculator at Moneychimp, because it is so straightforward.

Let's use it to see if it comes up with 10% for our example.

Return Rate (Discount Rate / CAGR) Calculator

Inputs		
Present Value:	$	10.00
Future Value:	$	25.94
Years:		10
Calculate		
Results		
Compound Annual Growth Rate:		10.00 %

It does.

Notice that the calculator only requires the beginning ("present") and final ("future") amounts, plus the length of time between them. It then calculates what consistent annual percentage rate of growth would get you from the first to the second over the time specified.

It doesn't matter what the actual path was to get from the beginning to the end. The real path could be jagged or inconsistent. It could dip one year, then double the next year. CAGR smooths the infinite possible paths into a single one – the curved line, as a matter of fact – defined by a steady annual compounded rate of return.

That allows meaningful comparisons between dissimilar paths to two different results. No matter how jagged or variable the actual paths, CAGR reduces the confusing visual to a single number. CAGR is the metric most often used to compare investments or evaluate historical growth rates.

Dividend growth investing utilizes stocks that increase their dividends every year. But it is rare to find stocks that increase their dividend by the exact same percentage each year. If you want to compare two stocks with inconsistent annual percentage raises, CAGR lets you do it easily. It creates the apples-to-apples comparison that we want.

In DG investing, a company's annual dividend CAGR is often called its DGR, meaning dividend growth rate. DGRs are often computed for 1-year, 3-year, 5-year, and 10-year time frames to facilitate comparison over different terms.

Also, as we'll see later, lining up a series of DGRs for different time frames lets you detect whether its speed of dividend growth has been rising, declining, or staying about the same over the past number of years.

Each company's DGR is independent from its yield. Current yield, you will recall, is the annual dividend payout divided by the stock's price. The company controls its payout, but it doesn't control its price. Price is controlled by the market.

That means that no company controls its yield, because market price is the denominator in the formula for yield. All a company can control is its payout, which is the numerator in that formula.

Big Five Definition #5: Dividend Reinvestment

Earlier, I said that an investor's overall dividends can grow in two ways:

- Dividend increases from the company
- Reinvesting the dividends

Reinvesting dividends means just what it sounds like: Investing the dividends you receive back into additional shares of stock.

Reinvesting dividends kicks off the second layer of compounding available to the stock investor.

Broadly speaking, there are two ways to reinvest dividends:

- Collect them in cash and then selectively target what stock(s) to buy.
- Have your brokerage automatically reinvest each dividend as soon as it's available, right back into the company that paid it.

Reinvestment Method #1: Selective Reinvestment

This is my preferred method. However, among investors at large, it is probably the less-common way to reinvest dividends.

The reason I prefer this method is that it lets me target where the money goes. That way I can start new positions, buy particular shares that help me steer the portfolio in desirable directions, and so on.

To illustrate selective reinvestment, here is how I do it in my Dividend Growth Portfolio. (This real-life portfolio is discussed fully in Chapter 16).

1. I allow dividends to accumulate in my brokerage account to a certain amount that I have predetermined. Currently that amount is $1000.

2. When the $1000 threshold is reached, I go shopping for more shares. I might look for a new stock, or I might add to an existing position.

3. I put as much thought into what to buy with the accumulated dividends as I would put into buying shares with new outside money.

There is nothing magic about $1000. It is just a nice round figure. Since my DGP is currently delivering $4500+ per year in dividends, I can go shopping (with $1000) four or five times per year.

For an example of how it works, here's a reinvestment that I made in 2020. I bought 7 shares of General Dynamics in May, 2020.

Here were some important outcomes of the purchase:

- It allowed me to start a new position in a high-quality dividend growth stock without adding new money to the portfolio. All the dividends used to buy General Dynamics had already come into the portfolio, via dividends, from other companies that I own.

- I was able to "catch" General Dynamics when it was offering an unusually high yield for that stock. That's because its market price had dipped. Here's where I bought it:



- The price dip had also caused General Dynamics to become unusually well valued. We will cover valuation extensively later, but for now just understand that it means that I was able to buy the stock when

its shares were worth quite a bit more (in my estimation) than I paid for them.

- Adding the new shares caused an immediate jump in my portfolio's ongoing dividend stream.

The last point, please note, fulfills the definition of compounding: General Dynamics' dividend was purchased with dividends already collected from other companies. So I was making money on money already earned.

Reinvestment Method #2: Automatic Reinvestment

This is the more common way to reinvest dividends. You set it up with your broker to reinvest dividends automatically, as soon as they are credited to your account, into the same stock that issued them.

Automatic reinvestment is usually called "dripping." Most brokerages make it as easy as checking a box to initiate free dividend reinvestments. I have accounts at E-Trade and Schwab, and with each it's just a matter of checking the right box.

Comparing the Two Methods of Reinvesting Dividends

There is no "right way" to reinvest dividends.

Selective reinvestment and automatic reinvestment are two ways to skin the same cat: You want your reinvested dividends, over time, to accelerate the building of:

- The number of shares you own;
- your wealth;
- your dividend streams.

Whether you choose selective or automatic reinvestment of dividends, the result is that your portfolio consistently gets new shares added to it.

The two methods are compared in the following table:

Two Ways to Reinvest Dividends		
	Selective Reinvestment	**Automatic Reinvestment**
How It's Done	Collect dividends in cash, then select new investments from time to time to make targeted purchases with lump sums.	Check the correct box. Dividends will be reinvested automatically back into the companies that paid them.
Labor Required	Stock for reinvestment must be selected by you, then you must enter a purchase order to be executed.	Check a box, the brokerage does the rest.
Valuation Considerations	You can always select a stock that is well-valued.	You will pay whatever price the market has for the stock when your dividends are reinvested by the brokerage. Over time, dripping becomes a form of dollar-cost averaging.
Can You Buy Partial Shares?	It depends on whether your brokerage offers "slices" or a similar partial-share program.	Yes. The brokerage will make the calculation and credit you with the correct number of whole + fractional shares.
Can You Start a New Position this Way?	Yes. You can buy any stock you want.	No. Dividend money is directed back into the same stock that delivered it.
Do You Automatically Build Positions?	No. You can, of course, direct funds into a stock you already own to build a position, but the choice of what to buy is not automatic. You must choose.	Yes. Funds are automatically routed back into the stocks that paid them.
Can You Use Both Methods in a Single Account?	Yes. Check-mark the stocks you want to drip and leave the other ones unchecked.	Same answer.
Can You Change the Method Whenever You Want?	Yes. Just check-mark the stocks that you want to drip back into.	Yes. Just uncheck the box for automatic reinvestment.
Do You Benefit from Compounding?	Yes.	Yes.

Many dividend growth investors use both methods within a single account. They drip some stocks but accumulate the cash from others. Some turn drips on or off as the valuations of individual stocks change, or as particular positions get "topped off" or fall behind.

Either way, reinvesting dividends causes share counts to rise, and since dividends are paid per share, it causes your dividend stream to rise too.

Remember that you get the benefits of compounding no matter which method you use to reinvest dividends. Compounding means to make money on money already earned. The "money already earned" is the incoming dividend stream. You compound it by reinvesting the dividends to purchase more shares. Either method – selective reinvestment or dripping – accomplishes that.

"Drip" is often used as a synonym for dividend reinvestment, but please note that dividends can be reinvested without dripping them. Selective reinvestment also qualifies as "reinvesting dividends." It just follows a different path to get there.

CHAPTER 4

17 REASONS THAT I LIKE DIVIDEND GROWTH INVESTING

Overview

There are millions of strategies for stock investing. There is no single "correct" way to invest.

While many define investment success as "beating the market," a better approach is to consider your own goals: Does your investing meet your financial objectives?

Many dividend growth (DG) investors define their goals differently from beating the market: They want to create a sufficient, reliable income stream that grows faster than inflation.

In 2011, Warren Buffett spoke to MBA students at the Terry School of Business of the University of Georgia (link to video). At one point, he told students, "The question is how much cash are you going to get, when are you going to get it, and how sure are you?"

That is a good way to look at DG investing. DGI is a time-tested, long-term strategy that speaks directly to those three questions. Successful DG investors have a pretty good idea how much cash they are going to get, when they will get it, and how sure they are about getting it.

In this chapter, I am going to discuss the positive aspects of the DG investing strategy. Herein, you will find why I am a dividend growth investor.

Note that not everything about DG investing is perfect. As with any investing strategy, it has its risks too. I will discuss those in the next chapter.

The rest of this chapter is devoted to positive aspects of dividend growth investing. I have boiled things down to "only" 17 main points.

1. Dividends Bypass the Market

Dividend payments are independent of the stock's price. Prices go up and down all the time, but dividend growth stocks increase their dividends every year.

The rewards of dividend growth investing are not dependent on the market, because the companies send cash directly to their shareholders. It doesn't come via the market.

Dividends and prices do have a common source, namely corporate earnings and cashflow. But dividends and prices are utterly different mechanisms for converting corporate cash into cash for the investor.

On the price side, Mr. Market translates corporate earnings and profits into stock prices. Unfortunately, Mr. Market sometimes goes haywire and takes prices through irrational swings that have nothing to do with the business success of the companies involved.

But Mr. Market has nothing to do with dividends. In the market, traders – who have nothing to do with running the companies – establish prices by auctioning shares back and forth to each other. The companies themselves are not involved in that trading activity.

However, it is the companies that determine dividends, and they do it in the boardroom, not in the stock market. Many companies have established long-standing dividend practices and policies, and they are usually much smoother and more predictable than stock prices.

As a result, a company's fluctuating market price has almost no impact on its dividend decisions.

For example, here is a five-year chart of one of the all-time great dividend-growth stocks, Johnson & Johnson. Notice how the dividend (orange line) has been stepped steadily upward by management to its current value of $1.01 per share, while the stock's price (blue line), determined by traders, has jumped all over the place, including precipitous drops in early 2015, 2018, and 2020.



What's the signal and what's the noise on that chart? Clearly, the orange dividend line is all signal, and the blue price line contains a lot of noise.

The independence of dividends from market prices means that the best dividend stocks provide a degree of emotional and financial insulation from turbulent markets. The dividends provide a positive return even when stock prices are tumbling. That, in turn, can provide peace of mind to the investor.

DG investing suggests a different understanding of the *value* of an investment from the widespread fixation on prices and market values. The DG investor recognizes that the value of his or her investment is not only

the total amount that you own or what you could sell it for. A stock's value also includes dividend yields, cashflows to the investor, and the comforting expectation that dividends will grow.

2. Dividend Growth Investing Can Relieve Obsession over Market Volatility

Many DG investors find that focusing on their growing dividend stream lifts a great worry off their shoulders: They no longer worry very much about prices.

The fixation of the investing industry and media on the drama of prices (which change constantly) leads to short-term focus, and it influences investors to think that investing is all about a series of short-term price triumphs or disasters.

An investor focused on prices gets too much feedback from the wrong place — the market. It is difficult to interpret the meaning of price changes. Are they based on noisy market volatility, company problems, or something else? Many investors will not hold on long enough to find out, choosing instead to sell as prices drop, because the fear engendered by price declines and paper losses triggers a flight response. Such fear can make the investor feel that they must *do something,* and what they often do is sell.

Dividend growth stocks help sidestep this problem by providing positive returns that arrive in cash quarter-to-quarter. The positive feedback helps reduce the temptation to sell at unfortunate times. Some investors call this "getting paid to wait."

As we saw earlier, dividends account for around 30 percent of stocks' average annual total return, and they are a lot more stable than prices. Despite this real-life importance, few "dividend dashboards" exist in the financial media. Dividends are remarkably under-covered. Look up a stock quote, and what you'll get is a price chart, often as short as one day long.

After I reorganized my investing strategy around dividend growth, I found that I was no longer stressed about stock price fluctuations or the market. It was a major shift in my thinking, and once I made it, I knew that I had found a sensible way to invest.

As a DG investor, you look to profit from being the *part-owner of a profitable business* rather than by holding a lottery ticket. Many investors have lost sight of a notion that was common to our grandparents: **You can profit by receiving a portion of earnings every year directly from the companies that you own stock in.**

If you focus on the notion of simply participating in the success of your companies, you can take the market's ups and downs in stride. Dividends *do not* depend on the market's behavior. Your income can go up each year no matter what prices the market assigns to your stocks. Your dividends do not come through the market.

To a DG investor, the term "market" itself takes on a different meaning. It is simply a store where you go to buy, and occasionally to sell, stocks. You do not go there to engage in trading battles.

Here is how the investing legend Benjamin Graham talked about stock prices in *The Intelligent Investor:*

> "Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies."

Speaking personally, my interest in market prices went way down, and my tolerance for market volatility went way up, when I shifted my focus to dividends. I lost the need to check my portfolio all the time. Life got easier. I became all but inoculated against panic selling and other common behavioral mistakes.

I became an investor rather than a trader. That is, my focus shifted to seeking success by participating in the achievements of the companies I own rather than from short-term changes in their market prices.

As a result, I am now most interested in forming long-term relationships with wonderful businesses that distribute some of their profits to me. I am not saying that it is always easy to watch a stock drop in price. But it is a lot easier to stomach price declines if they are put into context:

- Your dividend cash flows are not affected by market price changes.

- Valuations become better, and current yields become higher, when a stock's price drops. If you are in a buying mode, you can embrace price drops as presenting buying opportunities rather than danger.

- You do not have to sell while prices are depressed, so the volatility really means little to you.

3. Dividend Increases Are Usually a Positive Sign About the Company

A dividend increase can usually be interpreted as a positive sign that management has confidence in the company's prospects.

A company following a managed dividend policy will look ahead a few years when considering whether to increase the dividend this year. During good economic times, a company with a sound approach does not want to raise the dividend so high that it might need to cut or freeze it later if its busines slows down.

So when a company declares a dividend increase, that can be seen as an indicator that management probably foresees good sailing for its business over the next few years.

Of course, sometimes companies get their outlook wrong, as many banks did in 2007-08. They continued to raise their dividends when they were actually running out of money.

Covid-19 has created a recession and difficult conditions for many companies. Some companies that raised their dividends early in 2020 may come to see that those increases are not sustainable, depending on how long the recession lasts.

On the other hand, many companies that raised their dividends early in 2020 will raise them again in 2021. A few have already announced such increases. Their businesses are such that management can smooth the results through a recession and keep the dividend flow to shareholders intact.

4. Dividends Are Positive Cash Returns to the Investor

Every dividend is a positive return to the shareholder. Cash is sent to you.

There is no such thing as a negative dividend. Even if a company cuts its dividend, the reduced dividend is still positive. If a company freezes its dividend, the dividend payouts are still made even though they don't rise. Only if a company suspends its dividend does it drop to zero. It never drops below zero.

5. Dividend Growth Investing Allows You to Set Realistic Goals that Can be Tracked

Dividends are far more predictable than prices. The following 10-year chart of Johnson & Johnson is a good illustration. Compare the steadiness of dividends (the orange line) to the erratic price changes (blue line).



Because of this reliability, a dividend growth investor can set realistic income goals and track progress towards those goals in a way that an investor focused on price cannot.

6. Dividend Growth Companies Are Usually Outstanding Businesses

The best dividend growth companies typically have:

- Proven, time-tested business models
- Steady annual growth, with many more up years than down years
- Sustainable competitive advantages (moats) and the resources needed to defend or expand them
- Product lines filled with stuff that people *need,* like food, electricity, healthcare, diapers, and beverages
- Solid balance sheets, without an over-reliance on debt

- The strength needed not only to survive recessions, but even to gain market share when competitors struggle

- Reliable generation of excess cash

The fact is that it requires an outstanding business to increase dividends for many years in a row. Weak businesses simply cannot do it.

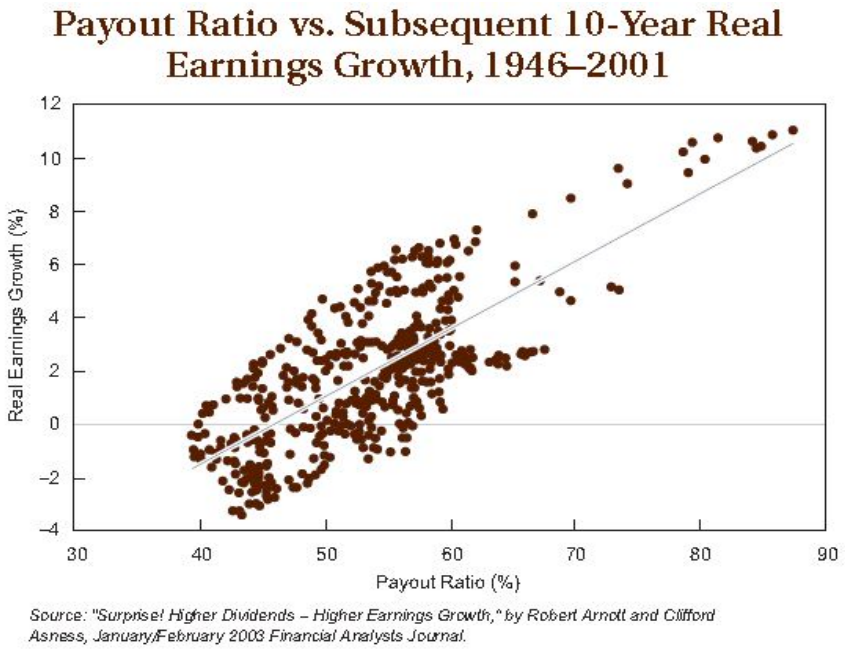
7. Dividend Companies Tend to Use Their Cash Wisely

A strong dividend program encourages – all but forces – management to be disciplined with the cash retained after dividends are paid.

Not all retained earnings are used productively. The common assumption that all retained earnings add value to the corporation is false. Dividend payments force companies to be efficient allocators of capital over longer periods. As observed by Robert Arnott and Clifford Asness in Surprise! Higher Dividends = Higher Earnings Growth (2003):

> "Empirical data suggest that too many companies squander their retained earnings when those retained earnings are more than is required for…future survival and competitiveness."

The following chart appears in the foregoing article. It shows that earnings growth after payment of dividends has tended to be higher the *more* that was paid out in dividends, contrary to many academic theories. Of course, there is no guarantee that a dividend-paying stock will exhibit higher earnings growth in subsequent years, but evidence suggests that a company paying dividends is not necessarily handicapped in its own growth by those payments.



Warren Buffet said in his 1984 Letter to Shareholders of Berkshire Hathaway:

> "[W]e believe managers and owners should think hard about the circumstances under which earnings should be retained and under which they should be distributed….In our opinion, management should choose whichever course makes greater sense for the owners of the business….[O]utstanding businesses by definition generate large amounts of excess cash….In such cases, shareholders would be far better off if earnings were retained only to expand the high-return business, with the balance paid in dividends or used to repurchase stock."

The best dividend growth companies follow Buffet's philosophy. Dividends reduce the cash available for corporate projects, so management exercises more discipline and vets those projects more carefully. The result is a more efficient business able to generate increasing profits in the future.

8. Dividend Programs Tend to Persist

The historical dividend growth patterns at many companies result from deliberate managed dividend policies, and the payments become pretty reliable. A long-standing dividend program can become woven into the culture of a company. Once such a policy has been established, it takes extraordinarily bad circumstances for the company to abandon it.

One dividend growth favorite, Realty Income Trust, has even branded itself around its dividend program.



Realty Income has paid more than 600 consecutive monthly dividends (over 50 years), including more than 90 increases. One has to believe that the company will try to continue those streaks if it possibly can.

While any company can be wounded during bad economic times, the best dividend companies are able to increase their dividends even during recessions. When hard times hit, the dividend growth rate may slow, but the company is still able to increase its dividend a little.

I have not studied this scientifically, but I believe that many companies go through a natural lifecycle. When they are young and establishing themselves, most companies cannot pay dividends. They need all their resources to fuel their own growth.

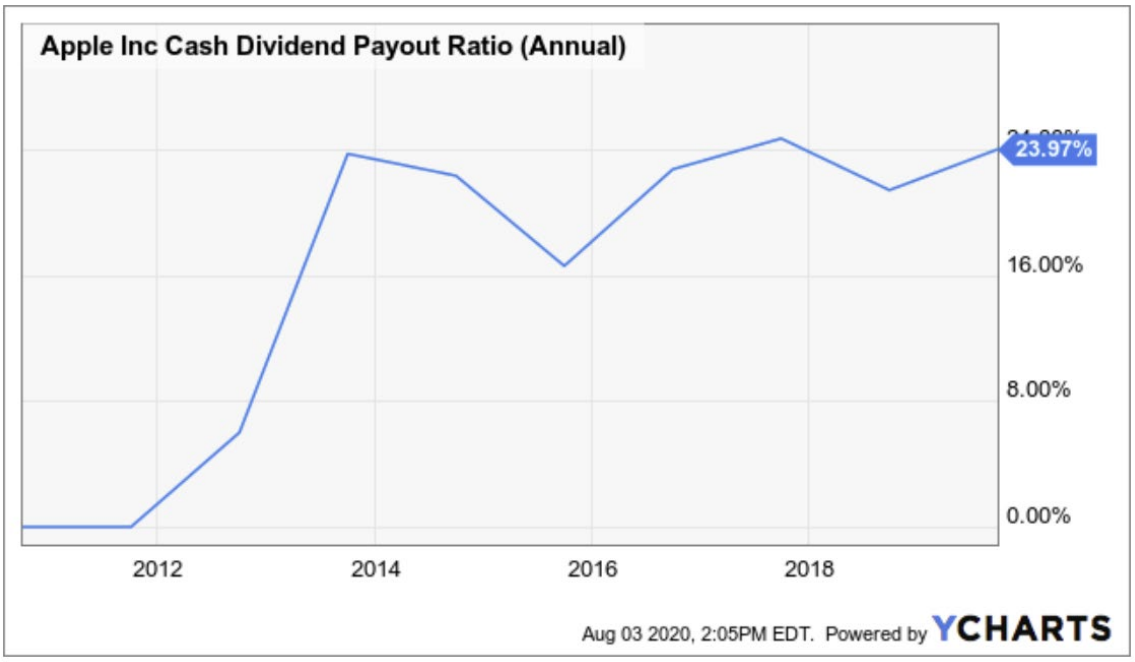
Even after they don't *need* to retain all earnings (say 10-25 years into their lifetimes), they still amass cash. It is what they have always done.

But along the way, some of them make the transition from hoarding to distributing some of that cash to shareholders. I suspect that it may be hard for many companies to declare their first dividend. But at some point, they

realize that they no longer need to retain every dollar to grow and operate successfully.

Once they make that leap, some companies ramp up their dividends rapidly for the next few years. They often are the companies with dividend growth rates of 15 or 20 percent per year. Their earnings may not be growing that fast, but they push their payout ratio up, seeking a natural balance between how much they need to retain and how much they can distribute to shareholders. Once they find that level, they will settle at a fairly steady dividend increase every year that reflects their earnings growth rate.

Apple is a good recent example. The company was founded in 1976, but it began paying a dividend in 2012 (36 years after its founding). Its payout ratio shot up for a couple of years, but it has since leveled out in the 16-25% range. So now its annual increases tend to mirror its profit growth and outlook each year.



9. You Do Not Have to Sell the Stock to Get the Dividend

If a stock pays no dividends, its total return comes solely from price changes, and you can only realize them if you sell the stock. There is no other financial benefit from ownership.

In contrast, dividends are sent to shareholders directly by the company. When you buy a share in a dividend stock, you receive an important *right of ownership* that comes "stapled" to each share: The right to receive future dividends from that company.

A problem with confining your view of ownership benefits to stock prices is that they are determined by the irrational intermediary, Mr. Market. In my experience, a carefully selected portfolio of DG stocks is pretty reliable about its dividend returns. That is not true of most stock prices, which fluctuate widely.

The DG investor often sees stocks differently from other stock owners. Stocks become like cash machines that generate streams of income. The dividend investor does not lose all interest in the prices of those shares, but price doesn't matter as much. During bull or bear markets, and even recessions, the dividends keep increasing.

Critics of dividend investing sometimes state that "a dollar is a dollar," what difference does it make if you get a dollar from dividends or a dollar from selling a few shares?

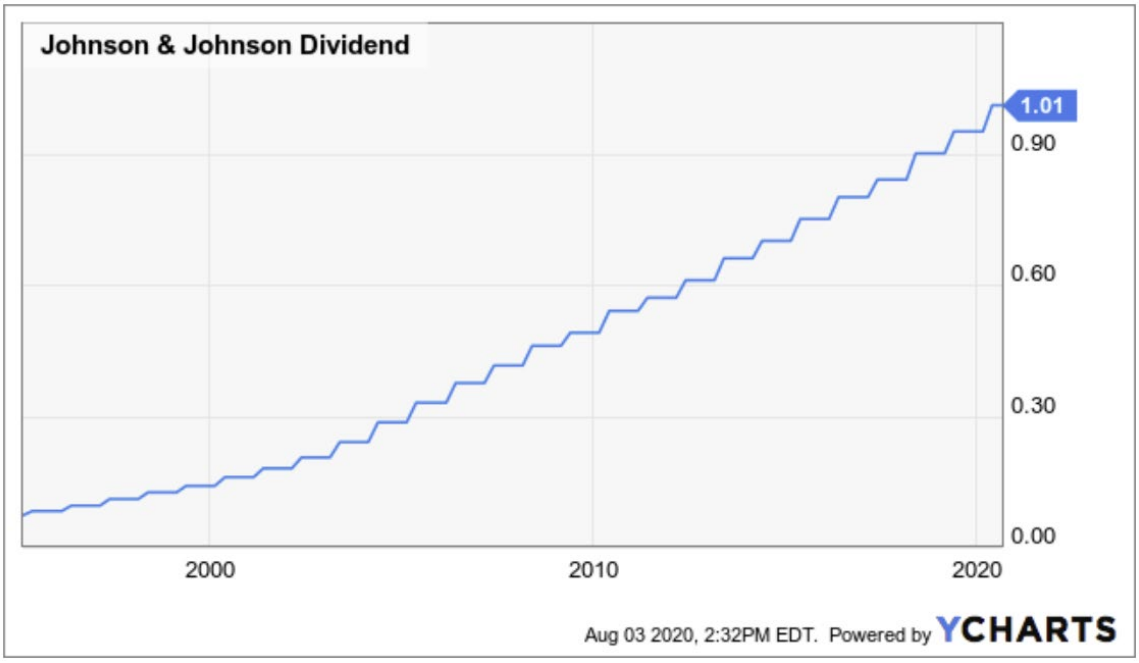
The difference should be obvious. **In order to get your hands on a dollar of capital gains, *you must sell shares*.** After selling them, you own fewer shares. The shares you sold can no longer accomplish anything for you, since you no longer own them. So the difference between getting a dollar from dividends or from capital is that you still own the shares in the first instance and don't own them in the second.

A dollar of dividend return does not deplete the number of shares that you own. They are still in your portfolio, and they will spin out more dollars next quarter. In contrast, a sold share is simply gone.

A common analogy is the case of a landlord. There is an enormous difference between a landlord who slowly sells off his rental properties to get money compared to a landlord who collects the rents and does not sell his properties. The first landlord will eventually run out of properties to sell. The second will not.

10. Dividend Payouts Rise Over Time

I don't know about you, but to me, this is beautiful:



Hundreds of companies have a long history of increasing their dividend regularly. Companies such as McDonalds, PepsiCo, and Realty Income have increased their dividends every year for decades. It is logical to expect that they will continue to do so if they possibly can.

When a company increases its dividend, your *yield on cost*—that is, the dividend payout divided by your original investment—goes up. This happens even though the current yield quoted online stays the same.

How can this be? It's simple math. Say you purchase XYZ Inc. when its price is $100 per share and its projected yield is 4%. If you buy 10 shares (cost = $1000), the stock pays you $40 in Year 1 of ownership.

No matter how the stock's price changes after you buy it, your yield on cost will always be based on that original $1000 that you spent on it. Unless you later add shares at different prices, your cost of ownership stays the same.

So let's say that XYZ's earnings increase 10%, and the company bumps up its dividend by the same percentage. That means in Year 2 the company pays out 10% more to you, or $44, so the yield on your original $1000 investment increases to 4.4%: $44 / $1000.

This annual growth of the cashflow paid to you is the most powerful aspect of DG stocks. It is why DG investors are content with slower-growing prices. It is why retirees — seeking income that keeps up with inflation — become attracted to these stocks. It is why many income investors consider dividend growth stocks to be more attractive than bonds, whose yields are fixed. It is why dividend investors can tolerate market pullbacks and fluctuating prices.

Dividend investors are, to a degree, set free from constant concern about stock prices. Dividend growth investing is a strategy for the long haul. The major attraction is not to make money from price increases, although that is delightful. The major attraction is the increasing dividend itself.

11. Dividends Have a Low Tax Rate

For most taxpayers, the current Federal tax rate on qualified dividends is 15 percent. That means that dividends are the least-taxed form of income you can get outside of low-paying jobs or tax-free municipal bonds.

By way of comparison, the Federal income tax rate on most bond interest is the same as your rate on ordinary income.

12. Dividend Stocks Tend to Be Less Volatile

A company called Ned Davis Research (NDR) has maintained an ongoing study of dividend stocks since 1972. Now in its 48th year, the study has provided a wealth of information about dividend stocks and investing.

One of NDR's findings is that dividend stocks, especially those that raise their dividends, tend to be less volatile than other stocks. Check out this table.

Average Annual Returns and Volatility by Dividend Policy

(3/31/72–12/31/19)

	Returns	Beta	Standard Deviation
Dividend Growers & Initiators	12.87%	0.92	15.61%
Dividend Payers	12.79%	0.98	16.36%
No Change in Dividend Policy	11.85%	1.13	17.92%
Dividend Non-Payers	8.57%	1.13	24.33%
Dividend Cutters & Eliminators	10.88%	1.23	24.08%
Equal-Weighted S&P 500 Index	12.29%	1.00	16.98%

Data Sources: Ned Davis Research and Hartford Funds, 2/20. Dividend policies shown are for stocks in the S&P 500 Index.

Source: Dreyfus.com/documents, "Consider Equity Income Funds for Today's Markets," Fall 2013.

(Source of display: Hartford Funds)

Companies' dividend policies are listed down the left column, ranging from "Growers & Initiators" to "Cutters and Eliminators." The column labeled Beta shows price volatility, where 1.0 equals the same volatility as the S&P 500 – which is a proxy for the market itself.

As you can see in the first line, Growers & Initiators have averaged a beta of 0.92, which is less than the market's 1.0. In plain English, dividend growth stocks, on average, have been almost 10% less price-volatile than the market since 1972.

Beyond that, the dividends themselves help cushion portfolio losses when equity prices are declining. The smoother overall ride generally makes dividend growth stocks easier to hold during times of market distress. That is an important advantage, as it helps counter a well-known behavioral mistake that many investors make, which is to trade too much. Over-trading almost always lowers returns.

Most DG investors are less likely to sell shares in response to short term price difficulties. That is because they recognize that success or failure in attaining superior cash flows over long periods of time are not much related to short term price changes.

13. Your Principal Can Increase Over Time

When you buy stock, you are purchasing a piece of the company. You can sell that piece any time you want or keep it as long as you want. Until you sell, the company sends you dividends.

If and when you sell, you will receive whatever price Mr. Market is offering at the time that you sell. Hopefully, that will be more than you paid.

In other words, the dividend stock investor potentially gets positive returns from **both** sources of total return: dividends and price appreciation. Remember the equation for total return:

Total return = Price return + Dividends

With that in mind, let's compare dividend growth stocks to bonds. When you buy a bond, the bond issuer takes your money (which is a loan from you) and keeps it until the end of the bond's term. The issuer pays you the fixed rate of interest stated on the bond. The bond is a contract between

you and the bond's issuer. At the end of the contact's term, your initial investment is returned to you.

Bonds are called *fixed income* investments. We can see the ways that they are fixed:

- Their term is fixed.
- Their rate of return is fixed.
- Their income growth rate is fixed (at zero).
- Their nominal value at the end of the term is fixed. You get back what you originally paid — in dollars that have been eroded by inflation.

Dividend growth stocks, on the other hand, provide *growing income,* not fixed income. Let's compare a 10-year bond with a dividend growth stock.

First, the bond pays out a fixed return. The final interest payment is the same as the first. At the end of the 10 years, if inflation has been 3% per year, the money returned to you has only 74% of the purchasing power it had when you loaned it to the issuer of the bond.

With stocks, we don't know what Mr. Market will do over 10 years, but let's say that both the stock's price and its dividend appreciate at the rate of inflation, which we estimate at 3% per year. Then:

- The final dividend payment is 34% more than the first one was.
- The price of the stock is 34% more than you paid for it. If you sell it, you will get 34% more money than you paid.
- **Your purchasing power has risen**. The price of the stock has stayed even with inflation. But along the way, you have also received 10 years of rising dividends. That means that your *total return* has

exceeded inflation, giving you more purchasing power because of your investment.

Over long time periods, increases in dividends loosely track increases in the prices of the equities generating those dividends. That is why you do not often see the yields of high-quality dividend stocks climb to ridiculous levels even though they raise their dividends year after year. It is because the prices rise too, keeping the yields relatively stable.

Both stock prices and rising dividends are related to (indeed, they are ultimately caused by) the company's earnings growth. That growth is recognized in the boardroom by decisions to increase dividends. It is recognized in the market by rising share prices.

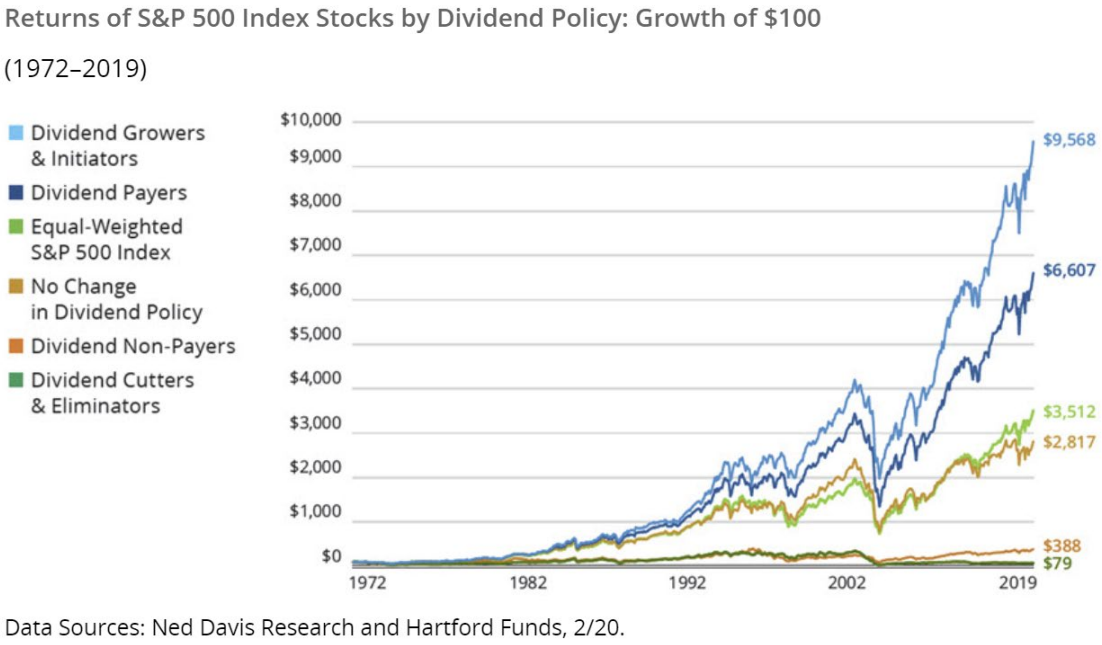
14. Historically, Dividend Growth Stocks Have Outperformed the Market in Total Returns

Historically, dividend growth stocks have outperformed the broad market in total returns.

Now, note well that whether you want to "beat the market" is a personal decision about goals. Many folks (including myself) have decided that is not a primary goal. My primary goal is to generate sufficient income that grows faster than inflation. How I do on prices when compared to the market is only of secondary interest.

That said, numerous studies have shown that dividend growth stocks provide the greatest total returns too. The studies differ in methodology and timeframes, but the similarity in their conclusions is consistent.

As we saw earlier, Ned Davis Research (NDR) has an ongoing study of dividend stocks that began in 1972. Its findings on total return are striking.

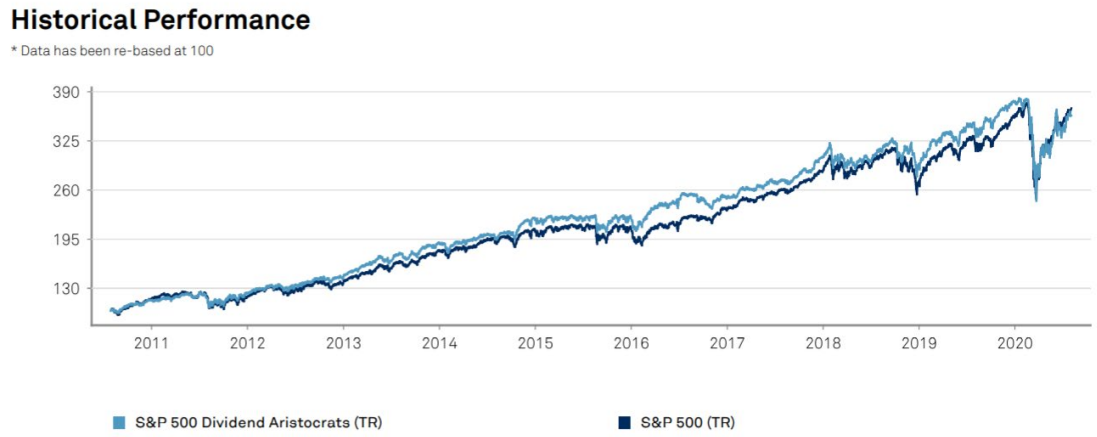


(Source of display: Hartford Funds)

Per the chart above, from 1972 through 2019, the total return from Dividend Growers and Initiators was more than 9000%, compared to about 3% for Dividend Non-Payers and about 3400% for a version of the S&P 500 Index.

The Covid-19 Recession that started in February, 2020, may have changed the historical advantage that dividend growth stocks have maintained in total returns. Standard and Poor's maintains an index – the S&P 500® Dividend Aristocrats – that measures the performance of S&P 500 companies that have increased dividends every year for the last 25 consecutive years. The index is equal-weighted and was launched in 2005.

Until 2020, the index surpassed the benchmark S&P 500 in total returns, by about 2% per year, as shown on this graph.



(Source: S&P Dow Jones Indices)

The Covid-19 Recession has brought the Dividend Aristocrats' out-performance back into line with the S&P 500. The main reason is that the recovery from the February, 2020 crash has been disproportionally driven by technology companies (plus Amazon), many of which do not pay dividends. Those stocks have proved to be pandemic-resistant. The Dividend Aristocrats, being equal-weighted, are underweighted in technology compared to the S&P 500, in which companies are cap-weighted.

The two tables below show the top 10 holdings in the S&P 500 (on the left, via the ETF called SPY) compared to the top 10 holdings of the Dividend Aristocrats (on the right via the ETF called NOBL). Notice that none of the top-10 overlap. Not a single top-10 holding of the Dividend Aristocrats is one of the giant tech stocks currently driving the S&P 500.

Of those top 10 in the S&P 500, five of them – Amazon, Facebook, both Alphabets, and Berkshire Hathaway – do not pay dividends at all.

Security Name	% of net assets
AAPL Apple Inc	6.45
MSFT Microsoft Corp	5.65
AMZN Amazon.com Inc	4.77
FB Facebook Inc A	2.33
GOOGL Alphabet Inc A	1.79
GOOG Alphabet Inc Class C	1.76
BRK.B Berkshire Hathaway Inc Class B	1.48
JNJ Johnson & Johnson	1.33
PG Procter & Gamble Co	1.26
NVDA NVIDIA Corp	1.14

Security Name	% of net assets
ADP Automatic Data Processing Inc	1.73
ABBV AbbVie Inc	1.65
CB Chubb Ltd	1.64
SHW Sherwin-Williams Co	1.64
ESS Essex Property Trust Inc	1.64
CL Colgate-Palmolive Co	1.62
CLX Clorox Co	1.60
HRL Hormel Foods Corp	1.60
ABT Abbott Laboratories	1.59
T AT&T Inc	1.59

Whether the end of the recession will cause a return to the historical total-return advantage that the Dividend Aristocrat Index had enjoyed over the prior 10 years remains to be seen.

Who knows? In a future edition of this book, the historical return advantage of dividend-growth stocks over the market may drop into the next chapter as a drawback, rather than advantage, of DG investing.

15. You Can Reinvest Dividends to Accelerate the Compounding Effect

Shareholders in dividend-paying companies can do three things with the dividends: Reinvest them, keep them, or spend them.

If you reinvest the dividends (either in the same stock or elsewhere), the reinvestment brings into play a second layer of compounding. (The first layer is the rising dividends themselves.) As you purchase more shares with the dividends, the number of shares on which you receive dividends goes up. They then generate additional dividends, which can then be reinvested.

This creates a virtuous cycle of dividends → reinvestment → more shares → more dividends, etc. This builds wealth and income at an accelerating

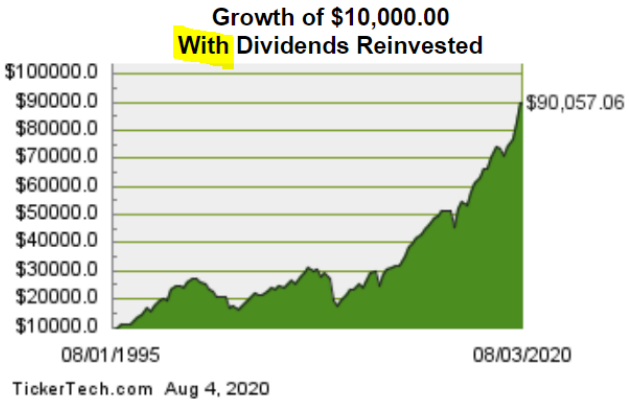
pace. Your share base grows faster and faster because of the reinvestments. The additional shares, in turn, accelerate the growth of the dividends you receive.



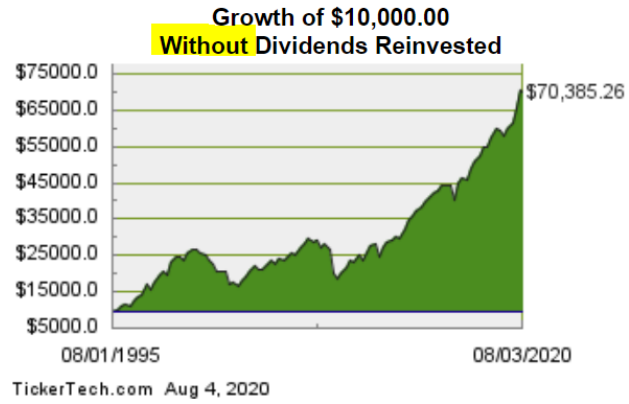
If the dividend itself is increasing, that acts as a super-charger to the process just described. **The reinvestment of *growing* dividends builds wealth at an accelerating pace, beyond that of the companies themselves.**

We can see the impact of reinvesting dividends in simple graphs that compare the total returns of the market with and without dividends reinvested. The following charts show total returns for SPY, the ETF mentioned earlier that holds the same stocks as the S&P 500 in the same proportions. The top chart shows SPY's returns with dividends reinvested, and the bottom chart shows SPY's returns if the dividends were not reinvested.

	SPY
Start date:	08/01/1995
End date:	08/03/2020
Start price/share:	$56.06
End price/share:	$328.79
Starting shares:	178.37
Ending shares:	273.63
Dividends reinvested/share:	$65.99
Total return:	799.66%
Average Annual Total Return:	9.18%
Starting investment:	$10,000.00
Ending investment:	$90,057.06
Years:	25.02



	SPY
Start date:	08/01/1995
End date:	08/03/2020
Start price/share:	$56.06
End price/share:	$328.79
Dividends collected/share:	$65.99
Total return:	604.17%
Average Annual Total Return:	8.11%
Starting investment:	$10,000.00
Ending investment:	$70,385.26
Years:	25.02



(Source: Dividend Channel)

The charts cover 25 years from 1995-2020. The advantage of dividend reinvestment over dividend non-reinvestment has been almost 200% greater total return. A $10,000 investment in 1995 became more than $90,000 with dividends reinvested vs. about $70,000 with dividends not reinvested.

If you draw dividends off as cash to spend, of course, the compounding effect of reinvestment is not present. Your income stream will still grow, however, in line with the dividend increases themselves.

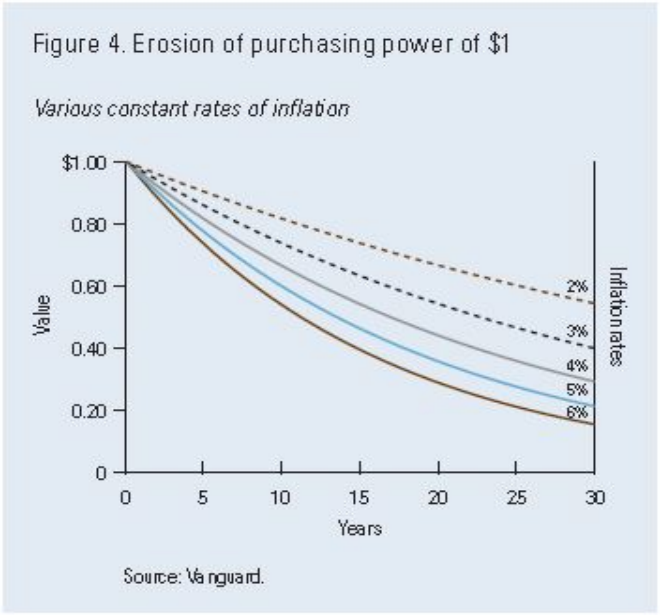
16. Rising Dividends Protect Against Inflation

"Risk" has many meanings in investing. One traditional meaning involves the risk to your *nominal* principal amount, which is to say how many dollars your investments are worth on the market from moment to moment. Since prices change all the time, risk in this sense means price volatility.

If there were no risk to prices, they would just stay in place, and a $500,000 portfolio today will be worth $500,000 ten years from now. Under that definition, investment-grade bonds are risk-free, because their nominal or par value does not change. The same is true if you put your money under the mattress: $500,000 remains $500,000.

But that common view of "risk-free" ignores inflation. Inflation erodes the purchasing power of money. For long-term investors, inflation can be the most important risk, as its effects compound over long time horizons. Over a 30-year retirement, an average inflation rate of 3 percent would cut a portfolio's purchasing power by more than half.

In this diagram, the 3-percent inflation line is the second line down. See how it cuts the purchasing power of money in half over 30 years.



(Source: Vanguard, "Preserving a Portfolio's Real Value: Is There an Optimal Strategy?" 2009)

So, for example, while bond principal is risk-free in *nominal* dollars, it is defenseless against inflation. Its purchasing power steadily drops. The same holds true for bond income: It is fixed in nominal terms for the life of the bond, but it steadily loses purchasing power to inflation.

In contrast, the income from dividend growth stocks grows, thus protecting against inflation. In my own study, "Has Dividend Growth Kept Up with Inflation?" (March, 2012), I drew the following conclusions from a 51-year study of the S&P 500.

- Dividend increases grew the initial dividend stream by 75 percent more than inflation over the 51 years.
- Dividend growth was higher than inflation in 31 of 51 years.
- The average yearly rate of dividend growth (5.4 percent) exceeded the average annual inflation rate (4.1 percent) by 32 percent.
- The dividend stream grew to more than 13 times its original size compared to about eight times the original amount for inflation.

17. You Do Not Need More Money to Generate 4% Income Instead of 4% from Sales

It is a common rule of thumb in retirement planning to assume that it is safe to liquidate 4% of your assets each year to live off in retirement. This is the so-called "4% rule," defining what withdrawal rate is safe such that you will never run out of money while you are alive.

It is also a common saying in investing circles to say that living solely off of investment income in retirement is only for the very wealthy who have really large portfolios.

But the fact is that it requires no more money to build a portfolio of stocks that will pay a dividend stream of 4% per year than to acquire a portfolio of stocks that must be liquidated to the tune of 4% per year.

The number of dollars taken from the portfolios is exactly the same. The difference is that the dividend collector not only gets the cash but also keeps all of his or her assets, while the asset-seller annually depletes what they own.

The difference is not in how high their wealth grew. The difference is in whether they chose DG stocks or not.

CHAPTER 5

DRAWBACKS AND ODDITIES OF DIVIDEND GROWTH INVESTING

After reading the previous chapter about the strengths of dividend growth (DG) investing, you might think that dividend growth stocks are the perfect investment.

But, as they say, there is no free lunch. There are definitely risks and negative features to the dividend growth investing strategy. Every DG investor should understand these risks thoroughly. Following the discussion of risks, I'll cover some special considerations about DG investing.

Risks and Negatives of Dividend Growth Investing

1. Market risk

Stock prices are determined by the stock market. Prices go up and down every day. **You cannot eliminate market risk if you invest in stocks.**

There may come a time when you desire or need to sell some of your shares for one reason or another. There is a possibility that your stocks' prices will have declined from your purchase price. If you sell, it will be at a financial loss. By selling, you lock in that price loss.

Further, if the stock's price has declined by an amount exceeding the total dividends you received while you held it, you will have lost money overall on that stock.

That said, many dividend growth investors do not worry very much about falling prices.

- First, their main focus is on the rising annual dividends, not the stock's price. This makes it easier to be relaxed when prices are plunging, as they did earlier in 2020 when Covid-19 first impacted the stock market. The same thing was true during the Great Recession of 2007-09.

- Second, dividend strategies take time to play out, so they help you to adopt a long-term perspective and be less reactive to day-to-day price volatility.

Over very long time periods, the risk that your dividend stocks' prices will fall and stay down gets smaller and smaller. In the meantime, you've been collecting the dividends.

2. Dividend risk

Dividends are discretionary with each company. Dividends can be frozen, cut, or eliminated at any time.

As we have seen, when you buy a dividend stock, you gain a right along with your ownership: The right to receive dividends as long as the company issues them. But in contrast to bonds, that is not a contractual right. It is not enforceable in a court of law.

Management may decide to change even long-established dividend policies.

- In 2009 Pfizer cut its dividend in half to help pay for its acquisition of Wyeth, breaking a decades-long string of consecutive annual increases.

- In 2010, British Petroleum experienced an operational calamity when its oil rig blew up in the Gulf of Mexico. Facing massive cleanup costs and the probability of lawsuits, they had to cut their dividend.

- In 2020, utility behemoth Dominion Energy decided to restructure its operations, shedding its oil storage and transport assets and reducing the size of the company. While that may make Dominion a more focused and better long-term investment, it will also be accompanied by a 33% cut in the dividend paid out on December 20, 2020. That will break a 17-year streak of increased dividends.

For a quarter or two, a company may avoid cutting its dividend even though it is out-paying its profits if it has sufficient cash available or borrows money to cover the dividend. Obviously, that is not sustainable. Sooner or later, if profits and cashflow do not cover the dividend, such a company must freeze, cut, or suspend its payouts.

Nearly every year, a few companies with long streaks of dividend increases break them. In even the most carefully chosen DG portfolio of 20 or more stocks, perhaps one or two of them will freeze, lower, or suspend their dividends in any given year.

The DG investor needs to be mentally prepared for this likelihood. Personally, I consider it “normal noise” in my investing, and I am prepared to deal with it if it should happen. If it doesn’t happen, obviously that’s fine too.

3. You may not be fully able to make up for a dividend cut

If you combine #1 with #2, you will see that a dividend investor can end up in a poor position: He or she owns a dividend stock that has cut its dividend, so they wish to sell it. But if the stock's price has fallen from the price at which it was purchased, the proceeds from selling will be less than what was invested in the first place.

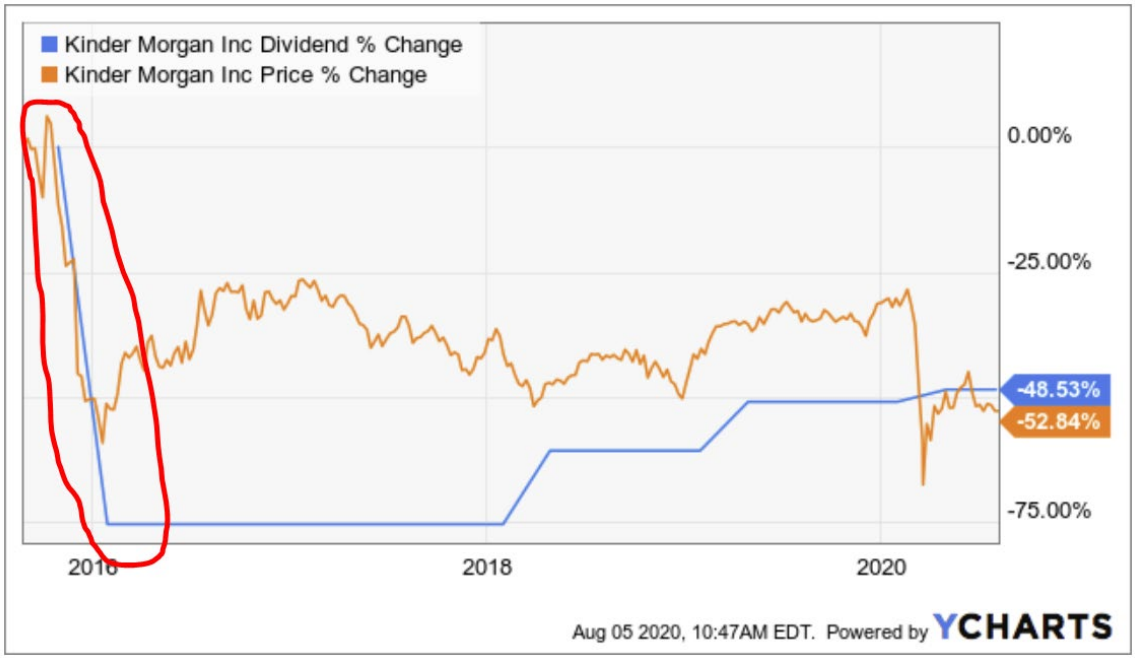
That means that the investor probably does not have enough money to purchase a new stock that will replace all of the income that was lost.

Here's a real example from my own investing. I used to own Kinder Morgan, a pipeline company. In 2015, Kinder got into a cash squeeze when the price

of oil crashed. The company had lots of debt, and its investment-grade credit rating was at risk.

I held too long, thinking that Kinder would find a way to protect its dividend and credit rating by cutting back on capital projects. But they chose otherwise, electing to drop their dividend by 75%. By the time they made that announcement, their price had also fallen more than 50%.

As shown on the following chart, neither Kinder's price nor its dividend has regained 2015 levels.



The savvy DG investor attempts to anticipate dividend cuts, and there are good tools nowadays to help with that, but realistically not every cut can be caught in time. The savvy investor also diversifies his or her holdings so that a negative scenario impacting one stock does not have too much effect on their overall dividend stream.

I will discuss both of those subjects – anticipating dividend cuts and portfolio diversification – later on in this book.

4. Unknown future dividend growth

A sub-category of dividend risk is that there is no way to know a future rate of dividend growth. Even if a company has increased its dividend 8 percent per year for the past 25 years, there is no way to know what it will do in Year 26. Even if it raises the dividend, we can't know how much the increase will be until it is announced.

When you buy a dividend growth stock, the yield you start with is known and locked in the minute you buy it. While you can make intelligent forecasts about the future rate of dividend growth, no one knows the size of future increases until they happen.

Some investors devote time to predicting the amount of future dividend increases. I do not. Instead, I simply note them when they are announced. In my experience, surprises run in both directions, both higher and lower than expected.

5. Dividends are taxed

I'm not sure that this is a drawback in the whole scheme of things, but let's state it for completeness. When a company sends out your dividend, that is taxable income for you, unless you hold the stock in a tax-deferred account or fall below the income floor for taxation.

There are a lot of exceptions and nuances to the taxation of dividends. Certain special corporate forms — such as real estate investment trusts (REITs), which will be discussed shortly — do not have their income taxed at the corporate level provided that they distribute enough of their taxable income. On the other hand, when you receive their dividends, they are taxable as ordinary income to you.

If you hold your dividend stocks in a tax-deferred account such as an IRA, the normal tax benefits of such accounts apply to the dividends flowing into the account.

Under current law, qualified dividends are taxed at the same rate as long-term capital gains, which is a lower rate than that which applies to ordinary income. If you realize a capital gain by selling, you are taxed on that gain. If you receive a dividend, you are taxed on it. Both taxable events, of course, are subject to other portions of the tax code, including the deferral of taxes in certain accounts such as IRAs.

Sometimes it is stated that dividends are less tax-efficient than capital gains. The reasoning is that when a share of stock is sold, only the gain is taxable, and until it is sold, there is no taxable event. This is true but a little misleading. In either case (capital gains or dividends) only gains are taxed, and the taxable event occurs when you *realize* the gain, that is, when you actually receive it in the form of cash.

Sometimes, investors become too focused on tax considerations. The primary appeal of dividends has never been based on a tax break. The chief appeal of growing dividends is the opportunity to receive reliable cash returns that are always positive, keep increasing, and are independent of price fluctuations.

6. Slower growing company (sometimes)

Dividend-growth companies are not usually among the fastest-growing companies in the corporate universe.

Dividend-paying companies generate enough cash to fund both growth and dividends. Occasionally you will read that dividend-paying companies forego growth opportunities by distributing dividends. While sometimes this may be true, it is a fallacy if offered as a general rule.

The reason it is a fallacy is that a dividend growth company may already be maxing out its best growth opportunities *without* reinvesting every penny that it earns back into itself. Retaining “too much” money within the company would be destructive of value, because it would go to second-rate projects and acquisitions, sit in cash earning essentially nothing, or be wasted in other ways. One cannot assume that every dollar of a company’s

retained earnings enables further growth at the same rate as “earlier” dollars retained.

Some earnings are truly more valuable to shareholders if they are distributed as dividends. Remember Buffett’s words from earlier:

> “[O]utstanding businesses by definition generate large amounts of excess cash…. In such cases, shareholders would be far better off if earnings were retained only to expand the high-return business, with the balance paid in dividends or used to repurchase stock.’

7. Below-average performance in bull markets (maybe)

DG stocks do not often lead the market up during bull markets. Their total performance may lag that of other stocks.

We have seen that in 2020. The market’s fast rise back from its steep fall triggered by Covid-19 was fueled the most by fast-growing technology companies, and many of them pay no dividends at all. Not only that, they did not fall as much in the first place.

The following chart illustrates that. The purple line represents the market at large via an S&P 500 fund since the beginning of the year. The orange line represents the returns of a technology-based fund. The out-performance of the technology stocks is obvious both on the way down and in the recovery since March.

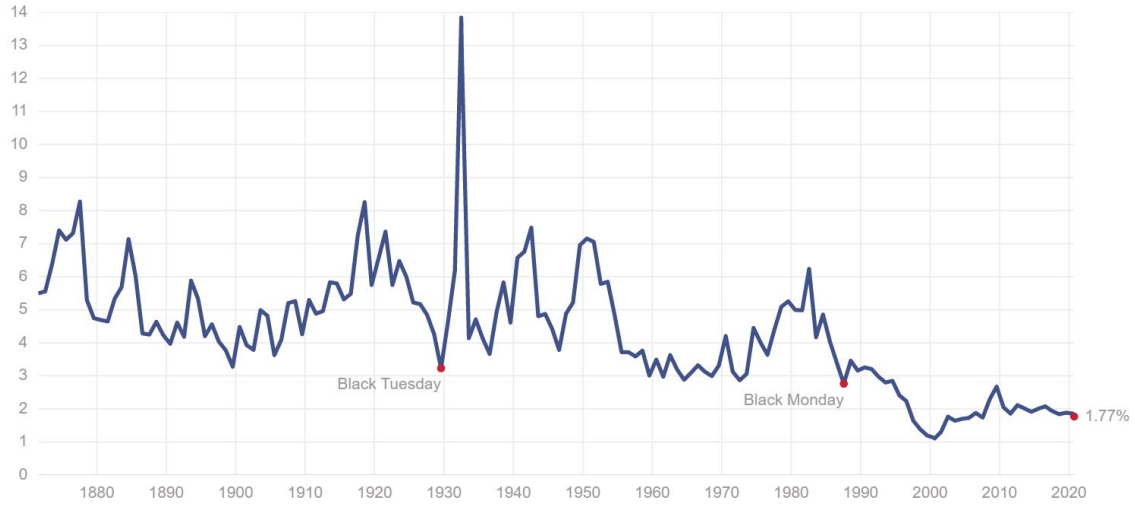


8. Initial low yield (sometimes)

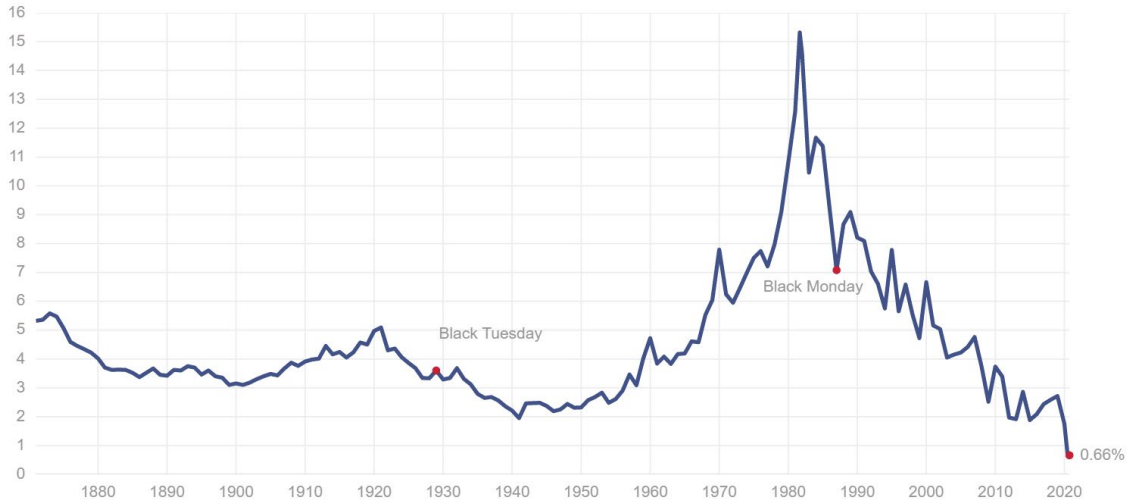
For many years, the dividend yield on a quality dividend growth stock was often less than you could get from an investment-quality bond, certificate of deposit, or money market account – all of which are essentially risk-free as to principal.

But fixed-income interest rates have been falling for years, and the general statement that fixed income yields are higher than most stocks is no longer true. The following two charts show historical values of the yield available on the S&P 500 stock index, followed by that on a 10-year Treasury note, which is often considered a benchmark for interest rates.

S&P 500:



10-year Treasury:



(Source: Multipl)

Yields on both stocks and fixed income have been generally falling for years, but stocks (viewed broadly) yield almost three times fixed income as of this writing. Many stocks are yielding much more than bonds, CDs, or money market accounts.

And don't forget, the yield on a 10-year T-note's cost stays fixed for its entire term, while your dividend stock's yield on cost will most likely rise over time due to dividend increases along the way.

9. Stock prices drop by the amount of the dividend

This is not really a disadvantage either, although some people view it as one.

Stock exchanges follow a long-standing practice. When a company declares a dividend, it sets the *record date,* meaning the date on which a shareholder needs to be on the company's records to receive the next dividend. Under exchange rules, the *ex-dividend* date is thereby established a couple business days prior to the record date. That ex-date becomes the first day on which new buyers of the stock will not receive the upcoming dividend.

Before the opening of trading on the ex-dividend date, the exchange reduces the quoted price of the stock by the exact amount of the declared dividend. The idea is that this money will not be received by new buyers, so they should not pay for it in the price of the stock.

Because of this price adjustment, shareholders who owned the stock before the ex-dividend date, and who hold on straight through, see the market price of their stock momentarily lowered by the amount of the dividend.

In practice, as soon as trading opens on the ex-dividend date, market participants establish the actual price of the stock. The exchange's price adjustment is usually hard to detect after an hour or two of trading. There certainly is no long-term impairment to the price of the stock.

Dividends Compared to Share Buybacks

Share buybacks are another way that a company can deploy its capital. Share repurchases are often lumped together with dividends under the heading of "returning cash to shareholders."

Let's look into that. I think it is a false equivalence.

In a share repurchase program, a company uses some of its money to buy shares of itself on the open market. For example, a company might announce that over the next year it will buy back $20 million worth of its own shares. If the stock sells for an average of $20 per share during that period, the company will purchase 1,000,000 shares.

Note that a share buyback does not literally involve sending cash to shareholders. Instead, it "returns money to shareholders" by removing shares from the market. The cash actually goes to people who become ex-shareholders as soon as they receive it.

Theoretically, a company's buyback of shares makes each remaining share worth a little more, because it becomes a larger slice of the whole corporate pie.

You can readily see that share buybacks and dividends are very **different** mechanisms for transferring value to shareholders. It is sometimes said that shareholders should be indifferent to whether the company pays dividends or buys back shares, or even that share buybacks are superior.

But share buybacks can *destroy* shareholder value rather than enhance it. For example, the company might buy its own shares back at inflated prices. That is a waste of the company's money.

With dividends, the company literally sends you cash. With share buybacks, the company sends you nothing, unless you are willing to become an ex-shareholder. At best, it removes shares of itself from the market. Whether the removal of those shares leads to an actual increase in the price of the remaining shares is a function of Mr. Market.

And, of course, even if the share price does rise, if you want to realize that for yourself, you have to sell shares and lose the rights of a shareholder as to those shares, including the right to receive future dividends.

Finally, don't be misled into thinking that every share repurchased by a company is actually removed from the market. Many of them are used to compensate executives.

Here are the pros and cons of share buybacks:

Pro: Since no money is sent to you, you are not taxed on any growth in the value of the shares unless you sell them.

Pro: To the extent shares are actually removed from the market, each remaining share represents a larger piece of the company. (The corporate pie, of course, has been shrunken slightly by the outflow of money used to buy back the shares.)

Pro: To the extent shares are removed from the market, there can be a benefit to the dividend recipient in the form of future higher dividends per share. Another way of looking at this is that the same total dividend pool needs to be spread among fewer shares, so it makes it easier for the company to raise the dividend next time around.

Pro: Buybacks are a way for a company to propel shareholder value without "overspending" on dividends. Companies with well-established dividend growth policies will try to avoid increasing the dividend too fast, lest it be unsustainable when times turn tough. If such "extra" money is used to buy back shares, that's a one-time deal that can be stopped at any time without becoming a permanent expectation of shareholders.

Pro, maybe: Presuming that purchased shares are in fact removed from the market, theoretically the value of the remaining shares is increased proportionally. However, to make this increased value real, Mr. Market must re-price the remaining shares upwards. Over time, this probably happens, because the reduction of shares improves all per-share statistics, which does not go unnoticed by investors.

Con, maybe: Sometimes, the shares that a company purchases from the market are used to compensate executives, who then turn around and sell

the shares, because they want the cash. When that happens, the shares are not removed from circulation. The theoretical increase in share value does not take place, or it is watered down by the number of shares not actually removed from circulation. The number of shares that the dividend pool must cover is not reduced.

Con, maybe: Companies are usually not as committed to share purchase programs as they are to dividend programs. Some share purchase programs are never completed. In hard times, most companies will abandon or suspend a share buyback program before they touch the dividend. We see that happen during each recession.

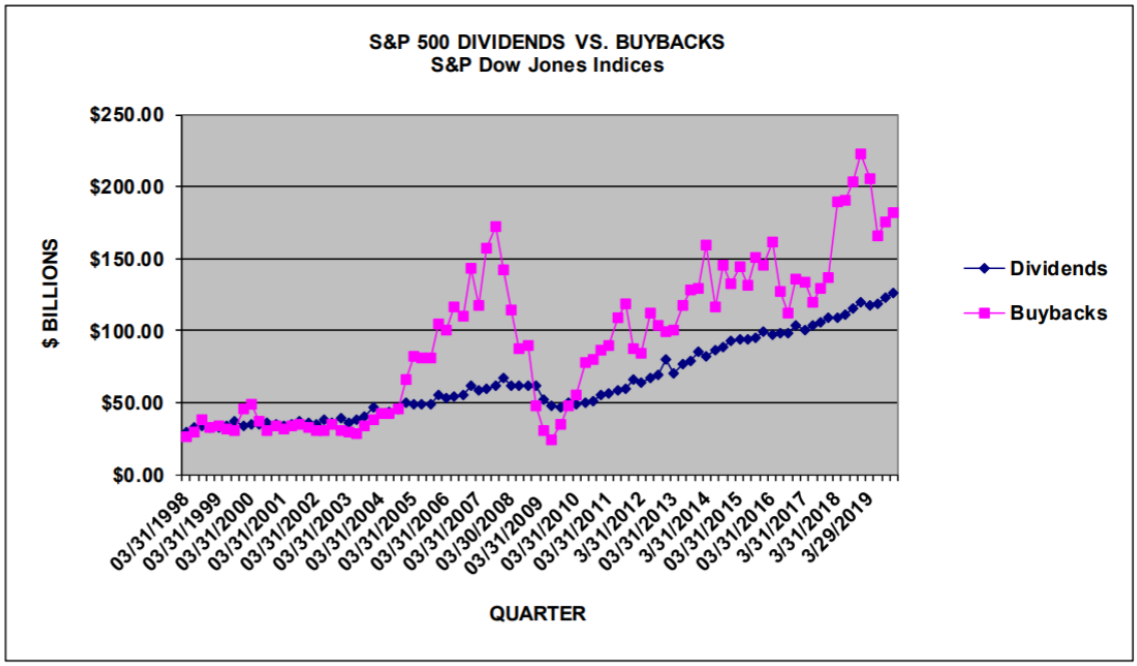
Con: No money is sent to you. If the market does re-price the shares upwards, you must sell them to get your hands on the increased value. If you do so, your gain will be taxed.

Con: Share purchase programs are generally authorizations from the board to management to spend up to $X over (say) five years to repurchase shares. Whether, when, and at what prices management executes the buybacks are not predictable. Dividend growth programs, on the other hand, tend to be long-term and somewhat predictable.

Con: Share purchase programs are not monitored as closely as dividend programs. Failures to complete share buybacks are inconsistently reported.

Con: Often, companies pay top dollar for their shares. That is because they may initiate a buyback program when times are good. But that may coincide with their stock's price being higher. Figures from S&P show that companies have pulled back on buybacks when stock prices are low (bad times) and increased them when prices are high (good times). For the most benefit, obviously, that timing should be reversed. Of course, when times are hard, companies have less cash for buybacks, and they will suspend buybacks before tinkering with the dividend.

On the following chart, you can see the big drops in buybacks during the Great Recession (2007-09) and the Covid-19 crisis early in 2020.



(Source: S&P press release, March, 2020)

Here's my bottom line: Over the years, so long as I am satisfied with a company's overall dividend practices, I have come to appreciate the declining share counts that often happen as the result of buybacks.

I don't pay much attention to the market price increases that may result, but I do think it is advantageous to have a lower share count across which to spread dividend pools.

And I don't want my companies to increase their dividends at an unsustainable speed that might lead to a freeze or cut down the road. So in cases like that, I am fine if a company channels some money to a share buyback program.

Certain Companies Are Organized Specifically to Pay High Dividends: REITs, MLPs, and BDCs

There are three special business structures that, by law, can avoid paying income taxes at the company level. By their nature, such entities distribute

a high percentage of their cash flow out to their owners. With each of these special types of businesses, the dividends or distributions are not qualified for favorable treatment under the Internal Revenue Code. They are taxed at your ordinary tax rate.

1. Business Development Companies (BDCs)

BDCs were created by Congress in 1980 to provide capital to small businesses. BDCs are public companies that provide capital and management expertise to small enterprises. Through them, an ordinary investor can participate in the business of "private equity" in a way that would otherwise not be possible. There are about 50 BDCs operating.

BDCs are regulated, must invest at least 70% of assets in small companies, and must provide significant managerial assistance to the companies in their portfolios.

The law requires BDCs to distribute the bulk of their net investment income and capital gains to shareholders in return for that money not being taxed at the corporate level. Thus, BDCs often have attractive dividend yields.

Here is how Investopedia sums up the pros and cons of BDCs:

Pros	Cons
• High dividend yields	• High-risk
• Profits not corporate-taxed	• Sensitive to interest-rate spikes
• Open to retail investors	• Illiquid/untransparent holdings
• Liquid	

There are no BDCs in this year's Top 30.

2. Master Limited Partnerships (MLPs)

An MLP is a partnership that is traded on a major stock exchange. By law, their activities are limited to operations in real estate, and the production,

processing, and transport of natural resources. MLPs give investors an opportunity to participate in partnerships that would otherwise be difficult for an individual investor to access.

MLPs' taxable income (or loss) is apportioned to the partners — who are called unit holders rather than shareholders — and taxation takes place at the unit-holder level. MLP units trade like stocks, have ticker symbols, and are "liquid" in the sense of being easy to buy and sell.

MLPs appear mostly in the oil and gas industry, especially among pipeline and storage businesses. These businesses are regulated, including their fees.

It used to be said that an attractive feature of pipeline MLPs is that they are insulated from price volatility in the products they transport: gasoline, diesel fuel, jet fuel, and the like. They do not sell such products; rather, they get paid to move them.

But when oil prices crashed in 2015, many MLP investors found that the quantity of oil moving through pipelines is somewhat price-dependent after all, and thus that MLPs are not totally insulated from the prices of the materials they transport.

MLP payouts are called "distributions" rather than dividends. MLP distributions are not taxed at the partnership level. As a result, the MLP can pay out significantly more of its cash flow to unit holders than a corporation could.

The distributions sent to MLP unit holders are not "qualified" dividends under the Internal Revenue Code, so they are taxed at ordinary tax rates. However, some of the distribution sent each quarter to unit holders is considered to be a return of the original capital invested. This returned capital is a return of your own money, so it is not taxed in the year you receive it. It lowers the cost basis of the shares that you own. Thus, the tax on the distribution is deferred until you sell the stock.

While this can be beneficial in terms of lowering the immediate taxes on distributions, many investors consider the special K-1 tax forms to be difficult to deal with. I think it is fair to say that over the past decade, dividend-investor interest in MLPs has waned to a significant degree.

There are no MLPs in this year's Top 30.

3. Real Estate Investment Trusts (REITs)

A Real Estate Investment Trust is a company that owns, develops, operates, and/or finances income-producing real estate. REITs were authorized by Congress in 1960. They allow anyone to invest in portfolios of real estate assets the same way they invest in other industries, through the stock market.

Real estate companies do not have to be REITs, and they must meet a number of requirements to qualify as REITs. They choose the REIT structure in order to avoid taxation at the corporate level.

Two of the most important requirements to qualify as a REIT are (1) the company must hold more than 75 percent of its assets in real estate and (2) it must distribute at least 90 percent of its taxable income to shareholders annually. If it meets these requirements, the distributed money is not taxed at the REIT level.

The responsibility for taxes is thus passed along to shareholders. The distributions to shareholders are not qualified for favorable tax treatment under the tax code. They are taxed as common income.

According to Nareit, an industry-sponsored promotional group, REITs invest in a dozen sectors, sometimes exclusively and sometimes in combination. The sectors include:

- Offices, including skyscrapers and office parks
- Industrial facilities, such as warehouses and distribution centers

- Retail, including malls, outlets, and shopping centers
- Lodging
- Residences, such as apartment buildings and student housing
- Healthcare facilities, such as medical office buildings, skilled nursing facilities, and hospitals
- Self-storage
- Data centers

Most REITs own and manage real estate investments and generate income by collecting rents. Some REITs operate what they own; others outsource operations. Some REITs sell their real estate developments once they have been completed, while others continue to own and operate them.

REITs are the only practical way for most individuals to invest in large commercial real estate developments. Real estate is often considered to be a distinct asset class (beyond the "big three" of stocks, bonds, and cash), and the returns from REITs are often not closely correlated with the returns from other types of assets. Therefore, REITs offer investors some benefits of diversification. Yields often are higher than other dividend growth stocks.

As with the other special corporate forms, REITs are subject to market risk, because their shares are traded.

There are two REITs in this year's Top 30.

Unique Considerations Regarding Foreign Corporations

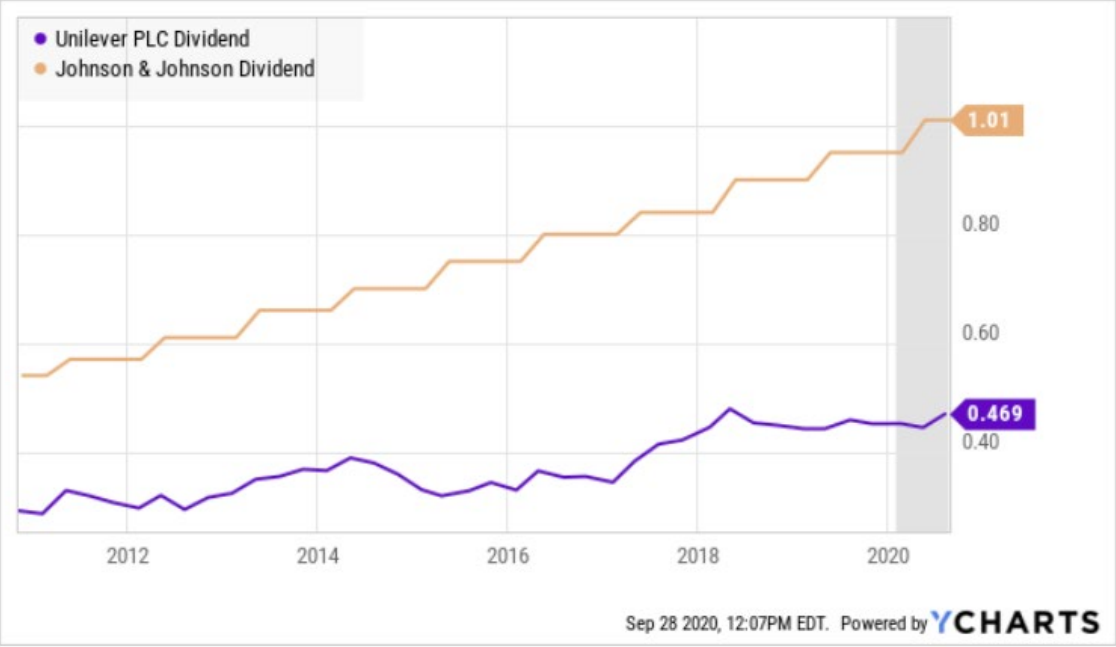
Foreign as well as domestic companies pay dividends. But foreign corporations present special considerations.

Payout procedures

The dividend programs of foreign companies often differ from domestic conventions:

First, many foreign companies compute each dividend as a fraction of recent earnings. Thus, as earnings vary, so do the dividends, which move up and down irregularly from payment to payment. Most American companies, by contrast, smooth their dividends. For example, they will raise the dividend once per year and make four payments at that new level until the following year's increase.

On this chart, compare London-based Unilever's dividend over the past 10 years to the USA's Johnson & Johnson.



Second, many foreign companies make semi-annual or annual payments rather than quarterly payments. Many investors prefer quarterly payments, which provide more frequent feedback about how your company is doing.

Obtaining information

Some investors feel that it is harder to acquire accurate information about foreign companies that do not trade on U.S. exchanges. Reporting requirements and practices may be different from U.S. requirements.

Currency translations

Depository banks convert and distribute dividends from foreign stocks, extracting a fee for this service. When foreign stocks pay dividends in their native currency, the dividends are converted to U.S. dollars and credited to your brokerage account. Any fee for conversion shows up as a debit on your brokerage statement.

Any benefit or detriment of a stronger or weaker dollar takes place during the conversion. When translated into U.S. dollars, foreign companies' payments will rise and fall in concert with foreign exchange rates.

For example, when the U.S. dollar strengthens vs. another country's currency, the dividends from companies in that country will be reduced when translated to U.S. dollars. A dividend increase in the native currency may actually be a decline by the time it gets to your brokerage account.

Taxation

While the U.S. government does not withhold taxes on dividends paid by U.S. companies, many foreign governments do withhold taxes on dividends paid by companies incorporated within their borders. The foreign companies in such countries deduct income withholding tax before sending you the dividend.

This has the practical effect of lowering the payout to you. Many countries have treaties with the U.S. that help U.S. investors avoid double taxation of dividends. For example, the treaty with Canada leads to most Canadian dividends being withheld at 15% rather than the basic rate of 25% under Canadian law.

Furthermore, under U.S. law involving foreign tax credits, you can claim a credit for the withheld amount on your U.S. income tax return. The credit does you no good if you hold the stock in a tax-deferred account such as an IRA. In that case, you do lose the amount that was withheld.

Canada does not withhold taxes if a stock is held in an IRA, provided they know that. Informing the Canadian company is usually done by your broker. Check with your broker before purchasing shares to be sure that they will do that as IRA custodian.

The U.K. does not withhold taxes on U.K. dividends.

The following document lists the withholding taxes for foreign countries: "S&P Dow Jones Indices Withholding Tax Rates." Be sure to consult with the IRS or your tax advisor on specific questions.

Summary regarding foreign corporations

As a result of the above issues, foreign dividend companies carry a "nuisance" factor. For that reason, some dividend growth investors avoid them. It is a personal decision. Undoubtedly, avoiding foreign companies means passing up on some good investment opportunities.

On the other hand, many domestic multi-national companies provide foreign diversification through their regular operations, often deriving 50% or more of their business from overseas markets. There are plenty of domestic, Canadian, U.K., and domestically traded ADR companies from which to form a good portfolio.

Taking all of the above into account, I have adopted the following policies for the purposes of the Top 30 in this e-book:

- I measure dividend growth year-over-year, not payment-to-payment.
- I require dividend growth to appear after translation to U.S. dollars.

- I only present non-domestic stocks that are traded on U.S. exchanges.

There are no foreign companies (not traded domestically) in this year's Top 30.

What's the Bottom Line on Dividend Growth Investing?

In the last two chapters, we've reviewed the pros, cons, and special situations of dividend growth investing.

Dividend growth investors generally believe that the benefits of healthy, reliable dividend-raising companies outweigh the drawbacks. They are attracted to a strategy of investing in superior companies with high probabilities of sustaining their earnings and dividend growth for many years. They are attracted to the idea that the increased purchasing power from dividend growth usually overcomes the erosion in purchasing power from inflation.

Dividend stocks send you money in cash. The income portion of total return from dividend stocks arrives immediately and directly in real time as you go along. As a shareholder, you do not need to sell shares to realize some of your companies' profits.

After years of my own study and research, I have come to the conclusion that dividend growth investing, if done competently, is a great way to invest. It is an excellent approach for the self-directed individual who has the patience and temperament to follow a steady strategy for the long term.

CHAPTER 6

SELECTING STOCKS – OVERVIEW

In the previous chapters, we've talked about the theory behind dividend growth (DG) investing, including how and why it works, and some of the pros and cons of the approach.

Now, and in the next several chapters, we turn to **executing** the DG strategy.

I strongly believe that having a logical organizational framework greatly simplifies investing. Therefore, I need to explain how I organize the operations involved in DG investing, because the chapters in this book correspond to the organizational framework.

First, I break DG investing into two broad phases: (1) Picking good stocks to buy, and (2) managing your portfolio.

These two broad phases are roughly chronological, but there is a lot of overlap. For example, you will evaluate stocks many times over the course of a long investing career, even though you already have one or more portfolios established.

Next, I break up the first phase – picking stocks – into two general areas: (1) Finding the right companies and (2) valuing their stocks.

To find the right companies, I evaluate three areas:

- Their dividend records (Chapter 7)
- Their business quality (Chapter 8)
- Their financials (Chapter 9)

After selecting good companies as candidates for investing, then I move into the second general area involved in stock picking, which is valuation (Chapter 10).

One thing I'd like every reader to come away with is a sense that they understand the overall investing process and feel less overwhelmed at the numerous pieces of information that come into play in making investment decisions.

Overview about "Stock Picking"

Dividend growth investing begins with finding individual stocks that fit the strategy well. I do not cover here the possible execution of DG investing via mutual funds, exchange-traded funds (ETFs), or closed-end funds (CEFs).

The phrase "stock picking" is often used pejoratively. Some advisors believe that selecting individual stocks is a fool's errand, and that investors should only invest in funds.

I disagree. Selecting stocks is a skill that can be learned. It is not voodoo or witchcraft. It is not available only to a chosen few with specialized skills or access to inside information.

Stock picking is merely the application of logic to facts. It does not require advanced math skills.

The purpose of stock selection is to identify the relatively few stocks that seem most likely to fit your goals and strategies, and to discard the rest.

In fact, I come at stock-picking "backward": I identify the stocks to discard first. I *love* to throw stocks out of consideration. It makes life easier if you can whittle the universe of stocks down to a manageable number that are truly legitimate candidates that fit your goals and aspirations.

If a company's record generates seeds of doubt, eliminate it. That's better than trying to stretch for reasons to retain certain stocks as candidates. I want the best of the best. Some people say this approach causes me to miss some opportunities. So be it. I still find plenty.

Eliminating stocks is best done unemotionally. Strive to make businesslike decisions, because you want to achieve businesslike results.

Picking stocks is a probabilistic activity. By that I mean you are trying to improve the odds that you will select stocks that, over the long term, will help you achieve your goals.

The future is not knowable, ever. But you can increase your chances of success by using facts, applying sound reasoning, and sticking to an intelligent process.

Getting Started

We do not just want to invest in companies that appear on some list of high yielding stocks. In your reading, you will encounter lists of dividend stocks that are poorly thought out. They ignore factors like risk, dividend sustainability, and business soundness. Surprisingly, they may ignore (or be unaware of) recent dividend cuts by the very companies they are touting.

Our goals go well beyond finding stocks with decent yields. We want to find the **best** dividend growth stocks, the kind that we can hold with confidence over long periods of time while we benefit from steadily increasing dividend streams.

In this chapter and the ones that follow, my goal is to present a comprehensive yet understandable process that you can use to find the 20, 40, 60, or 80 most investable stocks to execute your own dividend growth strategy.

First, use the CCC list

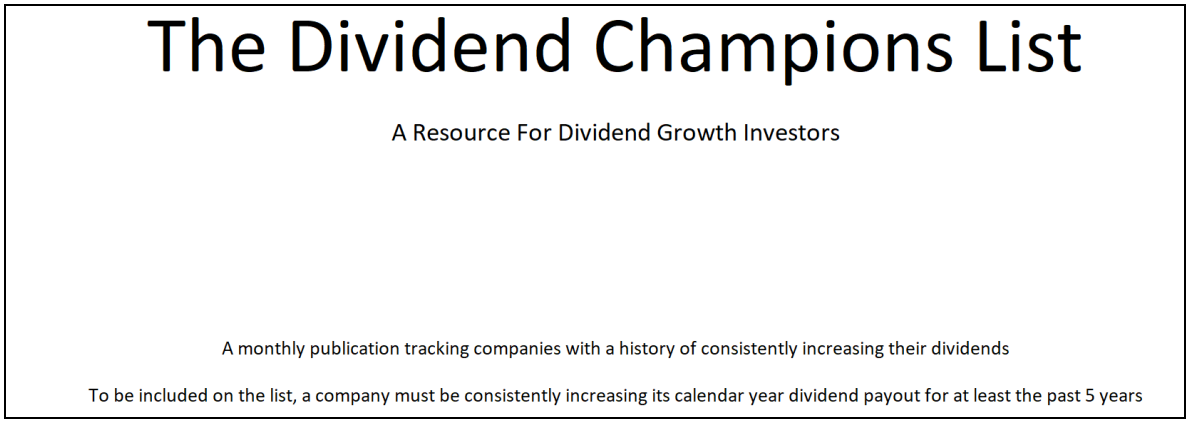
There are several thousand stocks listed on exchanges in the USA. How do you even begin to find the ones most suitable for dividend growth investing?

I start with a single criterion that eliminates thousands of stocks right off the bat: I require that every candidate have increased its dividend for five consecutive years.

After all, this strategy is called dividend **growth** investing. Obviously, we want companies that have established records of growing their dividends.

Fortunately, we all have free access to a remarkable research tool, called the Dividend Champions List, from the Dividend Investing Resource Center. The five-year requirement is used to select stocks for the Dividend Champions List, so it fits our needs perfectly.

Here's what the title page of the Dividend Champions document looks like:



The Dividend Champions List

A Resource For Dividend Growth Investors

A monthly publication tracking companies with a history of consistently increasing their dividends

To be included on the list, a company must be consistently increasing its calendar year dividend payout for at least the past 5 years

The Dividend Champions List (most people use it in spreadsheet form) has been around since 2007, growing in completeness and sophistication every year since then.

Its existence eliminates the necessity of hunting down all the companies that might be of possible interest for DG investing. The Dividend Champions

List, currently maintained by Justin Law, is informally called the CCC, to represent its three categories of DG stocks, which total around 750:

- **C**hampions, companies that have increased their dividends for 25 or more straight years (there are about 130 such stocks)

- **C**ontenders, 10-24 years (about 270)

- **C**hallengers, 5-9 years (about 350)

Is the CCC too restrictive?

By starting with the CCC, we eliminate several thousand stocks. Google, Facebook, Tesla—they are all gone. Is this too harsh?

Consider what I present here to be simply suggestions: This is how I do it. I always encourage readers to understand the basic principles, then to do what is right for themselves. This book is about a strategy, dividend growth investing. There are lots of ways to execute it.

- If you want to accept stocks that have raised their dividends for just four consecutive years, please do so.

- If you want to have a one-year leniency policy (that is, allow stocks that skipped a single year's increase in the middle of a much-longer streak), then that's what you should do.

The methods I describe herein have been honed over more than 10 years. They are directed to the goals of the DG strategy the way I see them, and they are relatively easy to perform.

As we go through each step, I hope you will gain confidence about picking stocks and gain the courage to do so. You will be able to see the reasoning behind the steps, and hopefully a lot of the mystery about "stocks" will disappear.

You can, indeed, pick stocks at home. Don't believe those who tell you that you can't and shouldn't even try.

Other Minimum Requirements

As I said, I love to eliminate stocks early that stand no chance of making it through as reasonable candidates.

Therefore, I use several additional factors to eliminate candidates in addition to the five-year rule described above. In stock investing, rules that draw a bright line in the sand are called "screens." They are pass-fail tests. Stocks that do not pass these initial screens are eliminated from further consideration.

Don't worry right now about how to find each piece of information. I'll tell you that later.

Here are my minimum requirements:

- At least five straight years of dividend increases, which allows you to start with the CCC List as described above.

- Price at least $5 per share. This eliminates "penny stocks" and others that may be illiquid because institutions are not allowed to buy them. I also drop pink-sheet stocks, companies being acquired or splitting themselves up, and firms that pay scrip dividends (that is, pay dividends in more shares of stock rather than in cash).

- S&P credit rating must be investment-grade (BBB- or better). I'll explain credit ratings later.

- Dividend Safety Grade from Simply Safe Dividends must be 61 or better (on a scale of 0-100).

- Most recent dividend increase must have been within past 12 months.

For this book, I did not use a minimum yield (like 1% or 2%) as a screen. In your own investing, you might wish to do so. For years, I only wanted stocks that yielded 3% or more, then I lowered that to 2.8% or 2.7%. But low-yielding stocks are often fast growers, and many investors (especially younger ones) want that growth potential.

Again, what have just been described are *screens.* They are used to eliminate stocks from consideration at the outset.

One of the screens above (Simply Safe Dividends) requires a subscription. If you don't subscribe, that's OK. For the Top 30 in this e-book, I will supply the data. For other stocks, just use the screens that involve free data. We're not actually picking any stocks at the beginning; we're just reducing the size of the universe to look at.

Anything you do to help eliminate quantities of unrealistic candidates is helpful. For example, for personal reasons some investors won't invest in tobacco companies or the energy industry. Those are easily identified on the CCC List and can be crossed out without further analysis.

Grading Stocks That Pass the Screens

Once I have winnowed stocks from the CCC using the minimum requirements described above, I stop screening. That is, I drop the idea of seeing the surviving stocks in a binary fashion as "good" or "no good." Things become more nuanced.

Investable companies lie along a spectrum, with truly excellent companies at one end of the spectrum and "just OK" companies at the other end. In my own investing, I try to stay near the upper end of the scale.

To determine where along the spectrum individual companies lie, I evaluate several pertinent factors about each company and come to an overall judgement about the company as a whole.

One reason to recognize shades of gray is to avoid eliminating a company on the basis of a single bad data point, which could be an aberration or even a data error.

Another reason is that sometimes different pieces of information tell different stories. For examples, one metric will be positive (like a high yield), but another will be negative (the dividend growth is very slow). Weighing such factors against each other helps develop an integrated view about the company's suitability for your portfolio.

My experience is that grading several important categories of information really helps identify which companies make the most attractive investments. The cream rises to the top.

Consider what I present in the following chapters as a basic system to start with, one that you can adjust and improve as you learn about stocks. Feel free to add or drop factors, change grading scales, or customize things however you wish.

But at a minimum, I would suggest that you use what is presented here as a checklist of things to look at when you are considering a stock.

One final suggestion. The following chapters do get into some detail, and for that reason, some readers may wish to skim through the material just to establish a basic understanding. You can always come back later to delve into a particular subject that you need to understand more deeply when you are actually considering specific stocks for yourself.

The following chapters (7-10) cover the main areas that I consider to select stocks to invest in:

- Dividend record
- Company quality
- Company finances
- Stock valuation

CHAPTER 7

SELECTING COMPANIES: DIVIDENDS

Overview on Grading Dividends

The first main grading category in searching for the best dividend growth (DG) stocks is to consider the companies' dividend record.

Think of each company as applying for a job. You are "interviewing" it for a position in your portfolio. The company (the applicant) presents you with its resume. Your job, as the interviewer, is to go over the resume and figure out whether the company is a good candidate for your position.

In evaluating the dividend portion of stock resumes, these are the factors that I examine:

- Yield
- Number of years of increasing dividends
- Dividend growth rate
- Dividend growth trend
- Dividend safety

I combine all of these into a single Dividend Grade on an old-fashioned A-F letter system like you probably were subjected to in school.

To get the overall grade, I rate the individual factors first. The following sub-sections discuss how I do that.

I suggest a point grading system for each of the individual factors, although you needn't get that formal. Ultimately, the goal is to understand how and why the individual factors are important and how to evaluate them.

Experienced investors will end up with their own system. The idea here is to get a handle on the basics.

Dividend Factor #1: Current Yield

To reach their goals, most DG investors want to achieve, by a certain point in their lives, a particular amount of income. Current yield defines how much income you are going to get from a particular stock as soon as you buy it. Later on, growth will kick in.

Higher yields get higher grades. Here is the scoring grid that I use on this factor.

Current Yield Scoring		
Yield	**Interpretation**	**Points**
>4.0%	Excellent	5
3.0-3.9%	Good	4
2.0-2.9%	OK	3
1.0-1.9%	Low	2
0-0.9%	Very low	0

The reason to require a minimum yield at all is to provide a decent dividend return on your money right from the start. While 1% yield does not sound like much, it is more than you can get from a 10-year Treasury bill (0.8% as of November 30, 2020).

Everybody wants to earn "enough" for the risk they are taking. Some DG investors pay less attention to yield than others, mainly because lower-yielding stocks are often faster-growing. That's a tradeoff that we all make. The table above reflects my own regard for yield. Feel free to change it to reflect your personal investing goals.

While there is no maximum yield, any yield above 9% or so is subject to suspicion that it is not sustainable. Dividends that are that high often get there because the company's share price has dropped significantly. That

could be because investors have detected something severely wrong with the company or believe that it is extremely risky. Make sure you understand why the company has such a high yield and whether its dividend payouts are sustainable.

Dividend Factor # 2: Years of Consecutive Increases

The more consecutive years that the company has increased its dividend, the higher its grade.

Length of Streak Scoring		
Years	**Interpretation**	**Points**
50+	**Excellent – Dividend King and/or Aristocrat**	**5**
25-49	**Good – Dividend Champion and/or Aristocrat**	**4**
14-24	**OK – Dividend Contender with 14+ year streak (meaning it raised dividend through Great Recession of 2007-09)**	**3**
5-13	**Short – Dividend Challenger or Contender with <14-year streak**	**2**
<5	**Not qualified**	**0**

A company with a long string of uninterrupted increases has demonstrated that it has a deliberate, managed dividend policy. Such evidence is the best we have that the company is committed to raising its dividend if it possibly can. Some companies make direct statements to this effect, while the policies of others must be inferred from what they have done.

Note, in this connection, that it can be insightful to see how a company portrays its own dividend policy and historical dividend record. You get a sense of that from its own website. If a company makes a big deal about its dividend record, it is more likely that they are committed to extending it.

When the string of dividend increases reaches truly long streaks (measured in decades), the company has demonstrated that it can adhere to its dividend-raising practices through all kinds of economic conditions — wars, recessions, different political administrations, and the like. The longer the

streak, the more varied situations the company has been in, maybe through successive generations of management.

All else equal, those are the kinds of companies we want. They are easier to have confidence in.

Note that the yellow "OK" category starts at 14 years, even though Dividend Contenders by definition start at 10 years. The reason that I make this distinction is that if a streak only goes back 10 years (or even 13), that means that the company did not raise its dividend during the Great Recession of 2007-2009. Therefore, I lower stocks with streaks between 10-13 years down a grade level.

Dividend Factor #3: Dividend Growth Rate

I grade dividend growth rates (DGR) on a curve: I judge DGR in relation to the stock's yield. A stock with a high yield does not need to have as fast a DGR as a stock with a lower yield.

Therefore, for scoring purposes I divide stocks into the same five yield categories that I used in the first step and evaluate their DGRs in relation to their yields. That gives me a sliding scale.

Note that dividend growth rates are "per year," meaning that they designate a speed rather than a static amount.

DGR Scoring						
Yield >>>	4% +	3.0-3.9%	2.0-2.9%	1.0-1.9%	< 1%	Points
Very Fast	>8%	>10%	>12%%	>14%	>16%	5
Fast	6-8%	8-10%	10-12%	11-14%	13-16%	4
OK	3-5%	4-7%	6-9%	8-10%	10-12%	3
Slow	1-2%	2-3%	3-5%	4-7%	6-9%	2
Very slow	<1%	<2%	<3%	<4%	<5%	0

The table looks more complex than it is. Yields are listed in the blue line at the top, while growth rates are listed in the white cells. Say you have a

stock with a 2.5% yield and a 5-year DGR of 6% per year. Use the middle column for the yield and scan down to the third row to see that's an OK DGR. The stock would get 3 points on this factor.

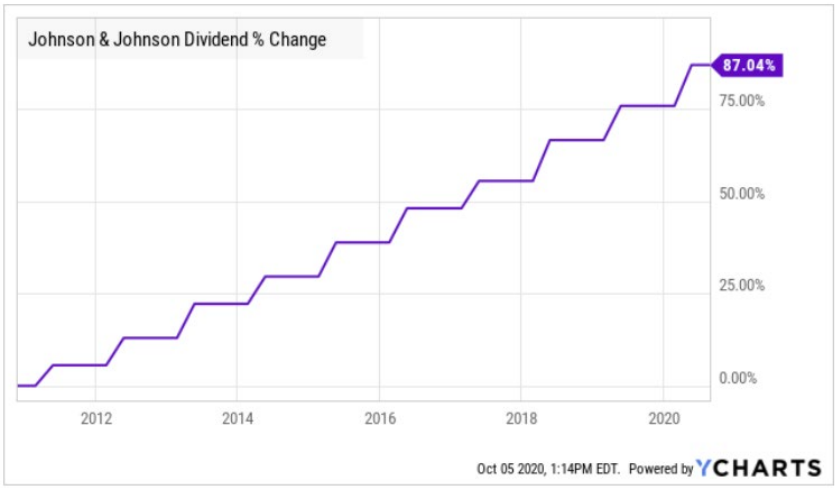
Notice the extremes of the table in the corners. If a high-yield stock (yield > 4%) has been increasing its dividend at >8% per year, that's very fast. (The fact is, companies with such a combination are rare.) To get the same "very fast" DGR rating, a stock yielding less than 1% would need a DGR of >16% per year.

Please note that **dividend growth is not conveyed by the stock's yield**. Yield varies with the stock's price, and therefore its fluctuations do not measure whether the dividend payout is going up. Rather, growth is measured by increases in the dollars-and-cents amount of the dividend.

Dividend Factor #4: Dividend Growth Trend

This is an evaluation of the stock's trend in raising its dividend.

Some companies raise their dividends like clockwork: Their increases come at about the same time each year, and they are usually around the same percentage amount. Here's an example:



The chart above shows Johnson & Johnson's dividend for the last 10 years. It's like a steady stairstep up: Same time each year and about the same percentage increase each time. Here is how that same period looks on the CCC's record of JNJ's dividend growth.

MR% Inc.	DGR 1-yr	DGR 3-yr	DGR 5-yr	DGR 10-yr
6.32	5.9	6.0	6.3	6.9

You can see that JNJ's dividend growth for every time period is similar. The company's 6.3% raise in 2020 was typical of the past 10 years.

Another example is AT&T. They've been raising their dividend by $0.04 per year for years. That increase by the same *dollar amount* each year results mathematically in their *percentage* increase, which isn't large to begin with, slowly declining each year.

MR% Inc.	DGR 1-yr	DGR 3-yr	DGR 5-yr	DGR 10-yr
1.96	2.0	2.0	2.1	2.2

Unlike those two steady examples, many companies vary the size of their raises and sometimes space them irregularly.

One thing to pay attention to is whether the company has been continually lowering the size of its dividend raises. Here's an example of that.

MR% Inc.	DGR 1-yr	DGR 3-yr	DGR 5-yr	DGR 10-yr
0.74	3.1	3.2	4.4	9.5

This company is John Wiley & Sons, a publishing company. You can see that each period's DGR is less than the longer period to its right. In other words, Wiley's most recent increase (2020) is less than its 1-year DGR (2019), which is less than its 3-year DGR, which is less than its 5-year DGR, which is less than its 10-year DGR.

I downgrade stocks like that in the absence of an explanation. An acceptable explanation might be that a stock is new in its dividend growth life. Such companies often have a declining annual pattern. Their first dividend, which is an increase from zero, is actually a DGR of infinity. Then maybe there's a 20% increase followed by a 10% increase, and so on as the company finds its footing as a new dividend growth stock and figures out how much it wants and can afford to pay out in dividends each year.

I would not penalize such a company for its declining DGR. In recent years, we have been seeing this pattern with established tech companies, former high fliers that one-by-one are initiating dividends as they mature.

For an example, here's Apple.

MR% Inc.	DGR 1-yr	DGR 3-yr	DGR 5-yr	DGR 10-yr
6.49	7.8	10.9	10.5	n/a

Apple's dividend increases have been declining in percentage value, but it hasn't been paying long enough to even have a 10-year record. I wouldn't assign much weight to this pattern of decline.

So the grading scale for DGR trend is somewhat subjective and requires judgement. Here is generally the way I think about it.

DGR Trend Scoring		
Pattern	**Interpretation**	**Points**
Steadily rising DGR	**Excellent**	**5**
Steady and consistent DGR	**Good**	**4**
Steadily falling DGR but with extenuating circumstances (like new DG company)	**OK**	**3**
Steadily falling DGR without extenuating circumstances	**Poor**	**1**
Frozen or cut dividend within past 5 years	**Not qualified**	**0**

Going back over the examples, I would give JNJ a 4, AT&T a 3 or 1, Wiley a 1, and Apple a 3. Companies in the bottom category should not have made it through the initial screens.

Dividend Factor #5: Dividend Safety

I consult Simply Safe Dividends (SSD) for these grades. They grade dividend safety on a 0-100 scale.

Dividend Safety Score	**0-20**	**21-40**	**41-60**	**61-80**	**81-100**
Is the current dividend safe?	**Very Unsafe:** High risk of being cut	**Unsafe:** Heightened risk of being cut	**Borderline Safe:** Moderate risk of being cut	**Safe:** Unlikely to be cut	**Very Safe:** Cut is very unlikely

I convert that system to my own scoring like this:

Dividend Safety Scoring		
SSD Grade	**Interpretation**	**Points**
81-100	**Very Safe**	**5**
61-80	**Safe**	**4**
41-60	**OK**	**3**
<41	**Not qualified**	**0**

As you can see, I don't mess around with safety. SSD's track record is pretty impressive, and I rarely disagree with it when I check their reasoning.

Therefore I only accept stocks in their top three categories, and I limit my investing mostly to stocks in the top two categories.

Final Dividend Grade

After considering the above five factors, I pull everything together into a unified dividend score. I award a simple A – F grade like most of us got in school. I arrive at that letter grade by adding the points from the individual factors above.

There is a total of 25 points available. I only consider a stock investable if it gets at least 15 points, which would give it an overall "C" grade for its dividend. There is no such thing (to my way of thinking) as an investable dividend growth stock that gets a "D" for a dividend grade. In fact, there are no "Ds." A stock scoring below 15 points gets an F and can be eliminated.

The following summary table brings the five dividend factors into one place. Obviously, it lacks all of the detail in the sections above, but after a little practice, it should help you put together a company's overall dividend score in just a few minutes.

Dividend Metrics Summarized					
Points	**Yield**	**Years**	**5-year DGR**	**DGR Trend**	**SSD Dividend Safety**
5	**> 4%**	**50+**	**Very Fast**	**Rising**	**81-100**
4	**3–3.9%**	**25-49**	**Fast**	**Steady and consistent**	**61-80**
3	**2–2.9%**	**14-24**	**OK**	**Falling but explainable**	**41-60**
2	**1–1.9%**	**5-13**	**Slow**	**Steadily falling**	**NA**
0	**< 1%**	**<5**	**Very Slow**	**Frozen or cut**	**<41**

To arrive at the company's "final grade" for dividends, simply use the total points to pick out the appropriate letter grade from the following table.

Final Dividend Grade		
Total Points for All Factors	**Letter Grade**	**Interpretation**
22 - 25	**A**	**Excellent**
19 - 21	**B**	**Good**
15 - 18	**C**	**OK; Investable**
0 - 14	**F**	**Ineligible**

Example: Johnson & Johnson

To demonstrate you how easy this can be, let's do an example, using the pharmaceutical company Johnson & Johnson (JNJ).

You may have noticed that I keep using JNJ as an example. That's not only because it's such a great company (it's a DG All-Star), but also because its record over the years is rich with examples of how to think about DG stocks.

Here are JNJ's dividend statistics, with the source noted, as of October 12, 2020.

- Yield: 2.7%. I got this from Simply Safe Dividends (SSD), but almost every source would tell you the current yield. Points = 3.

- Years of consecutive increases: 58. Source = CCC and SSD. Points = 5.

- 5-year DGR: 6% per year. I got this from SSD, but it is available also from the CCC document and some other sources. Points = 3.

- DGR trend: Steady at decent rate. I got this from CCC; the data was displayed earlier in the text. Points = 4.

- Dividend safety: 99. This is a proprietary data point from SSD. It will be displayed for the Top 30 stocks in this book through permission from SSD. Points = 5.

Here are JNJ's data points, circled on the summary chart from above:

Dividend Metrics Summarized					
Points	Yield	Years	5-year DGR	DGR Trend	SSD Dividend Safety
5	> 4%	50+	Very Fast	Rising	81-100
4	3–3.9%	25-49	Fast	Steady and consistent	61-80
3	2–2.9%	14-24	OK	Falling but explainable	41-60
2	1–1.9%	5-13	Slow	Steadily falling	NA
0	< 1%	<5	Very Slow	Frozen or cut	<41

Total points for JNJ = 20, for a dividend grade of B.

You may be wondering how a stock with a dividend grade less than A can be an All Star. The reason is that we're evaluating dividend growth stocks across many metrics, not only their dividends. A dividend grade of B is perfectly fine provided that the company and its stock jump over the other hurdles that we set up.

Most DG investors, when constructing (or adding to) established portfolios, appreciate the role that stocks with different characteristics play in the overall effort. Some investors think of their holdings as players on a team, each with different skillsets and positions to play. Every player does not have to be excellent at every role.

Understand the Principles! Don't Get Hung Up on Details

The dividend grading system that I just discussed, and all the other screens and evaluation systems in this e-book, are *suggestions.* While you can certainly follow them exactly, it is more important to understand the underlying reasoning and general principles.

Make your own tweaks and variations to how you score or grade your stock candidates, and use the principles to make suitable adjustments when unusual situations present themselves.

This would be my summary of the general principles for dividends:

- Higher yields are better than lower ones. That said, lower yields may come from companies that promise faster growth. At the other end of the spectrum, really high yields may carry unusual risk that should be investigated.

- Longer dividend growth streaks are better than shorter ones.

- Faster DGRs are better than slower ones, although “fast” and “slow” should be interpreted in the context of the stock’s yield.

- Consistently good or decent dividend raises are better than inconsistent or falling ones.

- Safe dividends are better than risky ones.

CHAPTER 8

SELECTING COMPANIES: QUALITY

This is one of my favorite quotes from the great investor Peter Lynch:

> "If you're prepared to invest in a company, then you ought to be able to explain why in simple language that a fifth grader could understand, and quickly enough so the fifth grader won't get bored." (Source)

Here's my translation: **If you don't understand how a company makes money, don't invest in it.** It's the same idea as Lynch's: On a macro level, you should be able to describe, in straightforward terms, what a company does for a living.

What we're looking for in investigating what a company does is its **quality.** We want companies that are reliable, leaders in their fields, consistently ahead of their competitors (or perhaps without real competitors), and financially sound. We want to invest in excellent companies with an understandable pathway to continued success.

The Company's Story

The Story is a paragraph or two about what the company does, how it makes money, and why its success is likely to continue.

I believe in writing out the Story. That helps me confirm that I understand it.

Good signs about a company can be many and varied. Not all companies have all of these qualities, but look for things like:

- legal monopoly
- dominant in its field; market leader where it competes
- not hindered by regulation (or assisted by it, like regulated utilities)
- coherent strategies and growth plans that sound sensible to you
- great business model
- great brands
- record of innovation and adapting to changing conditions
- economies of scale that would be hard for others to replicate or catch up to
- great distribution systems
- riding a long-term mega-trend (demographic, technological, etc.)
- makes/distributes timeless and everyday products and services that people need, like consumer staples, electricity, and healthcare
- relatively immune from technological disruption, shifting tastes or fads, and product obsolescence
- sustainable competitive advantages (moats)

Explain the company's Story to yourself in simple language. Be clear. This is no time to be vague, parrot unfamiliar jargon, or talk yourself into something that you really don't understand.

The idea in dividend growth (DG) investing is not to invest in nearly every decent DG company. That would put the burden on you to justify rejecting a stock.

The idea, rather, is to put the burden on the company to convince you that it deserves a spot in your portfolio. The company is an applicant, and you should pick and choose among them to identify the best ones.

Warren Buffett is famous for having a "too hard pile." That's where to put companies that you can't figure out. There's no shame in it. Stay near your areas of competence.

Common sources of information for the company's story are its own website; analytical articles on sites such as *Dividends & Income*, *Seeking Alpha*, and Simply Safe Dividends; and analyst reports from your broker.

Write out the Story and then grade it along the following lines:

Business Model and Story Grade		
Your Judgment of Company's Business	**Letter Grade**	**Interpretation**
Very strong, sensible, inspires confidence	**A**	**Excellent**
Strong, sensible, few questions	**B**	**Good**
Seems about average among companies	**C**	**OK; Investable**
Seems weak, many questions, can't understand it	**F**	**Ineligible**

Third-Party Quality Ratings

Either to supplement your judgment, or to help you to formulate it, there are a variety of sources that rate various quality aspects that you can use. The following are a few examples. I can vouch for the quality of the sources mentioned.

Credit ratings

Standard & Poor's rates the credit quality of most companies. They have 22 grading levels, ranging from AAA (the best) to D (the worst, indicating that a company is in default). The letter-grades are further nuanced by a plus or a minus (as in A+).

I won't reproduce the full chart of S&P's credit ratings here. If you'd like to look at it, click here. Note that you can get S&P's credit ratings via a free registration at S&P. They are also noted in the right-hand data panel if you subscribe to FASTGraphs.

We will focus on only the top 10 levels of S&P's system. Those levels are called "investment grade" by S&P, while lower levels indicate significant speculative characteristics. I require all qualifying stocks to be investment grade. I grade those levels as follows.

S&P Credit Rating	
AAA, AA+, AA, AA-	Excellent
A+, A, A-	Good
BBB+, BBB, BBB-	OK
Below BBB-	Not qualified

Moat

A company has a moat when it has sustainable competitive advantages. Morningstar assigns moat ratings based on their analysis of how long a company's competitive advantages are likely to last.

They recognize three levels: wide moat (20 years+); narrow moat (10-20 years); and no moat. I don't eliminate no-moat companies, because I look independently at their business model myself.

Morningstar Moat Rating	
Wide	Excellent
Narrow	Good
None	Poor

Value Line Safety rank

If you have access to Value Line (either through a subscription or your local library), they have a Safety rank that is related to company quality. It looks like this on their stock research pages:



According to their description, the Safety rank measures the total risk of a stock relative to the other stocks that Value Line covers. Safety ranks are given on a scale of 1 (Highest) to 5 (Lowest). Stocks rated "1" are the safest, most stable, and least risky, while those rated "5" are the riskiest and least safe.

Value Line says that stocks with better Safety ranks are often large, financially sound companies. It notes that such companies, being mature with a large revenue and earnings base, may have somewhat lower-than-average growth prospects.

I generally confine myself to stocks that rate in the top two or three levels.

Understand the Principles! Don't Get Hung Up on Details

As with grading dividends, the idea in evaluating a company's quality is based on understanding the principles. If I were to summarize what to look for, this is how I would describe a high-quality company:

- Sensible business model
- History of strong execution
- Significant competitive advantages that seem sustainable
- Visible and achievable path to growth
- Strong brands
- Products and services that are unlikely to become obsolescent for a long time
- Receives strong quality-related grades from independent sources, such as good credit rating
- Impressive operations, logistics, manufacturing quality, distribution systems

CHAPTER 9

SELECTING COMPANIES: FINANCIALS

The third major area of inquiry in evaluating a company is its financial situation. We want to find companies that are profitable, growing (or stable), and have strong balance sheets.

I am fortunate to have the permission of Brian Bollinger, the founder of Simply Safe Dividends (SSD), to utilize his rigorous stock analyses, including his top-notch charts and graphics, in the writing of this e-book.

SSD has some of the best graphics I have seen to present the financial characteristics of a company. The charts used to illustrate the following discussion of financials come from SSD's data for Johnson & Johnson (JNJ) as of mid-October, 2020.

I am going to present here the financial metrics that I use in the Top 30 analyses later in this book. What follows is detail that you can skim or skip if you don't want to get deep into the weeds about financials.

That said, I have made every effort to make this material understandable. As an investor, you don't need an accounting degree to understand basic company finances or to form an educated opinion of how solid a company is financially.

To simplify things for myself when it comes to financials, I often "forget" the Story and instead think of the company as a black box. That lets me focus on the revenues coming in one end, what happens to them inside the company, and the returns coming out the other end.

Revenue

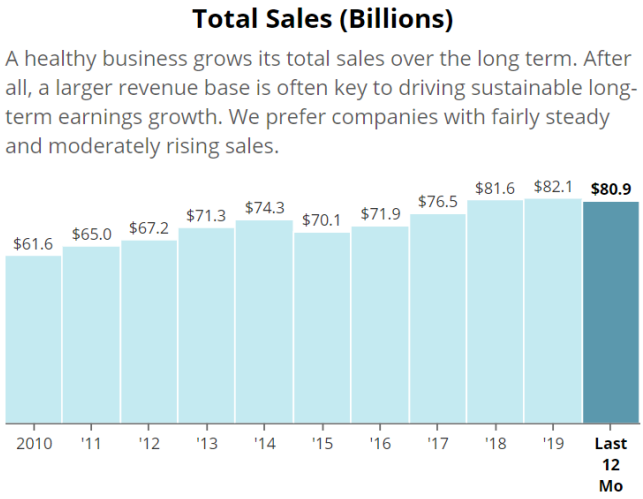
Revenue is easy to understand. It's the money the company receives from selling products and services. Revenue flows into the front end of the black box.

Obviously, all financials for a company begin with revenue. As one of my co-workers (a sales manager) used to say, "Nothing happens until somebody sells something."

We favor companies that are growing their revenues steadily. Flat or declining revenues make sustained earnings growth impossible. While a company can cost-cut its way to improved earnings without raising its revenue, it can only do that for so long. Over the long haul, a company must have growing revenues to grow its returns to you, the investor.

You may run into occasional exceptions, as where a company is deliberately shedding some product lines to focus on its core strengths. In such cases, revenue may go backward for a year or two before starting back up again. So-called cyclical companies may also see their revenues rise and fall with the general economy.

Here is Simply Safe Dividend's (SSD's) 10-year chart for JNJ's revenue. All of SSD's graphs are clear, similar in style, and contain their own brief explanation of what the chart shows. That's why I like them.



As you can see, JNJ's revenues have been generally rising for years. I don't care very much about the actual dollar amounts, because they depend on the size of the company. I'm more interested in the trend that the numbers show.

I would give JNJ a high mark for its revenue record. There's not explosive growth, but there's steady growth.

Earnings and Cash

Now we turn our gaze to the output end of the black box. There are two major ways that returns are measured: Earnings and cash.

Earnings

Earnings are the company's officially reported profits calculated according to Generally Accepted Accounting Principles (GAAP). When a company reports its earnings, the GAAP number is the "official" number. (Companies often simultaneously report non-GAAP results, which may better reflect performance trends.)

GAAP requirements can be quite involved, but an overview of the principles is appropriate to give you a flavor of how GAAP impacts the numbers. GAAP requires the following (source):

- Full disclosure of all information required for individuals to make informed decisions.

- Revenue to be recognized at defined times, which can require some artificial time-shifting from when cashflows actually came and went.

- Matching revenues and expenses to the events that cause them.

- Measuring assets and liabilities at actual cost (or market value). Things without a cost or market value cannot be recorded.

Here are a couple of common examples of GAAP's impact.

- Cash inflows and outflows are not always recognized at the time the cash is received or disbursed, but rather when the events associated with the cash take place. An example would be a subscription business that takes in cash when subscriptions are paid (often up front), but counts the revenue only when content is sent to the subscriber.

- When a company pays for long-lasting capital equipment or property, GAAP may require the cost to be depreciated over the useful life of the equipment (several years), rather than recording the entire expense in the year the equipment or property was acquired.

As you can see from those two examples, GAAP causes reported earnings to depart from the actual cash flowing through the company.

Cash

Because of the impact of GAAP rules on official earnings, cash flow becomes a metric of interest.

Cash is easier to understand. You probably run your own financial life on a cash basis. That is, you record income when you receive it and debit your

expenses when you hand out cash or write a check. You probably don't apply GAAP-like rules to your own finances.

While GAAP controls the reporting of "official" earnings, a company needs cash flowing in real time to be able to run itself. Cash is needed for the company to pay salaries, bills, debts, and dividends.

Cash is not time-shifted. It's either there or it's not. If the payroll is due this Thursday, the company must have the cash to make the direct deposits on Thursday. Debt payments must be made on time with available cash.

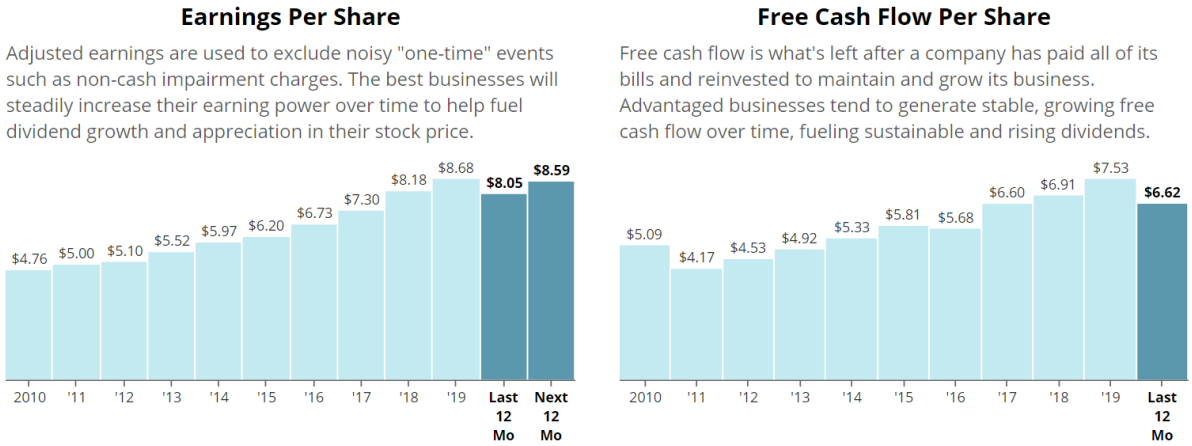
As investors, we want companies that are not only profitable under GAAP rules but also have strong real-time cash flow. I will omit the gory details, but a company can be GAAP-profitable yet strapped for cash. And vice-versa: A company can have sufficient cash to run itself but be unprofitable under GAAP rules.

One final note. Investors are usually interested in earnings and cash *per share.* If you divide GAAP earnings by the number of shares outstanding, you get the "headline number" when earnings are reported, namely earnings per share (EPS). The same idea applies to cash flows.

Here are SSD's graphs for JNJ's earnings and cashflow per share. Note the following:

- The earnings in the left graph have been adjusted from GAAP results to exclude one-time events in order to smooth the graph. In other respects, they reflect GAAP rules.

- The cash in the right graph is *free cash flow* (FCF), which is the cash produced by the company's operations less the cost of operating expenses and capital expenditures. FCF is the cash that a company has available for dividends, stock buybacks, and debt repayments.



Both graphs reflect a really good financial situation for JNJ:

- The company has delivered positive EPS in each of the past 10 years, rising every year until Covid-19 made its impact in 2020. We will see such an impact with many companies. As a result of the pandemic, a recession was declared in February, 2020, and it has not ended as of this writing.

- Similarly, JNJ's FCF per share is strong: Always positive and generally rising, with a pandemic-induced drop over the past 12 months.

As with revenue earlier, I care less about the particular numbers than about trends. I like to see consistency instead of volatility. Rising patterns are great, and flat patterns can be OK for a few years. Overall, we want to see growth. General decline over long terms is not desirable.

Efficiency

I use *efficiency* to refer to management's effectiveness in deploying the company's money. Efficiency reflects what is going on inside the black box. I follow two measures.

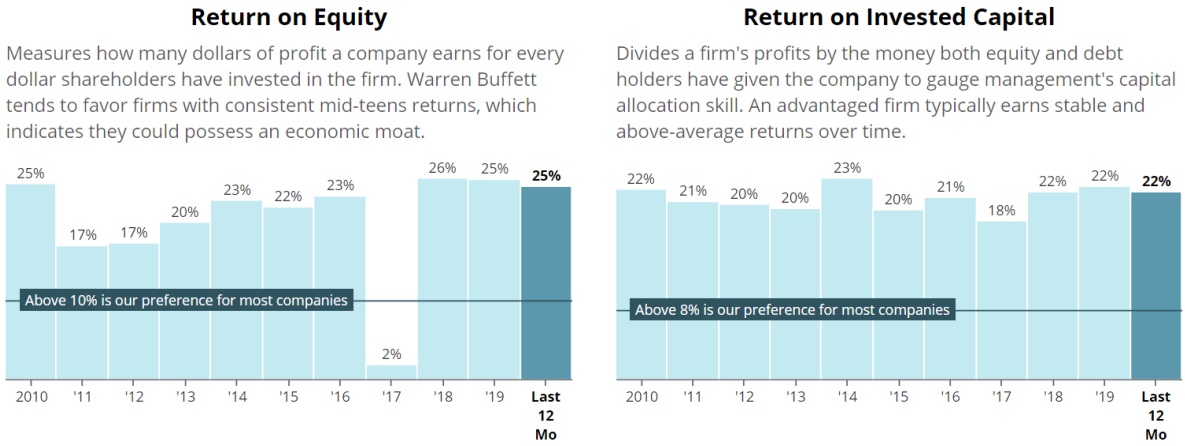
Return on equity (ROE) is a widely-used measure of company efficiency. It measures how much return a company generates for each dollar invested in it. As of October, 2020, the average ROE for all companies on the CCC List

is 11%, and all companies in the S&P 500 have a long-term average of 14% (source).

A little wrinkle is that a company's ROE can be inflated if it uses a lot of debt (the magnification is a result of how ROE is calculated). We will consider ROE unadorned here, but if an ROE is "artificially" high because of high debt, we will detect that later when we examine the company's debt.

Return on invested capital (ROIC) measures the company's effectiveness in deploying the capital at its disposal. *Capital* refers to the debt + equity + cash that the company has. ROIC indicates how well the firm is using its money to generate returns. ROIC for the S&P 500 has run in the range of 7-9% since the end of the Great Recession of 2007-09 (source).

These are the charts on these two metrics for JNJ.



As you can see, JNJ is very effective and efficient in using its money. Its results are far above the norms on both metrics. In the horizontal lines that you see on the graphs, SSD is suggesting benchmarks for the two metrics. JNJ is well above both benchmarks essentially every year.

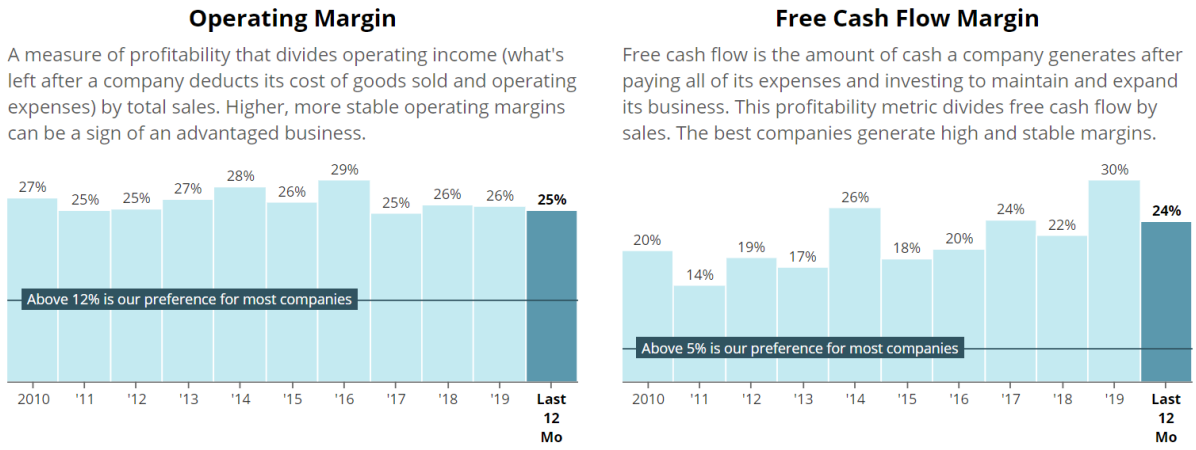
Profitability

Profitability is the next important area in assessing a company's financial performance. We want companies that consistently generate profits. Once again, there are two metrics that give insights into profitability.

Operating margin shows what percentage of revenue is turned into profit (after subtracting cost of goods sold and operating expenses). Per recent research, operating margins for S&P 500 companies have been in the 10-11% range (source).

Free cash flow margin is free cash flow (FCF) divided by revenue. Historically, FCF margin ran in the 5-10% range for S&P 500 companies. In the past few years, it has hovered a little above 10% (source).

For both profitability metrics, higher is better. Here are the two SSD charts for JNJ.



Once again, JNJ comes across as outstanding. Both of its profitability metrics have been consistently well above average for the past decade.

Debt

Debt is one of the ways that a company obtains cash. The other two ways are equity (money invested by shareholders) and the company's own revenue generation. Combined together, they total into the company's *capital* that we just saw in the ROIC discussion above.

Most companies carry at least some debt. They borrow money to help finance their operations, pay dividends, pay for acquisitions, and so on.

Even companies that could be self-funding often borrow money. The math behind doing that is that they believe they can make more money through the use of borrowed money than it costs to borrow the money. When it works, it is called *leverage.*

Some firms run their businesses with little debt, while others rely on debt a lot. Less is generally better, because debt repayments are obligatory and a constant drain on resources. Too much debt can weaken a company or even make its financial structure untenable.

Two metrics come in handy for assessing a company's reliance on debt.

Don't let the terminology on the first metric scare you. **Net Debt to EBITDA** uses a measure of profits that adjusts "official" earnings to reverse the impact of GAAP rules. (OK, here's what EBITDA stands for: Earnings before interest, taxes, depreciation, and amortization. EBITDA reverses those adjustments that are required by GAAP.)

In simple terms, EBITDA is a close cousin of cash flow.

To measure the impact of debt on a company, SSD compares EBITDA to *net debt,* which is the company's debt minus its cash on hand. SSD calculates the number of years it would take a company to pay off its debt utilizing only its cash flows. SSD's preferred upper limit on this timeframe is three years for most companies.

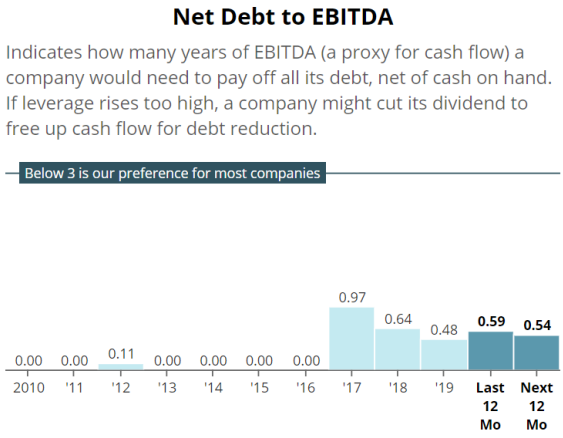
Debt to Capital (D/C) is a common measure of a company's indebtedness. The D/C ratio shows what percentage of a company's total capital structure is debt.

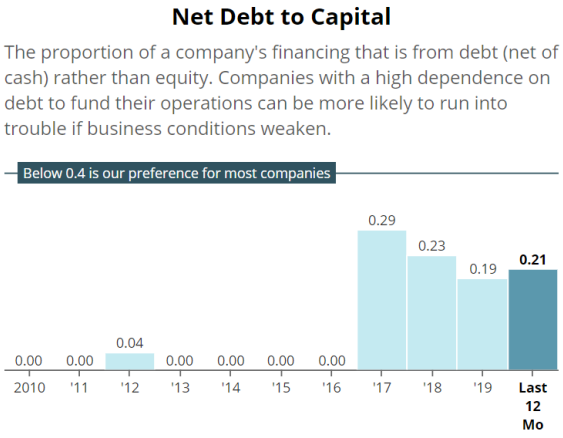
All else equal, the higher the D/C ratio, the riskier the company is. Companies that are highly dependent on debt are more likely to have trouble when business conditions weaken or a recession strikes, because the repayment obligations don't go away.

As noted earlier, a high debt load can give a company an artificially high ROE number. We credited high ROEs earlier. But if the company is achieving a high ROE via high debt, we will detect that here.

In the low-interest-rate world of the past few years, many companies have taken on more debt because it has been so cheap to do so. Average D/C ratios nowadays are often in the 50% range, meaning that half the company's total capital comes from debt.

Here are the debt charts for JNJ.





I score JNJ's debt metrics very high. It would take JNJ just over half a year to repay its debt from its cashflows, and the company's D/C has been below 30% for the past decade. In several years it has been essentially zero.

JNJ's debt took an obvious jump in 2017, when it made a major acquisition, but it never approached levels of concern, and the company has been paying the debt off since then.

We can now verify that JNJ's great ROE record (that we saw earlier) has not been artificially raised by high debt.

And recall S&P's credit rating, which is focused on a company's ability to repay its debt. JNJ's credit rating is AAA, the highest grade available. (There are only two companies with AAA credit ratings. The other is Microsoft.)

It is pretty obvious that debt is not a problem for JNJ.

Share count trend

This is my final go-to financial metric.

We saw earlier that a company finances itself from its own operating cash flow, debt, and equity. Equity means shares sold to raise money. All publicly traded companies had an IPO (initial public offering of shares) at one time. Over the past couple decades, there have been some famous IPOs, such as Visa in 2008, Facebook in 2012, and Tesla in 2010.

Once a company "goes public," it may issue more shares in secondary offerings from time to time. The company would do this to help finance its operations and growth plans.

For some companies, issuing new shares or taking on debt to raise capital may be the only way to finance growth initiatives. Real estate investment trusts (REITs), for example, must by law pay out most of their profits to shareholders as distributions. Therefore, they must issue more shares and/or borrow money to fund their growth. Utilities – which have huge capital needs to maintain and upgrade their distribution networks – also often issue new shares to raise money.

Once a company is well established (perhaps decades after its IPO), it may buy back shares from the public to either retire them or use them for executive compensation. Some companies have ongoing buyback programs, approved by their boards and executed by management, that are more-or-less continually buying back their own shares.

They can do this because they have money left over practically every year after paying all their bills and dividends. When a tight year comes along, they may suspend the buyback program, then restart it when things loosen up again.

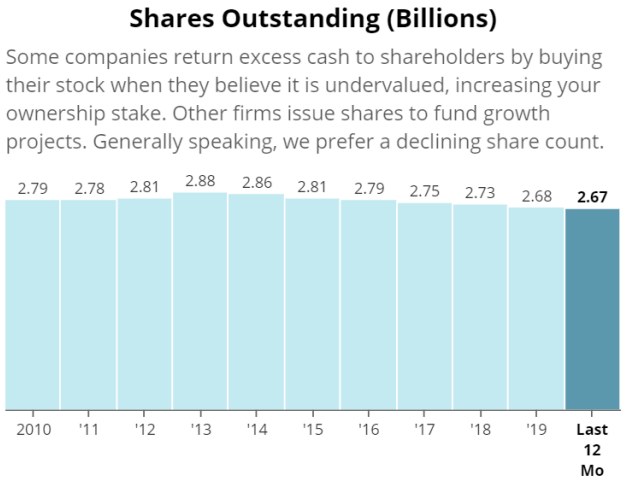
Companies often tout the size (in billions of dollars) of their authorized buyback programs. However, you cannot assume that because a company buys back shares that it will retire them. Some repurchased shares are used to pay executive compensation. So be aware that the only value to shareholders comes if the company retires the shares that it buys back.

The import of all this is that the number of shares outstanding – the *float* – changes over time. It is not stuck on the number of shares that were issued at the company's IPO.

I look at the share count trend to see whether shares outstanding are increasing in number, remaining flat, or decreasing.

I like declining share counts, because the annual dividend pool is spread across fewer shares each year. (Dividends are paid *per share.*) By retiring its own shares, the company is investing in itself, expanding each remaining share into a larger piece of the pie, and improving all per-share statistics.

Here's the graph for JNJ's share count:



Overall, this is a picture of a company whose number of shares outstanding has stayed pretty flat. JNJ has 4% fewer shares now than it did 10 years ago. They rose a little, then fell a little. The difference is not very significant, and I would simply rate this as OK.

Final Financial Grade

In the end, I distill everything I have learned into a single financial grade, maybe adding a couple of notes to highlight the best spots and the worst spots.

In the text, I did not assign specific grades to each financial metric, although that can be done, as we did with the dividend data earlier.

However, I did provide examples of reasonable interpretations of each financial metric, and some of the SSD graphs provide benchmarks for good performance.

To reach a final grade, I suggest that you form an opinion of the company's overall financial strength, and then assign an overall Financial Strength grade to the company. Use a scale something like this.

Financial Strength Grade		
Your Judgment of Company's Financial Strength	**Letter Grade**	**Interpretation**
Strong metrics across the board	**A**	**Excellent**
Mixture of strong metrics with average ones	**B**	**Good**
Mostly average metrics; maybe a weak one or two	**C**	**OK; Investable**
No strong metrics or only a couple; many average and weak ones	**F**	**Ineligible**

Johnson & Johnson would get an A for its finances. Almost all of its financials are better than the benchmarks, sometimes by significant margins, for long periods of time.

When we get into the Top 30 companies, generally we will find good or very good financials, but we will run into a few cases where judgments and tradeoffs need to be made. Those will be discussed in the analyses of the individual stocks.

Third-Party Financial Ratings

Besides making our own judgements directly from a company's financials, there are other sources that offer interpretations of corporate financial strength.

One that I often consult is Value Line. They have a Financial Strength Grade rating that summarizes and scores a company's overall financial situation, such as this grade for JNJ:



Value Line's grades run from A++ (the highest) to C in 9 steps. I like to compare their rating to my own assessment. I usually agree with Value Line's rating, although sometimes I think it's a little too generous, other times a little too harsh.

Other sources can be found among the free stock analyst reports provided by many brokers. I have accounts at Schwab and E-Trade, and between them they offer more than a half-dozen reports from information providers of greater or lesser reputation. Here are a couple of examples.

Morningstar packages its information (including some that would otherwise require a subscription) into stock reports that are available for free from some brokers. Morningstar bestows "Financial Health" grades. Here is their grade for JNJ, highlighted in yellow:

Johnson & Johnson JNJ

Morningstar Rating	Last Price	Fair Value Estimate
★★★	148.34 USD	147.00 USD
14 Oct 2020 18:24, UTC	14 Oct 2020	14 Oct 2020 18:20, UTC

Morningstar Pillars	Analyst	Quantitative
Economic Moat	Wide	Wide
Valuation	★★★	Overvalued
Uncertainty	Low	Medium
Financial Health	—	Strong

Source: Morningstar Equity Research

Argus Research reports are available from some brokers. They summarize each company's "Financial Strength," such as in this example about JNJ:

Financial Strength	
Financial Strength Rating	HIGH
Debt/Capital Ratio	32.5%
Return on Equity	33.0%
Net Margin	21.0%
Payout Ratio	0.50
Current Ratio	1.26
Revenue	$80.86 Billion
After-Tax Income	$16.99 Billion

Note that I am talking here only about third-party grades on company financials, not on other grading categories, nor about the overall recommendations (buy, hold, sell, etc.) that most sources apply.

Understand the principles! Don't get hung up on details

With the first two general categories of rating stocks – Dividends and Quality – I suggested that you not get too hung up on details.

With the financials, I think you do need to look at the data, but the extent that I presented them here is deep enough in most cases. You can even rely on third-party evaluators such as Value Line, Argus, or some other information provider that you trust. In the end, you want to be confident that you are not considering an unsound company to be sound or vice-versa.

To summarize the financial category:

- Revenue exhibiting long-term growth is better than long-term decline or flatness, unless there are extenuating circumstances.

- Earnings and cash should be positive every year (with maybe a couple exceptions in a decade), and a generally rising pattern is ideal.

- Management and operations should be efficient, with ROE and ROIC preferably in double-digits and steady most years.

- The company should display consistently good profitability.

- Lower debt is better than higher debt. If debt went up in a particular year for an understandable reason, ideally management should be bringing it down in subsequent years.

- Except in certain industries such as REITs, the company should not be regularly issuing new shares to raise money. Flat share counts are OK, and steady share decline is even better.

Miscellaneous Factors in Selecting Stocks

I have categorized the most important stock-selection factors into three main groups in this chapter and the two preceding.

Category #1: Dividends
Category #2: Company Quality
Category #3: Financials

Whenever you analyze stocks, you will run into far more information than you can assimilate. There are literally scores of free and subscription sites that provide data and/or analysis in various forms, including the numerous analyst reports that are available from brokers.

My three-category breakdown is meant to help you organize the loads of information you will encounter and give you ways to separate the important data and facts from the less-important.

Here, to finish up this chapter, I want to present two other data points that don't fit neatly into any of the three main categories, but which can be important to some investors.

Beta

Beta measures a stock's price volatility vs. the S&P 500 index's volatility.

- A beta of 1.0 is defined as the stock being equal in volatility to the index, which is a stand-in for the market as a whole.

- A beta of less than 1.0 means that the stock, on average, has less price volatility than the market. A beta of 0.7 suggests that the stock's price moves, on average, 30% less than the market moves.

- A beta of more than 1.0 means that the stock's price moves, on average, more than the market. A beta of 1.3 suggests that the stock's price moves, on average, 30% more than the market.

Generally, I prefer lower-beta stocks, because they tend to give you fewer reasons to worry about price swings.

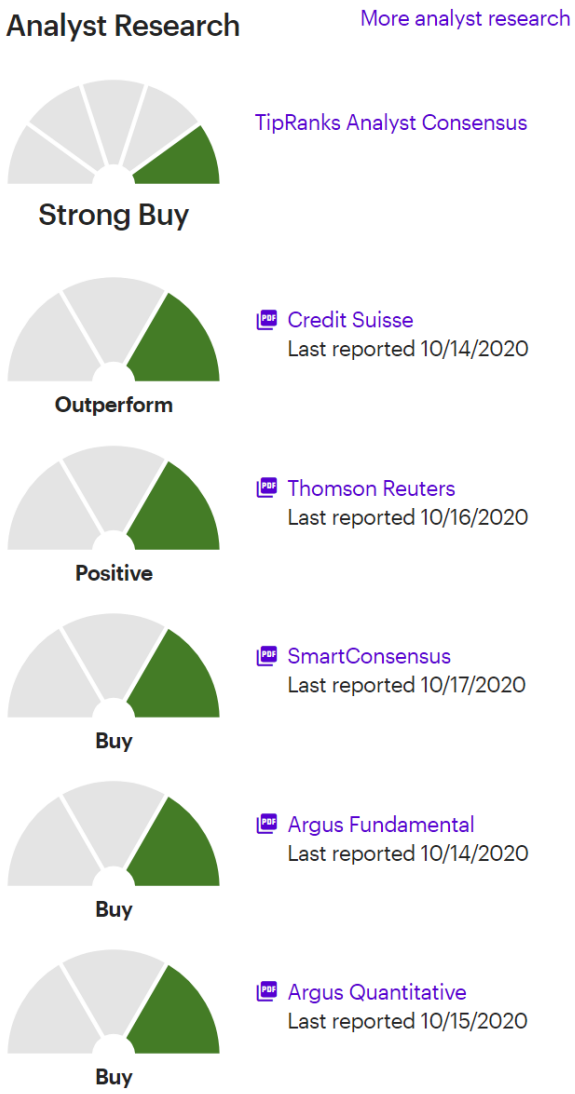
Not only that, but there is also research that suggests that low-volatility stocks produced higher total returns than the market over several decades, although more recent research suggests that the low-volatility advantage has been reversed during the long bull market that began in 2009.

Analyst's recommendations

I mentioned earlier that analysts, some of whom are independent information providers and others who work for major brokers, provide

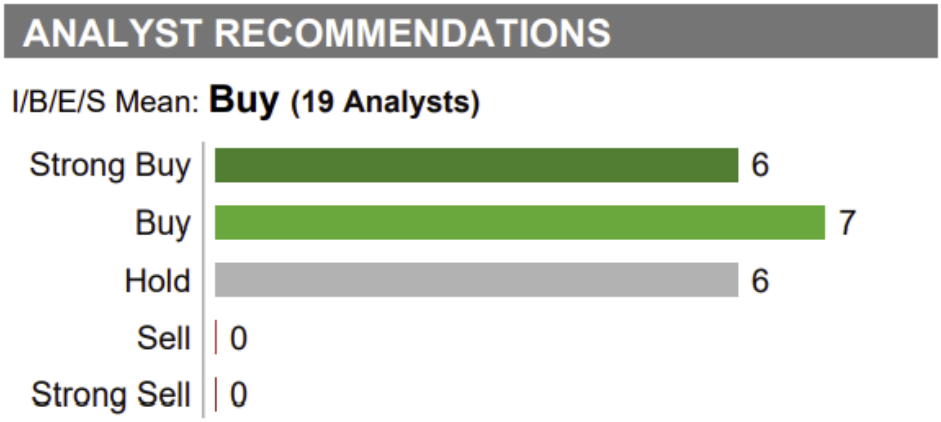
scads of reports, many of which are provided free to customers by brokerages and major financial institutions.

Here, for example, is the way that E-Trade presents its array of free analyst reports:



This selection is presented for Johnson & Johnson as of October 18, 2020. Every one of the purple titles is a link to a full multi-page report. The graphics along the left side present the analysts' recommendations, which are supported by data and reasoning in the reports themselves.

Some of the reports include polls of other analysts to create an average or consensus score. For example, the Thomson Reuters report has this summary of 19 *other* analysts within its own report:



When I am researching a stock, I do consult a few analyst reports, as a safety check against my own work.

That said, I don't consider the bottom-line recommendations (Buy, Sell, etc.) to be very useful. After all, the analysts don't know your personal situation. Your stock-buying and portfolio management practices should be tailored to your own goals, not to some generic concept of what stocks are "buys" right now and which ones are "sells."

Most analyst reports are geared to trading stocks, not to collecting and holding them over long time periods. Most DG investors don't trade very much, because it's generally used as a strategy for collecting shares (and dividends!) over time.

That said, when I have analyzed a stock and am seriously considering adding it to my portfolio, it's nice to see that a bunch of analysts have positive opinions about it.

CHAPTER 10

VALUING STOCKS

Introduction

The previous three chapters were titled, “Selecting Companies.”

Why weren’t they called “Selecting Stocks”? Because *company* and *stock* are not synonymous.

The company is the corporation or other entity that you are buying a fractional share of. It conducts its business without knowing that you own a part of it. Your little piece of ownership means nothing to the management team and board running the company.

Each stock share, on the other hand, represents that ownership of a fraction of the company. Those shares are traded and exchanged in the stock market.

The latter fact – the trading of shares in the stock market – influences stock selection in a different way than the dividend, quality, and financial factors we examined in looking into the company itself.

One such influence is that many investors find, from time to time, that a stock they want seems too expensive to purchase, while at other times the price seems, if anything, surprisingly cheap.

The stock market – not the company – establishes those prices through constant trading by professional traders, fund managers, and other active market participants. As small investors, we must decide whether we find

the price of something we want to buy attractive at the time we want to act.

This chapter discusses the second major phase in picking great dividend growth stocks: Valuation. The first major phase was evaluating the company: Interviewing it (so to speak) for a position in our portfolio.

In the valuation process, we attempt to discover which of our favorite dividend growth companies are selling at prices that make them good investments.

I believe that not every great company is a good investment if it costs too much to buy. Price matters.

I should note that there is a segment of the dividend growth (DG) community that largely eschews valuation. They simply want to own the best companies, period. Or they want to build positions in certain sectors, or target particular stocks for other reasons, and they will buy them almost regardless of price. Many DG investors drip dividends with no regard to valuation.

That diminished view of valuation has been reinforced by the lengthy bull market that started in 2009. So-called value stocks have been outperformed in price by so-called growth stocks by a wide margin.

The following chart compares price returns of the largest Vanguard value and growth ETFs (purple and orange lines, respectively) over the past 17 years.



You can see that in the 2004-08 time period, value stocks outperformed growth stocks. But since the lowest point in the bear market that accompanied the Great Recession (March 2009), growth has steadily pulled away from value. Overall, since 2004, growth has tripled value's price gains.

While the memory of that recession is still vivid to me, it occurred quite a way back in time. Many younger investors have never invested during a period when value stocks outperformed growth stocks. Quite the opposite, some younger investors think that "value is dead."

Once again, we face a situation where reasonable minds can differ over the best course of action. Personally, I heavily weigh valuation into my stock selections. It is up to you to decide what weight to give valuation in your own stock picking.

Valuation from 30,000 Feet

Basic concepts

Valuation helps you understand if the asking price for a stock is fair. Here are a couple of basic definitions to get us started.

Valuation: To appraise the *intrinsic value* of a stock and compare it to the actual price at which it is selling. The result is an assessment of whether the stock's price is fair, too high, or a bargain.

Intrinsic value: The fair, true, or inherent value of a company's stock. You cannot measure intrinsic value with a ruler or gauge. It is not a physical quality. Rather it is an assessment based not only on data but also on estimates and assumptions. There is always uncertainty about valuation. There is also unknown (unknowable) data: The future, when valuation will manifest itself.

There are a variety of techniques to calculate the intrinsic value of a stock, and they rarely arrive at the same number. No matter the method used, the idea behind valuation is to establish a reasonable reference point for a stock's inherent financial value at the current time.

Value is not the same as price

One of the most famous quotes in investing comes from Warren Buffett:

> "Long ago, Ben Graham taught me that 'Price is what you pay; value is what you get.' Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down." (Source)

In contrast to the range of fair value estimates that can exist for a stock, its market price is an exact number that you can look up at any moment. Prices change with every trade in the stock market.

In contrast to its continuously changing price, a stock's value does not continually change. Intrinsic value changes more slowly, as the company

conducts business, carries out strategic programs, introduces new products, implements cost-cutting programs, and so on.

If all you know about a stock is its price, you do not know whether the stock is fairly valued. Here are two common ways that the concepts are mixed up.

- The fact that a stock has pulled back from a recent high does not necessarily mean that it is well valued. The price may have fallen for an important reason. Maybe the company issued a bleak earnings outlook or suffered a disaster like an oil spill. Or maybe the stock was way overvalued to begin with, and it remains overvalued even after losing a few bucks off its price.

- Similarly, a sudden or prolonged price increase does not necessarily mean that a stock has become overvalued. There may be good reasons for a rise in price, and the stock may still be a relative bargain even though it is selling for more than it was a few weeks ago.

Valuation is an **interpretation** of a stock's price. The interpretation attempts to tell you whether the price is too high, fair, or a bargain.

I liken valuation to appraising a house. We all instinctively know what "house appraisal" means, and we understand that five honest, experienced appraisers may compute five different estimates. The estimates may be tightly clustered or surprisingly far apart.

It is similar with stocks. Five different analysts, all using reasonable methods and attempting to be unbiased and rigorous, could arrive at five different estimates of intrinsic value for the same stock. Reasonable minds can differ.

The way the market works, using an auction approach, actual prices can differ from fair prices (intrinsic value) markedly. While in theory, a stock's fair value should be tightly correlated to the company's quality and

prospects, both lousy companies and excellent ones can be undervalued or overvalued.

No matter how excellent a company is, its price can be too high. When that happens, it is probably not a good time to buy shares in that company.

By the same token, an excellent company can have its price fall below its true worth. For the long-term investor, price drops like that can present terrific buying opportunities.

Valuation is an attempt to estimate the future

Valuation's role in investing is to help you decide whether a stock's price *right now* will turn out to have been fair *in the future*, when you can look back and make such a determination.

You can't actually *know* that right now. The returns you get from any stock investment will happen in the future, and nobody knows the future. Valuation is a technique to help you improve the odds that you're making a good investment decision right now, under conditions of uncertainty and missing data.

Some people say that every stock's actual price right this minute is its fair price, because it is the outcome of many well-informed people (and bots) trading with each other, so the current price is the best estimate of fair value possible right now.

If you believe that is true, you can really skip the rest of this chapter. You won't be interested in valuation.

Reasons to Value Stocks

Here are the reasons that I use valuation in making investing decisions.

To get better yields

Dividend yield, mathematically, moves inversely to stock price. Yield goes up when price goes down, and vice-versa. That is plain from the definition of yield:

Yield = 12 Months' Dividends / Price

Price is the denominator in that equation. When price goes down, yield goes up. So buying at a better valuation (lower price) means that you get a higher yield right out of the starting gate.

You can see the inverse relationship between yield and price on any graph that plots the two values together. Price change and yield change are mirror images of each other. Here are plots of Johnson & Johnson's price (top) and yield (bottom) over the past year.



Obviously, the Covid-induced price drop in February, 2020 was an extreme and unusual event, and it pushed JNJ's yield to over 3.3%. The market changed JNJ's stock price, and the jump in yield was a byproduct of that.

Since then, JNJ's price has not only recovered, but it is higher than it was at the beginning of the chart. One year before the image was taken, JNJ was yielding 2.9% instead of todays' 2.7% (despite a dividend increase in the meantime).

Any DG investor would rather get JNJ at 2.9% yield than 2.7% yield. It's the same company with the same prospects. Assuming JNJ does not cut its dividend while you own it, your initial yield is locked in. Your yield on the price you paid will *never* get lower. The higher initial yield will benefit you for as long as you own the stock.

To reduce price risk

Most investors want their stocks' prices to rise over the long term. If you can purchase a stock at less than its intrinsic value, you are tilting the odds in your favor that future price movements will be upwards. The larger the difference between the price you pay and intrinsic value, the larger your margin of safety.

While nobody knows the future, a "best practice" in investing is to put the odds in your favor whenever you can. You can never be like "the house" in Las Vegas, where long-term profits are all but guaranteed, but you want to move yourself in that direction as much as you can.

Good valuation will not shield you from short-term price declines, no more than being "the house" shields casinos from short-term losses. Nevertheless, knowing that you bought at a sound valuation should provide some comfort from the stress of falling prices and fortify you to keep your eye on the main prize, which is the rising stream of dividends.

Buying at good valuations can also become important if some calamity strikes a company, forcing it to cut its dividend. If the calamity leads you to sell it, the more capital you recover the better, because you will need to reinvest it to replace the income lost by selling the shares. The more cash you get from the sale, the easier it will be to replace the full income stream,

or at least a high percentage of it. If you bought it at a bargain price, that improves the odds that you will recover more of what you paid.

To get better overall returns

Investing at favorable valuation mitigates overall risk. That is because it combines the two good effects just discussed: better yields and lower price risk. Again, risk is not eliminated. But if you start with what turns out to be a bargain price, you will capture better yields immediately *and* the market will tend to move the price upward over time.

Four Models for Valuing a Company

I use four valuation models, then average the results to arrive at my estimate of a stock's fair price.

Models #1 and #2: Relative P/E's

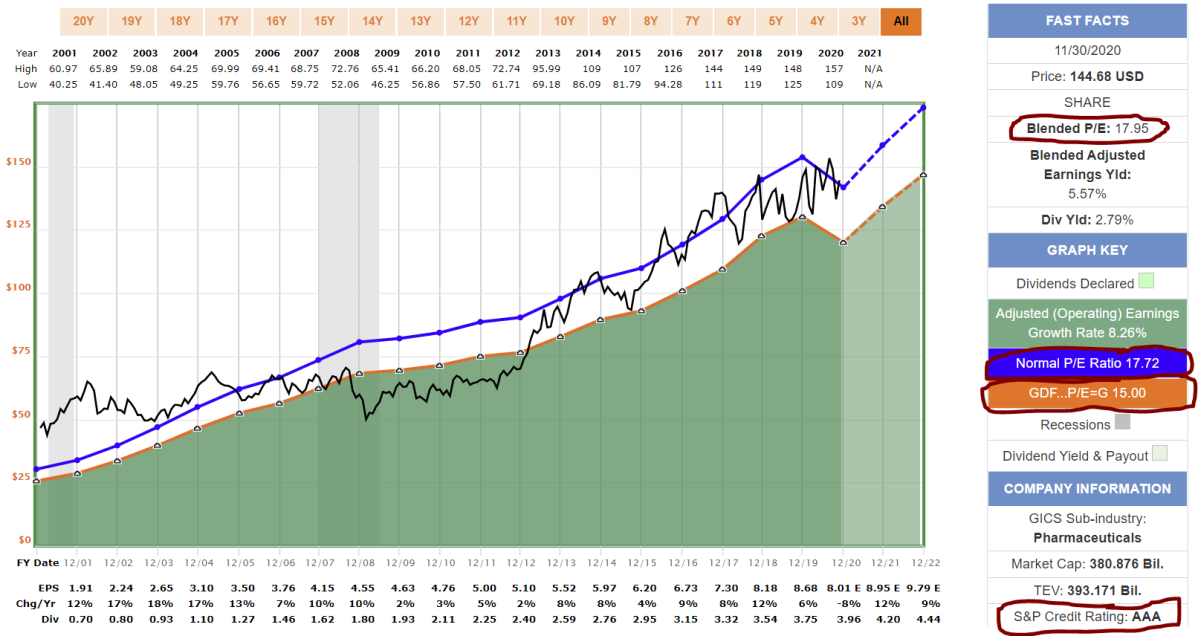
The first two models are both based on relative price-to-earnings ratios. The price-to-earnings ratio – abbreviated P/E or just PE – is one of the oldest and most common ways to value a stock.

- **Model #1:** Compare stock's P/E to historical P/E of the **market**.
- **Model #2:** Compare stock's P/E to **stock's own** historical P/E.

Just as I said earlier that I am fortunate to be able to use, with permission, Simply Safe Dividends' wonderful graphs and company analyses in this e-book, I am also fortunate to be able to use FASTGraphs for these first two valuation models. Permission for such use has come from Chuck Carnevale, FASTGraphs' creator.

FASTGraphs implement a profound idea: Plot valuation reference lines and a stock's actual price on the same graph. That allows for easy comparison and a visual representation of whether the company is selling for a good price or not.

Here's how it works, again illustrating with Johnson & Johnson (JNJ). The data on this graph goes back 20 years.

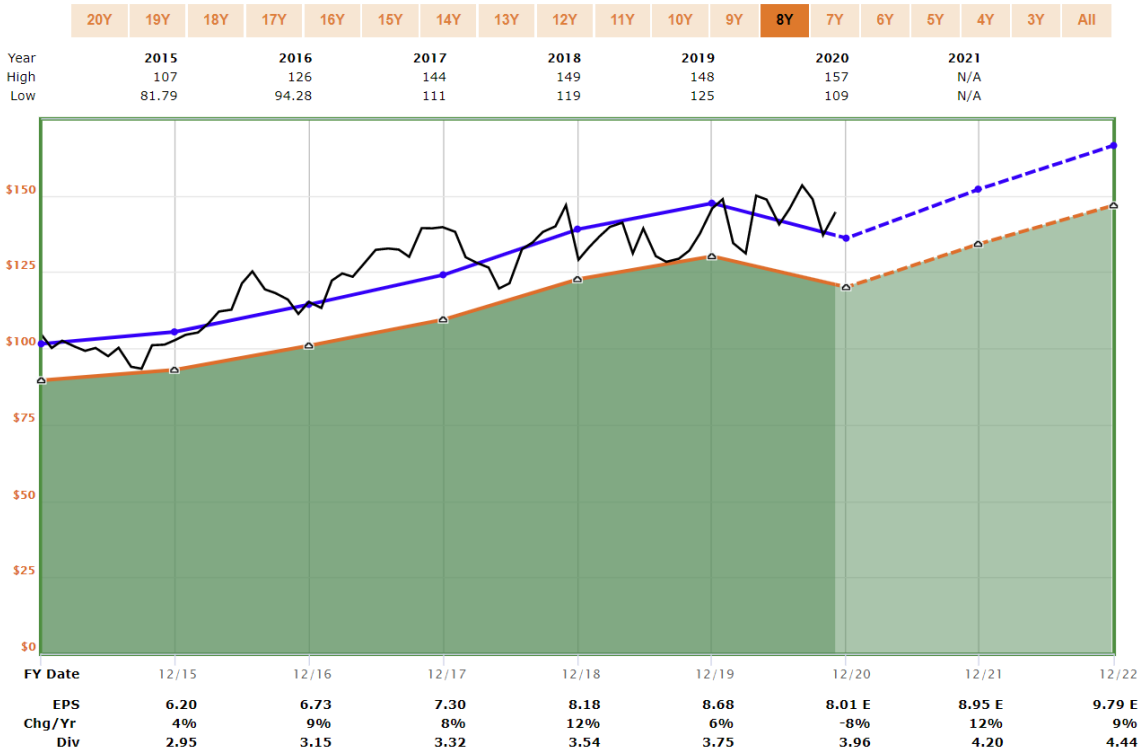


FASTGraphs provide a lot of information on one screen.

- The stock's actual price is the black line.
- Two fair-value reference lines – for Models 1 and 2 – are the orange and blue lines.
- The FAST FACTS panel along the right side gives some fundamental information about the stock, including the P/E ratios that we will use in the two valuation models (circled) and the stock's credit rating (also circled).
- The rows of numbers across the bottom show JNJ's earnings per share (EPS) and dividend each year. Just above them, the dates are labeled to indicate the end of the company's fiscal year (which is not always the calendar year).

- The dark green area shows earnings per share visually.

For our purposes, I will turn off some of the features, expand the graph for easier reading, and reduce the time-period covered to eight years. Thus the graphs will look like this:



Reducing the time-span to eight years causes FASTGraphs to use the past five year average P/E to draw the blue line. That's the history that I want.

Now we can implement valuation models #1 and #2.

Model #1 compares JNJ's current P/E ratio to the historical P/E of the market itself, which for most stocks is 15. (It can go higher or lower, based on a company's very fast or very slow growth rate, but for most of our stocks, it will be 15.)

In all the models, I form a *valuation ratio* to show how the model's fair valuation compares to the stock's current valuation. For the first model, the process looks like this:

Valuation ratio = Stock's P/E divided by Reference P/E

Valuation ratio for JNJ Model #1 = 18.0 / 15 = 1.20

What this tells me is that, under this model, JNJ is overvalued. Its actual P/E is 20% above its fair P/E. We can see that visually on the graph: JNJ's actual price is quite a bit above the orange reference line.

All of the valuation models use the *valuation ratio* concept, which compares the stock's actual valuation to its "fair" valuation as defined by each model.

- If the valuation ratio is under 1.0, it suggests that the stock is undervalued.

- If the valuation ratio is above 1.0, it suggests that that stock is overvalued.

This probably seems very involved, but it's really quite simple in practice. You get all of the P/E ratios from the information panel on the right of the FASTGraph.

Model #2 uses JNJ's own 5-year average P/E ratio as the fair-value reference rather than the market's historical P/E of 15. I call this "normalizing" the P/E comparison to the stock's "normal" valuation. Some stocks, it seems, are "always" overvalued or undervalued compared to the orange line.

The formulas are the same as in the first model:

Valuation ratio = Stock's P/E divided by Stock's 5-year average P/E

Valuation ratio for JNJ Model #2 = 18.0 / 17.7 = 1.02

The numbers, again, came from the right-hand FAST FACTS panel. The result confirms what we see on the graph. JNJ's price line is just slightly above the blue reference line, so it's really in a fair-value territory as defined by this model.

In my experience, Model 1 (which compares the stock's P/E to the *market's* historical P/E) is sometimes far out of step with the other models. In that case I will sometimes discard that model from the array used to calculate valuation for a particular stock, or cap it at 1.20.

Model #3: Discounted cash flows

The third model is considered the gold standard by many investors. It is called the discounted cash flow (DCF) method.

DCF is a math-heavy approach, and I am not going to go into all the details, because ultimately you can easily get DCF valuation estimates from numerous sources, with the math already done for you.

I will just briefly define DCF here by quoting something that Warren Buffett told his shareholders in 1996:

> "Intrinsic value is an all-important concept that offers the only logical approach to evaluating the relative attractiveness of investments and businesses. Intrinsic value can be defined simply: It is the discounted value of the cash that can be taken out of a business during its remaining life. "(Source) (Highlight added)

"Discounting" in finance means to determine how much money to be received in the future is worth today, taking into consideration the time value of money. The latter is the idea that a dollar in your hand today is worth more than it will be a year from now.

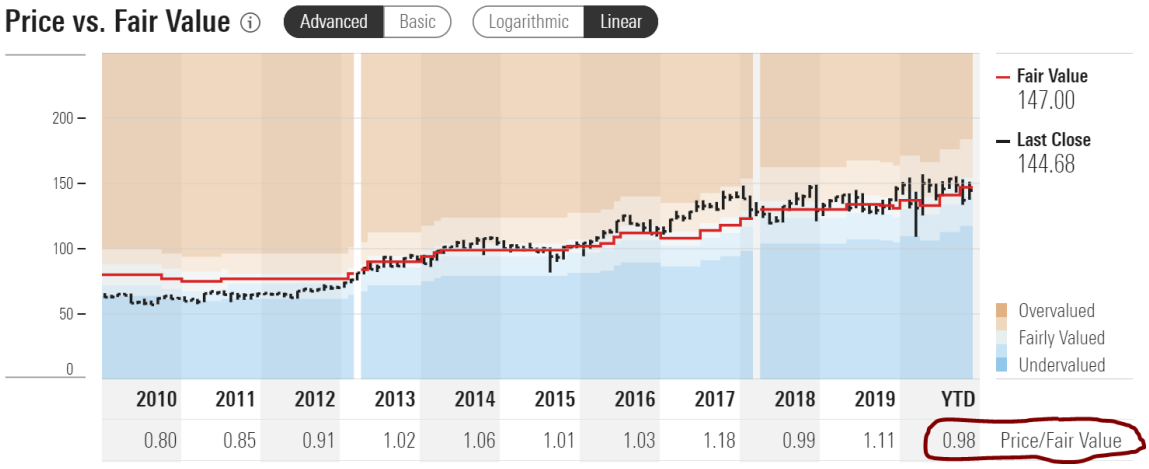
The rate at which the value of money decays is called the discount rate. You use it to discount future values of cash back to the present.

The DCF model for valuing a stock requires the analyst to model all of the company's future cash flows (year by year out to infinity), then discount the sum of them back to the present. That process brings you to Buffett's description of fair value as the discounted value of the company's future cash flows.

I'll repeat myself here: Nobody knows the future, not even Buffett. So DCF, by its nature, is an estimate based on a variety of educated guesses about what will happen in the future. It can be a rigorous approach (that's why it is the gold standard for many investors), but its weaknesses come from its sensitivity to the values chosen for inputs to its equations. Things such as future rates of cash growth and appropriate discount rates must be estimated.

I have looked at many financial sources over the years, and the one I most often turn to for DCF valuations is Morningstar. Their analysts use DCF to evaluate stocks, and I believe that they are appropriately careful and conservative in estimating the inputs needed for DCF.

Using JNJ as an example again, here is how they see JNJ's valuation:



In this display, Morningstar shows you their valuation ratio (circled in the image). The colored bands in the graphic are similar to my five valuation ranges, they just use different colors. (I think mine are better.)

Morningstar's valuation ratio of 0.98, being lower than 1.0, indicates that they see JNJ as slightly undervalued.

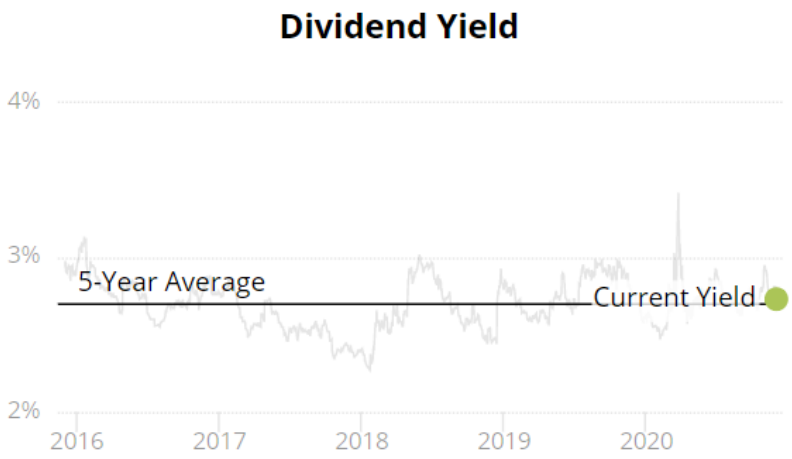
Model #4: Relative yield

The last model compares the stock's current yield to its historical yield. I call this model relative yield; many investors refer to it as the yield metric.

The idea with this approach is that over long periods of time, the market will tend to price a stock in a way that its yield stays within a range typical for that stock.

Departures from that typical area are potential signals of under- or over-valuation. To be specific, if the yield is higher than usual, that suggests under-valuation (because yield moves inversely to price). And vice-versa, if the yield is lower than usual, it suggests over-valuation.

One easy way to visualize this approach is to use Simply Safe Dividend's historical yield display.



The green dot shows us that JNJ's current yield is right on its 5-year average, which would suggest that JNJ is fairly valued.

JNJ's current yield and 5-year average yield both round to 2.7% at the moment. As with the other models, we form a valuation ratio:

Valuation ratio = Stock's 5-year average yield
divided by Stock's current yield

Valuation ratio for JNJ Model #4 = 2.7 / 2.7 = 1.0

When using this method, I cut off the valuation ratio to keep it within +/- 20% of neutral. In other words, the floor is 0.80 and the ceiling is 1.20. I do this because I think this is the least direct way to measure valuation, so I want to eliminate extreme outliers.

Combining the four models

To synthesize the models, I simply average them. I use ranges to describe the valuation ratios:

Interpreting Valuation Ratios	
Valuation Ratio	**Interpretation**
<0.80	Significantly undervalued
0.80 – 0.89	Undervalued
0.90 – 1.10	Fairly valued
1.11 – 1.20	Overvalued
>1.20	Significantly overvalued

Note that I have a pretty wide range for calling a stock "fairly valued." The fair-value range extends +/- 10% in either direction from what I compute to be a stock's fair value.

Putting together the four models for JNJ gives us this summary:

JNJ Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	1.20	Overvalued
#2: P/E to Stock's 5-year average	1.02	Fairly valued
#3: DCF (from Morningstar)	0.98	Fairly valued
#4. Relative Yield 5-year comparison	1.00	Fairly valued
Average of Models: Valuation ratio = 1.05 = Fairly valued		

Thus, I would conclude that Johnson & Johnson's current price is within 5% of its fair price, which means that it's fairly valued. Given JNJ's high quality, I would be very willing to buy it at this price + 10% on top of that.

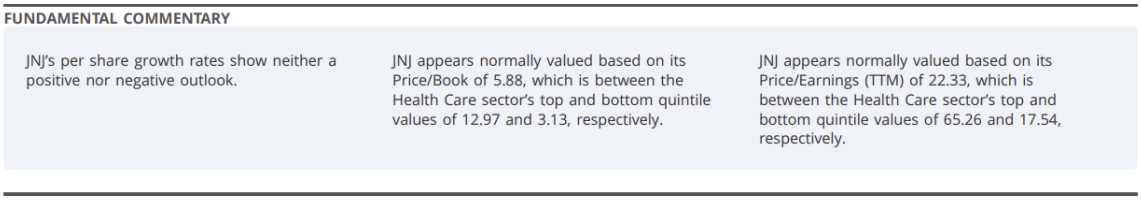
I calculate a fair price (at the time of this writing on December 1, 2020) of $138, with a willingness to pay 10% over that, or $152.

In this example, all of the four models came out pretty close to each other, so there was no need to consider dismissing or adjusting an outlier. I usually rely on the simple average, but you may run into situations where you conclude that it is wise to toss out or adjust the outlier and just average the remaining models.

Other Sources

There are other sources for valuing stocks. For example, the many analyst reports available for free from brokerages often evaluate stock prices.

Ned Davis Research, a report I retrieved from my Schwab account, said this about JNJ at the same time that I pulled the charts used in my own valuation:



FUNDAMENTAL COMMENTARY

JNJ's per share growth rates show neither a positive nor negative outlook.

JNJ appears normally valued based on its Price/Book of 5.88, which is between the Health Care sector's top and bottom quintile values of 12.97 and 3.13, respectively.

JNJ appears normally valued based on its Price/Earnings (TTM) of 22.33, which is between the Health Care sector's top and bottom quintile values of 65.26 and 17.54, respectively.

JNJ looks fairly valued to them, same as our conclusion.

Second example, from CFRA:

Fair Value Calculation	**USD 147.64**	Analysis of the stock's current worth, based on CFRA's proprietary quantitative model suggests that JNJ is undervalued by USD 3.64 or 2.53%

They see JNJ as undervalued by 3%, which would fall within my +/- 10% fair-value range. Their fair price is within $10 of mine.

I'll leave it up to you whether you want to roll your own valuations or depend on others. I will occasionally turn to other sources such as the ones just listed, for example if I have an ambiguous situation and need a tie-breaker. But normally, I stick to the four models that I illustrated.

Should You "Pay Up" for Quality?

Some investors maintain that if you have a truly high-quality company, you should be willing to "pay up" for it: Pay full fair value, even more, because 10-20 years from now, you won't care that you paid a buck or two more for the shares. They will have appreciated, and you will have cashed in on all those years of dividend growth too.

I generally agree with this concept, but with caveats. *Quality* is an amorphous concept, and not all investors agree on what it means. As we saw in the last three chapters, I measure the desirability of a company according to factors and grading systems that I have developed over many years.

For the stocks that rank as high-quality on my own system, I will pay full value, which means the top of the fair-value range, which is 10% more than my calculated fair-value price.

That gives me a fair-price band that is pretty wide. If I calculate the fair price for a high-quality stock to be $100, that means that I would pay up to $110 for it.

But beyond that, I usually will not pay an overvalued price, no matter how good the company.

The decision whether to pay a particular price for any stock is influenced by considerations like these:

- How does the stock fit into my portfolio?
- Does it add to diversification goals? (I diversify across different industries, yields, dividend growth rates, etc.)
- What is its impact on my portfolio's overall yield or likely DGR?
- What is its impact on my portfolio's dividend safety and reliability?
- If I already own it, would buying more cause the position to become overweight?
- Are there better alternatives available?

I do not believe that I have ever paid what I consider to be an overvalued price for any stock, taking into account my fair price band discussed earlier. That does not mean that the prices of some of my selections have not fallen after I purchased them, because they have. But at the time of purchase, I was making the best decision possible using sound valuation techniques.

Market Valuation vs. Stock Valuation

It is important to distinguish valuation of an individual stock from valuation of "the market."

At any given time, the market as a whole — as represented by a broad index such as the S&P 500 — may be overvalued, fairly valued, or undervalued, and you will see considerable discussion and debate about that topic. The market's valuation changes all the time, because price levels change all the time. When the Dow goes up 400 points, that changes the market's valuation.

But valuation of the market is *not* what we are discussing here. If you look one-by-one at each stock in any index, you will see that some are overvalued, some are fairly valued, and some are undervalued.

That notion is important to us. As stock-pickers, we are far more interested in individual stock valuations than broad market valuations. The end-game is to construct a portfolio of carefully selected stocks, not to purchase the whole market.

Therefore, I generally ignore broad market valuations when I evaluate stocks. I even ignore sector valuations. Someone might say that "Utilities are overvalued now." That may be correct overall, but it does not mean that every single utility is overvalued.

Appraise stocks one at a time. Fairly valued stocks are almost always available if you look for them, even when the market is generally overvalued.

My principle of not overpaying for stocks has never prevented me from buying a quality stock that helps move me toward my goals, and getting it at a good price. Partly, that is because I don't care what order I buy good stocks in. I don't mechanically build positions one at a time. I try to go where the opportunities are, and that means there may be long gaps between buying a stock the first time and building it up later on.

CHAPTER 11

SELECTING STOCKS – REVIEW AND SUMMARY

We covered a lot of ground in the previous five chapters. I think it would be a good idea to summarize the major points in this short chapter.

Selecting Companies

For dividend growth (DG) investing, we want to hold high-quality companies. The reason for seeking excellence is that we intend to depend on them, over long time periods (measured in decades), to build reliable, growing dividend income streams that we can use to be financially independent in retirement.

I tend to be demanding when I am selecting companies. Some investors seem to want to own practically every DG stock. They jump into many opportunities, often relying on recommendations made by others. Such recommendations may appear in articles with titles like, “This Stock Deserves a Place in Every Portfolio.”

I’m not like that. No stock “deserves” a place in my portfolio. Quite the contrary, I view companies as being applicants for one of the few coveted positions in my portfolio. I “interview” them, investigate their resumes, and make my decision independently.

In my opinion, here’s what to look for in making these decisions about companies:

Strong dividend record

Eliminate companies that lack at least a 5-year streak of raising their dividends. Among the remainder, identify companies with acceptable yields, appropriate dividend growth rates, and strong dividend safety.

Build a portfolio – a team – of companies with a variety of dividend characteristics. Each stock will play a role in helping you reach your long-term goals.

Strive for dividend diversification. By that, I mean that some high-yield DG stocks will make the cut, while others will have lower yields but faster dividend growth rates. If you intend to trade low current yield for fast growth potential, do it with your eyes wide open.

Company excellence

Most DG companies are pretty good quality, because that is required to be able to increase their dividends every year for long periods of time. Weak companies can't do it.

That allows us to reach for the best of the best. Evaluate your candidates on a variety of quality factors, such as the soundness of their business models and the sustainability of their competitive advantages.

Write out each candidate's Story: What makes it attractive? Explain its business model; whether it has sustainable competitive advantages; why it is likely to be successful in the future; and supportive demographic, economic, and regulatory trends.

Eliminate any company if you can't understand, on a high level, how it makes money. What's your investment thesis – you should be able to state it plainly. Consult reliable third-party sources to check your own evaluations against theirs.

Good financials

To make it into your portfolio, a company should display impressive financial achievements that are outcomes of their high business quality and good execution by management.

Pretend that you don't know what the company does and must rate it solely on its financial record. How would you grade it?

While financial results typically vary from year to year, and nothing goes straight up, look for things like generally rising revenues, consistent positive earnings each year, upward trends in earnings and cash flows, financial efficiency, and good profit margins.

Pay particular attention to debt. Corporate debt levels have risen over the past decade. Make sure your company is financially sound and not likely to be upended by debt problems if business goes bad for a while.

Valuing Stocks

In the steps above, we evaluated companies. In valuation, we decide whether the stock is selling at a fair-enough price for us to buy it.

The intrinsic, inherent worth of a stock must be estimated, because its true current value won't be known until years later. Current valuation is a projection of future worth.

Many valuation techniques have been developed by investors trying to make better and better estimates. I use four models, then average the results:

- Comparison of stock's P/E (price to earnings ratio) to the market's long-term average P/E for stocks with similar growth rates.

- Comparison of stock's P/E to its own 5-year average P/E.

- Discounted cash flow computed by trusted source.

- Comparison of stock's yield to its own 5-year average yield.

Using these methods, I compute my estimate of the stock's fair price today. Then I form ranges around that central point to characterize the stock as fairly valued, overvalued, or undervalued.

If my four models are in strong disagreement, I will seek out other sources to see if there's something approaching a consensus among analysts.

I usually consider my fair price +/- 10% to define a fair-value range. For most companies, since they already passed my quality and financial tests, I will pay up to the high end of that range to obtain the stock. The range exists, after all, because estimating intrinsic value is inherently uncertain.

Final Decision

We haven't looked yet at portfolio construction, including the all-important concept of diversification. Principles like that (which will be covered in Chapter 13) will play into your final decisions about what stocks to buy, hold, and sell.

However, those selections will be made from among the small universe of stocks that have been identified and verified by the steps just described.

CHAPTER 12

PLANNING YOUR INVESTMENT JOURNEY

The Qualities of a Sound Dividend Stock Program

The investing legend Benjamin Graham often referred to an "investment operation" when he was making the distinction between investing and speculating. I like the term, because it implies that you, as an investor, are running a business, as differentiated from, say, gambling.

Here's what Graham said:

> "An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative." (Source)

A good dividend growth (DG) investment operation has these characteristics:

- It is a realistic program for a self-directed individual investor to implement and maintain.
- It provides sufficient, reliable, and growing cash flows from dividends that match or beat inflation over long periods of time.
- It offers probable long-term safety, and good chances for growth, of principal.
- It provides peace of mind and psychological relief from market volatility.

Run Your Investing Like a Business

In The Millionaire Next Door, the author, who was compiling the common traits of millionaires, found that 66% of millionaires own their own business.

I urge you to think of your DG investing as a business that you own. Give it a name, like Paul's Dividend Growth Company. Buy a sign or plaque and place it where you see it when you are at your computer.

As we saw in an earlier chapter, when you select DG stocks, you require that you understand what each company's business model is. In running your investing business, you should demand the same thing of yourself. **You should be able to clearly articulate how you make money and why that is sustainable.**

You are the founder, owner, CEO, and CIO (Chief Investment Officer) of your investing operation, and you want to run it well. Every well-run business has:

- a central goal or goals
- strategies designed to achieve those goals
- tactics, programs, and activities to execute the strategies

Goal(s)

Your goals are personal to you. Sometimes that gets forgotten or buried under the prevailing assumption that everyone invests to get wealthy or to beat the market.

But that is not why everyone invests. Those who gravitate to DG investing often do so because they want to optimize their cash flow. By "optimize," I mean that they want their cash flow to be reliable, sufficient, safe, and growing.

If you are such an individual, your main focus is on creating a dependable and increasing dividend stream. You buy stock shares to obtain future dividends. To the DG investor, the fact that you also get the chance to make money on prices is often of secondary importance.

Write down a specific central goal for Your Dividend Investment Company that you believe is reasonable and achievable.

For example, here is the main goal of my real-money Dividend Growth Portfolio:

> **Primary Goal of My Dividend Growth Portfolio**
>
> Build a reliable, steadily increasing stream of dividends over many years that can eventually be used as income for retirement.

Notice that my goal is simple. An approach often used in goal-setting is called SMART, which means that your goal(s) should be Specific, Measurable, Attainable, Realistic, and Timely. My primary goal meets those standards:

Specific: My cash flow will come from dividends.

Measurable: The dividend stream can be measured as to its reliability, rate of increase, and amount.

Attainable: The existence of hundreds of DG stocks tells me that I can construct a portfolio that will reach my goal.

Realistic: I have, or can develop, the skills needed to be a DG investor.

Timely: My frame of reference is "over many years," not short-term.

You may want to add a secondary goal. My own secondary goal is the following:

Secondary Goal of My Dividend Growth Portfolio

Deliver total returns that are competitive with the general stock market as measured by the S&P 500 with dividends reinvested.

Strategies

Strategies come after goals.

Strategies are your plans to attain your goal(s). Strategies form a roadmap or blueprint. They lay out a sensible process for getting to where you want to be.

The strategic point of view is high-level and long-term. After you take your first stab at writing down your goal(s), you should take your first stab at developing your strategies. Ideally, you should do this before you buy your first share of stock, but even if you are a long-time investor, you can write out your strategies. They will be informed and improved by the experiences that you have accumulated already.

I suggest that you keep things pretty simple. Your first effort at developing strategies will probably not be complete or fully integrated. There may be a few internal contradictions. That's OK. You'll improve them as you go along and learn more things.

Much of the benefit of planning comes from the process of doing it. As Dwight Eisenhower said, "Plans are nothing; planning is everything."

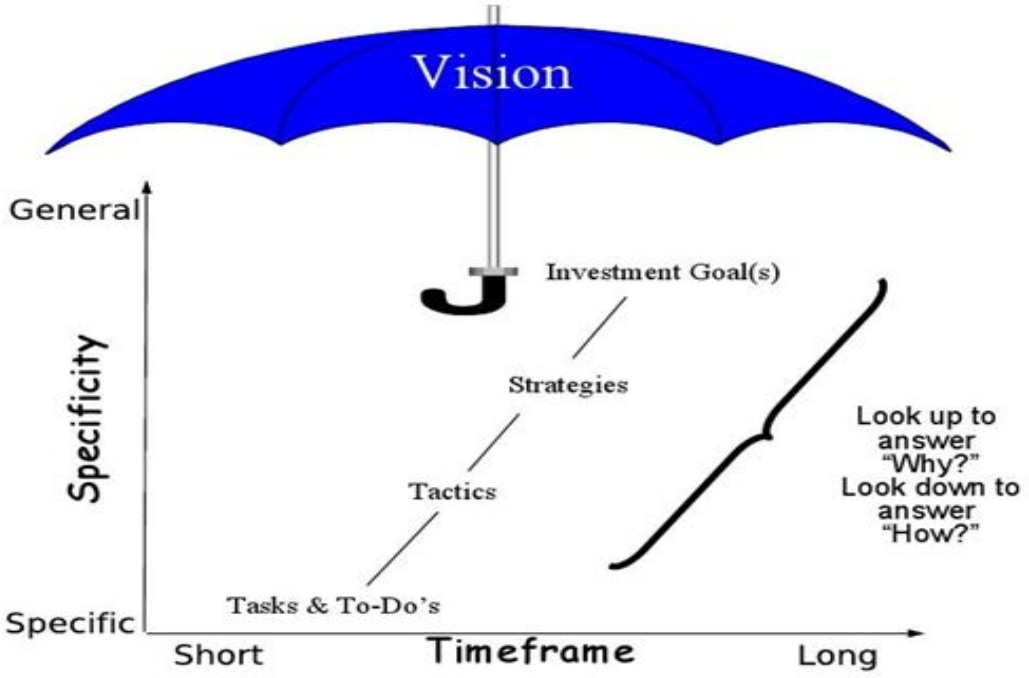
Why do all this? Because in your investing business, as in all businesses, you will make capital-allocation decisions. These are important decisions, and you want to make them in the best way possible to help you reach your goals.

In thinking about your strategies, use a long time-frame measured in years or even decades. You're creating a map, not a turn-by-turn trip guide.

Your strategies must be right *for you.* You should be able and willing to stick to them. If you do not or cannot believe in your strategies, perhaps they are flawed. Tinker with them until they feel right.

How goals, strategies, and tactics relate to each other

I developed the following diagram when I was in corporate strategic planning. It is meant to explain how strategies relate to goals, how tactics relate to strategies, and so on.



You can see that your goals are the most general and cover the longest timeframe. Strategies are more specific, but they are still pretty general. Tactics are more specific than strategies.

Note the legend off to the right:

"Look up to answer 'Why?' Look down to answer 'How?'"

This is important. Say that a few years pass, and you are reviewing your strategy document. You read a strategy, and you don't even remember why it is there.

In that case, you look upwards, and you see "investment goal(s)." In other words, the reason that the strategy exists is because it helps you reach your goal(s). If that doesn't seem to be true as you re-read it in the present moment, then something has to change. Assuming your goal is still the same, then what has to change is your strategy. After all, the strategies are there to get you to your goals.

In the other direction, looking down helps you understand how to accomplish something. Say you re-read a strategy, and say to yourself, "How do I do that?" Look down to see your tactics. Those tell you how to execute your strategy.

At the bottom, tasks and to-do lists are the most specific and cover the shortest timeframes. They don't belong in your strategy document at all. They are weekly and daily considerations, not strategic. Don't clutter your strategy document with them.

Write Out Your Business Plan!

Write out your investment goals and strategies. You can probably do this on a couple sheets of paper.

Remember when we were talking about how to ascertain the quality of a company to invest in, one of the things to look for is coherent goals and strategies? We want the same coherence for our own investing operation.

In drafting your strategy document, use the diagram above to guide you.

- You might start out with a **vision:** your long-term aspiration, where you want to be years from now. Example: "Retire at 55."

- After your vision come your **goal(s):** the one or two top objectives that you need to attain in order to make your vision come true. Example: “Have $25,000 annual investment income by 2040.”

- Then come your **strategies:** high-level steps to reach your goals.

Writing these out is an important step to disciplined investing. Some would say that if it’s not written, it’s not a plan. Don’t trust yourself to just keep everything in your head. Write it down.

The strategy document being discussed here is like a Constitution: It lays out your enduring goals and principles. In fact, when I started in DG investing, I used to call this document my Constitution. Now I simply call it my business plan.

Here are typical topics to cover in your business plan:

- Your objective(s) – If you have more than one, prioritize them

- How you will identify excellent DG companies

- How you will recognize a good entry point for each stock

- Your rules and guidelines for portfolio construction – number of stocks, diversification, maximum size of any single holding, etc.

- Your rules and guidelines for selling and trimming

- What you will do with dividends when you receive them

- How you will measure performance

Here are how strategies differ from tactics or to-do’s: Your high-level business plan does not tell you which stocks to purchase nor when to buy

them. Rather, it tells you *how you will pick them and know when to buy them.*

The focus is on principles, not specific situations.

Refer Back to Your Plan

When you are actually investing, follow your strategies. That's why you have them. They remind you of how you plan to achieve your goals. They help you keep your eye on the ball.

Referring back to your plan is especially helpful when you find yourself in a perplexing or fast-moving situation. Your document will remind you of how you analyzed things when you were detached and thinking clearly.

Your strategy document need not be rigid or unchanging. It can be amended. **Review it annually**. Make adjustments as your circumstances change, you learn more, and you become a better investor.

Revising your business plan is better than making repeated exceptions or overriding it on a regular basis. If you feel the need to make frequent exceptions, that probably means that the document is incomplete and/or that it contains self-contradictions. Amend it to preserve your best thinking.

If this sounds like a lot of soul-searching and analysis, it is. But if you are going to invest your money in the best way possible *for you*, there is really no better tool than a written plan that you have thought hard about and then utilize for guidance.

Note: At the end of this chapter, I present a generic "Dividend Growth Business Model." I developed this years ago, and I thought of dropping it from this book. However, it does present a simple and logical way to visualize DG investing. You will find it in the last section of this chapter.

My Dividend Growth Portfolio's Business Plan

Later, in Chapter 16, I will go over my real-life, real-money, real-time Dividend Growth Portfolio.

Here, I want to present that portfolio's business plan as an example of a simple but sufficient DG investment plan.

Dave Van Knapp's Dividend Growth Portfolio Business Plan

Last updated: October 27, 2020

Primary Goal of the Dividend Growth Portfolio

Build a reliable, steadily increasing stream of dividends over many years that can eventually be used as income for retirement.

Secondary Goal

Deliver total returns that are competitive with the general stock market as measured by the S&P 500 with dividends reinvested.

Portfolio Inception

The portfolio was begun on June 1, 2008 with a starting value of $46,783 funded by the author.

Additional New Money

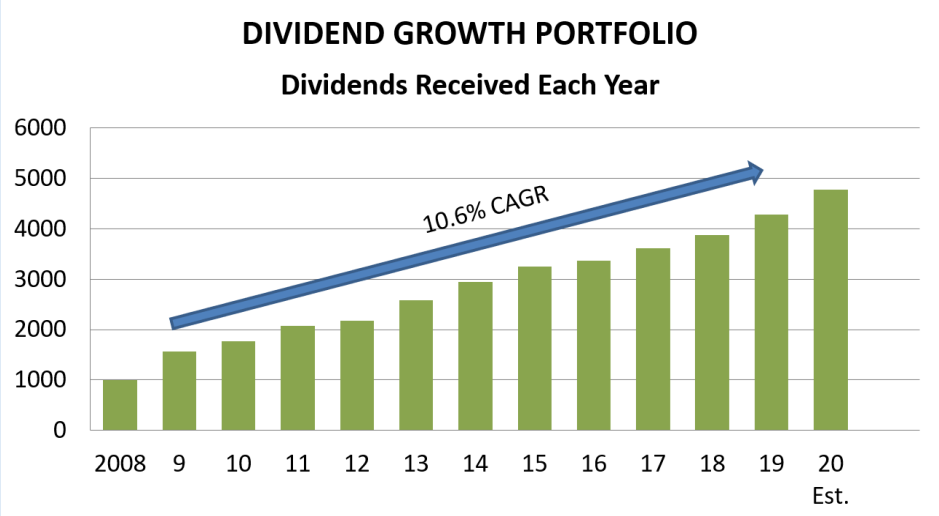
No new outside money has been or will be added to the original amount.

That simplifies the calculation of returns, because all dividend amounts and growth are generated organically within the portfolio, from (1) the original investment and (2) monies generated by the original investment.

Dividend dollars, of course, enter the portfolio as they are paid by the companies. While these become dollars to reinvest within the portfolio, they are not "new outside money," because the portfolio generates them on its own.

Dividend History

This is the portfolio's dividend history through October 1, 2020:



The portfolio's income increased at a compound annual growth rate of 10.6% per year from 2009 – 2019. 2020's increase is expected to be 12%. (2008 is ignored in the calculation, because 2008 was a partial year.)

Selecting Stocks

1. To select stocks, I use the analytical methodology described in [this e-book]. Practical applications and illustrations of the approach can be seen in the Dividend Growth Stock of the Month series.

2. I purchase stocks with "Fair" or better valuations using the methodology described in [this e-book] and applied in the Dividend Growth Stock of the Month and High Quality Dividend Growth Stock of the Month series.

3. It is possible that a dividend-oriented ETF (exchange-traded fund) or CEF (closed-end fund) may be added to the portfolio. Thus far, no such funds have been added.

Reinvesting Dividends

1. Dividends are reinvested but not dripped.

2. When incoming cash accumulates to **$1000**, I will select the best candidate at that time to buy. It could be a new stock or fund for the portfolio or more shares to add to an existing position.

3. When reinvesting dividends, I try to improve the portfolio along one or more dimensions, such as yield, company quality, dividend growth, dividend safety, diversification, and the like.

4. Since the major focus is on income and not share prices, the portfolio will usually be 100% invested (except for accumulating dividends awaiting reinvestment). Cash beyond the $1000 kitty for reinvestment will not be held in efforts to time the market or for any other purpose.

Portfolio Characteristics

1. The portfolio will normally contain 20-30 stocks or funds.

2. The portfolio will be well-rounded. It is diversified across economic sectors and industries. It is also diversified across a variety of yields and dividend growth rates.

3. The portfolio is meant to be a straightforward illustration of all-purpose dividend growth investing. It will not be unduly tilted either toward fast dividend growth or high yield stocks. The DGP's yield will usually be in the vicinity of 3.5%. Its annual dividend growth rate is expected to be in the 9% range per year, including the impact of reinvesting dividends.

4. The portfolio will normally hold no more than 10% of its total value in a single stock.

5. Other than the 10% ceiling, the portfolio is agnostic on position sizing. There is no minimum size requirement. The weights of holdings will self-adjust as prices change and dividends are reinvested. Small positions may be built up through repeated reinvestments in the same stock.

6. The portfolio is not rebalanced on any set schedule. However, occasionally a large position may be trimmed, with the money used to initiate or build up other positions.

Selling Guidelines

1. This portfolio is expected to have a low turnover rate. Unless there is a strong reason to sell or trim a position, the default action is to hold. The underlying

strategy is to buy, collect, and hold good dividend growth stocks for long periods of time.

2. However, selling or trimming will be seriously considered if any stock or fund:

(a) Cuts, freezes, or suspends its dividend.
(b) Bubbles or becomes seriously overvalued.
(c) Is impacted by significant fundamental changes.
(d) Is going to be acquired.
(e) Announces plans to split itself into 2 companies or spin off a significant portion of its operations into a separate company.
(f) Sees its current yield rise above 9% or drop below 2%.
(g) Grows to where it is beyond 10% of the portfolio.

Strategic Reviews

1. The portfolio is reviewed from a strategic level once or twice per year.

2. This business plan is reviewed once per year and amended as appropriate.

Strategies and Practices Not Used

1. Margin.
2. Shorting.
3. Options, futures, or other derivative investments.

Major Issues Addressed in the Plan

The sample plan just presented addresses the major issues that I have run into in my own DG investing journey. I have developed my answers to those issues – and preserved those answers in the plan – over many years.

Again, let me emphasize that the plan represents *my* answers. You may need completely different strategies. But in the remainder of this chapter, I want to expound on several of the major issues:

- Setting numerical goals
- What “buy and hold” means

- Whether to sell what you would not buy now
- Whether to rebalance your stocks
- The use of options

Setting Numerical Goals

You probably noticed that my goals are directional, but they are not quantified.

I wasn't always that way. In the early years of my DG journey, I had numerical goals for the dividend income I wanted to achieve.

To be specific, I wanted to achieve 10% yield on cost within 10 years of starting the portfolio. (Reminder: Yield on cost means the yield on your initial investment. So, for my starting cost of $46,783, a 10% yield on cost would mean that I would be receiving $4678 per year in dividends. That *cash flow* would be figured independently from the *current value* of the portfolio, which plays no role in the calculation.)

I chose 10 and 10 for two reasons. First, 10 percent is a healthy rate of return, about equal to the long-term total annual return of the stock market itself. Second, 10 years is a useful time frame for many people – not too short and not too long.

The tables in this section proved to be quite popular with readers. They illustrate the dynamic interaction of initial yield with dividend growth rate.

Intuitively, it seems obvious that attaining 10% yield on cost within 10 years can be accomplished along many paths, each defined by a different combination of initial yield plus the subsequent rate of growth.

The first table shows how long it would take various combinations of yield and growth rate to achieve 10 percent yield on cost within 10 years.

10 by 10 Table for Dividend Growth

Number of Years to 10% Yield on Cost

Initial Yield

DGR	2.0%	2.5%	3.0%	3.5%	4.0%	5.0%	6.0%	7.0%	8.0%
4%/yr.	40	35	30	26	23	17	12	8	5
5%/yr.	32	28	25	21	18	14	10	8	4
6%/yr.	27	23	19	18	15	12	8	6	3
7%/yr.	24	20	17	15	13	10	7	5	3
8%/yr.	21	18	15	13	12	9	6	4	3
9%/yr.	19	16	14	12	11	8	6	4	2
10%/yr.	17	15	13	11	10	7	5	4	2
11%/yr.	15	13	12	10	9	7	5	3	2
12%/yr.	14	12	11	9	8	6	5	3	2
13%/yr.	13	11	10	9	8	6	4	3	2
14%/yr.	12	11	9	8	7	5	4	3	2
15%/yr.	12	10	9	8	7	5	4	3	2
16%/yr.	11	9	8	7	6	5	4	3	2
17%/yr.	10	9	8	7	6	5	3	2	2

Notes:
(1) The DGRs are averages per year. It is rare for a company to increase its dividend by the same percentage each year.
(2) The table does not illustrate the accelerating effect of *reinvesting* dividends, which would reduce the number of years to reach the goal. It simply shows the increase in yield on cost from growth in the dividend itself.

The table shows initial yields (across the top) and annual dividend growth rates (down the left side). Where those two values intersect, the number within the cell shows how many years it takes to achieve a 10 percent dividend return from your initial investment (i.e., yield on cost).

The combinations of initial yield and DGR that can achieve the 10 by 10 goal are shaded. So, for example, a 4% initial yield growing at 10% per year achieves the 10% return goal in 10 years. So does a 5% initial yield growing at 7% per year.

But a 2% initial yield cannot reach the 10 by 10 goal at any rate of increase below 17% per year, which is unlikely to happen over 10 years. That's one of the reasons that I like to get an initial yield of at least 2.7% in my own investing.

Many DG investors are interested in stocks with lower yields that have faster DGRs. Such stocks take longer to achieve 10% yield on cost. The table

can be adjusted to indicate "success" over any length of time. For example, the table below is a 10 by 15 table, meaning I have expanded the shaded "success" area to include time spans of up to 15 years instead of 10.

10 by 15 Table for Dividend Growth

Number of Years to 10% Yield on Cost

Initial Yield

DGR	2.0%	2.5%	3.0%	3.5%	4.0%	5.0%	6.0%	7.0%	8.0%
4%/yr.	40	35	30	26	23	17	12	8	5
5%/yr.	32	28	25	21	18	14	10	8	4
6%/yr.	27	23	19	18	15	12	8	6	3
7%/yr.	24	20	17	15	13	10	7	5	3
8%/yr.	21	18	15	13	12	9	6	4	3
9%/yr.	19	16	14	12	11	8	6	4	2
10%/yr.	17	15	13	11	10	7	5	4	2
11%/yr.	15	13	12	10	9	7	5	3	2
12%/yr.	14	12	11	9	8	6	5	3	2
13%/yr.	13	11	10	9	8	6	4	3	2
14%/yr.	12	11	9	8	7	5	4	3	2
15%/yr.	12	10	9	8	7	5	4	3	2
16%/yr.	11	9	8	7	6	5	4	3	2
17%/yr.	10	9	8	7	6	5	3	2	2

The only difference between the two tables is the definition of success – how many years are you allowing to get to 10% yield on cost? The first table defined success as 10 years. In the second table, 15 years are allowed. Thus, more cells in the second table are shaded, and lower initial yields become viable routes to success.

Note also that — whatever your goal — the faster you hit it, the fewer years that your stock selection is subject to the risk that you overestimated its dividend growth rate.

Obviously, it takes longer for a stock with a lower yield to achieve 10% yield on cost (or any other target) than a stock with a higher initial yield. But if a stock can maintain a high DGR for many years, it will catch and then surpass the annual dividend payout of a stock that had a higher initial yield. Each year after the crossover point, the high-DGR stock will widen its lead on an annual basis. (It will, however, take several more years to catch up on a *cumulative* basis, because the stock with the higher initial yield got off to a head start.)

One final point. The tables do not reflect the accelerating effect of reinvesting the dividends. Reinvesting dividends shortens the time for a portfolio's dividend growth to build up.

Be Cautious about Projecting Dividend Growth Rates

An inherent difficulty with projecting DGRs is predictability, especially over long time periods.

Your initial yield is locked in the moment you purchase a stock, but future rates of dividend growth are speculative. You can make an educated guess by looking at past dividend growth rates and checking future estimated earnings growth rates, but it is still a guess, and there's no way around that. Companies decide every year how much to raise the dividend, or to cut it or freeze it. Dividend growth rates can and often do change.

Dividend growth stocks with high DGRs are especially appealing to younger investors, who can look forward to decades of compounding before they retire. But I get worried that some may think you can count on a stock to maintain a high DGR for years and years. You can't. It may happen, but you cannot count on it.

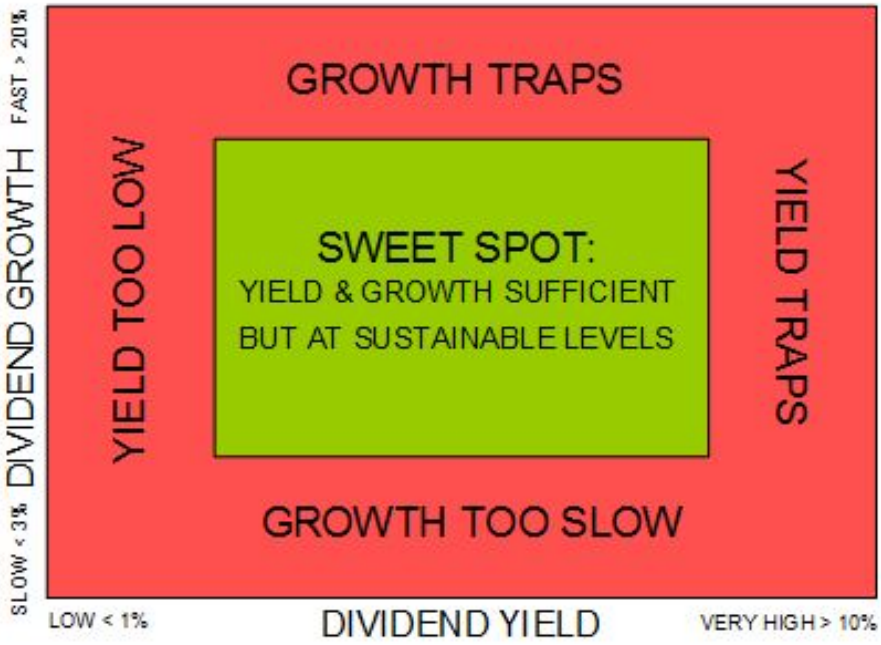
So, please be cautious about thinking that a company with, say, a 5-year DGR of 15% per year will be able to maintain that pace for very long. It just does not happen often. The higher the rate is of projected annual dividend growth, the more risk – meaning higher probability – that it may not be achieved.

In contrast to the unknown future DGR, a stock's initial yield is locked in. What I mean is that — if the company does not cut its dividend — the initial yield at which you purchase the stock is the lowest yield on cost that you will ever have. The stock's current yield will vary up and down as the years go by, but if the company keeps raising its dividend, your yield on cost will only go up.

The "Sweet Zone" in Picking DG Stocks

Many DG investors have concluded, after years of experience, that the most reliable and predictable DG stocks lie in a "sweet zone" defined by yield and growth rate. The sweet zone has stocks whose yields are neither too high nor too low, and dividend growth rates (DGRs) that are not too fast or too slow.

The diagram below illustrates the "sweet zone" for many DG investors.



On the diagram, the left (vertical) axis represents the dividend's likely growth rate. It ranges from very slow (say less than three percent per year) to very fast (say 20 percent per year or more).

The bottom (horizontal) axis represents the initial dividend yield, from very low (less than one percent) to very high (greater than 10 percent).

The Sweet Zone contains stocks that are moderate in both dimensions: Yields between about 2.5% and 6%, combined with growth rates that are

between about 4% and 9% per year. Those are generally sustainable numbers.

The red area represents four danger zones. Here is why:

- The left red edge, labeled “Yield Too Low,” is where the stock’s yield is simply too small to be rewarding. Of course, how low a yield you will accept is a matter of personal choice. In recent years, I have noticed more interest in very low-yielding stocks, as some DG investors have begun to focus more on fast growth rates.

- The lower edge, labeled “Growth Too Slow,” is where dividend growth goes at a glacial pace. Of course, that’s a relative concept too, as a slow growth rate for a high-yielding stock may be perfectly acceptable to many investors.

- The top edge is labeled “Growth Traps.” This is where the growth rate is probably unsustainable because it is too high. It’s a “trap,” because a high dividend growth rate appears attractive and can fool you. As we stated earlier, really fast DGRs are rarely sustained for very many years.

- The right red edge is labeled “Yield Traps.” Again, a high initial yield is a good thing, up to a point. But extremely high yields often point to a problem, and they exist not because of fast dividend increases but rather because of severe price plunges. Many extremely high-yielding stocks have a dividend cut in their futures.

Should You Use Options?

Some dividend investors use options to “increase yield,” as they put it. In other words, they sell options and collect the premiums from the option buyers. That money is like additional income to them.

The simplest option strategy is to sell *covered calls.* These are contracts sold by you to buyers that allow them to “call” (take) your shares if they reach a

price specified on the contract (the “strike price”). “Covered” means you already own the shares for delivery to the buyer if necessary.

Covered calls are considered to be a low-risk way to increase income, because when writing a call, you receive a cash premium from the buyer, and that cash is yours to keep. If your shares are not called, you still own the stock. However, there is a risk that the shares will be called, and that you will lose a stock that you really wanted to own (and the future benefits of ownership).

A second options strategy is to sell *cash-secured puts* for stocks that you want to buy. These give the buyer the right to “put” shares to you at the contract price. They are paying you for the right to offload the stock onto you. If you select a price at which you’d be happy to buy the stock anyway, this can be a way of creating revenue from a stock that you don’t even own. “Cash secured” means that you have set aside the money to buy the stock.

In fact, an investor who only wants to buy a stock at a certain maximum price can use cash-secured puts to get the stock at that price. The downside, of course, is that the cash may be tied up for a long time and the strike price may never be hit.

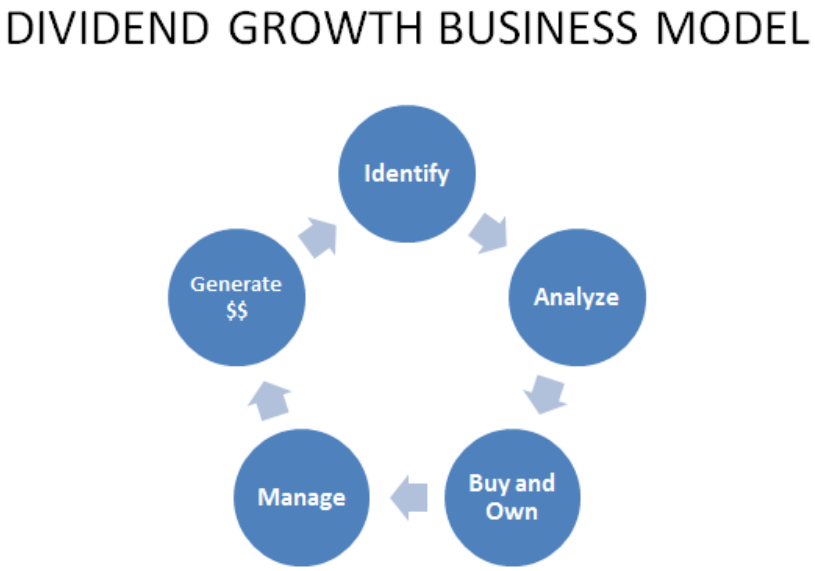
Speaking personally, I have never wanted a particular stock so badly that I would wait solely on it (with money set aside) and pass on other equally good opportunities that are already at prices I am willing to pay.

Options are beyond the scope of this book. I do not use them. I prefer to invest directly in the companies themselves. I have read a lot from satisfied users of options, but to me it seems like making short term price bets. My investing business model is not based on making price bets.

If I ever get involved with options, I would treat that as a separate line of business with its own goals, strategies, and tactics.

The Dividend Growth Investing Business Model

This is a diagram that I developed years ago to help visualize the DG business model. I wanted to present DG investing as a virtuous cycle of repeating steps that build a portfolio over a long term.



Let's start at the top and work clockwise around the circle.

Identify



As a dividend growth investor, you seek out dividend-growth stocks. This is a unique subset of stocks with some very special characteristics. Chief among them is their propensity and ability to increase their dividends each year.

Analyze



We want to own high-quality companies. Starting with the 750 or so DG stocks, we analyze them to find the best companies for our collection.

When the portfolio has been assembled, we want it to generate a steadily increasing stream of dividends paid by excellent, low-risk companies.

Note that as an investor, you must make your purchase decisions carefully, because you will depend on each company's management to run it.

Your own competency is not in being able to run each business in your DG stock collection. Rather, acting as your own Chief Investment Officer, your skillset involves identifying which companies are good at making money and have the intent and wherewithal to send streams of their profits to shareholders in cash.

Buy and Own



Dividend growth investing is not a system for trading or flipping companies. Rather, the idea is to carefully select appropriate companies for your portfolio, with the intent of holding them for a long time. Usually your hoped-for holding period is *forever.* Of course, things do not always work out that way, but that is the original intent.

Usually this quest leads you to companies that are in sound sustainable businesses, economically conservative, and committed to prudent growth. That is what supports and sustains annual dividend increases.

In the buy-and-own process, you will amass *dividend rights.* These are the rights that you get, as a part owner of great companies, to receive the dividends that they distribute. Dividends are paid *per share.* The more shares you own, the more dividends you get. The accumulation of shares over time causes the dividend stream to go up as a result of the annual increases declared by the companies.

Manage



Managing your portfolio involves several things: Keeping an eye on your companies, handling the incoming dividends, and remaining business-like yourself.

Dividend growth investing, for most, is not a "buy-and-forget" proposition. Instead, "buy-and-monitor" is a better description of what you do. The dividend growth investor keeps track of the companies that he or she owns, thinks about ways to improve the portfolio, and reacts intelligently to problems.

As a self-directed investor, you fully *own* the decisions that you make. You never play the victim card. You know in advance that there is risk, and that some things will not turn out as planned. You are prepared to react in a businesslike fashion when something goes wrong.

Risk management is unemotional. You are simply following sound business principals. All decisions should be based on facts and reasonable inferences drawn from the facts.

Portfolio management includes deciding what to do with the dividends as they flow to headquarters. You can either keep them as spending money or reinvest them. Many DG investors do a little of both.

Generate $$



In DG investing, money is generated both in the form of dividends and, over long terms, rising capital values.

Not only that, one of the pleasures of this investment method is that the payoffs happen frequently. Say you own a dividend growth portfolio that has investments in 20 companies that pay quarterly dividends plus two companies that pay monthly. That's 104 paydays per year, averaging nearly 9 per month or twice per week.

If each company increases its dividend once per year, that's also 20 increases per year. Some people call this type of investing "boring." It's really not!

CHAPTER 13

GETTING STARTED – PORTFOLIO CONSTRUCTION

Getting Your DG Portfolio Started

I am going to assume that you already know how to buy a stock. That is, my purpose here is not to discuss opening a brokerage account or how to place an order to buy or sell. Rather, the purpose is to consider big-picture issues about constructing your portfolio.

I am not going to delve into asset allocation among asset classes. *Asset allocation*, in the financial world, generally means dividing your money among different categories (kinds) of assets that have different financial characteristics. The "big three" asset classes are stocks, bonds, and cash, with many sub-classes having been defined within them. Some advisors consider real estate to be a fourth major asset class.

The reason not to talk about asset-class allocation is that this book is aimed at a single asset class: Dividend-growth (DG) stocks. Most academics would tell you that DG stocks are not an asset class by themselves, they are simply a sub-category of the asset class called "stocks."

Either way, in this book we're talking about DG stocks. As an investor, you certainly will want to explore what bonds and cash can do for you, not to mention non-DG stocks. But that's not the mission here. Let us focus on DG investing alone.

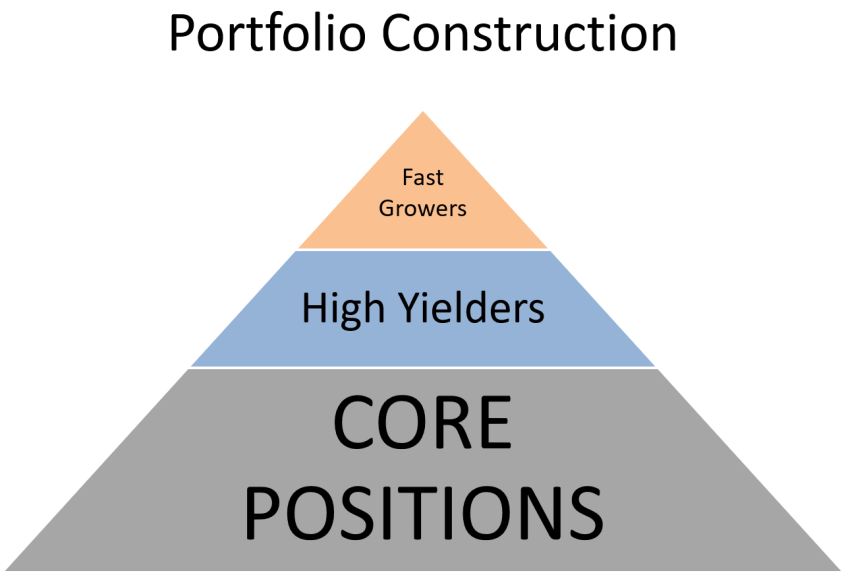
When an investor moves into DG investing, they usually start from one of two situations: They are converting a pre-existing portfolio into a DG portfolio, or they are starting a DG portfolio from scratch.

The biggest difference between the two starting points is that in the first instance – conversion – you have the opportunity to create a DG portfolio all at once, whereas in the second instance, you must create your portfolio over time, step-by-step, with monthly, bi-monthly, or weekly contributions of cash (from your paycheck, for example).

Build a Base First

Probably the two most common ways to visualize portfolios are either as a structure or as a pie chart.

Let's try the structural view using a pyramid as the visual structure.



I like the structural view, because it conveys the idea of your portfolio having a foundation. The foundation is the base of stocks that you pick to not only get yourself off to a good start, but also to provide strength and durability over the long term.

The foundation of a house holds up the rest of the house and gets it up off the ground. That's what the foundation of your portfolio does.

A good way to think about your foundation is that it holds “core” stocks. There are many defintions of “core” holdings, but these general ideas are consistent across most definitions:

- Stocks that you intend to hold for many years.
- The most stable, reliable stocks that you own.
- The stocks that are the most central to your goals.

The idea is that once you’ve built your portfolio’s foundation, you can then consider other stocks to augment them.

The pyramid above is labeled in a way that works for me:

- Core positions are mostly mid-yield, mid-growth, ultra-safe stocks that are the foundation of my portfolio. Think of the green “sweet spot” stocks in the diagram in the last chapter.
- Building up from the foundation, the middle layer is a few high yielders, which typically have little growth and are less safe, but provide big doses of income.
- The top layer contains fast-growing stocks, which typically come with lower yields (1% or less) but grow their payouts really fast from year to year.

The general idea about getting started in DG investing would be to build your base first, then turn your attention to the other layers once you have a strong foundation in place.

Let’s use a simple example for illustration. Let’s say you’ve decided that the most risk you want out of any single position is 3%. That implies a portfolio of 30-35 stocks. You are just getting started: You don’t own any stocks yet, but you can contribute $1000 per month to your new enterprise.

I would break that monthly contribution into pieces to start building the portfolio 's foundation "sideways" first. In other words, think of the foundation as being made up of building blocks. Each purchase is a building block: Block #1 (stock #1), block #2 (stock #2), and so on.

Rather than stacking all the blocks for a single stock straight up, with no support around the stack, it seems better to lay the initial blocks next to each other to provide mutual support. That means buying several different stocks with your first few months' worth of purchases.



(Source)

So maybe split the $1000 each month into two $500 purchases of two different stocks for your foundation. Within a year, you can make 24 purchases, which means 24 blocks for your foundation.

By the end of that first year, some of the purchases will start to become repeat purchases of the same stock. You could aim to have established 10-15 stock positions by the end of the year, which means you can buy the first two blocks of most positions. By year-end, you will have a solid foundation underway.

Nowadays, some brokers (Schwab and Fidelity, for example) offer stock "slices," meaning fractional shares. You select the dollar amount, and the

broker puts the fractional share(s) into your account in the dollar amount you designated. That makes getting started easier, because you can literally spend exactly $1000 each month without regard to the share prices of the stocks that you are buying.

There are many ways to use slices. If you want, you could divide the $1000 into 20 portions of $50 each, and start building your foundation that way. By the end of the first year, you would have made 240 small purchases, which could be a low-but-solid foundation of 20 or more core stocks.

Of course, not all of your initial purchases need to be for the foundation. If you see a good deal on a high-yielder or fast grower, you can pick that up too. Just don't put all your money in one place. Spread it around. Get multiple dividend streams going.

In the beginning, try to keep your positions roughly equal-weighted, to spread the financial risk among them. After you are well into building your portfolio, the positions will stray from being about the same size – both through their own price changes and some unevenness that may be inherent in what you choose to buy. That's fine. We'll talk about rebalancing later.

Stock Selection

The Top 30 selections contain a variety of foundational stocks, with a few high-yielders and fast growers mixed in. Consider them to be a "starter kit" of candidates across the board.

Your definition of foundational stocks will depend on your business plan. Some investors consider low-yield, fast-growth DG stocks as foundational. They might start with those first, then later add what I call sweet-spot stocks to act as ballast that will keep their portfolio a little more grounded if some of the high fliers hit rough patches. All of us old enough to have lived through the dot-com bust (2000-2002) remember how fast a bunch of "sure things" can crash to earth.

And there are investors, who don't necessarily consider themselves DG types, whose entire portfolio consists of high yielders. They want income payoffs right away and are not very concerned about growth from each individual piece. They plan to generate their own growth via reinvestments of the large dividends they receive. (For a good book about high-income investing, see *The Income Factory* by Steven Bavaria.)

So the way the pyramid diagram is labeled reflects my own goals and biases. I already own many of the Top 30, and I will use the list, along with stocks that I write articles about over the next 12 months, as my own shopping list for 2021. That doesn't mean that I will buy every one of them. But I will confine myself to them or to building positions that I already own.

When you are contemplating a purchase from a stock that you read about (here or elsewhere), I suggest that you update your understanding of the stock's dividend safety and current valuation. Dividend yields and valuations change daily, and dividend safety changes based on news about the company, its industry, or the numbers it reports quarterly.

Other factors (such as business quality) change more slowly and don't necessarily need to be updated as frequently.

The Role of Valuation in Stock Picking

Sometimes, investors put themselves on a program to build up certain stock positions. Perhaps it's a great company or two that they want to own more of. In doing that, they may diminish the importance of, or entirely drop, valuation from their selection process.

I can see why they do this, but I approach things differently. I view valuation as a risk-coping technique. I want to decrease the risk that over the long term, I lose money on a stock. Another way to say that is that I want a *margin of safety* for everything that I buy.

Benjamin Graham called margin of safety the central concept of investment. He devoted an entire chapter of *The Intelligent Investor* to it

and said that the concept ran implicitly throughout the entire book. He stated:

> "The margin of safety is always dependent on the price paid. It will be large at some price, small at some higher price, and nonexistent at some still higher price."

I believe that is true, even (or especially) in times like now when stock prices are generally elevated following the bull market conditions of 2009 to the present.

Building a margin of safety into your purchase decisions helps protect against steep price declines, over-optimistic projections of future growth, and bad luck.

I also want to increase the probability that, when I purchase a stock, I am getting it at a good yield for that stock. A good initial yield benefits the investor for the entire term of ownership, not just for (say) the first year.

So I invariably hunt out stocks that have fair valuations when I buy them, or (better still) are on sale.

A researcher in behavioral economics might say that I don't care what order I buy stocks in. That would be correct: Just because I have started a position does not make me feel that I must proceed to build it up even if its valuation goes through the roof. I much prefer that each individual purchase is sensible at the time that I make it – according to the way that I evaluate stocks, including having a margin of safety.

Therefore, I steer myself to stocks that are well-valued at the time of each purchase. My experience is that if you approach portfolio-building that way, then eventually — 10 years from now, or 20 — you will have positions in most of the ones that you want. The math of the matter is that you will be better off having purchased your stocks at good valuations.

You Need Not Own Every "Good" Stock

Some investors seem to feel almost guilty if they don't own certain iconic DG stocks, as if they are hurting the stock's feelings if they don't own it. Article writers sometimes push this idea with headlines like, "This Stock Deserves a Place in Every Portfolio" or "Every Investor Should Own This Stock."

There's no need to feel that way. Stocks do not know whether you own them or not. While you're stressing about not owning some great stock, or reaching to get it at an inflated price, you may be missing better opportunities elsewhere.

If a great DG stock never seems to have a good valuation when you have money to invest, it's fine to go your entire life without ever owning it. The money will have gone to good use in other places.

Diversification

Diversification refers to not putting all your eggs in one basket. It is a well-recognized risk management technique. The idea is to spread your bets around to help reduce the damage if any single bet goes against you.

Diversification cannot insure against loss, but under-diversified portfolios have greater potential to suffer painfully large losses of capital or income cuts if a single position runs aground.

Each of your stock holdings generates its own revenue stream that contributes to the portfolio's total output. Multiple revenue streams are generally safer, because the total stream is not at large risk from a single tributary stream going dry. Similarly, spreading yourself across economic sectors reduces the chances that difficulties experienced in a particular sector will have an outsize impact on you.

We have an example in 2020 of a sector that fell upon hard times: Energy. XLE is the largest energy-centric ETF. Here's what it has done in the prior 12 months as of this writing:



Energy – in terms of both oil prices and petroleum usage – may well recover. A lot of people are betting on that. But investors who are over-weighted in energy have had a really bad year so far.

I apply the diversification principle by making my portfolio "well rounded": I want it to contain stocks from different sectors and industries, with different yields, a range of dividend growth rates, and so on.

How Many Stocks to Own

Another concept related to diversification is position size and number of stocks. After many years of conversing with other DG investors, I have concluded that how many stocks you own, and how large any position size should be, are highly personal choices, because the central issues concern your own comfort levels, or as it is often called, risk tolerance.

The math part of the issue is easy. Simple math tells us how many positions you need to own if you want to put a ceiling on the maximum damage that any one position can do.

RISK VS. NUMBER OF STOCKS	
Maximum Acceptable Damage to Portfolio or Income Stream from One Position	**Requires that You Own This Many Stocks (Assumes Equal-Weighting)**
100%	1
50%	2
33%	3
25%	4
10%	10
9%	11
8%	12-13
7%	14
6%	16-17
5%	20
4%	25
3%	33
2%	50
1.5%	67
1%	100

I shaded the 5% - 2% lines green, because this area seems to be where many investors are comfortable. An investor might say to herself, “I can handle 3% damage to my portfolio if a single position fails completely.” That means she must own at least 33 stocks (equal-weighted). The green shaded area covers portfolios of 20-50 stocks, and that range seems to be quite common.

Some investors define their “maximum allowable damage” in terms of the percentage of portfolio dividend income at risk rather than the capital at risk.

Either way, if your maximum position size is exceeded, consider splitting up the holding to dilute the concentration and spread the risk around. For example, if your maximum capital-at-risk guideline is 3%, and a position

grows to 4-5% of your portfolio, consider trimming the oversize position and moving the money into a different position.

However, I would not suggest that you buy a low-quality company or an overvalued one simply to become more diversified. Stick to your guns on quality, dividend safety, and (if you use it) valuation.

CHAPTER 14

MANAGING YOUR PORTFOLIO AND YOURSELF

Introduction

I found it hard to name this chapter. At first, I was just going to call it "Portfolio Management." But as you get into the topic, you realize that a lot of portfolio management is as much about psychology as it is about math. That means that it is as much about managing yourself as it is about managing your portfolio.

What makes people trade too much? What does "trade too much" even mean? Over the past several years, I have come to realize that answers to questions like that are often based in psychology, emotions, and impulses. Cold, hard mathematical answers simply do not explain the behaviors. It's clear that portfolio management is part math and part psychology.

Behavioral finance is a field of study that has been around since the 1960s. In a nutshell, it attempts to explain irrational financial decisions that cannot be explained by conventional economic theory. In conventional theory, every person is rational, and they make only rational decisions. It turns out that real investors do not act like this. Real decisions, studies show, often deviate from what would be considered optimal or rational by classic economics.

In 2002, Daniel Kahneman was awarded the Nobel Memorial Prize in Economic Sciences for his integrated insights into economic science, especially concerning human judgment and decision-making under uncertainty. Richard Thaler was awarded the same prize in 2017 for his work in incorporating psychologically realistic traits – such as limited

rationality, social preferences, and lack of self-control – into analyses of individual economic decision-making.



(Source)

Behavioral economics is far too vast a field to even summarize here, but you will find that some of the discussion in the rest of this chapter gets into subjective matters as well as mathematical reasons for doing things in certain ways.

Active vs. Passive Investing

Dividend growth (DG) investing is an *active* strategy. At a minimum, DG investing requires decisions about stock selection, position sizing, what to do when bad things happen, how to handle dividends, and so on.

DG investors usually monitor their portfolios to a greater or lesser extent. Often the monitoring leads to decisions to change nothing. That can lead to DG investing being seen as passive investing to the untrained eye. But that's not what is going on. Decisions are being made all the time. A decision to hold can be and often is an intentional act.

Which brings us to an important question: Is DG investing "buy-and-hold" investing? Believe it or not, this can become an emotional subject. It need not be.

Buy and Hold

Investopedia defines buy and hold this way:

> "Buy and hold is a passive investment strategy in which an investor buys stocks…and holds them for a long period regardless of fluctuations in the market. An investor who uses a buy-and-hold strategy actively selects investments but has no concern for short-term price movements." (Highlights added)

Under that definition, some activity is required: Actively selecting investments. To my way of thinking, that removes it from being called "passive," but Investopedia says that it is passive. I highlighted the words to call attention to what I think is an inherent contradiction.

We can get around that by adjusting the definition to acknowledge that buy and hold involves active decision-making at the beginning, followed by long periods of *not trading* afterwards. That probably matches how most people think of the concept in real life. However, not trading can be the result of active decisions not to trade, not only passivity.

My business plan includes selling guidelines, so obviously I have not adopted the most extreme interpretation of buy and hold, which is that you never sell anything. (Some people do adopt that approach: Once they purchase something, they will ride it to zero, but never sell it.)

I think it's best to look at the buy-and-hold cliche along a continuum. At one end would be the people just described, who interpret *buy and hold* as meaning that you hold forever and never sell. That might be described as "buy and forget."

At the other end of the continuum would be active traders who try to make their money by beating the market. Ben Graham would call them speculators rather than investors.

Everyone needs to find their own place along that continuum. In my business plan, I do say that I expect to have a low turnover rate and that my strategy is to collect stocks and not trade them very much. The selling guidelines are pretty restrictive. So that puts me toward the conservative end of the buy-and-hold continuum.

Most DG investors don't forget their stocks, they monitor them. Stocks are purchased with the purpose of sharing in each company's success, and often with the intent to hold them "forever," but the investor does not get so tied to his or her positions that they stop evaluating them.

I would describe the selling guidelines in my business plan as setting the framework for a flexible kind of buy-and-hold. The system has deliberate proactive steps — monitoring for bad news, conducting formal portfolio reviews, and so on — whose purpose is to determine whether and when to sell or trim. I think these steps are as important as initial stock-picking.

This can be one of the hardest concepts to get across about dividend growth investing: Holding is what you do most of the time, but selling from time to time is something that you do too. That is why I say that dividend growth investing is an active (not passive) strategy, even if the predominant activity is to monitor your portfolio without making many trades.

Coping with Risk

Coping with risk is an important part of any investing strategy.

Risk is a complex subject. Unfortunately, in Modern Portfolio Theory (MPT), investment risk is usually defined as, and confined to, price volatility, as if nothing else matters. But dividend growth investors are often more concerned about their dividend/cashflow than about the absolute value of their portfolio.

MPT further posits that risk and reward are tradeoffs: The larger amount of reward an investor seeks, the more risk that investor must undertake. Under MPT, less risk leads inevitably to less potential reward.

I humbly submit that there are other ways to look at risk. In particular, risk can be viewed as avoidable circumstances that, if side-stepped, *improve* your chances of investing successfully.



If you step up onto a ladder to trim a hedge, there is risk that you will lose your balance and fall off the ladder. To reduce that risk, you ask someone to hold the ladder for you. By reducing the risk, you increase the chances of a successful outcome. Taking on less risk does not reduce your potential reward.

In other words, the relationship is not more risk = more reward, it is that *less* risk = more reward, at least some of the time. Avoiding certain risks *improves* your chances of success. This is akin to Graham's thoughts about margin of safety: The larger the margin of safety, the more likely you are to reap greater rewards.

Obviously, any money you put into the stock market is at risk. I don't think that the goal in investing is to avoid risk entirely. What you can do, however, is *cope* with it, and thus improve your chances of dealing successfully with a world in which you must take on some risk to meet your financial goals.

Coping implies that you recognize and identify investment risks, and also determine to deal with them rationally. Once you get into that mental framework, you can plan:

- How much risk you want to accept.
- What kinds of risk you can work with and what kinds to avoid entirely.
- How to sidestep the risks that you don't want to deal with.
- What you will do when a risk (that you have accepted) manifests itself and becomes a reality that requires a decision on your part. In other words, you can pre-plan your responses for when bad things happen.

In the glossary, I state that risk refers to the chance that one will be exposed to danger, harm, loss, or things not turning out as hoped or expected. Let's get more specific. As a DG investor, I use *risk* to refer to the possibilities of suffering *realized loss of capital* or *unexpected decrease in dividend flow*.

I suggest that you view risk in probabilistic terms, not as a binary black/white proposition. In other words, it's not risk-on/risk-off, which is a term you will often see. That concept is too generic and presents risk as binary, which it is not.

Rather, you want to home in on the risks pertinent to your goals: **Maximize the probability of achieving your goals, while minimizing the chances of realizing a capital loss and/or suffering an unexpected decrease in dividend cash flow.**

The sections in the remainder of this chapter are suggestions about how to accomplish those objectives.

Immediate Reviews When "Something Happens"

While I expect to sell my DG stocks infrequently, that does not mean that I never sell.

The way I look at it, each stock carries a presumption that it will be held for a very long time. That's the reason to put so much care into selecting each one in the first place. But, like any presumption, the "default option" against selling can be overcome.

I recommend that you base selling decisions on formal portfolio reviews (discussed later), *augmented by immediate investigations* when certain extraordinary circumstances arise.

My DGP Business Plan, presented earlier, covers the situations that lead to an immediate investigation. Here is the relevant portion again:

> **Selling Guidelines**
>
> 1. This portfolio is expected to have a low turnover rate. Unless there is a strong reason to sell or trim a position, the default action is to hold. The underlying strategy is to buy, collect, and hold good dividend growth stocks for long periods of time.
>
> 2. However, selling or trimming will be seriously considered if any stock or fund:
>
> (a) Cuts, freezes, or suspends its dividend.
> (b) Bubbles or becomes seriously overvalued.
> (c) Is impacted by significant fundamental changes.
> (d) Is going to be acquired.
> (e) Announces plans to split itself into 2 companies or spin off a significant portion of its operations into a separate company.
> (f) Sees its current yield rise above 9% or drop below 2%.
> (g) Grows to where it is beyond 10% of the portfolio.

Now let's look at the potential selling situations in a bit more detail to demonstrate how they work in practice.

(a) The company cuts, freezes, or suspends its dividend. It is hard to paint a dividend cut as good news. A dividend cut often precedes (or follows) other bad news. As a DG investor, a cut reduces your ongoing income stream, the growth of which is your principal goal. A cut calls into question management's confidence in the company's future prospects.

A dividend freeze carries similar connotations, although a freeze does not negatively impact your income stream. A freeze may be a prudent company decision to conserve capital while the company works its way through a rough patch. You may wish to stick with such a company, especially if it has a high-enough yield even after the freeze. See whether management's explanation makes sense to you.

(b) The stock bubbles or becomes seriously overvalued. Normally you are watching the dividend stream, not prices. However, if for some reason the company becomes clearly overvalued for an extended time, it may be a good idea to trim or sell your position and use the money to purchase a higher-quality and/or better-valued stock. If you find a good alternative to the stock you already own, do the math and see whether a swap would make your dividend stream even better. Your decision may be affected by capital-gains taxes you might owe if you sell.

(c) The company is impacted by significant fundamental changes. I had an example of this in 2020. The utility Dominion Energy announced a fundamental strategic change. In July, it announced that it would sell its gas transmission and storage assets in December. That would significantly change Dominion's business model and reduce both its revenue and earnings. Combined with a decision to lower its dividend payout ratio, the result to shareholders was a future 33% dividend cut to take effect in a few months. (Kudos to Dominion for "pre-announcing" the cut.)

I decided to sell Dominion and replace it with a different high-quality utility. Other investors decided to hold their Dominion shares and simply absorb the cut, in the belief that Dominion would be a stronger company after the changes than it was before, and that it would commence raising its dividend from the new lower level in line with its history.

Don't play the victim card when unforeseeable events happen. Instead, be proactive, investigate the situation, and decide what to do. It's not a bad idea to anticipate that you will face situations like this a few times each year. That way, when one happens, you can say to yourself, "This is one of those situations to investigate," and go about deciding what to do.

(d) The company is going to be acquired. Proposed mergers and acquisitions are usually announced months in advance. That gives you time to study the situation. You probably have no way of knowing what the new company's dividend policy will be, and you may be sitting on a large paper profit, because the acquired company's stock price usually goes up following the announcement that it is the target of an acquisition offer, because the acquiring company usually offers a premium price. You may want to turn that paper profit into cash and use it to buy a different high-quality DG stock. That allows you to sidestep the uncertainty about the new company's quality, management, and dividend policy.

(e) The company announces plans to split itself into two companies or spin off part of itself into a separate company. Again, these moves are often announced well in advance. It may be hard to determine how the old company's dividend will be apportioned between the two new companies, or what the new companies' dividend policies will be. At least one of the two new companies will have no dividend track record at all. Will it inherit the parent company's dividend DNA?

This situation popped up in 2011 when Abbott Laboratories, an iconic DG stock, announced plans to split into two companies by the end of 2012. In the months following the announcement, the company released little information about its dividend intentions.

For that reason, I sold Abbott from my Dividend Growth Portfolio in late 2012. I had a sizeable capital gain and was able to replace my shares with different stocks that increased my dividend stream immediately. As it turns out, both offspring companies from Abbott have done well for investors.

(f) The company's yield rises above 9% or drops below 2%. A ballooning yield is often, but not always, a red flag that the dividend is in peril.

I just checked Simply Safe Dividends' screener for companies with safety scores below 21 (i.e., very unsafe), and many of them sport yields like 15.8%, 24.0%, and 12.5%. If you see a stock's yield balloon way beyond its normal range (meaning that its price has plunged), check out the reason. It might be a sign of trouble ahead.

On the other hand, a yield that drops below the minimum that you use for *buying* may have fallen not because there is anything wrong with the dividend, but rather because its market price has shot way up. For example, Microsoft's yield has fallen to the 1% range because its price has risen like a hot-air balloon in the past three years, as shown here.



Since your focus is on the dividend stream, you may want to cash in some of those gains and use the proceeds to purchase a stock with a higher current yield. If you do so, you will immediately increase your dividend stream.

Of course, you may be satisfied with the company's overall performance, dividend reliability, DGR, etc. You might decide that it is doing its job and keep all your shares. That's what I've done (so far) with Microsoft.

(g) A position's size increases beyond 10% of the portfolio. My 10%, upper limit for position size is probably higher than most investors' risk tolerance would allow. Plug in your own number.

For obvious reasons, this reason for investigation often goes hand-in-hand with two other reasons from above: (b) the company becomes seriously overvalued, and (f) the company's yield falls below your lower buying limit. Over the years, it is a combination of these factors that have led to most of my trims and replacements.

The countervailing reason for *not* trimming, of course, is that the company is performing great. Why would you want to sell or trim one of your best performers?

The answer becomes a matter of weighing the potential risks and rewards. I tend to follow a pretty conservative path. I have had several situations over the years where a high-quality company's price has become far overvalued, the position has gone to 11-12% of my portfolio, and its yield has dropped far below where I bought it. All at the same time.

In those instances, I have happily trimmed the stock back to about 7-8% of the portfolio, then used the cash proceeds to buy one or two different high-quality stocks at better valuations with higher yields. My income, of course, jumped up immediately upon making those transactions, and I still owned a bunch of shares.

Controlling your emotions

One final thought: Notice that none of the reasons for selling a stock is emotional. They are all based on sound business principles.

Don’t ever panic. If price drops make you uncomfortable, remind yourself that the dividend stream is unaffected. When a company cuts or freezes its dividend, it is legitimate to question whether the company is still worth owning. That is not a panicky response, it is merely applying a legitimate business question to your investment business.

Periodic Formal Portfolio Reviews

I recommend that you conduct a *formal* portfolio review once or twice per year. Take a look at the following for each of your holdings.

Does each company still pass muster as an excellent company? Have there been negative developments impacting the company’s business model or the safety of its dividend? Have its various quality metrics declined?

Is there a chance to improve your portfolio by making a stock swap? Be on the lookout for ways to improve your portfolio. That said, note that there is risk in pushing too hard to increase portfolio yield. While the initial yield on a new stock might exceed the yield of a stock you would trim or sell, you may introduce other unwanted factors, such as a lower dividend growth rate. It is hard to justify a swap unless the complete picture for your portfolio is quite a bit better with the new stock than with the one you currently hold.

Has the rate of dividend growth taken a turn for the worse? Can you figure out why? Sometimes a company, while still increasing its dividend, slows down the annual rate of growth. If the stock's price goes up gradually, the combination of rising price and decelerating dividend growth can cause the current yield gradually to drop. On the other hand, as noted elsewhere, slowing down DGR may be normal and expected for some companies as they mature, especially if they started raising their dividend at breakneck speed in the first few years.

Are you progressing toward your financial goal? When I perform my portfolio reviews, I take a look at the portfolio’s progress toward its

ultimate goal. Originally for me, that goal was to achieve a 10% yield on cost within 10 years. It took me a couple years longer, but my yield on cost is now over 10%. The goal has been reached, which “liberates” me from striving for a specific numerical result. (I did not replace the original specific goal with another one.) The goal now is, more broadly, to keep the dividend stream growing each year. In the course of that, I look for opportunities to improve the portfolio’s overall quality and dividend safety. I don’t want the portfolio to “drift backward” because of inattention.

The bottom line in the formal portfolio review is to look at it from a broader, higher perspective. That will help you notice things like long-term trends that might escape your attention in the day-to-day management of your investments.

Articulate your reasons for keeping, trimming, or selling each stock. Write them down as part of your portfolio review. That becomes your “report to yourself” that you can use to catch up on your thinking the next time you sit down to do another review in six or 12 months. It will remind you of where your thinking stood on each holding.

Sell If You Wouldn’t Buy?

One often sees the notion, “If you wouldn't buy a stock now, you should sell it.” While I used to wonder about that, I now believe it is a false guideline.

Holding is different from buying. When you make the decision to hold a stock, you obviously already own it. You also own all the rights that come with ownership, including the rights to receive future dividends and to participate in price increases (or decreases) as they occur.

Presumably you bought your position at favorable valuations. Now that you own it, you are still benefitting from those initial favorable valuations on both the dividend and price fronts. Your initial dividend yield was greater, and therefore your yield on cost is greater now than if you'd paid a higher price originally. Similarly, your capital gain in the stock is higher now than if

you'd paid more for it.

If you want to lock in that gain, you can sell it. That's what traders do, and even non-traders partially do the same thing when they rebalance. But in the dividend growth strategy, you are not so much interested in locking in gains as in continuing to participate in the benefits of ownership.

So even if the stock is overvalued now, you may simply choose to do nothing. You know that the stock's price is going to vacillate and that you will continue to receive dividends. For many investors, that is enough. The fact that they would not purchase more at this time (because of the overvaluation) is not reason enough to sell the stock.

When real businesses make a profit, they do not normally turn around and sell off their assets. Instead, they reinvest in the business to make even more profits next year. Dividend growth investors do the same thing: Dividend reinvesting grows the investment operation.

There is one characteristic of investing that sets it apart from most businesses: Sometimes the opportunity arises (because of Mr. Market) to collect an unexpected and very large “windfall” profit by selling a stock. You can look at it as collecting several years’ worth of dividends all at once.

When such opportunities present themselves, and if you have your eye on a better-valued and higher-yielding stock to swap in, it may be wise to make the switch. Study each opportunity on a case-by-case basis.

That principle is embodied in my own guidelines. A simple price run up, unaccompanied by overvaluation, is just market noise. But severe overvaluation is a reason to investigate. Many times, severe overvaluation is accompanied by low current yield (since yield moves inversely to price). And sometimes, severe overvaluation leads to the stock exceeding my maximum-size guideline.

Bottom line, in the right circumstances, I may sell or trim a position to swap into a better valued, higher yielding one. I have done that a number of times in my portfolio over the years.

Become Accustomed to Varying Principal

Dividend stocks are not fixed income investments. Therefore, get used to the idea that the overall value of your portfolio will go up and down.

Some veteran dividend growth investors reach a point where they hardly care what prices their stocks are selling for, because the increasing income stream is what they are after. That is how they judge the stock's value. They have shifted their focus to the metric that is of most interest to them.



Many investors have simultaneous goals of wealth growth and dividend growth. Fortunately, those goals are not contradictory over the long term, because both price growth and dividend growth originate from the same source, which is growth in corporate earnings and cash flow. Over short terms, of course, Mr. Market can do crazy things with prices.

But the market has no impact on dividends, so if you keep your eye on the growing dividend stream, you will find it easier to worry less about short-term market price declines.

Dividends tend to be much more stable and reliable than prices. Holding a stock for many years means that you will see some significant price fluctuations along the way. Get used to that. Follow your strategies, focus on the underlying businesses, and make rational business decisions.

When planning your strategies, hopefully you anticipated that market corrections will occur, and therefore you already know what to do when they happen. Your reaction will not be the product of panic. It will be the product of having thought about the situation beforehand.

You may have noticed, in my own business plan earlier, that no selling guideline is based on a stock's price *declining.* Market skids, to be honest, often pass unnoticed. I have found that to be a major benefit of DG investing. In fact, if you are accumulating shares, you may *welcome* price drops as opportunities to purchase more shares at better valuations and higher yields.

That does not mean that you become a "buy and forget" investor. You monitor. But the monitoring is not about whether the market is up or down. It rather is about looking after the companies that you own: Are they still good companies? Do they still have the qualities you liked when you bought them? If their prices are falling, does that really mean anything, or is it just market foolishness? Is their earnings power still strong? Are they maintaining their dividend practices?

You have your list of guidelines for selling in your business plan. As you monitor, let your guidelines steer you in the right direction. You will often find that the best decision is to stay put.

Rebalancing

Rebalancing refers to periodic adjustments that you make to a portfolio to bring it back to initial or target proportions. The actual proportions – meaning the relative sizes of positions to each other – may have wandered from their targets as prices change. If you drip your dividends, that can also cause position sizes to drift.

Rebalancing involves selling a portion of your "oversize" holdings for redeployment into "undersized" holdings. This restores target sizes to a portfolio that has become lopsided or too lumpy for your comfort.

For example, in a 25-stock portfolio, if you desire equal-weight positions, the target size for each position is 4% of the total portfolio. If you allow for reasonable wiggle room around the exact target, you might trim positions that exceed 5% and use that money to add to positions that have dropped below 3%.

The main purpose of rebalancing is to flatten risk across a portfolio. Rebalancing may also generate more income if the yields on oversize positions have fallen compared to those on undersize positions. (This may well be the case, as yield moves inversely to price.)

Now that we're in the era of commission-free trading, rebalancing no longer increases expenses in the form of brokerage fees.

Some dividend growth investors rebalance routinely — say quarterly or annually — while others do not rebalance at all. Routine rebalancing may help some investors stick to their basic plan by "enforcing" position sizes that were well thought-out to begin with.

I take a relaxed approach to rebalancing. I do have a maximum position size guideline (10% of the portfolio), and that may cause me to trim a large holding from time to time to bring the position back under the ceiling. I also consider trimming a stock if it becomes significantly overvalued, and the outcome of such a sale (along with the purchase of something else) is similar to rebalancing. It also invariably moves some money from a lower yielding stock into a higher-yielding one.

Watch Your Own Behavior

Under conventional theory, emotions and cognitive mistakes do not influence people when they are making economic choices. However, studies suggest that seemingly irrational decisions are made all the time. They are based on the influence of emotions and biases that the investors themselves may not recognize.

My personal experience is that if one follows a sound DG business plan, you are less likely to shoot yourself in the foot with some of the most common behavioral errors. For example, DG investing almost inoculates me against panic selling. I do not follow what the market does every hour, nor every day, nor my particular stocks. I have not totally lost interest in what the market is doing — it can be entertaining — but I know that my goals are not determined very much by the market's pricing activities.

Of course, your process of routine monitoring, or a formal portfolio review, may lead you to discover that one or two of your companies are actually having fundamental troubles. Perhaps they no longer fit the profile of companies that you want to own. In that case, follow your selling guidelines. There need not be much emotion involved. When something is wrong, fix it.

One behavioral factor that deserves special mention revolves around the notion of *beating the market.* Many investors define success as outgunning an index such as the S&P 500. This intense focus can lead them to check their portfolios and the market several times per day. It also leads to jumpiness and over-trading.

Most of the investment media pushes in that direction, with streaming quotes, colorful price displays, excited talking heads, and a sense of urgency attached to every topic. Every little price move is treated as important and needing a reason to explain it. Alarming red arrows indicate declining prices no matter how small the decline.

The common theme is fear. Fear of losing money as prices slide downward. Fear of giving up in just a few days the gains that it took years to achieve. Fear of falling behind an index. Fear of underperforming your neighbor. Fear of missing out.

But as a DG investor, you know that while the market controls your stocks' capital value, it does not control your income.

While the market can be entertaining and occasionally informative, it is hard to see how obsessing over it can be helpful if your goals revolve around generating inflation-beating income streams. If you insist on having a benchmark, focus on having your income growth beat inflation.

Or track your annual progress toward an income dollar goal that is years away. Are you on pace to meet it?

Does Price Matter at All?

Some dividend growth investors go so far as to say that they *don't care* about price. Depending on context, that view can come across as dogmatic or naïve.

I think that what such investors are really saying is that dividends are disconnected from stock prices. Therefore, since their main interest is focused on the income stream, they can be sanguine about price declines that make other investors fearful.

My own view is this. **The market plays no role in the determination of dividends.** The separation of market volatility from corporate dividend declarations is one of the most attractive aspects of DG investing. Dividends are direct transactions between each company and its shareholders. In fact, it is *often* the case that a company's dividends are increased while its stock price is moving down.

Few investors, in their hearts, wish to see the principal value of their investments go way down even if their income stream remains intact. When they say they don't care about price, they are not saying that they want their companies to go bankrupt or lose all capital value. Rather, they are taking the same point of view as a landlord who is more interested in having his rental income go up each year than in what he could sell his properties for. His business is collecting rents, not flipping properties. His business model is being a landlord, not a deal maker.

Price matters when you are buying, but even there, in my book valuation trumps price. If you are considering adding more to a stock that you already own, the price you paid previously is irrelevant to the current decision. Don't become anchored on that former price. What matters today is valuation based on the current price, current earnings, and the company's prospects.

I will close this section with two quotes. The first is from Benjamin Graham's *The Intelligent Investor:*

> "Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies."

The second is from Warren Buffett's 2012 Letter to Shareholders:

> "If you are going to be a net buyer of stocks in the future, …you are hurt when stocks rise. You benefit when stocks swoon. Emotions, however, too often complicate the matter: Most people, including those who will be net buyers in the future, take comfort in seeing stock prices advance.... And here a confession is in order: In my early days I, too, rejoiced when the market rose. Then I read Chapter Eight of Ben Graham's *The Intelligent Investor*, the chapter dealing with how investors should view fluctuations in stock prices. Immediately the scales fell from my eyes, and low prices became my friend. Picking up that book was one of the luckiest moments in my life."

Reinvesting Dividends

In my Dividend Growth Portfolio, I reinvest dividends. That is desirable for people in the *accumulation* phase of their lives. Dividend reinvestment helps the accumulation process along. It adds the second layer of compounding that was discussed earlier in this book.

Many dividend growth investors do not reinvest dividends. They have reached the *harvest* phase of their lives, and their dividend stocks provide income for living expenses. They don't want to lose principal on the original investment, of course, but they can tolerate it if the reliability and growth of the income stream remain intact. Their attitude becomes similar to that of a bond-holder who simply collects payments from the bond.

Dripping means to automatically reinvest dividends. In the old days, this was done via special arrangements with each company, but nowadays it is a free service that you can turn on or off with your brokerage.

Many dividend growth investors are highly satisfied with automatic reinvestments, and they swear by them as a way to build wealth slowly and steadily.

Some also like the "autopilot" nature of drips, as it helps them to be disciplined during times of market volatility. The fact that they put the stock on drip represents a decision that the stock is one to hold rather than trade. So they don't worry about swings in the stock's price.

I don't use drips for the simple reason that I wish to invest all of my money at good valuations. I use reinvestments to improve my portfolio. I let my dividends accumulate to a certain dollar amount ($1000). Then I go through my normal procedures for stock selection. I might buy more shares of a company I already own, or I might buy an entirely new company. The non-automated reinvestment process lets me pick stocks that are favorably valued at the time of purchase. The lower price not only makes it more likely that I will accrue capital gains over the long term, but it also means that the stock has a higher initial yield.

Whether to drip dividends or not is entirely up to you. Many DG investors turn the drips on and off for individual stocks to implement their current goals.

CHAPTER 15

TOP 30 DIVIDEND GROWTH STOCKS FOR 2021

How the Top 30 Were Chosen

I used two screens to winnow down the starting universe of candidates. To be considered, a stock had to pass both screens.

- The stock must be a dividend-growth (DG) stock as I define that term: Raised its dividend for at least five straight years. That's about 750 stocks, derived from the Dividend Champions (CCC) List.

- The stock must have a dividend safety grade from Simply Safe Dividends (SSD) of 41 or better, meaning that its dividend is Borderline Safe, Safe, or Very Safe as SSD defines those terms. That's about 725 companies.

After isolating those companies, the rest of the selection process was a matter of grading companies for their dividend records, business quality, and financials, using the methods described in Chapters 6-11.

Whenever I do this sort of exercise, the cream always rises to the top. Grading and evaluation systems are quite effective. For the final selections, I wanted to present a diversified group. Therefore, the Top 30 stocks represent a variety of sectors, industries, yields, and dividend growth rates.

Every company is also graded for valuation, but I did allow a few overvalued stocks into the final 30. One reason is that valuations change as market prices go up and down, and also as earnings estimates change. During the coming year, some valuations might improve. The second reason is that I

want to bring some truly good DG companies to your attention even if they are not well-valued when this book is published.

I did not include in the Top 30 any stock that is significantly overvalued (i.e., selling for more than 20% above my calculation of its fair price) at time of publication.

For all companies, I show what I consider to be the fair price as well as the top price I would pay to purchase that stock.

Dividend Growth All Stars

All of the Top 30 are, in my opinion, fine choices for a DG portfolio, assuming they match up with your goals and needs.

But some of them are "more excellent" than others, and I decided to call the special ones out by designating All Stars. Not everyone will agree with my designations. These are judgement calls. Six stocks were "voted in" as All Stars.

One thing that's interesting about the All-Star concept is that, unlike a Hall of Fame in sports, an All-Star stock has to be still performing at a high level. These selections are not about honoring retired players for their great careers: The stocks are still playing and need to be performing at a high level right now too.

I reserved the All-Star designation for just a few stocks. The designation doesn't really mean anything in making your selections, that is always up to the individual investor. It's just a fun addition this year, something to debate off to the side.

Summary of Rating Factors

I know that many of you skimmed Chapters 6-11, so here I want to *briefly* summarize the factors that you will see in the analyses of the individual stocks. For complete explanations about my approach to stock analysis, please go back and read the chapters mentioned above when you run into something that you do not understand.

After a brief summary and overview, there are four main sections in each stock presentation:

- Dividend Record
- Business Quality
- Financials
- Valuation

Dividend Record

The first section for each stock examines the company's dividend record. Strong and weak areas are highlighted. Each dividend section ends with a summary table like this, which includes an overall grade in the last line.

JNJ Dividend Summary		
Factor	**Data**	**Rating**
Yield	2.7%	Mid
Years of Increases	58 (Dividend King, Champion, Aristocrat)	A
5-year DGR	6% per year	C
DGR Trend	Steady at decent rate	B
SSD Safety Rating	99 / 100 = Very safe	A
Total Dividend Grade = B		

The streak-line states whether the stock is a King (50+ years), Champion (25+ years per CCC), Aristocrat (25+ years per S&P), Contender (10+ years per or 14+ years if the streak went through the Great Recession per CCC), or Challenger (5+ years per CCC).

Business Quality

The second section examines the company's business: Its business model, strengths and weaknesses, competitive advantages, and so on. The final quality grade (A-F) is a blend of the most important factors, and of course it has my own subjectivity baked in. The grade is based on this approach:

Business Model and Story Grade		
Your Judgment of Company's Business	Letter Grade	Interpretation
Very strong, sensible, inspires confidence	A	Excellent
Strong, sensible, few questions	B	Good
Seems about average among companies	C	OK; Investable
Seems weak, many questions, can't understand it	F	Ineligible

Financials

The third section explains the most important financial aspects of the company. I apply a grade (A-F) to the overall record.

Financial Strength Grade		
Your Judgment of Company's Financial Strength	Letter Grade	Interpretation
Strong metrics across the board	A	Excellent
Mixture of strong metrics with average ones	B	Good
Mostly average metrics; maybe a weak one or two	C	OK; Investable
No strong metrics or only a couple; many average and weak ones	F	Ineligible

Valuation

Whereas the preceding three sections were about the company itself, this section is about the company's pricing in the stock market.

I use the four valuation models explained in Chapter 10 and summarize them in a table like the one below.

JNJ Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	1.23	Very overvalued
#2: P/E to Stock's 5-year average	1.08	Fairly valued
#3: DCF (from Morningstar)	1.00	Fairly valued
#4. Relative Yield 5-year comparison	1.00	Fairly valued
Average of Models: Valuation ratio = 1.08 = Fairly valued		

Occasionally, one or two of the four models is far out of step with the others. In those cases, I used my judgement whether to toss out the outlier, or cap it to reduce the effects of extreme values that dominate the entire calculation. Then I base the final valuation on the adjusted models.

Beneath the table, I note the fair price that I calculated for the stock as well as the maximum I would pay. Prices at or below that top price form a "buying range" for the stock.

If the top of my usual fair-value range is different from the maximum I would pay, I note the top of the range for those who may be willing to go that high.

Breakdown by Sector

There is sufficient variety in the Top 30 to create a well-rounded portfolio across sectors and industries. The table below shows the sectors represented by the 30 stocks. The individual analyses show both the sector and industry categories for each stock.

Sector and industry designations follow the GICS classification system, which is a joint product of S&P and MSCI (source). The system was developed in 1999 and most recently updated in 2018.

There are 11 sectors in GICS. The table below shows how the Top 30 are distributed among the sectors.

SECTOR BREAKDOWN OF TOP 30 DG STOCKS FOR 2021	
Sector	**Number of Stocks**
Energy	-0-
Materials	-0-
Industrials	4
Consumer Discretionary	2
Consumer Staples	4
Health Care	6
Financials	1
Information Technology	2
Communications Services	4
Utilities	5
Real Estate	2

Index to Top 30 DG Stocks for 2021

The table on the next page summarizes this year's Top 30. The stocks are listed in alphabetical order by company name. The one stock whose company name begins with a numeral (3M) is listed last.

The colored columns reflect the four rating sections in each report. The colors are meant to provide an at-a-glance overview of how each stock graded out, using my usual color scale:

- Dark green = excellent
- Green = good
- Yellow = OK or average
- Orange = below average

Company Name	Stock Ticker	GICS Sector	Dividend	Quality	Financials	Valuation	Yield %	5-year DGR %/yr	Page
AbbVie	ABBV	Health Care					5.0	20	212
Aflac	AFL	Financials					3.0	7	220
American Electric Power	AEP	Utilities					3.6	6	228
Amgen	AMGN	Health Care					2.9	15	235
AT&T	T	Communications Services					7.2	2	242
Automatic Data Processing	ADP	Information Technology					2.2	13	250
Cisco	CSCO	Communications Services					3.4	12	257
Comcast	CMCSA	Communications Services					1.8	13	264
Consolidated Edison	ED	Utilities					3.7	3	272
Duke Energy	DUK	Utilities					4.1	3	279
Essex Property Trust	ESS	Real Estate					3.3	8	287
General Dynamics	GD	Industrials					2.9	10	294
Hormel Foods	HRL	Consumer Staples					2.1	13	302
Johnson & Johnson	JNJ	Health Care					2.7	6	309
Kimberly-Clark	KMB	Consumer Staples					3.1	4	316
Lockheed Martin	LMT	Industrials					2.8	10	323
Lowe's	LOW	Consumer Discretionary					1.6	17	330
McDonald's	MCD	Consumer Discretionary					2.4	8	337
Medtronic	MDT	Health Care					2.1	9	345
Merck	MRK	Health Care					3.0	6	353
PepsiCo	PEP	Consumer Staples					2.8	8	361
Philip Morris	PM	Consumer Staples					6.0	3	369
Pinnacle West Capital	PNW	Utilities					3.8	5	376
Realty Income	O	Real Estate					4.6	4	383
Snap-on	SNA	Industrials					2.8	16	391
UGI	UGI	Utilities					3.7	8	397
UnitedHealthcare	UNH	Health Care					1.5	21	405
Verizon	VZ	Communications Services					4.1	2	412
Visa	V	Information Technology					0.7	20	419
3M	MMM	Industrials					3.4	7	426

The Top 30 stock reports begin on the next page. Each report is 7-8 pages long. The slides in some reports come from company presentations. Use the last column in the table above to find the page on which each stock report begins.

ABBVIE (ABBV)



ABBVIE (ABBV)			
SECTOR: Health Care			
INDUSTRY: Biotechnology			
Link to ABBV Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
B	**C+**	**C-**	**Significantly undervalued**

AbbVie is a biotech giant whose results have been driven for years by the overwhelming success of a single drug, Humira. The company is losing patent protections on that drug, leading to a major acquisition of Allergan for future growth opportunities. The future is a little cloudy, but for now, ABBV is a high-yield, fast-growth stock with obvious risk attached to its future. That risk, along with a massive debt load, explains its seemingly attractive valuation.

Dividend Record (Grade = B)



ABBV's high yield (5%) has been accompanied by a fast growth rate. Its short streak deserves an asterisk, as the company was just created from parent Abbott Laboratories a few years ago; Abbott had been a dividend-raiser for decades, and ABBV seems to have its DNA. In fact, S&P retains ABBV as a Dividend Aristocrat. The dividend safety score is borderline, although ABBV just announced a dividend increase of 10.2%.

ABBV Dividend Summary		
Factor	**Data**	**Rating**
Yield	5.0%	High
Years of Increases	6 years (Dividend Challenger, Aristocrat)	D
5-year DGR	20% per year – Very fast	A
DGR Trend	Large increases, although rate is declining	B
SSD Safety Rating	50 / 100 = Borderline safe	C
Total Dividend Grade = B		

Business Model and Company Quality (Grade = C+)

ABBV is a global biopharmaceutical company. Its therapeutic areas of focus are immunology, oncology, neuroscience, eye care, virology, women's health, and gastroenterology. In addition, it has an aesthetics portfolio (Botox).

ABBV's high yield reflects uncertainty about its growth prospects.

Its rheumatoid arthritis drug Humira, which in 2019 accounted for over 55% of sales, loses exclusivity in the U.S. in 2023. That long-term hole will need to be filled by other revenue streams. That need drove ABBV's decision in 2019 to acquire drug-maker Allergan for $80+ billion. The deal closed in May, 2020.

The acquisition caused a spike in ABBV's debt levels. Management reaffirmed its commitment to the current dividend and plans to deleverage aggressively in the years ahead. As a result of the elevated leverage, S&P downgraded ABBV's credit rating to BBB+, which is a low investment-grade rating. Management's goal is to pay down $15-18 billion of debt by the end of 2021, with further deleveraging through 2023.

Fortunately, AbbVie's high-margin business should continue generating excellent cash flow to support its deleveraging goals while continuing to cover its dividend.

AbbVie's business focuses on therapeutic products that treat serious diseases. Deferring treatment for these patients is typically not recommended, although AbbVie did see a "modest impact" on the number of new-patient starts in the wake of Covid-19.

Most of Allergan's product portfolio enjoys similar defensive qualities, but it also derives

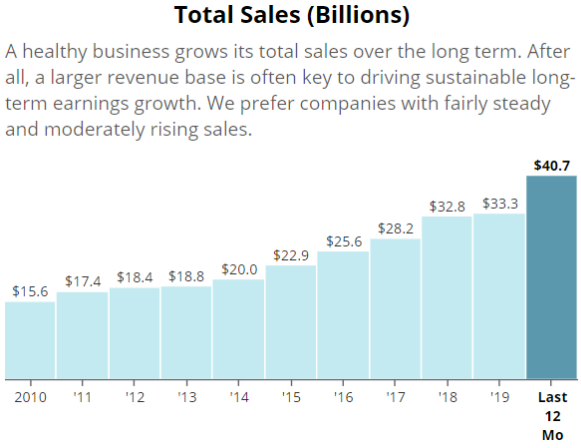
about 1/3 of its revenue from its aesthetics business (e.g. Botox plastic surgery). At its recent Q3 earnings call, executives said that the “aesthetics portfolio is demonstrating a strong V-shaped recovery” from the slowdown caused by Covid-19.

Humira will remain a major driver for the business, accounting for close to 40% of the combined company's sales. With the upcoming loss of exclusivity in the U.S. market, analysts expect ABBV’s revenue will begin declining after 2022.

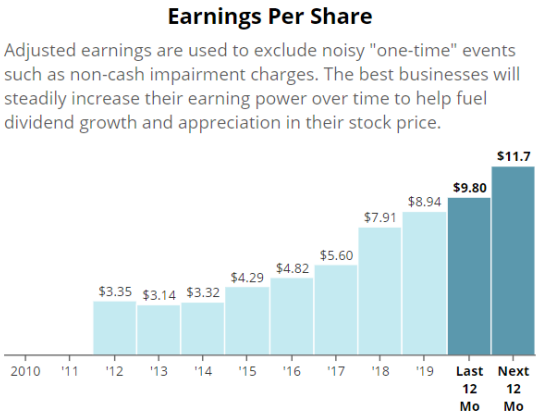
My quality grade for ABBV is C+, reflecting a blend of positive and negative factors, the largest of which is uncertainty about its ability to fill the hole looming from the loss of patent protection on Humira.

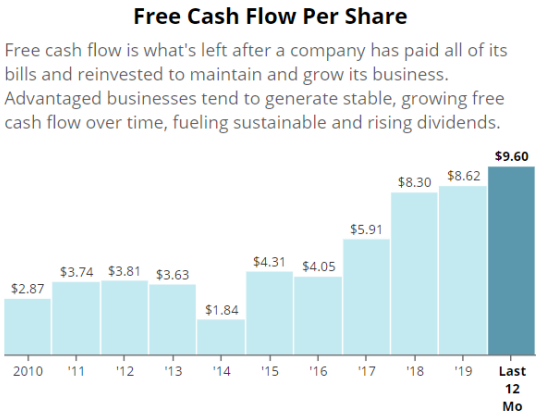
Financials (Grade = C-)

ABBV’s revenue grew every year for the past decade, including a big jump this year as Allergan’s results were folded in. As mentioned above, many analysts see revenues start to decline post-2022 after Humira patent protection is lost.

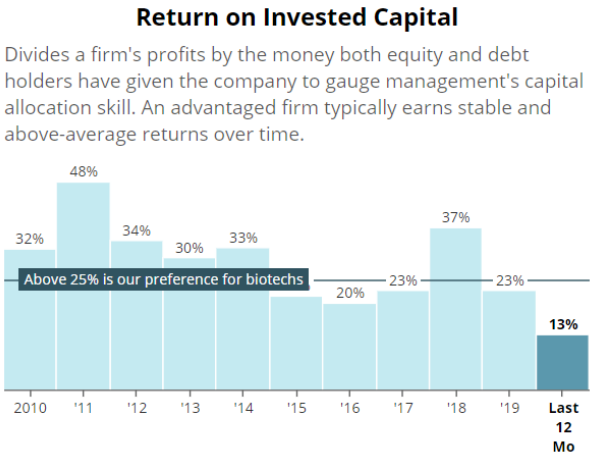


ABBV’s earnings and cashflow have been strong since its spinoff from Abbott Labs in 2012.

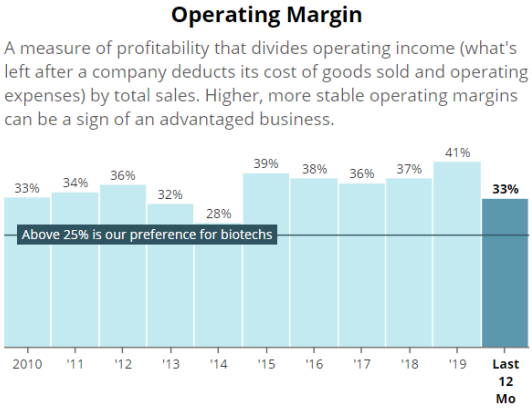


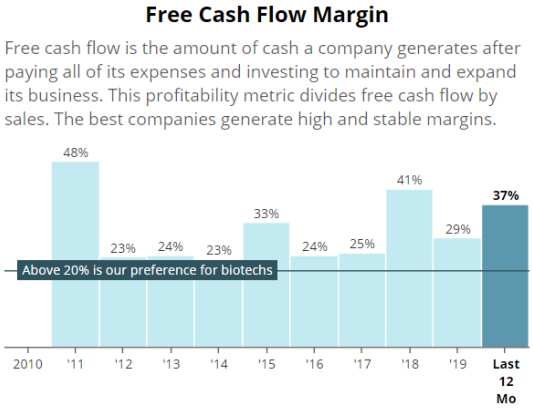


ABBV's ROE chart is distorted by the Allergan acquisition, so I don't display it here. Its ROIC chart had shown generally good performance, but the metric also has sunk in the wake of the acquisition.



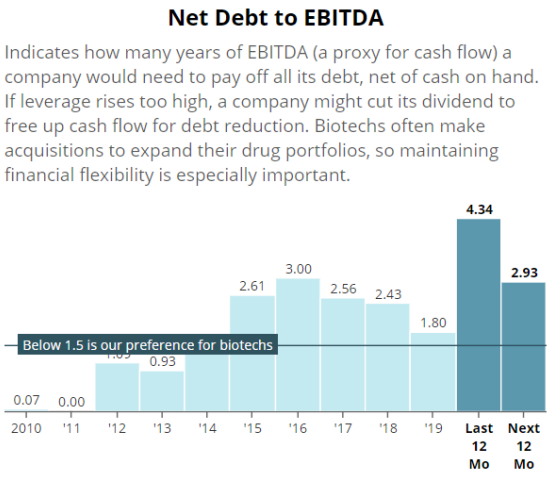
ABBV's profitability has been strong.

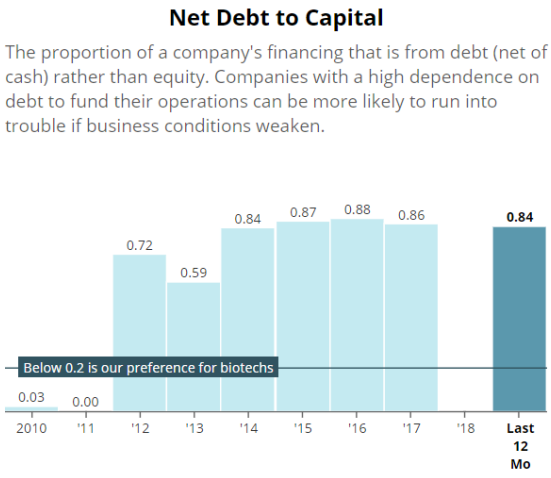




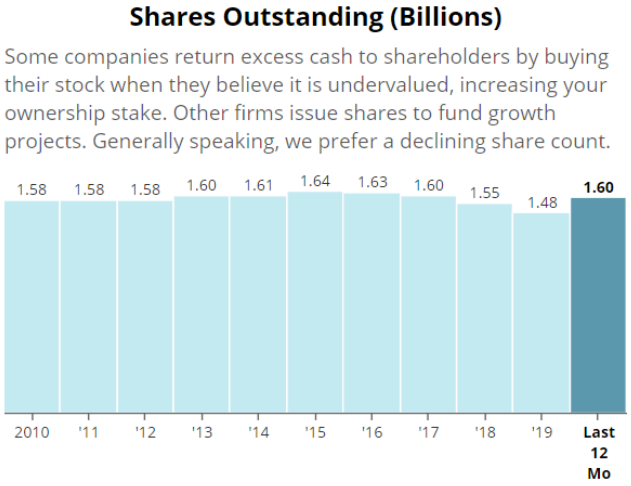
In the left debt graph, you can see the huge jump in ABBV's debt levels for the Allergan acquisition. The next-12-month projection shows the debt dropping if the company

makes its forecasted paydowns. Both graphs show that ABBV has been a debt-reliant company practically since its creation.





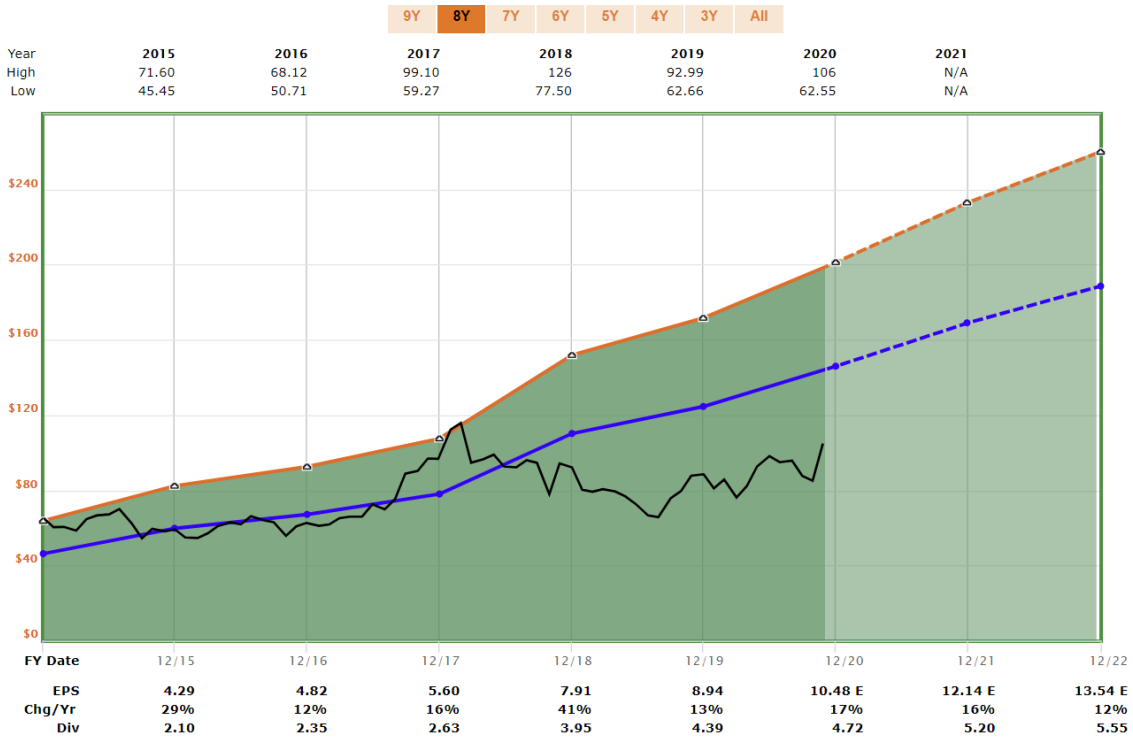
Finally, ABBV has not been reducing its share count very much, and the float went up with the Allergan acquisition.



Overall, ABBV's financials present a very mixed record. I looked up Value Line's financial grade, and it ranks ABBV 9th out of 11 peers. My overall grade is C-.

Valuation (Significantly undervalued)

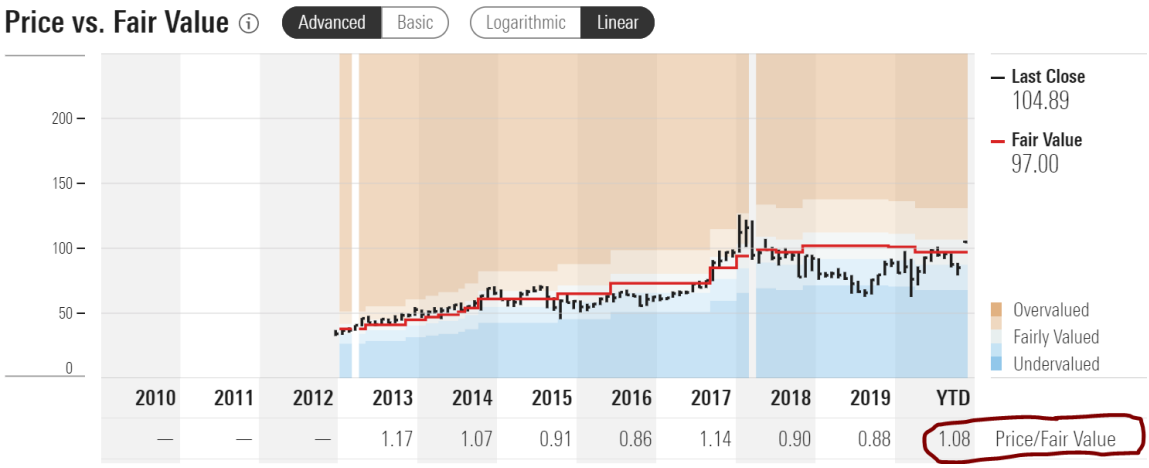
Models #1 & #2: P/E ratios (FASTGraphs)



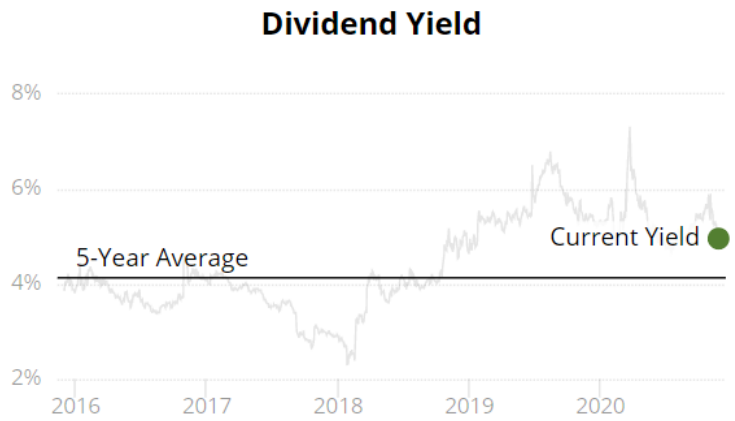
ABBV is undervalued by both P/E models. Its current P/E is 10.2 and its 5-year average is 13.9. Because of ABBV's fast growth, the orange line is drawn at 19.2 (rather than 15). The valuation ratios are Model 1 = 0.53 and Model 2 = 0.73.

Model #3: DCF

Using its discounted cash flow (DCF) model, Morningstar calculates a valuation ratio of 1.08, which suggests fair valuation.



Model #4: Relative yields (Simply Safe Dividends)



ABBV's current yield of 5.0% is well above its 5-year average of 4.2%. That suggests undervaluation, and the valuation ratio is 0.84. I put a floor under that of 0.80.

ABBV Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	0.53	Significantly undervalued
#2: P/E to Stock's 5-year average	0.73	Significantly undervalued
#3: DCF (from Morningstar)	1.08	Fairly valued
#4. Relative Yield 5-year comparison	0.80 (cut off)	Undervalued
Average of Models: Valuation ratio = 0.79 = Significantly undervalued		

The Morningstar model is out of step with the others, but I keep it, because its effect is to moderate them.

Applying the calculated valuation to ABBV's recent price leads to this fair price:

Fair price = $133

Because ABBV is already well under its fair price, and influenced a little by Morningstar's conclusion that it is fairly valued at its current price, I would not pay more than the fair price just calculated. I normally consider +/- 10% to be in a "fair range," I'd make an exception to the conservative side here.

Maximum buy price = $133

Top of normal fair-value range = $146

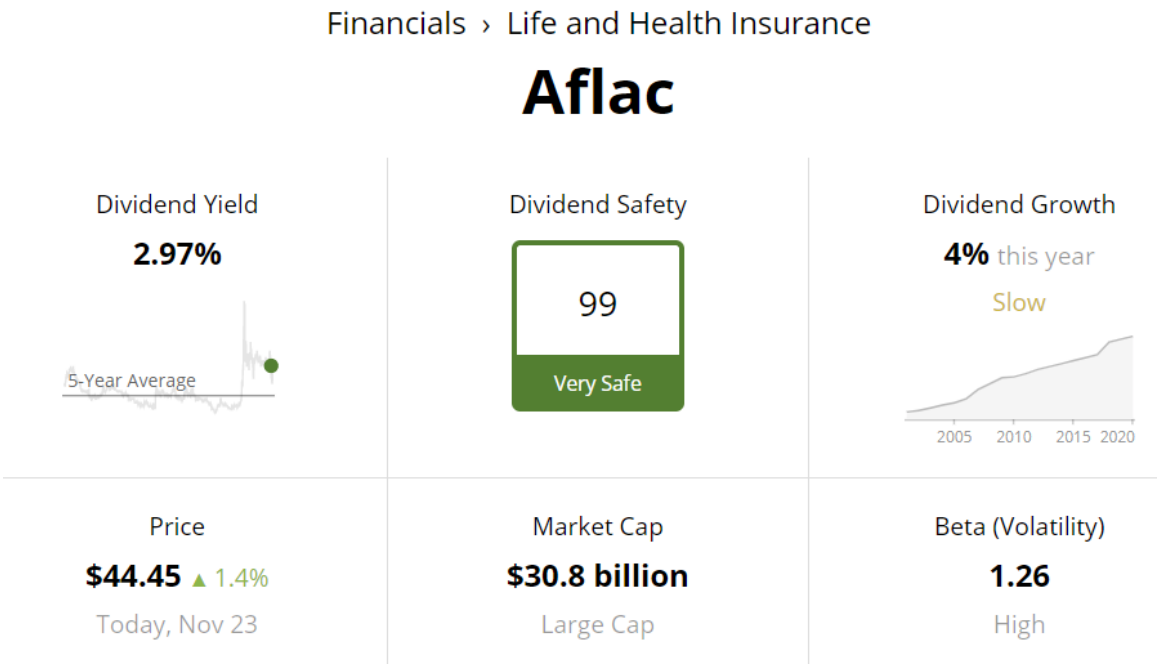
AFLAC (AFL)



AFLAC (AFL)			
SECTOR: Financials			
INDUSTRY: Insurance			
Link to AFL Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
B	**C+**	**C**	**Undervalued**

Aflac is an American insurance company that generates most of its business in Japan. It faces growth challenges, but its business is well-run, has a strong balance sheet, and the company has raised its dividend for 39 straight years.

Dividend Record (Grade = B)



AFL's dividend record is solid. Its annual increases are usually in mid-single digits, but it jumped 13% in 2018, and the company has announced a nearly 18% increase for its first dividend in 2021 (payable in March). SSD's safety rating is 99, the highest score available.

AFL Dividend Summary		
Factor	**Data**	**Rating**
Yield	3.0%	Mid
Years of Increases	38 (Dividend Champion & Aristocrat)	B
5-year DGR	7% per year (OK)	C
DGR Trend	Usually in 4-5% per year range. See text.	B
SSD Safety Rating	99 / 100 = Very safe	A
Total Dividend Grade = B		

Business Model and Company Quality (Grade = C+)

Aflac primarily sells supplemental health and life insurance in the United States and Japan. Overall, the company provides protection to more than 53 million people.

"Supplemental insurance" means that the company pays cash to policyholders when they get sick or injured. The idea is that financial support for expenses not covered by health insurance allows policyholders to focus on recovery, not financial stress. The company operates in two segments:

Aflac Japan (70% of sales, 72% of profits): Offers supplemental insurance products, general medical indemnity plans, medical/sickness riders, ordinary life insurance, and annuities. Aflac insures ¼ of households in Japan.

Aflac U.S. (30% of sales, 28% of profits): Provides products to protect against depletion of assets, critical illness/care, hospital indemnity, dental/ vision care plans; and loss-of-income products, such as life and short-term disability plans.

AFL sells its products through a large network of sales associates, brokers, independent agents, and affiliated corporate agencies.

Aflac has a long history of highly disciplined underwriting, meaning that it consistently turns a profit on its policies by taking in more money than its policies pay out.

The other way Aflac makes money is by investing the "float," which is the money it holds between the time customers pay premiums and the time they make claims on their policies.

Morningstar accords Aflac no moat, which is surprising given its brand strength (think Duck) and market dominance in Japan.

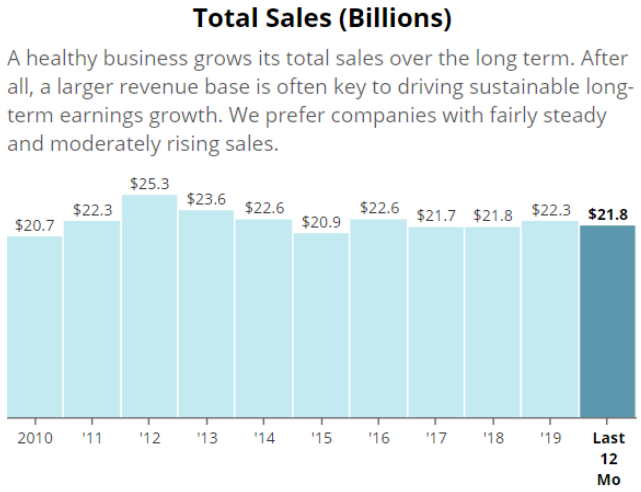
Aflac has had trouble growing its overall business in recent years. It faces unfavorable demographic trends in Japan, which leads to its growth plans being centered on the USA.



Until it delivers on meaningful growth, AFL's challenges in that area lower its overall business quality grade to C+.

Financials (Grade = C)

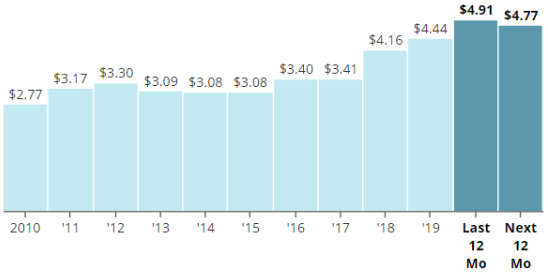
AFL's sales have been flat for several years. This is the major issue facing the company. Demographic trends in Japan (older population, historically low birth rate) are working against the size of its addressable market there.



AFL's earnings per share record is strong. While free cash flow is not as insightful for insurers, AFL's FCF record is also strong.

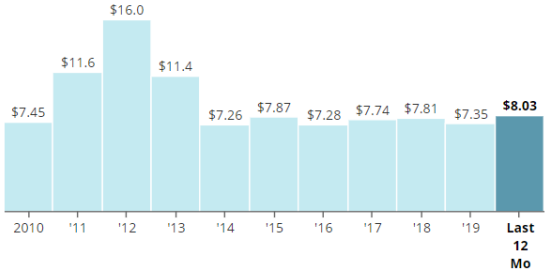
Earnings Per Share

Adjusted earnings are used to exclude noisy "one-time" events such as non-cash impairment charges. The best businesses will steadily increase their earning power over time to help fuel dividend growth and appreciation in their stock price.



Free Cash Flow Per Share

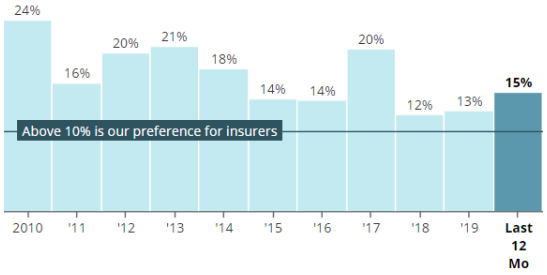
It usually makes more sense to review an insurer's earnings rather than its free cash flow. Cash flow can be highly volatile and hard to define since insurers do not make material capital expenditures, their investment portfolios can create noise, and the timing of payouts on their policy liabilities is unpredictable.



AFL's efficiency metrics are very good, well above the benchmarks.

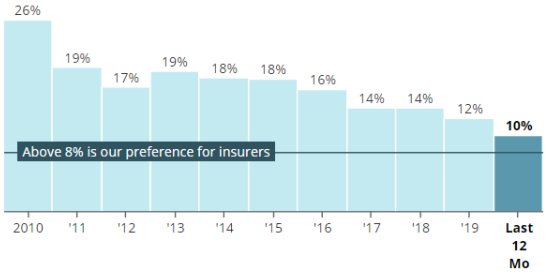
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



Return on Invested Capital

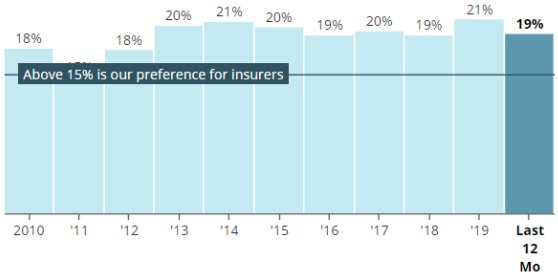
Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



AFL's operating margin (profitability) is consistently strong. (FCF margin not shown because it is noisy.)

Operating Margin

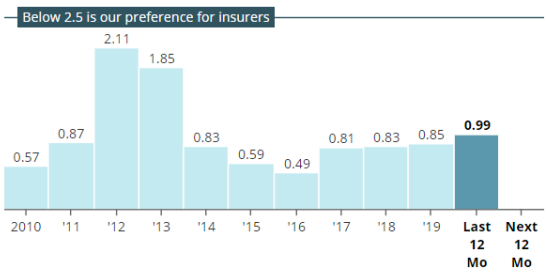
A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



AFL does not rely heavily on debt. Its debt metrics are well below the benchmarks. Its credit rating is A-, which is a solid mid-investment-grade.

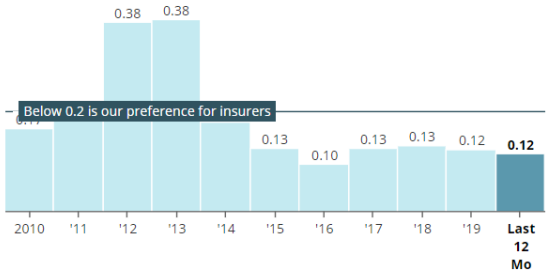
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.

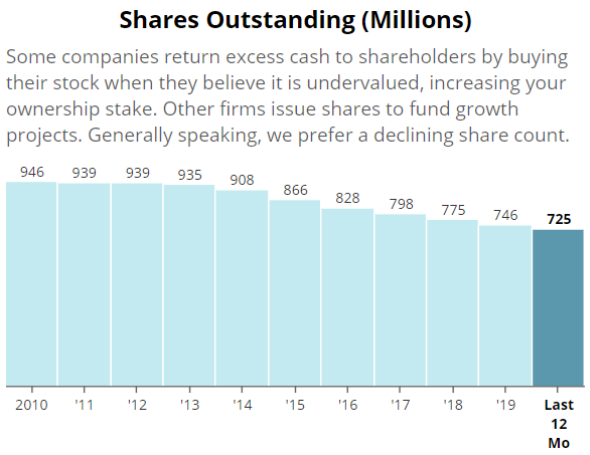


Net Debt to Capital

The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



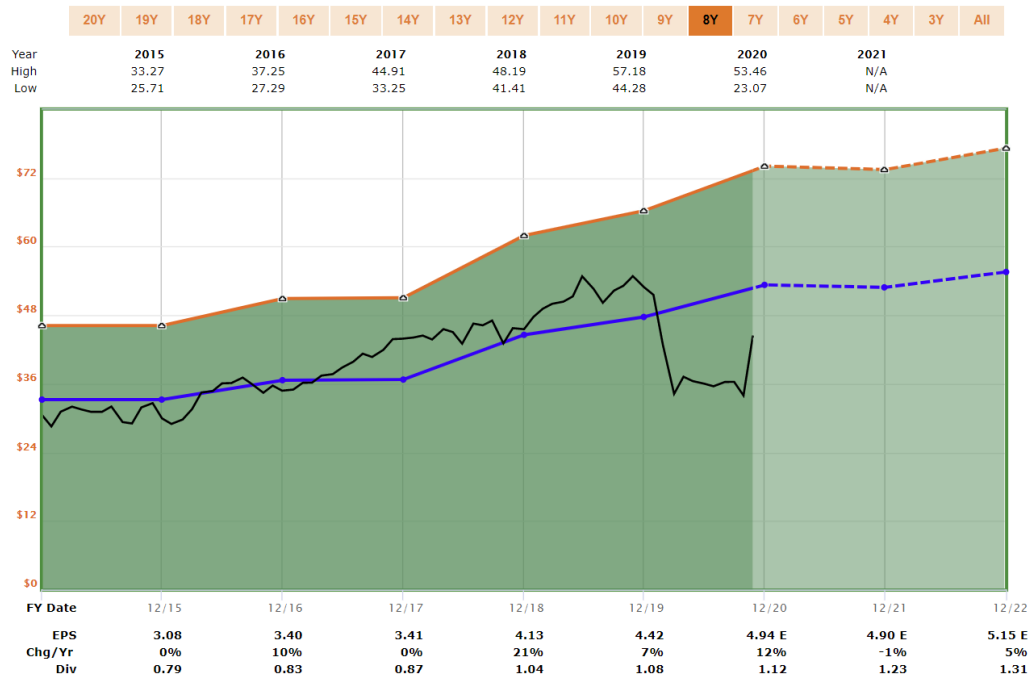
Aflac has been reducing its share count steadily. That use of its abundant cash has created growth in per-share metrics when the company itself is not growing overall. AFL has 23% fewer shares outstanding than it did 10 years ago.



Overall, Aflac's financials are strong against the backdrop of lack of overall growth. It is a carefully run, profitable company with a strong balance sheet. However, the lack of overall growth cannot be ignored, and that drops its overall financial grade to C.

Valuation (Undervalued)

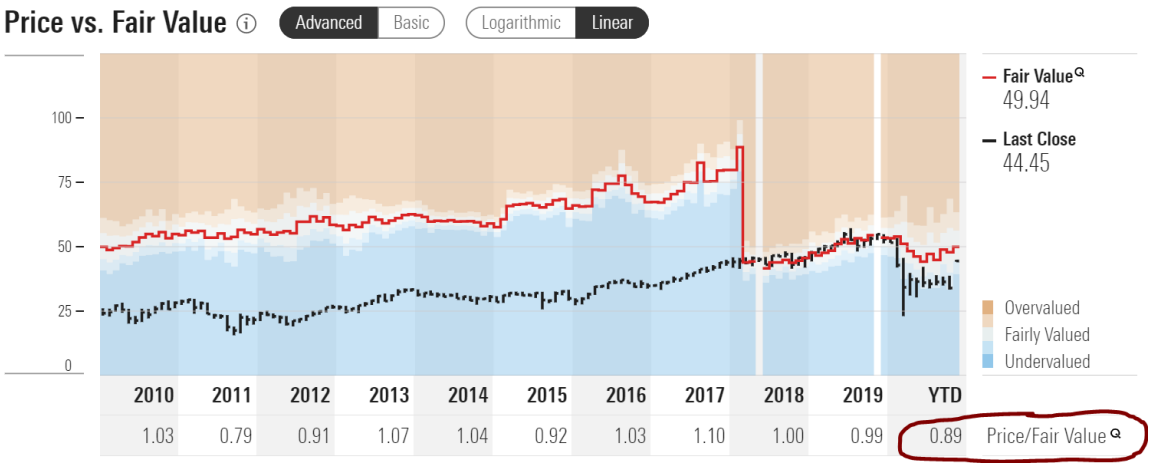
Models #1 & #2: P/E ratios (FASTGraphs)



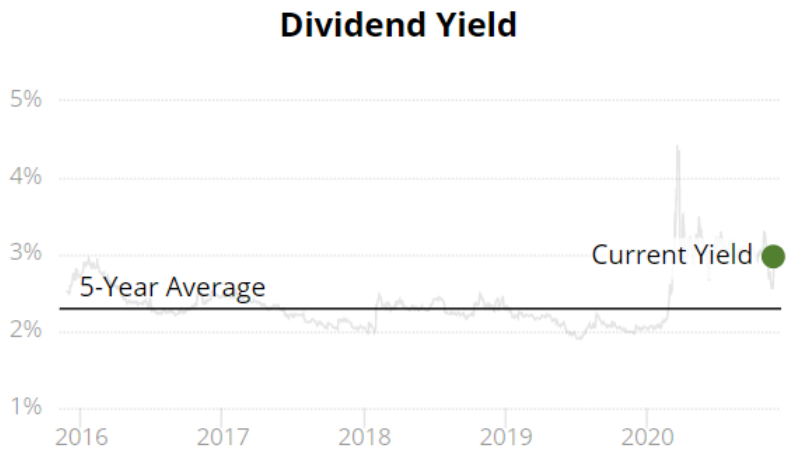
AFL is undervalued by the two P/E models. AFL's current P/E is just 9.1 compared to its 5-year average of 10.8. Model 1's valuation ratio = 0.61 (price compared to orange line), and Model 2's valuation ratio = 0.84 (price compared to blue line).

Model #3: DCF (Morningstar)

Using its discounted cash flow (DCF) approach, Morningstar calculates a valuation ratio of 0.89, which suggests undervaluation. The Covid-19-induced price drop earlier this year took AFL into undervalued territory, and it has stayed there.



Model #4: Relative yields (Simply Safe Dividends)



The 2020 price drop also put Aflac's yield (3.0%) well above its 5-year average (2.3%). I cut off the valuation ratio at 0.80 for this model.

AFL Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	0.61	Very undervalued
#2: P/E to Stock's 5-year average	0.84	Undervalued
#3: DCF (from Morningstar)	0.89	Undervalued
#4. Relative Yield 5-year comparison	0.80 (cut off)	Undervalued
Average of Models: Valuation ratio = 0.79 = Very undervalued		

While all the models agree that Aflac is undervalued, Model 1 is an outlier, and that results from the orange line being drawn at a P/E of 15. Normally that would be where to draw that reference line, but again the company's lack of overall growth must be considered. I would toss out Model 1, which leaves us with this:

AFL Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#2: P/E to Stock's 5-year average	0.84	Undervalued
#3: DCF (from Morningstar)	0.89	Undervalued
#4. Relative Yield 5-year comparison	0.80 (cut off)	Undervalued
Average of Models: Valuation ratio = 0.84 = Undervalued		

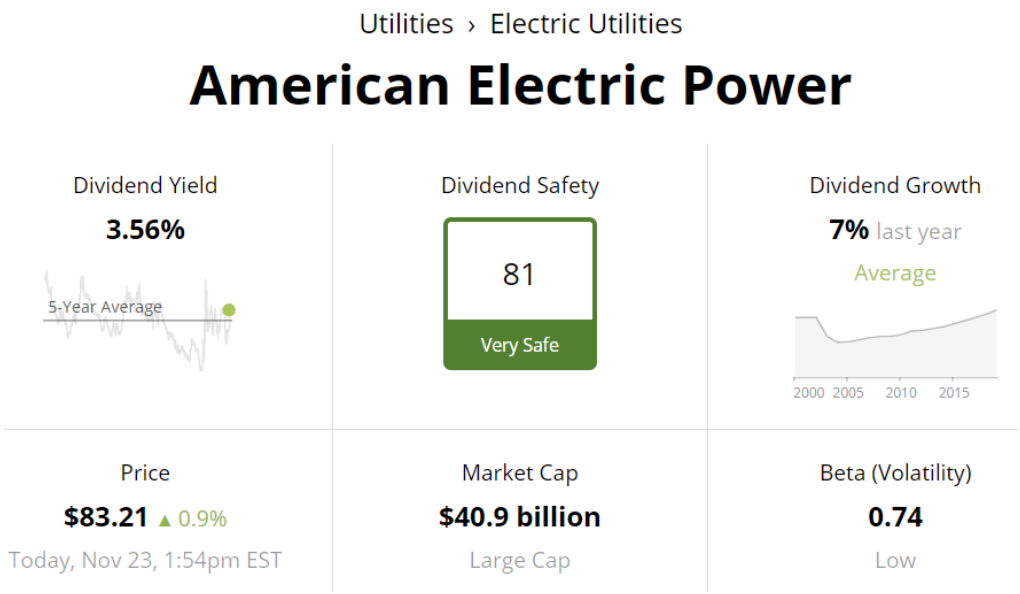
That makes the **fair price = $52** and the top of the fair value range = **maximum buy price = $58**.

AMERICAN ELECTRIC POWER (AEP)

AMERICAN ELECTRIC POWER (AEP)			
SECTOR: Utilities			
INDUSTRY: Electric Utilities			
Link to AEP Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
C	**B**	**C+**	**Fairly valued**

American Electric Power is a utility serving several mid-Atlantic and Mid-western states. It is a well-run utility that doesn't seem to have any remarkable characteristics, positive or negative. It would appear to be a fine core candidate for a DG portfolio.

Dividend Record (Grade = C)



]

AEP is a mid-yield, mid-growth stock with a very safe dividend. It froze its dividend for one year during the Great Recession. It has paid dividends for 15 straight years.

AEP Dividend Summary		
Factor	**Data**	**Rating**
Yield	3.6%	Mid
Years of Increases	10 years (Dividend Contender < 14 years)	D
5-year DGR	6% per year (OK)	C
DGR Trend	Rate steadily in 6% range	B
SSD Safety Rating	81 / 100 – Very safe	A
Total Dividend Grade = C		

Business Model and Company Quality (Grade = B)

American Electric Power Company, founded in 1906 and headquartered in Columbus, OH, is an electric utility holding company. It serves about 5.5 million customers in AK, IN, KY, LA, MI, OH, OK, TN, TX, VA, and WV. Most of those states are considered to have constructive regulators.

AEP engages in generation, transmission, and distribution of electricity for retail and wholesale customers. It operates through Vertically Integrated Utilities, Transmission and Distribution Utilities, AEP Transmission, and Generation & Marketing segments.

AEP generates electricity using coal and lignite (43% of generation, expected to drop to 24% by 2030), natural gas, nuclear, and renewable sources such as hydro, solar, and wind (18%, expected to reach 39% by 2030)

AEP also supplies and markets electric power at wholesale to other electric utility companies, rural electric cooperatives, municipalities, and other market participants.

Morningstar accords AEP a Narrow moat, which is all a utility can get under its system. The moat is based on service territory monopolies and efficient scale advantages.

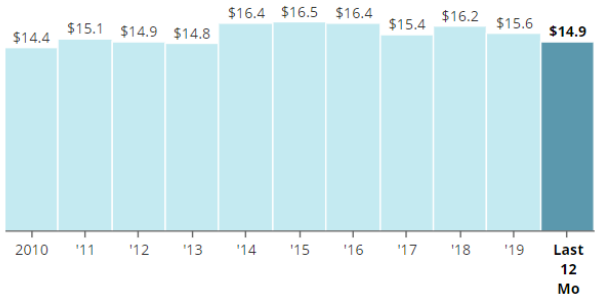
My quality grade is B.

Financials (Grade = C+)

AEP's revenues have been basically flat for a decade. That has not prevented the company from generating healthy earnings and dividend increases, as AEP has been diligent in attending to cost savings.

Total Sales (Billions)

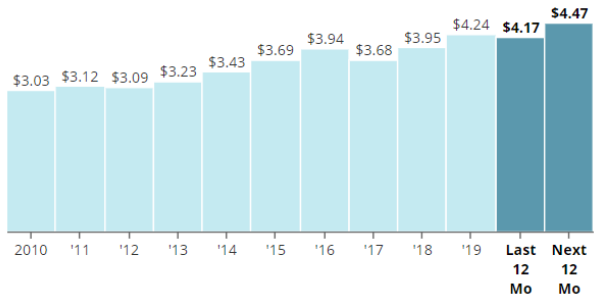
A healthy business grows its total sales over the long term. After all, a larger revenue base is often key to driving sustainable long-term earnings growth. We prefer companies with fairly steady and moderately rising sales.



AEP's earnings per share have been consistently positive and strong. Free cash flow is not shown, as typically for utilities it is misleading because of their capital-intensive business models.

Earnings Per Share

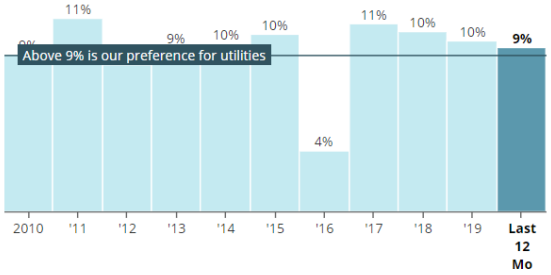
Adjusted earnings are used to exclude noisy "one-time" events such as non-cash impairment charges. The best businesses will steadily increase their earning power over time to help fuel dividend growth and appreciation in their stock price.



AEP's efficiency metrics are OK, a little below the benchmark for ROIC.

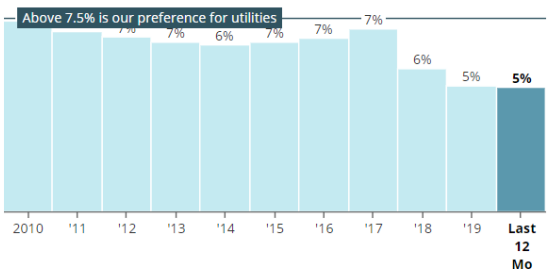
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



Return on Invested Capital

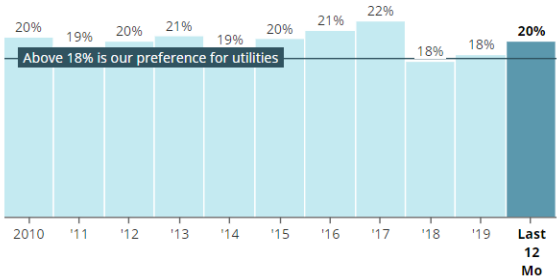
Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



AEP's profitability has been better than average for a utility most years.

Operating Margin

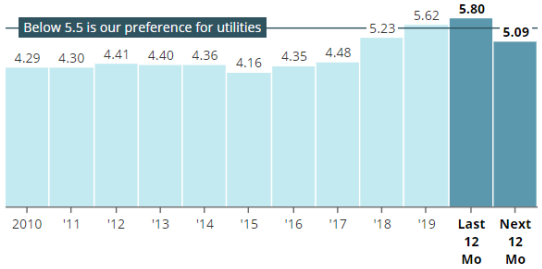
A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



AEP's debt situation is fine for a utility. The company has a good investment-grade credit rating of A-.

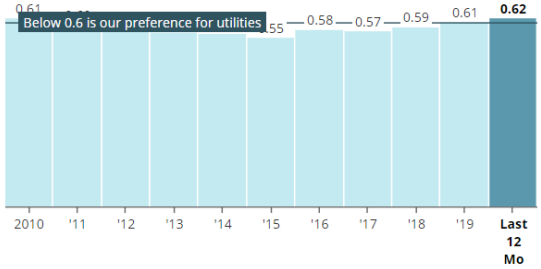
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.

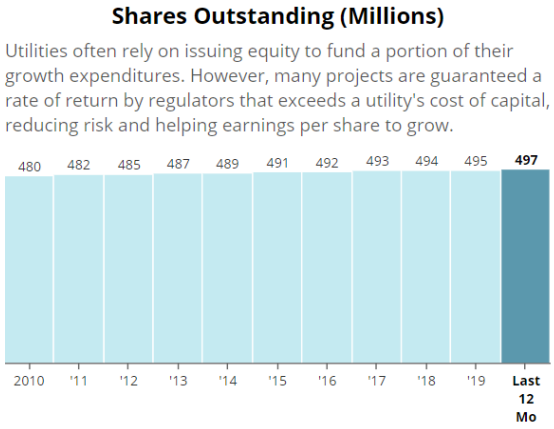


Net Debt to Capital

The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



Like most utilities, AEP's share count grows as it issues new shares to help pay fund its capital needs. AEP's share-growth rate has been modest.



Overall, AEP's financials are about average for a utility. My overall grade is C+.

Valuation (Fairly valued)

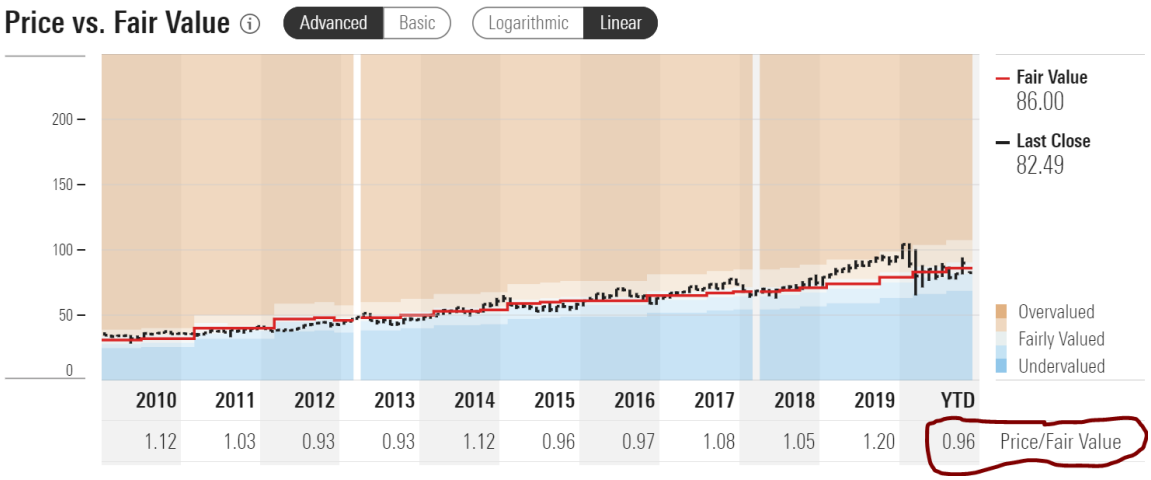
Models #1 & #2: P/E ratios (FASTGraphs)



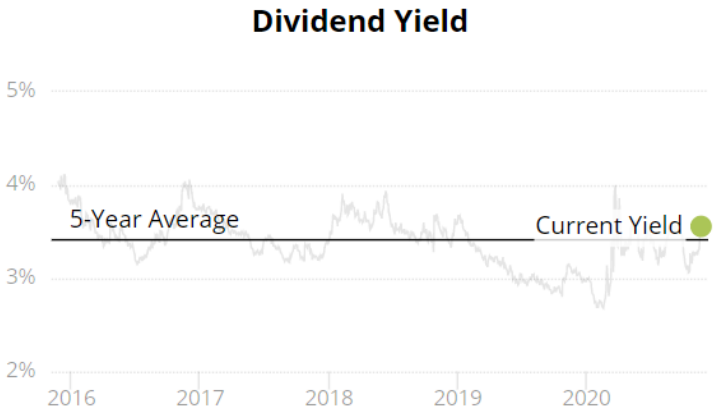
AEP is overvalued under the first P/E model and fairly valued under the second. AEP's current P/E is 19.1 and its 5-year average is 18.5. The valuation ratios are Model 1 = 1.27 and Model 2 = 1.03.

Model #3: DCF

Using its discounted cash flow (DCF) model, Morningstar calculates a valuation ratio of 0.96, which suggests fair valuation.



Model #4: Relative yields (Simply Safe Dividends)



AEP's current yield of 3.6% is a little above its 5-year average of 3.4%. That suggests fair valuation, and the valuation ratio is 0.94.

AEP Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	1.27	Significantly overvalued
#2: P/E to Stock's 5-year average	1.03	Fairly valued
#3: DCF (from Morningstar)	0.96	Fairly valued
#4. Relative Yield 5-year comparison	0.94	Fairly valued
Average of Models: Valuation ratio = 1.05 = Fairly valued		

Model 1 is clearly out of step with the others, but there's no need to toss it out, because there would be no ultimate effect on the conclusion that AEP is fairly valued.

Applying the calculated valuation to AEP's recent price leads to this fair price:

Fair price = $78

I would be willing to pay anywhere in the fair value range for AEP.

Maximum buy price = $86

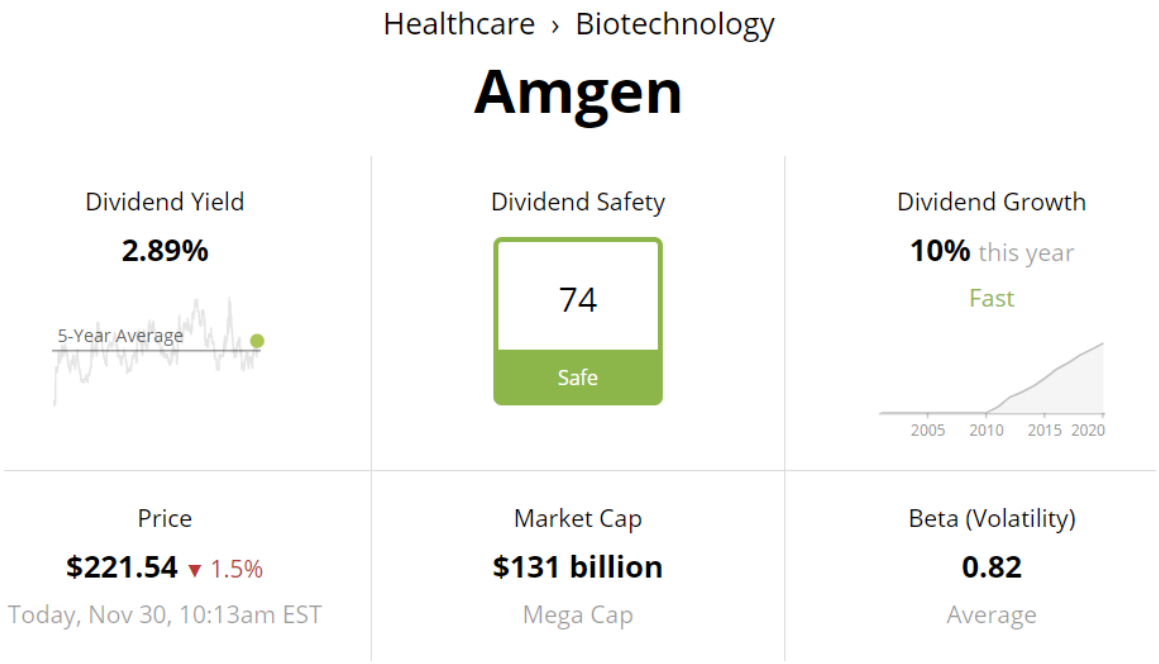
AMGEN (AMGN)



AMGEN (AMGN)			
SECTOR: Health Care			
INDUSTRY: Biotechnology			
Link to AMGN Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
C	**B+**	**B**	**Fairly valued**

Amgen is a very high-quality biotech company with a mid-yield, fast-growth dividend record. It has been raising its dividend since it began paying one in 2011.

Dividend Record (Grade = C)



Amgen began paying dividends in 2011 and has raised them every year since. Its explosive early annual percentage growth has slowed down to the 10% range. It is a mid-yield, fast-growth DG stock.

AMGN Dividend Summary		
Factor	**Data**	**Rating**
Yield	2.9%	Mid
Years of Increases	10 (Dividend Contender < 14 years)	D
5-year DGR	15% per year (Very fast)	A
DGR Trend	Dropping to around 10%, OK for relatively new dividend payer	C
SSD Safety Rating	74 / 100 = Safe	B
Total Dividend Grade = C		

Business Model and Company Quality (Grade = B+)

Amgen was founded in 1980, and it is one of the world's leading biotechnology companies. Its founding mission, which still holds, is deeply rooted in science to transform new ideas and discoveries into medicines to treat serious illnesses.

Philosophically based on "biology first," Amgen develops and delivers human therapeutics based on the science of human biological processes. Its focus is on six therapeutic areas: cardiovascular disease; oncology; bone health; neuroscience; nephrology; and inflammation. Some of its best-known products include Otezla (for psoriasis); Enbrel (inflammation); Neulasta (cancer patients); Prolia (osteoporosis); Xgeva (skeletal-related events); Aranesp (anemia); and EPOGEN (anemia caused by chronic kidney disease).

Amgen also markets other products in some markets through collaborative relationships with their producers.

Amgen has a presence in about 100 countries, and its therapeutics have reached millions of patients around the world. It markets to physicians, clinics, dialysis centers, hospitals, and pharmacies. It distributes its products through pharmaceutical wholesale distributors, as well as direct-to-consumer channels.

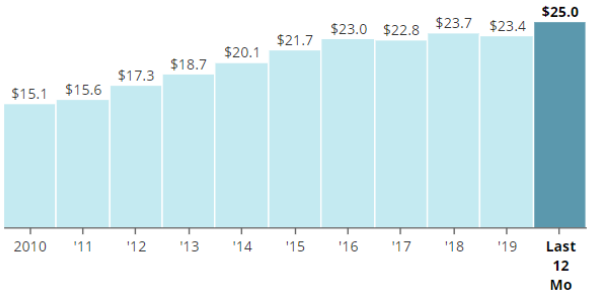
Morningstar awards Amgen a Wide moat. I grade its business as a B+.

Financials (Grade = B)

Amgen's revenue has grown steadily over the past decade. Covid-19 has not had much impact.

Total Sales (Billions)

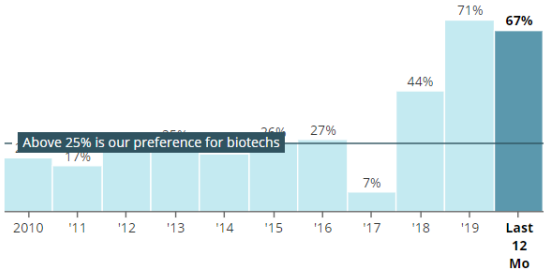
A healthy business grows its total sales over the long term. After all, a larger revenue base is often key to driving sustainable long-term earnings growth. We prefer companies with fairly steady and moderately rising sales.



Amgen's efficiency metrics have been a little below par, with improvement to better levels over the past 2-3 years.

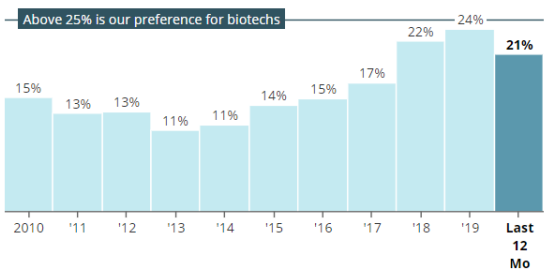
Return on Equity

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Return on Invested Capital

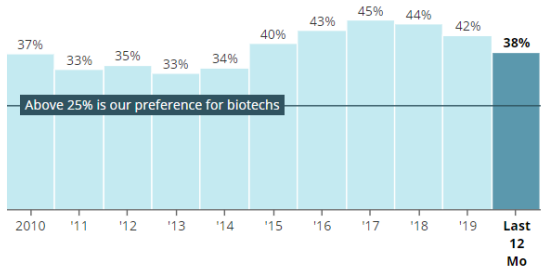
Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



Amgen's profitablity metrics have been well above the benchmarks for most of the last decade (graphs on next page).

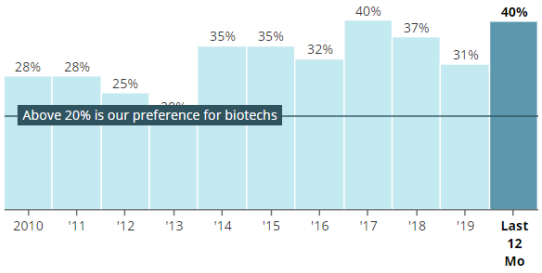
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

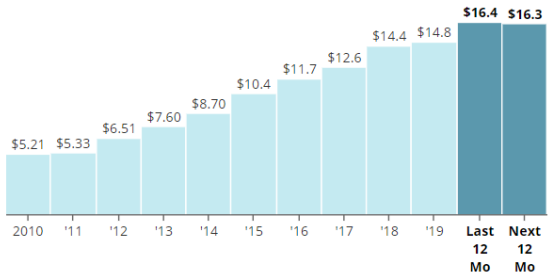
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



Amgen's earnings and cashflow records are outstanding. It is rare to see a company with earnings growth for 10 straight years, but Amgen did it over the last decade.

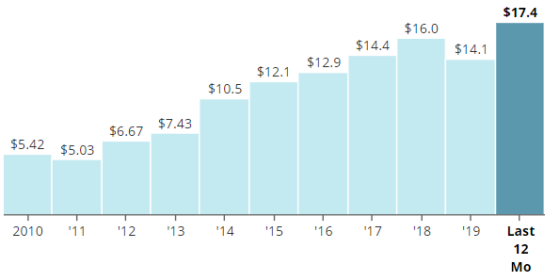
Earnings Per Share

Adjusted earnings are used to exclude noisy "one-time" events such as non-cash impairment charges. The best businesses will steadily increase their earning power over time to help fuel dividend growth and appreciation in their stock price.



Free Cash Flow Per Share

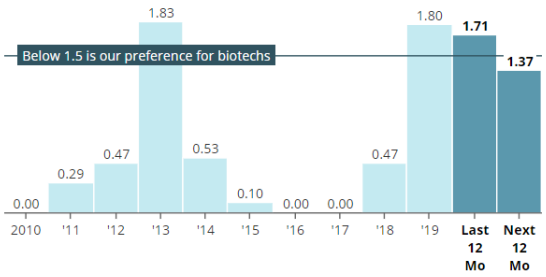
Free cash flow is what's left after a company has paid all of its bills and reinvested to maintain and grow its business. Advantaged businesses tend to generate stable, growing free cash flow over time, fueling sustainable and rising dividends.



Amgen's debt levels are surprisingly high. The company has a mid-investment-grade A-credit rating.

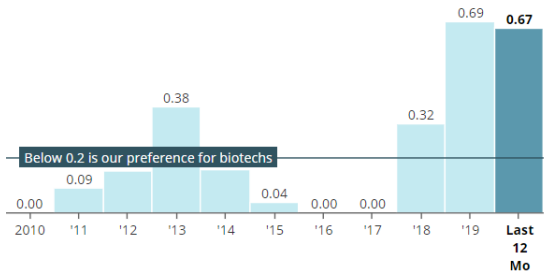
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction. Biotechs often make acquisitions to expand their drug portfolios, so maintaining financial flexibility is especially important.

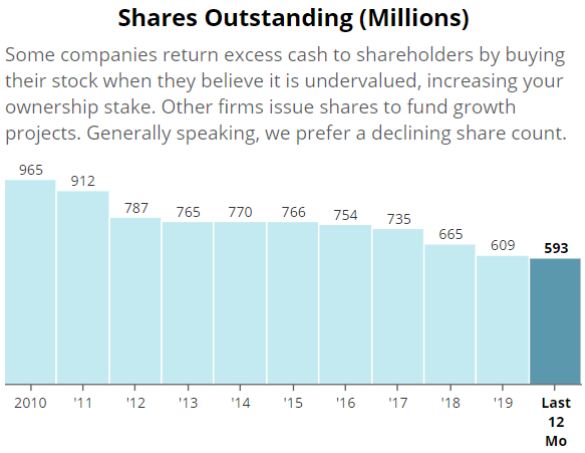


Net Debt to Capital

The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



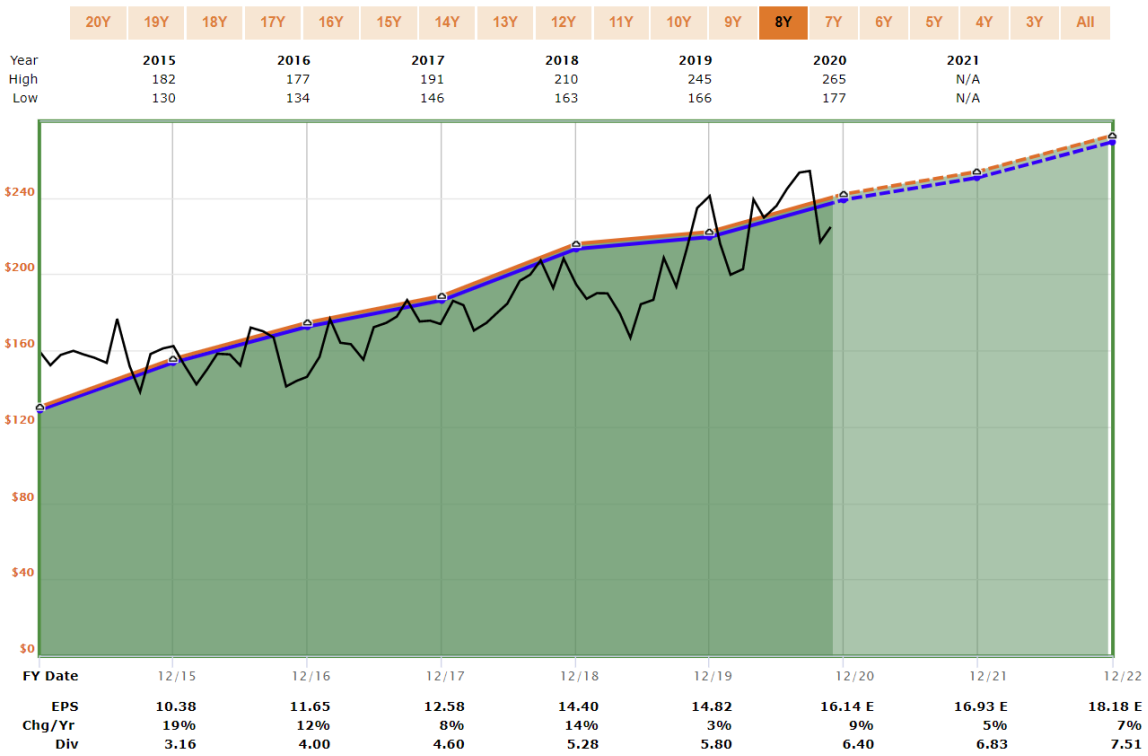
Amgen has been reducing its share count steadily, even with the pandemic this year. It now has a whopping 39% fewer shares outstanding than it did a decade ago.



The only blemish on Amgen's financials are its debt levels. My overall grade is B.

Valuation (Fairly valued)

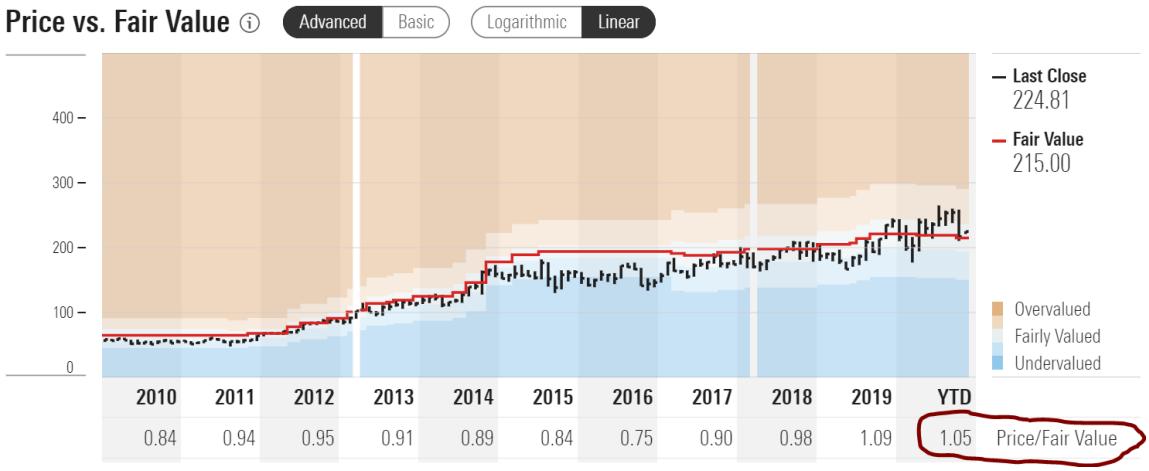
Models #1 & #2: P/E ratios (FASTGraphs)



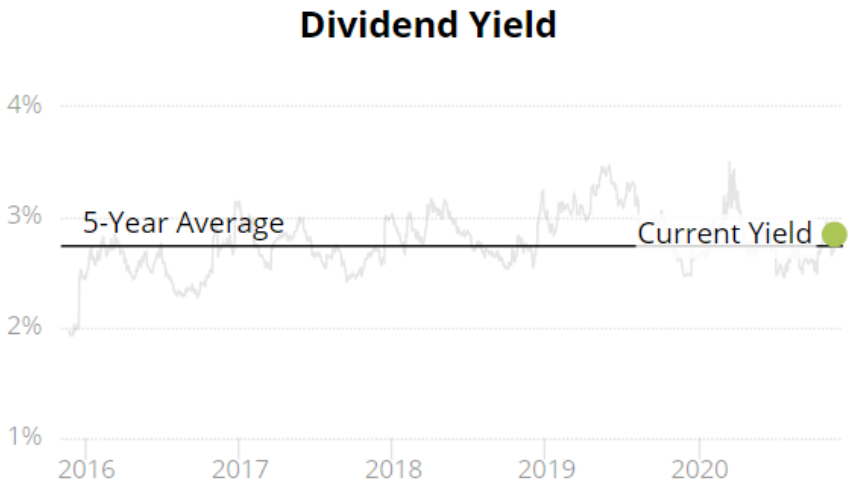
Amgen's price is a little below the fair-price references for Models 1 and 2. Its current P/E ratio is 14.0 vs. its 5-year average of 14.8. The valuation ratios are Model 1 = 0.93 and Model 2 = 0.95. Both are in the fair-value range.

Model #3: DCF (Morningstar)

Using its discounted cash flow (DCF) model, Morningstar calculates a valuation ratio of 1.05, which suggests that Amgen is fairly valued.



Model #4: Relative yields (Simply Safe Dividends)



Amgen's dividend yield completes the unanimous verdict that Amgen is fairly priced. With a current yield of 2.9% compared to its 5-year average of 2.8%, we get a valuation ratio of 0.97.

AMGN Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	0.93	Fairly valued
#2: P/E to Stock's 5-year average	0.95	Fairly valued
#3: DCF	1.05	Fairly valued
#4. Relative Yield 5-year comparison	0.97	Fairly valued
Average of Models: Valuation ratio = 0.98 = Fairly valued		

Fair price = $230

Because of Amgen's very high quality, I would pay to the top of the fair-value range for the stock.

Maximum buy price = $253

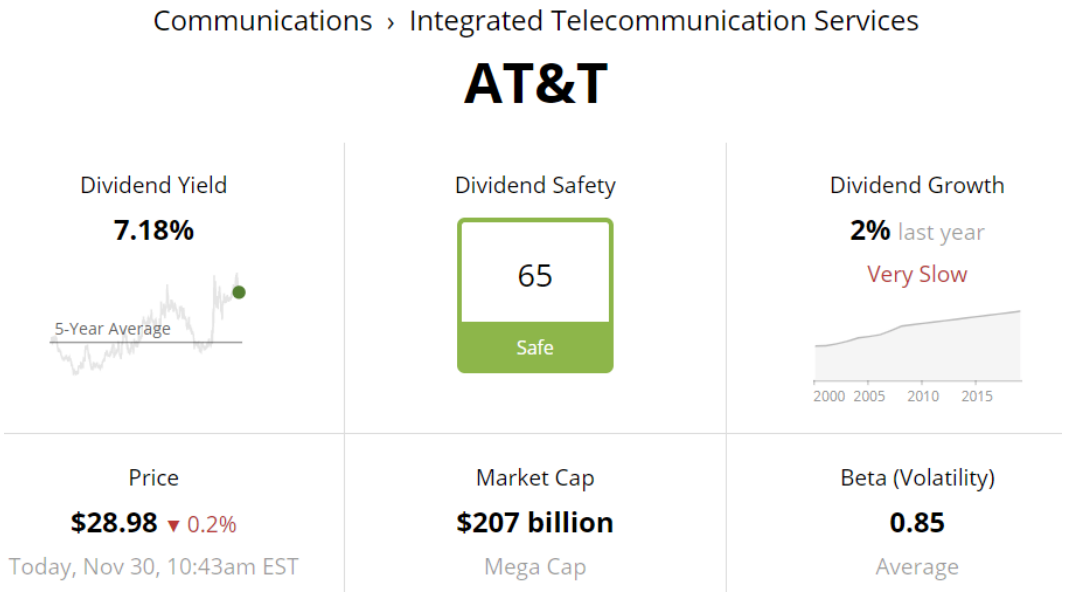
AT&T (T)



AT&T (T)			
SECTOR: Communication Services			
INDUSTRY: Diversified Telecommunications Services			
Link to T Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
B	**C**	**C**	**Very Undervalued**

AT&T is a staple in many dividend growth portfolios, due to its high yield coupled with its long history of slowly raising the dividend each year.

Dividend Record (Grade = B)



AT&T's dividend is considered to be almost bond-like by many investors. Rather than raising its dividend by a percentage each year, T has been raising it by $0.01 per quarter for years. Thus, its annual increases measured as a percentage have been slow, now

down around 2% and slightly sinking each year. Of course, that's fine with many investors. T fills a high-yield-slow-growth niche that they want.

T Dividend Summary		
Factor	**Data**	**Rating**
Yield	7.2%	High
Years of Increases	36 (Dividend Champion, Aristocrat)	B
5-year DGR	2% per year (Slow)	D
DGR Trend	Unvarying raises of $0.04/year for many years	B
SSD Safety Rating	65 / 100 = Safe	B
Total Dividend Grade = B		

Business Model and Company Quality (Grade = C)

AT&T is the namesake survivor of the AT&T that our grandparents knew. That company was broken up in 1984 for anti-trust reasons. One of its "Baby Bells," SBC Communications, bought the survivor of the original AT&T in 2005 and adopted the historic name. The current AT&T's dividend growth streak is measured from the founding of SBC in 1984.

AT&T is a telecom and media conglomerate that operates four business segments, two of which provide almost all its profits:

- **Communications (77% of revenue, 79% of operating income):** Provides wireless (40% of sales) and wireline phone and internet services to consumers and businesses, as well as legacy paid TV services (17% of sales - streaming, U-verse, and DirecTV). Pay TV services are in secular decline, while streaming services are ascending.

- **WarnerMedia (18% of revenue, 20% of operating income):** Consists of Time Warner assets acquired in 2018, including Turner channels, HBO, and Warner Brothers studios.

The telecommunications part of T's business is competitive and resilient. In Q3, T reported solid wireless subscriber growth, the best in years. It is also capital-intensive. The company spent over $20 billion in 2018 on maintaining, upgrading, and expanding its wireless and wireline networks. New CEO John Stankey recently reiterated T's commitment to increased fiber investment.

T's strategy for several years has been to combine its telecommunications assets with media assets acquired through acquisitions. In 2015, T acquired DirecTV for $67 billion, and in 2018 it acquired Time Warner for $85 billion.

T's forays into entertainment and media have not played out very well so far. It bought DirecTV just as cord-cutting was beginning to skyrocket. The service has been losing customers ever since.

Most observers consider the launch of HBO Max in March, as T's premier streaming service, to have been underwhelming, although the impact of Covid-19 and promotional come-ons make it difficult to judge its potential. International rollout is slated for 2021.

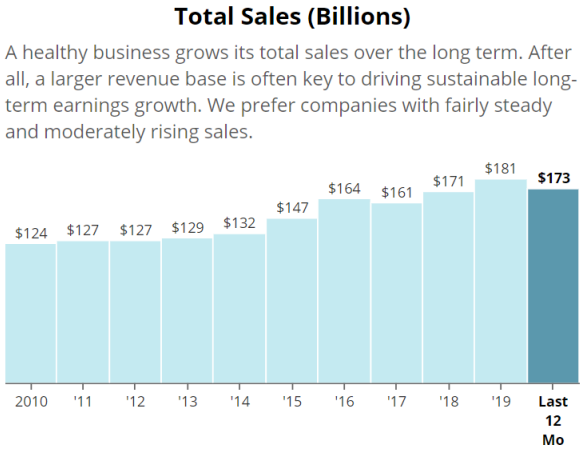
The streaming field is crowded already with content experts such as Netflix, Disney, Amazon, and NBCUniversal. That said, the streaming wars are in their infancy, and T has great content possibilities with the Time Warner acquisition. Content creation is also capital-intensive; for comparison, Netflix expects to spend $17 billion on content this year.

The acquisitions gave AT&T the highest corporate debt load in America. The company has indicated that the acquisition spree is over and that reducing leverage is management's top priority.

I grade T's business quality as C right now, with a recognition that grade might grow higher depending on its long-term accomplishments in content and streaming.

Financials (Grade = C)

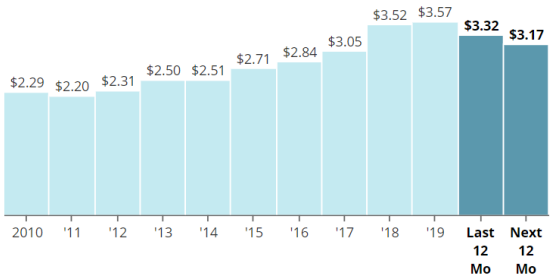
AT&T's revenue has shown a general pattern of slow growth over the past decade. The drop in the past 12 months reflects the impact of Covid-19, which has affected not only wireless revenues and but also Warner Brothers production and release schedules.



T has solid earnings and cash flow records, again noting the obvious hit from Covid-19.

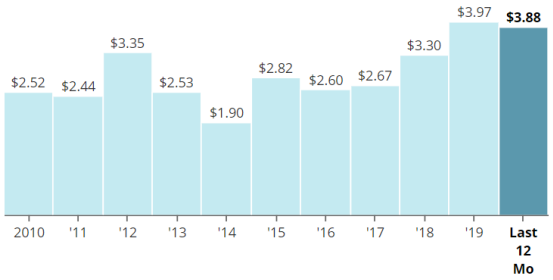
Earnings Per Share

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Free Cash Flow Per Share

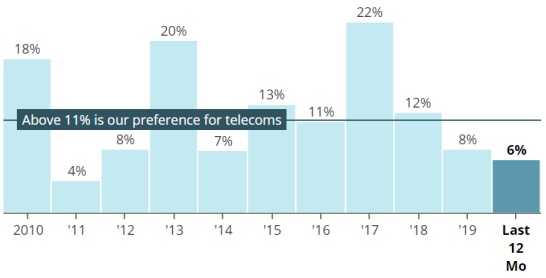
Free cash flow is what's left after a company has paid all of its bills and reinvested to maintain and grow its business. Advantaged businesses tend to generate stable, growing free cash flow over time, fueling sustainable and rising dividends.



T's efficiency metrics are mediocre.

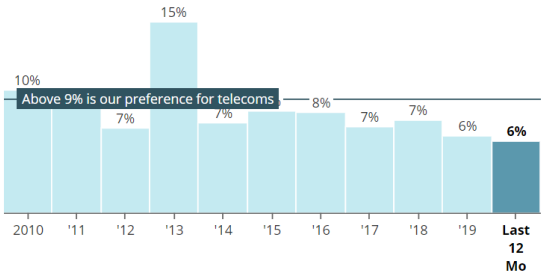
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



Return on Invested Capital

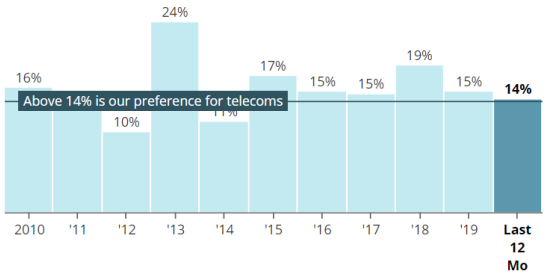
Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



T's profitability runs right around the benchmark for operating margin, and well above the benchmark for FCF margin. The latter reflects T's robust generation of cash from its businesses. (Graphs are on next page.)

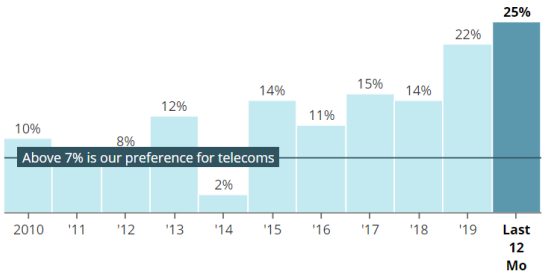
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

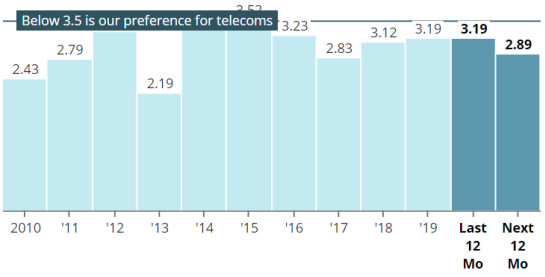
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



T carries huge amounts of debt, about $149 billion net debt even after reducing it by $2.9 billion in Q3. That said, its debt metrics look stronger than one might expect. It is a top management priority to keep paying down the debt to lower levels.

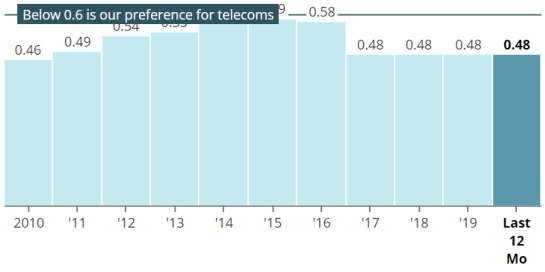
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.



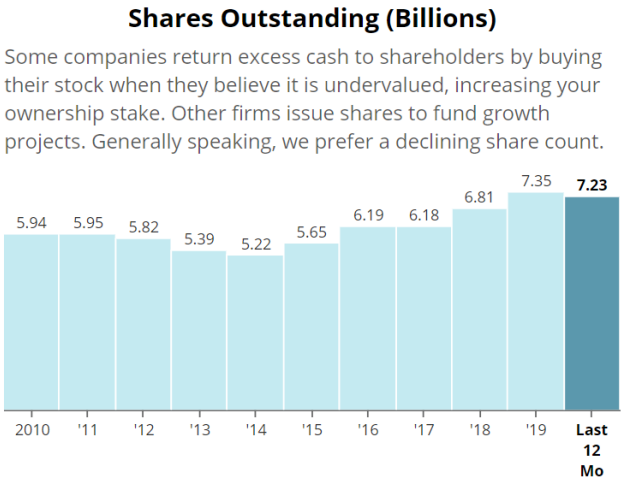
Net Debt to Capital

The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



While the debt metrics are large but not scary in context, T's credit rating is BBB, which is barely into investment-grade territory. Paying down some debt will help T keep that investment-grade rating.

Part of the reason that the debt numbers don't look too bad is that T's acquisitions have been financed not only through debt, but also by issuing new shares. As a result, T's share float graph does not have the steady decline that we like to see.

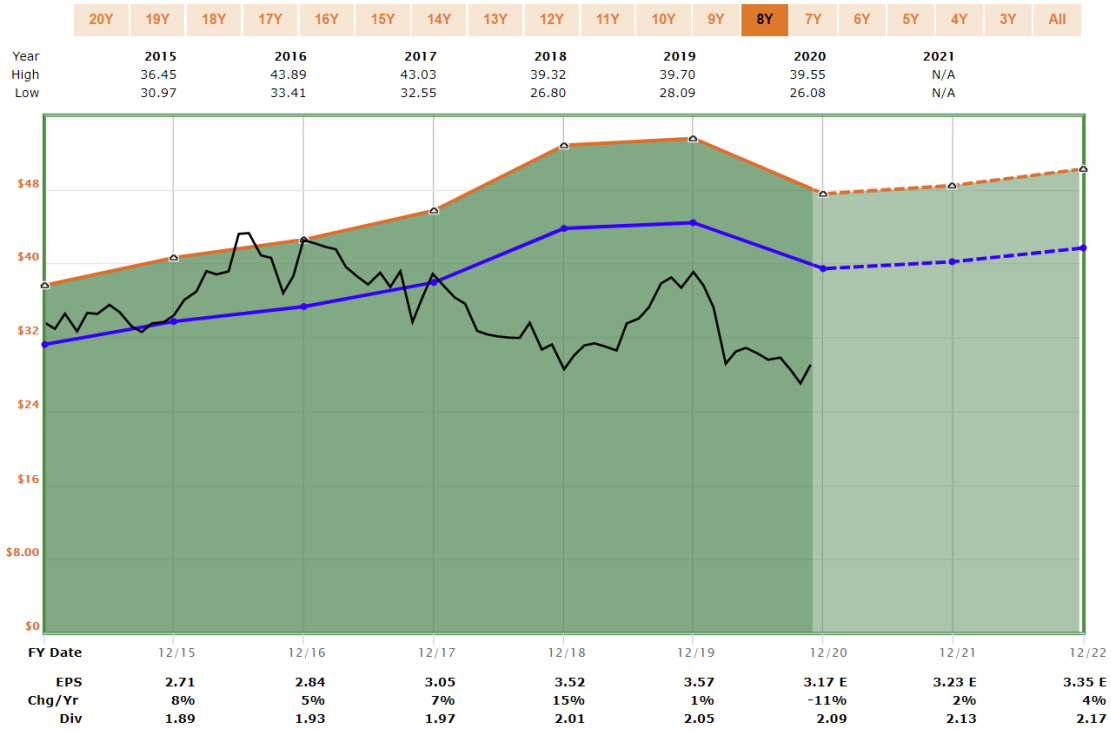


Overall, T's financials get a grade of C. That grade will rise if the company shows continued discipline in paying down debt, maintaining its investment-grade credit rating, and generates growth from its content properties and capabilities.

Valuation (Very undervalued)

Models #1 & #2: P/E ratios (FASTGraphs)

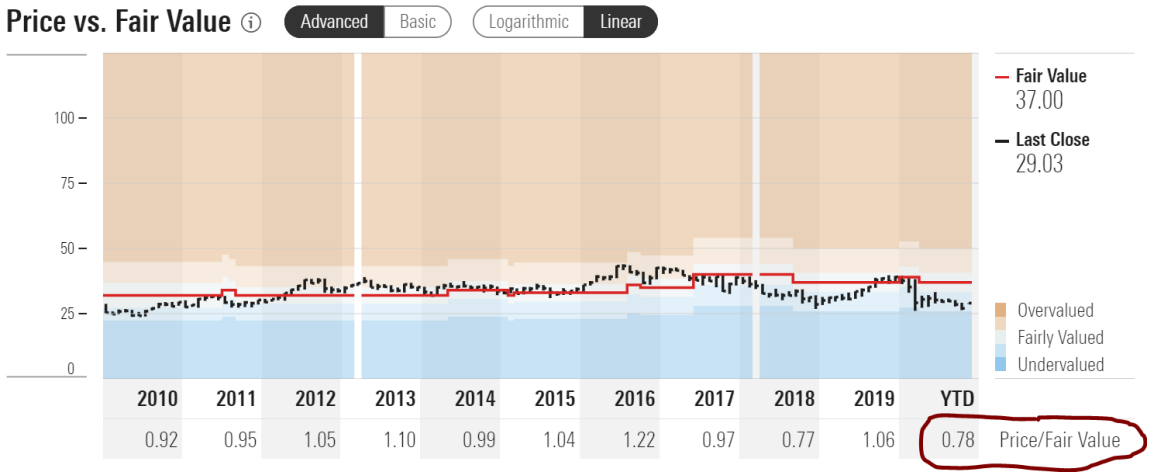
T's price has been declining since the DirecTV acquisition in 2015. While that hasn't pleased long-term shareholders, it presents a good valuation picture now.



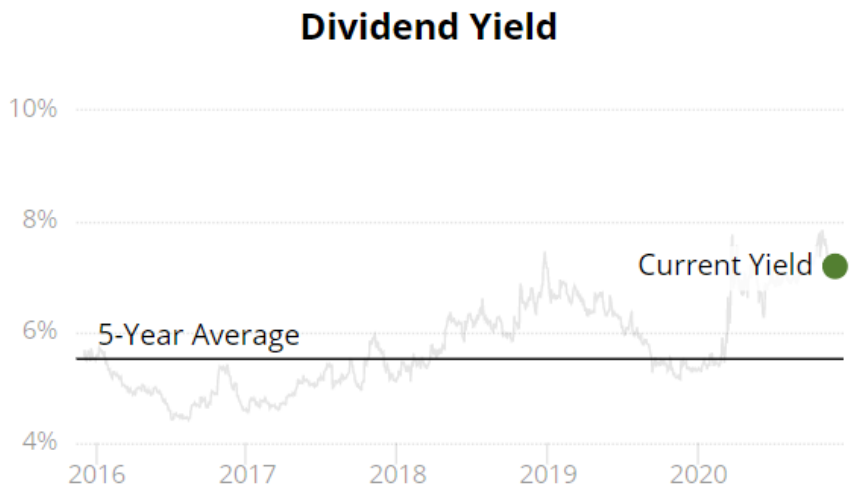
T is undervalued under both P/E models. Its current P/E ratio of 9.1 is well below the basic reference fair value of 15 (orange line) and its own 5-year average of 12.4 (blue line). Its valuation ratios are: Model 1 = 0.61 and Model 2 = 0.73.

Model #3: DCF

Using its discounted cash flow (DCF) techniques, Morningstar calculates a valuation ratio of 0.78.



Model #4: Relative yields (Simply Safe Dividends)



The relative yield metric completes the unanimity on T being undervalued. T's 5-year average yield of 5.5% compared to its current yield of 7.2% suggests a valuation ratio of 0.76, which I cut off at 0.80.

T Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	0.61	Very undervalued
#2: P/E to Stock's 5-year average	0.73	Very undervalued
#3: DCF (from Morningstar)	0.78	Very undervalued
#4. Relative Yield 5-year comparison	0.80 (cut off)	Undervalued
Average of Models: Valuation ratio = 0.73 = Very undervalued		

T is significantly undervalued at its current price of about $27.

Fair price = $40

Given that T is available so far below its fair price currently, I see no need to move higher in the fair-value range to obtain shares. T's "C" grades for quality and financials do not suggest that it deserves any sort of premium at the current time.

Maximum buy price = $40

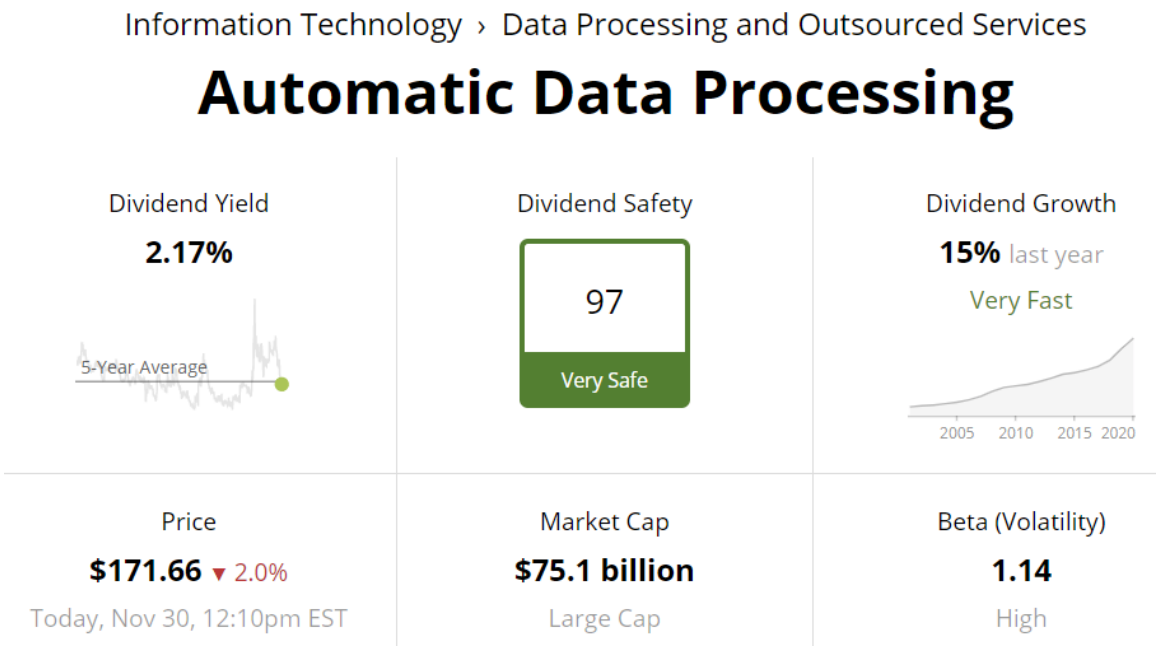
For those who feel differently, the top of T's fair-value range would be $44.

AUTOMATIC DATA PROCESSING (ADP)

AUTOMATIC DATA PROCESSING (ADP)			
SECTOR: Information Technology			
INDUSTRY: IT Services			
Link to ADP Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
A	**A**	**A**	**Overvalued**

Automatic Data Processing is a DG All Star, based on its excellent record of dividend growth; solid standing in the human resources and payroll business; and excellent financials resulting from its cash-rich and non-capital-intensive business model. Its price is currently overvalued.

Dividend Record (Grade = A)



ADP has an excellent long-term dividend record. Its most attractive elements are its long streak of increases (45 years), consistently fast increases (5-year DGR of 13% per year), and top dividend safety rating (97).

ADP's mediocre yield is balanced by its fast dividend growth rate.

ADP Dividend Summary		
Factor	**Data**	**Rating**
Yield	2.2%	Mid
Years of Increases	45 (Dividend Champion, Aristocrat)	B
5-year DGR	13% per year (Very fast)	A
DGR Trend	Steady at very fast rate	A
SSD Safety Rating	97 / 100 = Very safe	A
Total Dividend Grade = A		

Business Model and Company Quality (Grade = A)

Automatic Data Processing (ADP) was founded in 1949. It is now one of the largest providers of human capital management (HCM) solutions in the world.

ADP has more than 740,000 clients in over 110 countries and territories. Clients range from single-employee companies to some of the world's largest enterprises. Over 80% of Fortune 100 companies use at least one ADP service. More than 40 million people around the globe are affected by ADP's products and services, including 1 out of every 6 workers in the USA. No client accounts for more than 2% of total revenue.

Moving beyond payroll, ADP has expanded its suite of products over the last decade to cover most of the HCM spectrum, including HR, time and attendance management, and benefits administration.

ADP is organized into two segments:

- **Employer Services (72% of revenue, 86% of earnings):** Covers payroll services, benefits administration, recruiting and talent management, HR management, insurance services, retirement services, and compliance solutions.

- **Professional Employer Organization Services (28% of revenue, 14% of earnings):** Provides employment administration outsourcing solutions through relationships in which employees who work for a client are co-employed by ADP. Such employees enjoy ADP's 401(k) and other benefits,

which the client pays for but at lower rates that ADP negotiates.

Geographically, about 86% of ADP's sales are generated in the USA, 9% in Europe, 2% in Canada, and 2% in other countries.

Morningstar awards ADP a Wide moat. Its primary competitive advantages derive from its scale and long-standing customer relationships. ADP has the most complete suite of products and services in the HCM market. As it becomes more ingrained with clients, customer switching costs rise, because users are trained to use more of ADP's software solutions. ADP's overall client retention rate has remained above 90% every year since fiscal 2011.



With little capital required to run its business (capital expenditures average less than 1.5% of revenue), ADP has been able to reinvest heavily in the latest solutions and technology. These investments have helped the company transition nearly all of its HCM customers to cloud-based software, with many now using its mobile app.

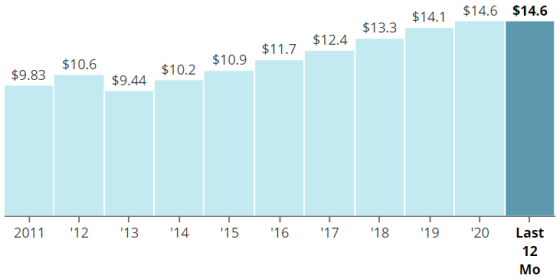
ADP has approximately 10% share world-wide of the highly fragmented HCM market, which is estimated to be growing at about 6% per year. Management believes international expansion can help ADP continue driving solid company growth for the foreseeable future.

Financials (Grade = A)

ADP's fiscal 2020 ended in June. As with many other companies, the pandemic impacted 2020's results, and estimates for 2021 have been lowered. For example, total sales almost remained flat in fiscal 2020.

Total Sales (Billions)

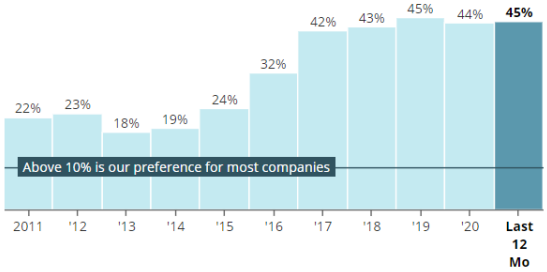
A healthy business grows its total sales over the long term. After all, a larger revenue base is often key to driving sustainable long-term earnings growth. We prefer companies with fairly steady and moderately rising sales.



ADP is a very profitable company, with efficiency and profitability ratios well above usual norms:

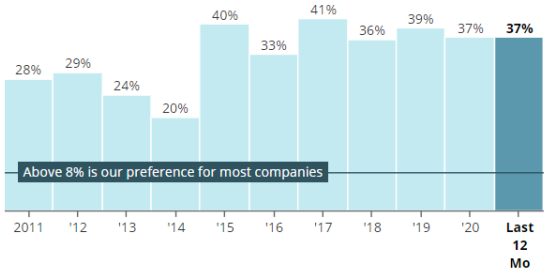
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



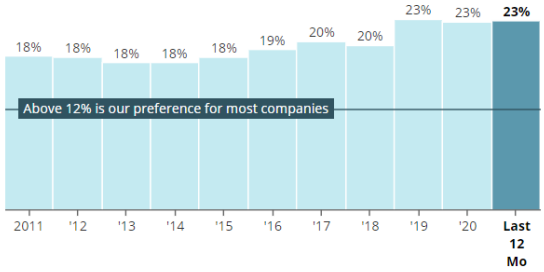
Return on Invested Capital

Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



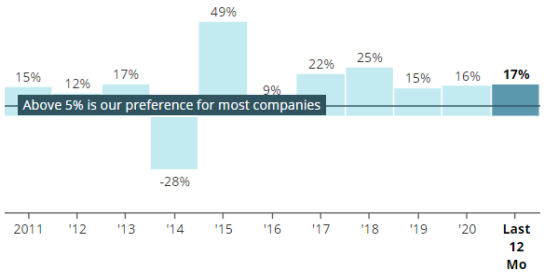
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.

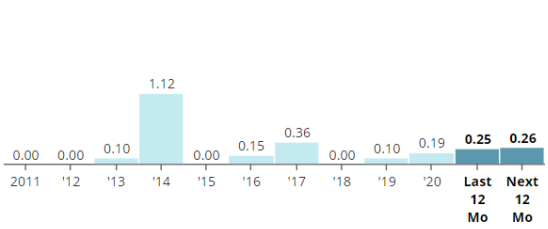


At the same time, ADP is not highly dependent on debt, and it sports a fine AA credit rating.

Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.

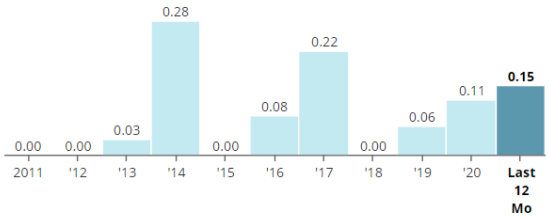
Below 3 is our preference for most companies



Net Debt to Capital

The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.

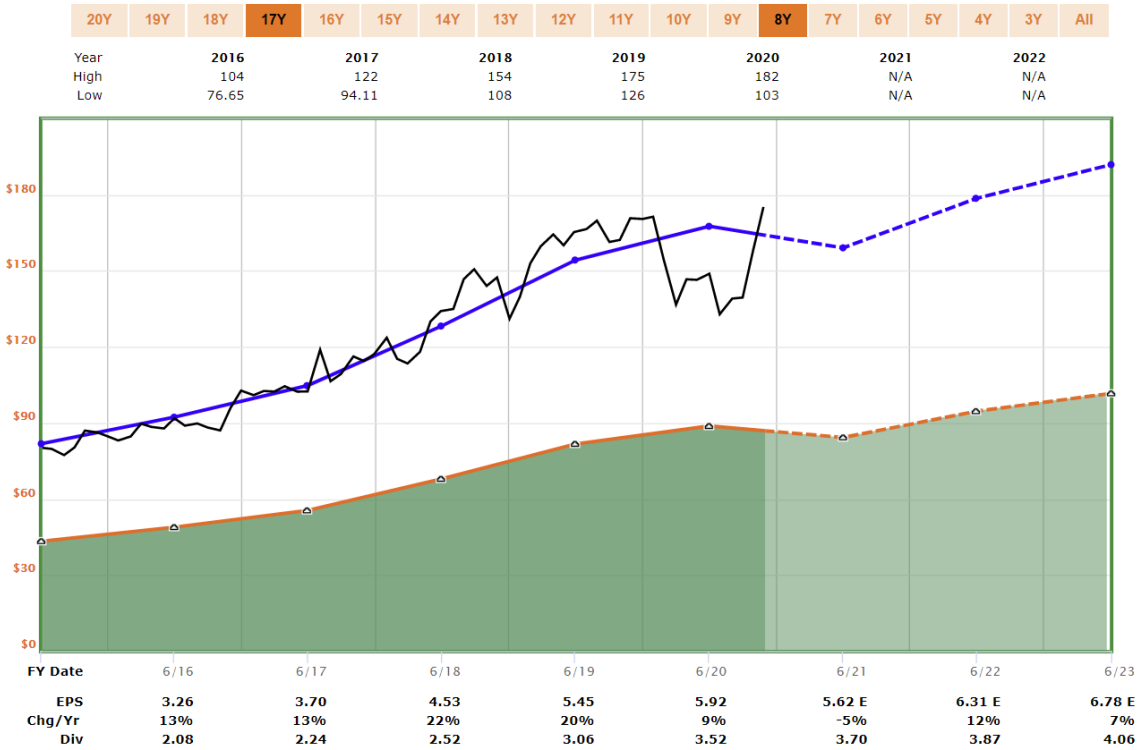
Below 0.4 is our preference for most companies



There is little to criticize in ADP's financials. Grade = A.

Valuation (Overvalued)

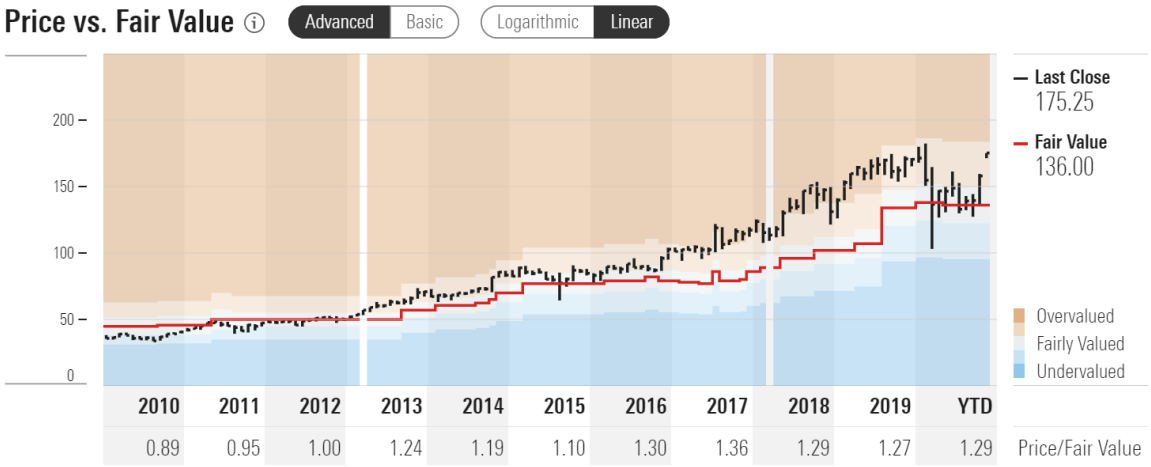
Models #1 & #2: P/E ratios (FASTGraphs)



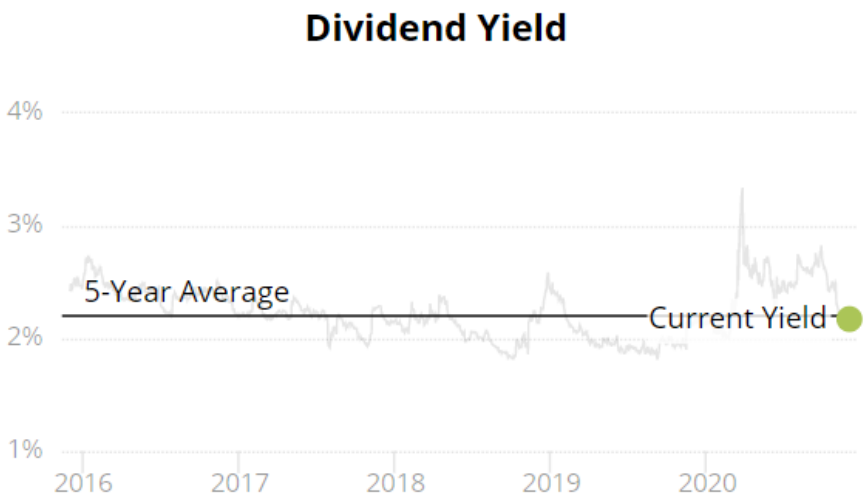
As we can see visually, ADP is way overvalued under Model 1 and just a bit overvalued under Model 2. Its current P/E ratio of 30.2 is well above the basic reference fair valuation of 15 (orange line), and slightly above its own 5-year average of 28.3 (blue line). Its valuation ratios are Model 1 = 2.01 and Model 2 = 1.07.

Model #3: DCF

Using its discounted cash flow (DCF) techniques, Morningstar has ADP as very overvalued, with a valuation ratio of 1.29.



Model #4: Relative yields (Simply Safe Dividends)



ADP's current yield and its 5-year average both round to 2.2%. That suggests that ADP is fairly valued with a valuation ratio of 1.00.

ADP Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	2.01	Very overvalued
#2: P/E to Stock's 5-year average	1.07	Fairly valued
#3: DCF (from Morningstar)	1.29	Very overvalued
#4. Relative Yield 5-year comparison	1.00	Fairly valued
Average of Models: Valuation ratio = 1.34 = Very overvalued		

ADP presents a case where one of the models (Model 1) is way out of step with the others and dominates the calculation of fair value. I am inclined to drop that model.

ADP Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#2: P/E to Stock's 5-year average	1.07	Fairly valued
#3: DCF (from Morningstar)	1.29	Very overvalued
#4. Relative Yield 5-year comparison	1.00	Fairly valued
Average of Models: Valuation ratio = 1.12 = Overvalued		

Fair price = $156

I would be willing to pay up to the top of ADP's fair-value range.

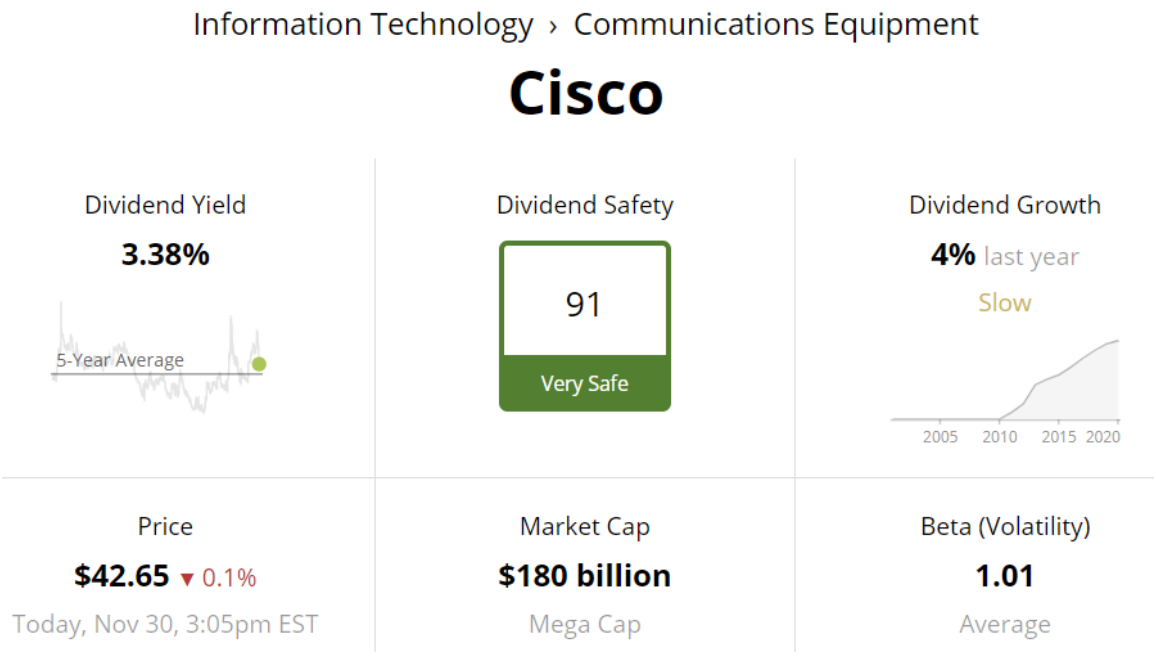
Maximum entry price = $172

CISCO (CSCO)

CISCO (CSCO)			
SECTOR: Information Technology			
INDUSTRY: Communications Equipment			
Link to CSCO Investor Site			
DIVIDENDS	QUALITY	FINANCIALS	VALUATION
C	B	B	Fairly valued

Cisco is a blue-chip technology infrastructure company. Its dividend offers a 3%+ yield and is very safe, although its growth rate has slowed down over the past few years.

Dividend Record (Grade = C)



While Cisco is a well-established blue-chip technology stock, it is a relative new DG stock. CSCO just started paying dividends in 2011. It has raised its dividend every year

since, but its short record means that it did not weather the Great Recession with dividend raises (because it was not paying them at all).

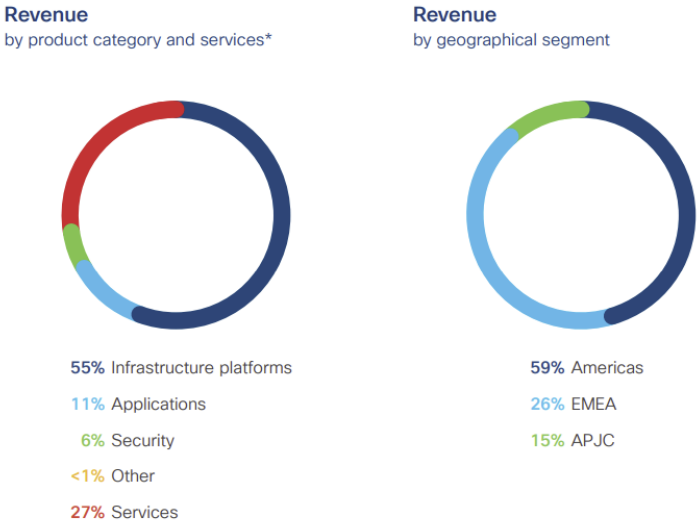
CSCO's DGR trend has been downward. Its yield is attractive compared to many other established DG stocks, and its dividend safety grade is outstanding.

CSCO Dividend Summary		
Factor	**Data**	**Rating**
Yield	3.4%	Mid
Years of Increases	10 (Dividend Contender < 14 years)	Short
5-year DGR	12% per year (very fast)	A
DGR Trend	Trending downward; 2.9% in 2020	D
SSD Safety Rating	91 / 100 = Very safe	A
Total Dividend Grade = C		

Business Model and Company Quality (Grade = B)

Cisco describes itself as the worldwide leader in technology that powers the Internet. It designs and sells a broad range of technologies that have been powering IT systems since 1984.

Cisco is managed by geography, but it tends to be analyzed more by its product groups: Infrastructure Platforms (switches and routers); Applications; Security; and Services.



Established IT hardware products are cyclical, and Cisco's have been significantly impacted by Covid-19, which has slowed IT spending, especially by smaller customers.

One of Cisco's strategic goals is to shift away from cyclical hardware sales and focus more on recurring software and service revenue.

Cisco has major positions in its core markets. For example, its share in the Ethernet switching market is about 50%; in routers and services it is about 38%.

Cisco is facing secular changes in technology itself, as more firms abandon their on-premises IT operations and turn to the cloud for its capacity and functionality. Cisco has spent more than $18 billion on research and development over the last three years to stay relevant in the cloud-based era. They recently announced plans to accelerate the transition of R&D spending into cloud security and cloud collaboration offerings.

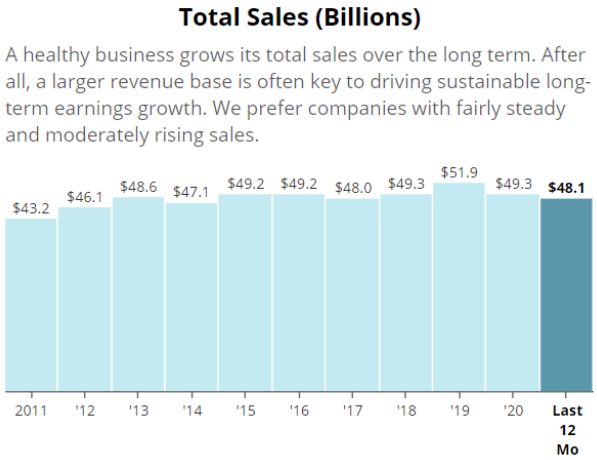
Cisco has a massive installed base that provides steady revenue opportunities. The company is moving more aggressively to convert the majority of its offerings to services. This would generate more stable revenue while also potentially creating even stickier customer relationships.

Management has also revealed plans to take out over $1 billion of costs (about 6% of total operating expenses) over the next few quarters, providing greater flexibility as the business continues transitioning.

Morningstar awards Cisco a Narrow moat, based primarily on the switching costs that customers would endure by changing vendors. Cisco is entrenched in many data centers and has strong brand equity with IT professionals.

Financials (Grade = B)

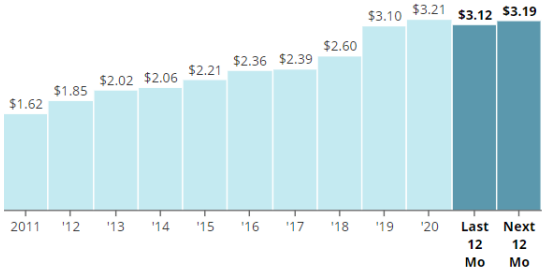
Cisco's revenue growth has been slowly growing over many years, although the trend has been interrupted by Covid-19.



Cisco's earnings and free cash flow records are solid, but growth has leveled off in the last couple of years. Cisco is a prolific generator of cash.

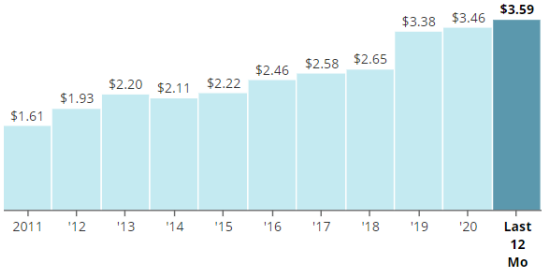
Earnings Per Share

Adjusted earnings are used to exclude noisy "one-time" events such as non-cash impairment charges. The best businesses will steadily increase their earning power over time to help fuel dividend growth and appreciation in their stock price.



Free Cash Flow Per Share

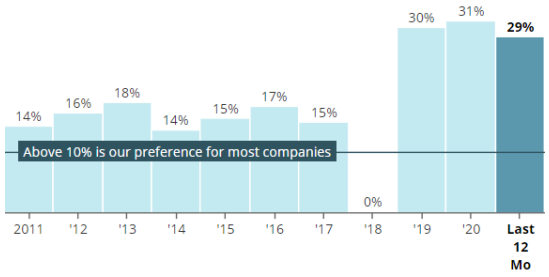
Free cash flow is what's left after a company has paid all of its bills and reinvested to maintain and grow its business. Advantaged businesses tend to generate stable, growing free cash flow over time, fueling sustainable and rising dividends.



Cisco's efficiency metrics (shown in the first pair of graphs below) and profitability metrics (shown in the second pair) are outstanding, with all metrics being well above their benchmarks.

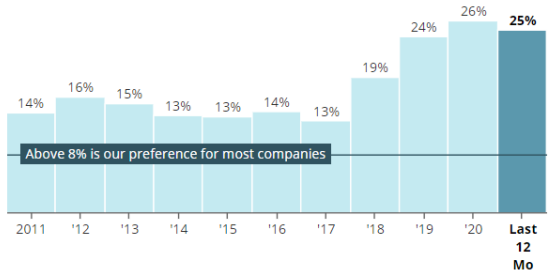
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



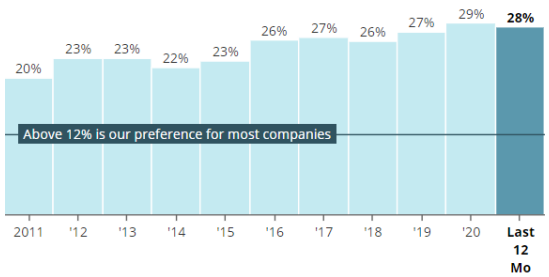
Return on Invested Capital

Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



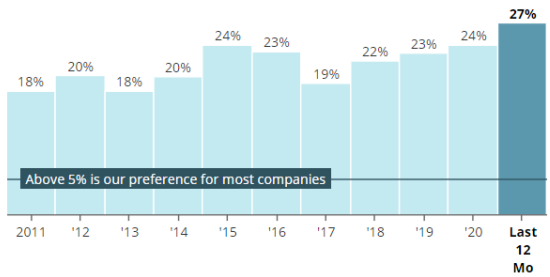
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



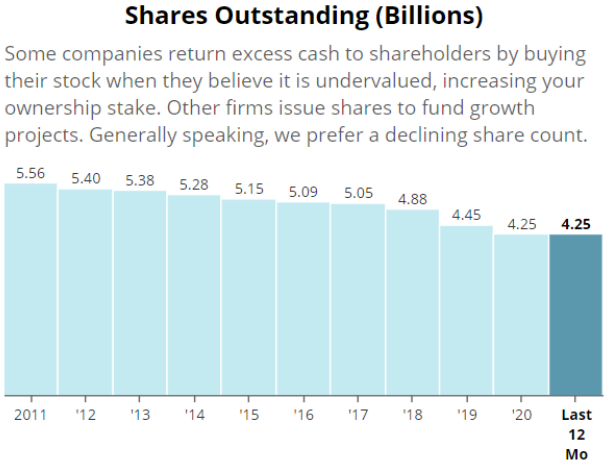
Free Cash Flow Margin

Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



Cisco has essentially no net debt (debt minus cash on hand), and it hasn't had net debt for years. It has not followed the trend among many companies to use more and more debt in an era of low interest rates. Cisco ended its most recent quarter with $29.4 billion of cash compared to less than $15 billion of total debt. The company's S&P credit rating is AA-, putting it in the top tier of investment-grade categories.

Cisco has been reducing its share count steadily. It has 24% fewer shares outstanding than it did 10 years ago.

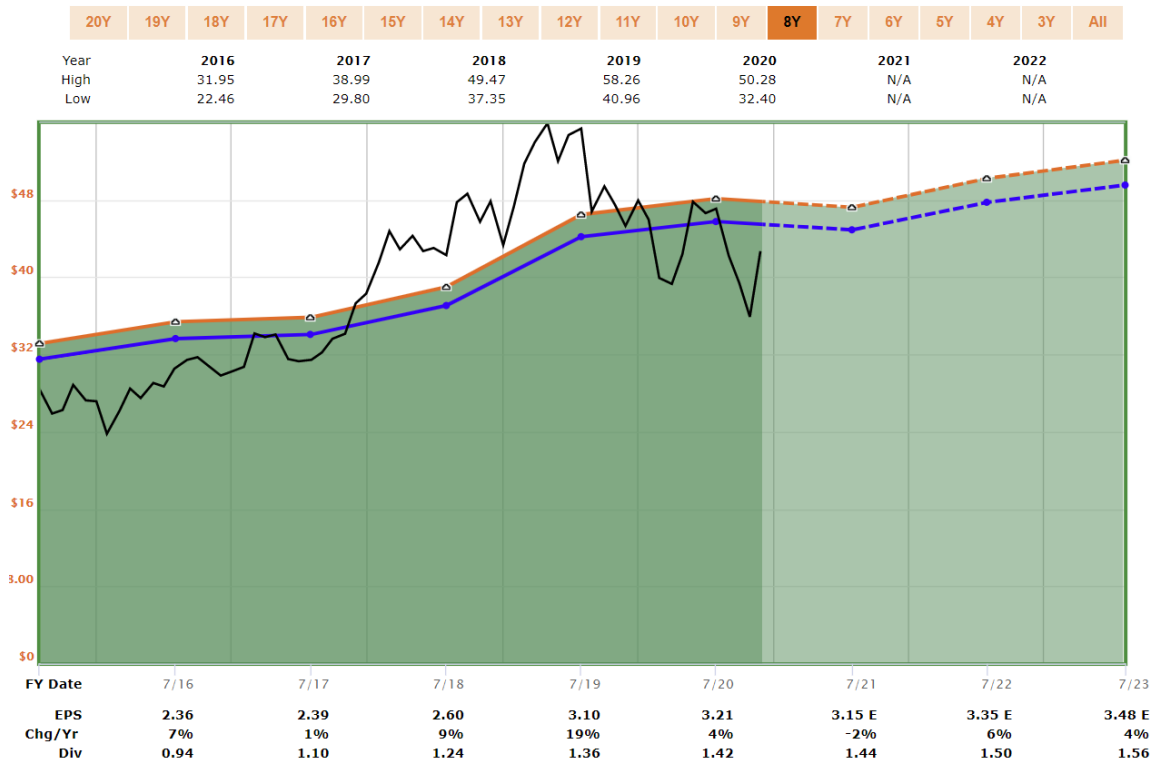


Overall, Cisco's financials would merit a grade of A were it not for the stubborn issue of slow revenue growth. That issue drops the grade to B.

Valuation (Fairly valued)

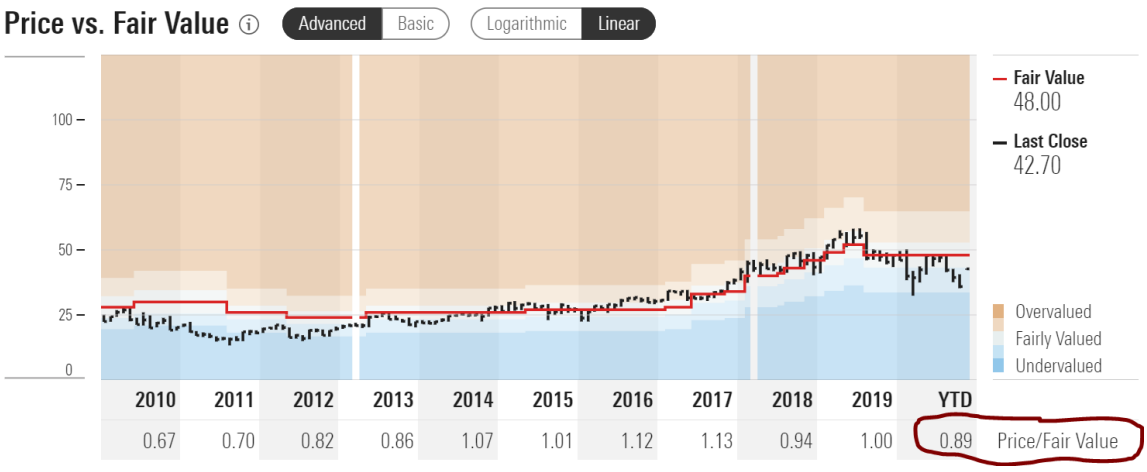
Models #1 & #2: P/E ratios (FASTGraphs)

Cisco is undervalued by the standards of the first P/E model and fairly valued by the second. Model 1's valuation ratio = 0.89 and Model 2's = 0.94. Cisco's current P/E ratio is 13.4 compared to its 5-year average of 14.3.

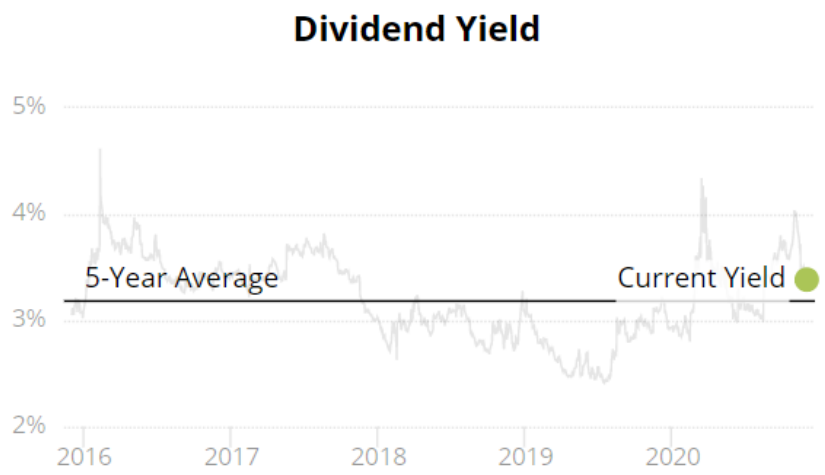


Model #3: DCF

Using its discounted cash flow (DCF) techniques, Morningstar calculates a valuation ratio of 0.89, which suggests undervaluation.



Model #4: Relative yields (Simply Safe Dividends)



Cisco's current yield of 3.4% is a little above its 5-year average of 3.2%. The yield comparison suggests a valuation ratio of 0.94, which suggests fair valuation.

CSCO Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	0.89	Undervalued
#2: P/E to Stock's 5-year average	0.94	Fairly valued
#3: DCF (from Morningstar)	0.89	Undervalued
#4. Relative Yield 5-year comparison	0.94	Fairly valued
Average of Models: Valuation ratio = 0.92 = Fairly valued		

The valuation models are tightly bunched, and they all suggest that Cisco is on the border between being undervalued and fairly valued. Applying the average valuation ratio to Cisco's recent price of $43 brings us to:

Fair price = $47

Because of Cisco's difficulties in growing its revenues, I am sure that some investors would not want to go to the top of CSCO's fair-value range to buy the stock, but I think that it would not be unreasonable to do so. The top of the range is:

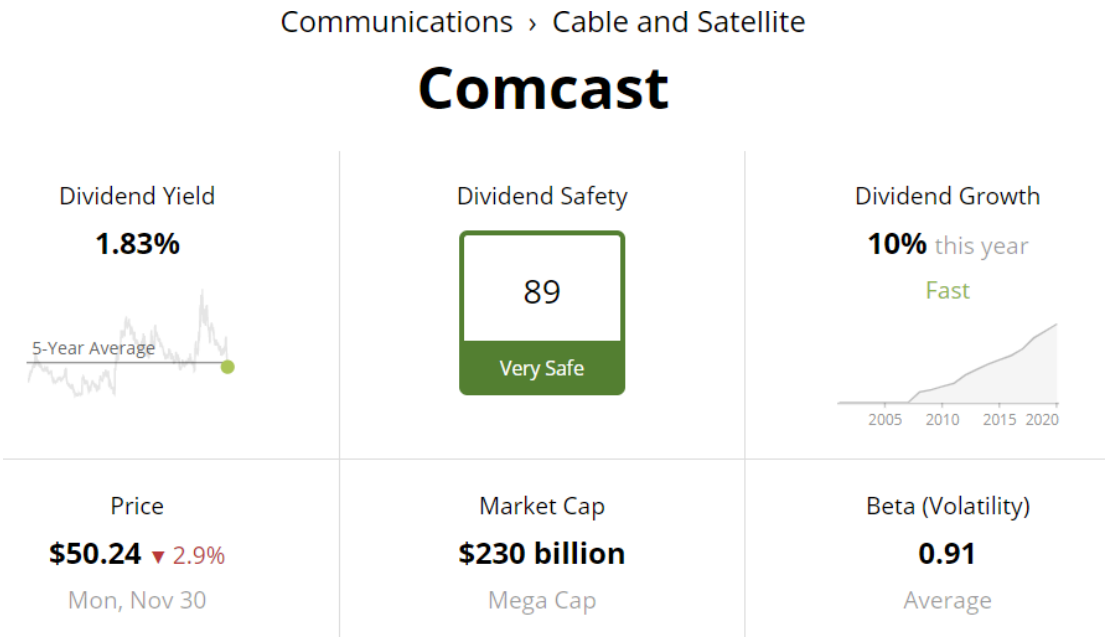
Maximum buy price = $51

COMCAST (CMCSA)

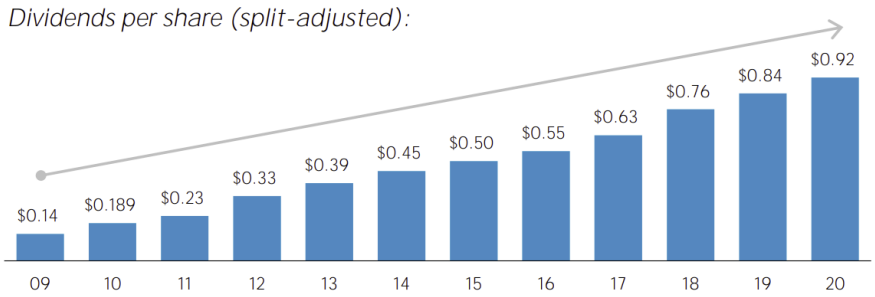
COMCAST (CMCSA)			
SECTOR: Communication Services			
INDUSTRY: Media & Entertainment			
Link to CMCSA Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
C	**B+**	**B**	**Overvalued**

Comcast is a good mid-yield, fast-growth DG choice for many investors. It generates cash prolifically, feeding both fast dividend growth and share reductions steadily over the past decade.

Dividend Record (Grade = C)

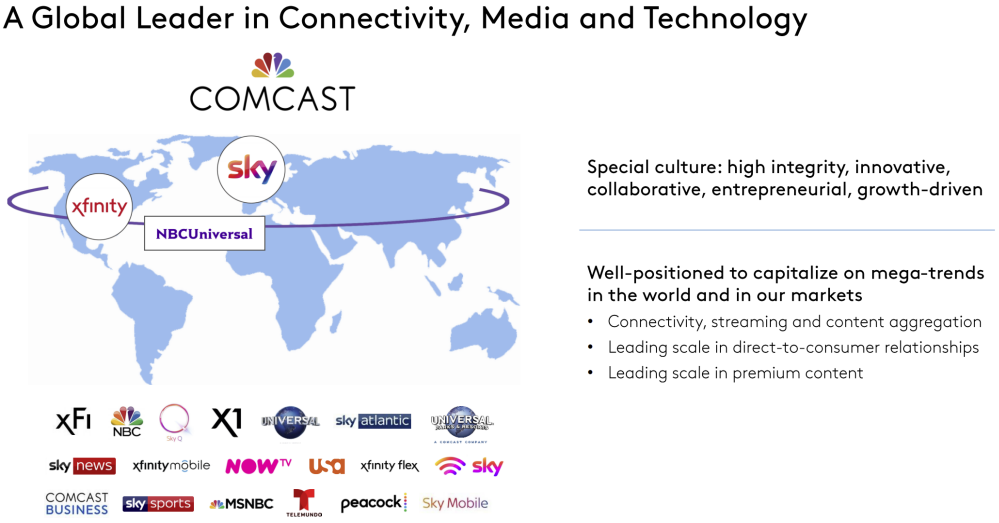


Comcast began its dividend during the Great Recession. It has been raising its dividend by double-digits annually ever since, although 2020's increase dipped to 9.5%.



CMCSA Dividend Summary		
Factor	**Data**	**Rating**
Yield	1.8%	Low
Years of Increases	12 (Dividend Contender <14 years)	Short
5-year DGR	13% per year (Fast)	B
DGR Trend	Consistent double-digit increases	B
SSD Safety Rating	89 / 100 = Very safe	A
Total Dividend Grade = C		

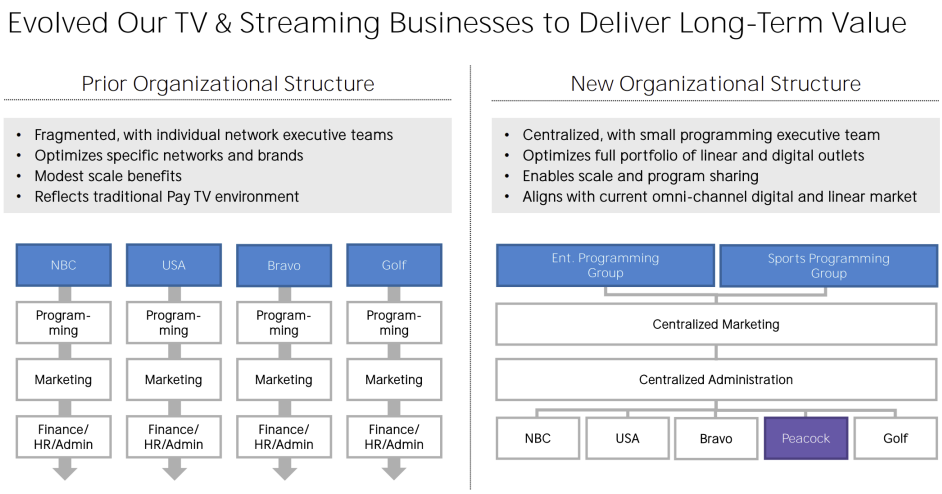
Business Model and Company Quality (Grade = B+)



The slide above gives a bird's-eye view of Comcast's vast worldwide media and technology operations.

Comcast's service offerings are vast, including cable, high-speed Internet, video, voice, wireless, security and automation, and advertising services. Programming and content include various entertainment, news, information, and sports content; regional sports and news networks; international cable networks; and various digital properties. The company operates broadcast television studio production operations.

Comcast streamlined its TV and streaming businesses this year into two major groups, Entertainment Programming and Sports Programming.



Comcast's most famous brands include the NBC and Telemundo broadcast networks (and local stations); Universal Pictures; DreamWorks Animation; Universal theme parks in USA and Japan; and Sky. Comcast also owns the Philadelphia Flyers, as well as the Wells Fargo Center in Philadelphia, PA where Comcast is headquartered.

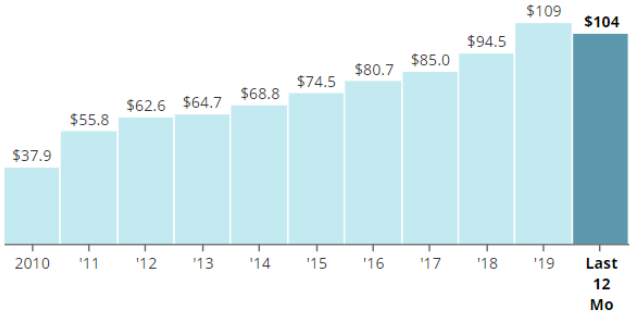
Morningstar considers Comcast to be a wide-moat business, mostly because of the strength of its cable operations across nearly half of the U.S. Besides delivering TV, the cable is the source of Internet access for most of its customers.

Financials (Grade = B)

Until this year, CMCSA's revenue has grown steadily. This year's drop is probably a reflection of Covid-19, as it is with so many companies.

Total Sales (Billions)

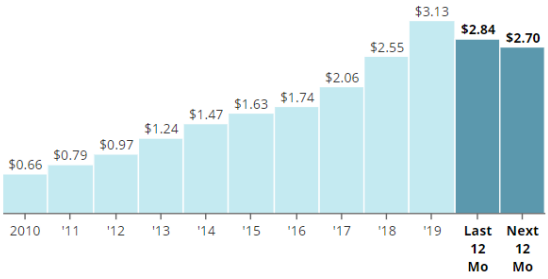
A healthy business grows its total sales over the long term. After all, a larger revenue base is often key to driving sustainable long-term earnings growth. We prefer companies with fairly steady and moderately rising sales.



Comcast has had solid earnings and cashflow returns and near-constant growth in both over the past decade, with a Covid-19 impact on earnings in 2020. Comcast generates healthy cash flows.

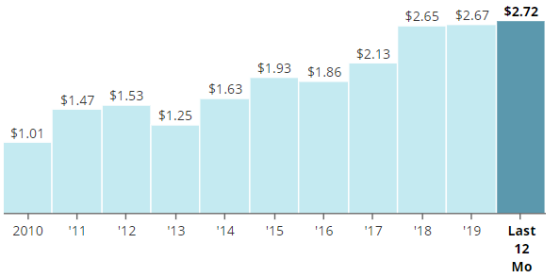
Earnings Per Share

Adjusted earnings are used to exclude noisy "one-time" events such as non-cash impairment charges. The best businesses will steadily increase their earning power over time to help fuel dividend growth and appreciation in their stock price.



Free Cash Flow Per Share

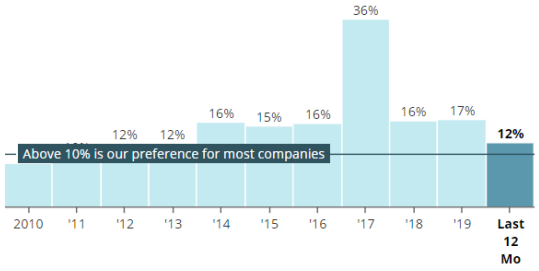
Free cash flow is what's left after a company has paid all of its bills and reinvested to maintain and grow its business. Advantaged businesses tend to generate stable, growing free cash flow over time, fueling sustainable and rising dividends.



Comcast's efficiency metrics (shown in the first pair of graphs below) and profitability metrics (shown in the second pair) have been above the benchmarks for almost all of the past 10 years.

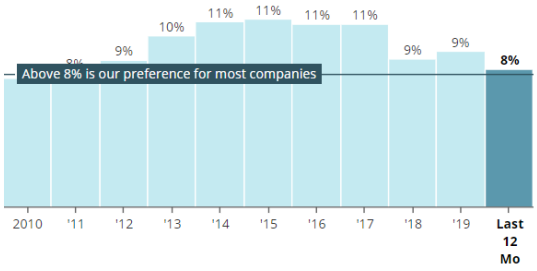
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



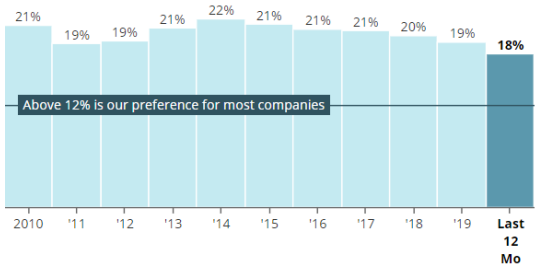
Return on Invested Capital

Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



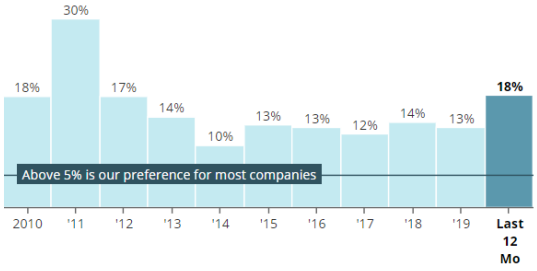
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

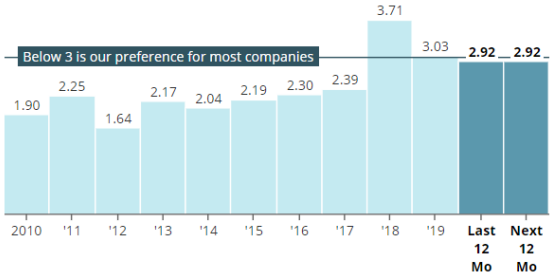
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



The only blemish on CMCSA's financials is its somewhat large debt load. Its net debt to EBITDA ratio runs generally higher than the benchmark, although not by a large magnitude. S&P's credit rating is A-, which is mid-investment-grade.

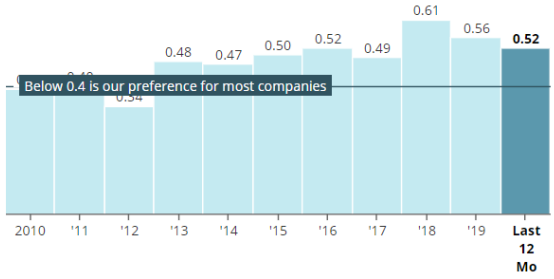
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.

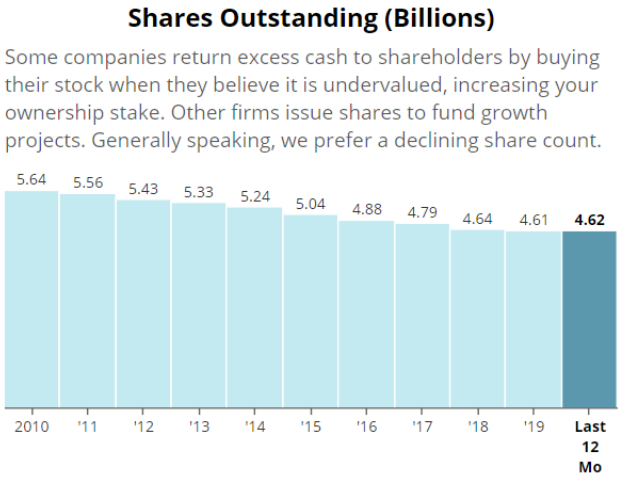


Net Debt to Capital

The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



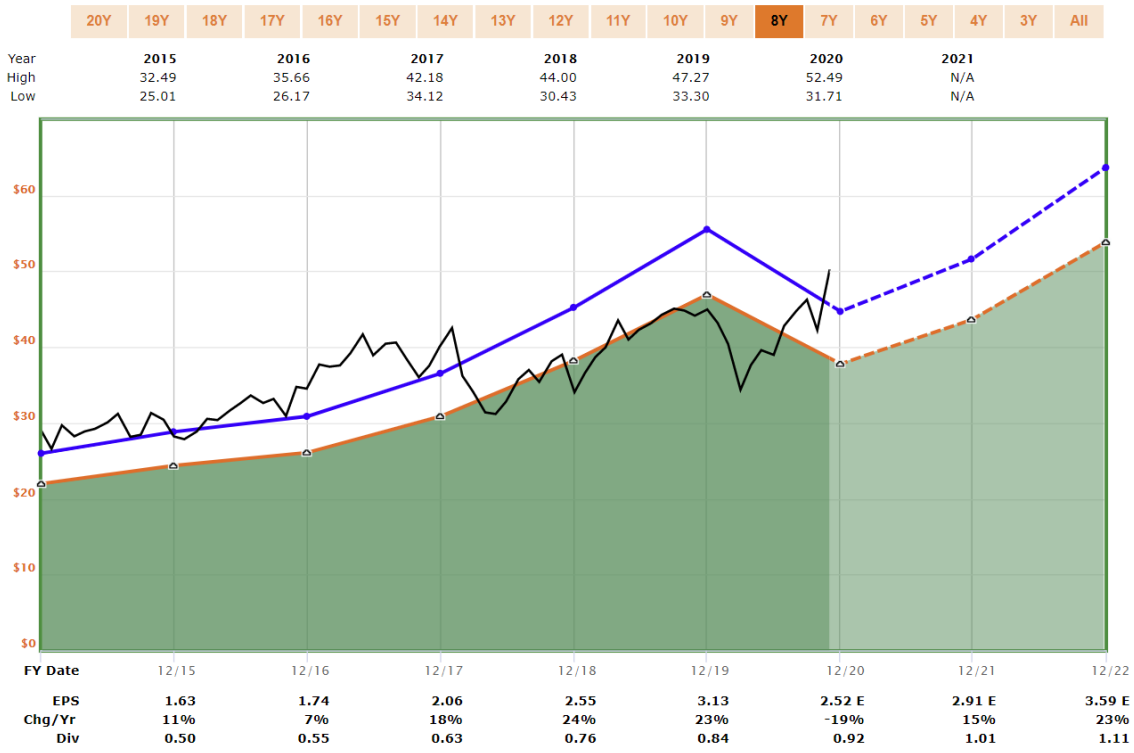
Comcast has been reducing its share count steadily. It has 18% fewer shares outstanding than it did 10 years ago. Both its share-reduction and dividend-growth records reflect its healthy generation of cash and use of it to benefit shareholders.



Overall, I would grade Comcast as an A for its financials but for the debt. That drops it to B, which is still very good.

Valuation (Overvalued)

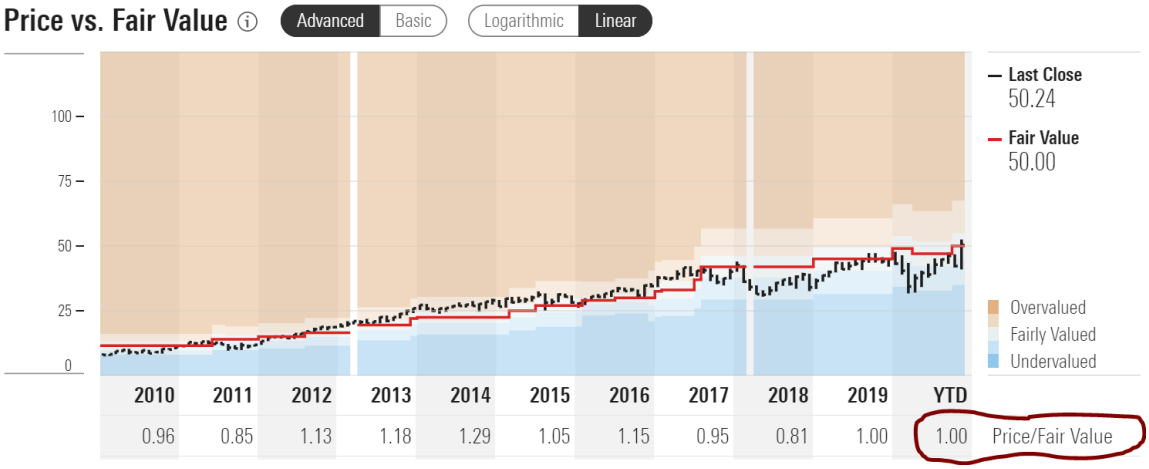
Models #1 & #2: P/E ratios (FASTGraphs)



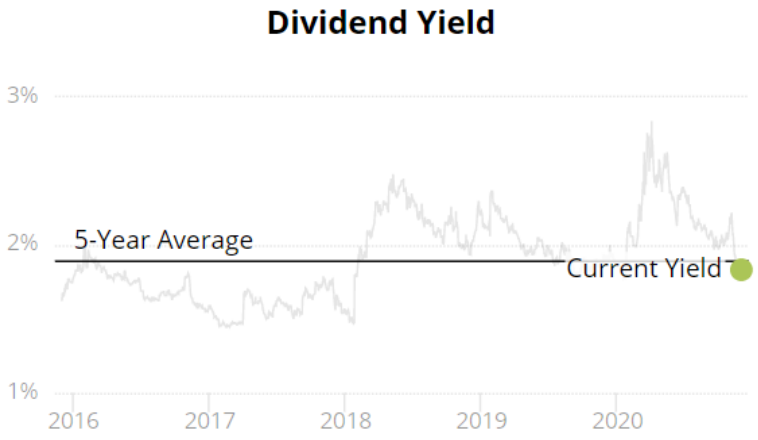
Comcast is overvalued under Model 1 (valuation ratio = 1.30) and fairly valued under Model 2 (valuation ratio = 1.10). Its current P/E ratio is 19.5 compared to its 5-year average of 17.7.

Model #3: DCF

Using its discounted cash flow (DCF) techniques, Morningstar calculates a valuation ratio of 1.00, which is squarely on fair valuation.



Model #4: Relative yields (Simply Safe Dividends)



Comcast's current yield of 1.8% is just below its 5-year average of 1.9%. The yield comparison suggests a valuation ratio of 1.06, which is fair value.

CMCSA Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	1.30	Very overvalued
#2: P/E to Stock's 5-year average	1.10	Fairly valued
#3: DCF (from Morningstar)	1.00	Fairly valued
#4. Relative Yield 5-year comparison	1.06	Fairly valued
Average of Models: Valuation ratio = 1.12 = Overvalued		

Comcast checks out as slightly overvalued.

Fair price = $45

Given Comcast's high quality and good financials, I would pay to the top of its fair-value range, which is 10% over the calculated fair-value price, which is right about where it is selling now.

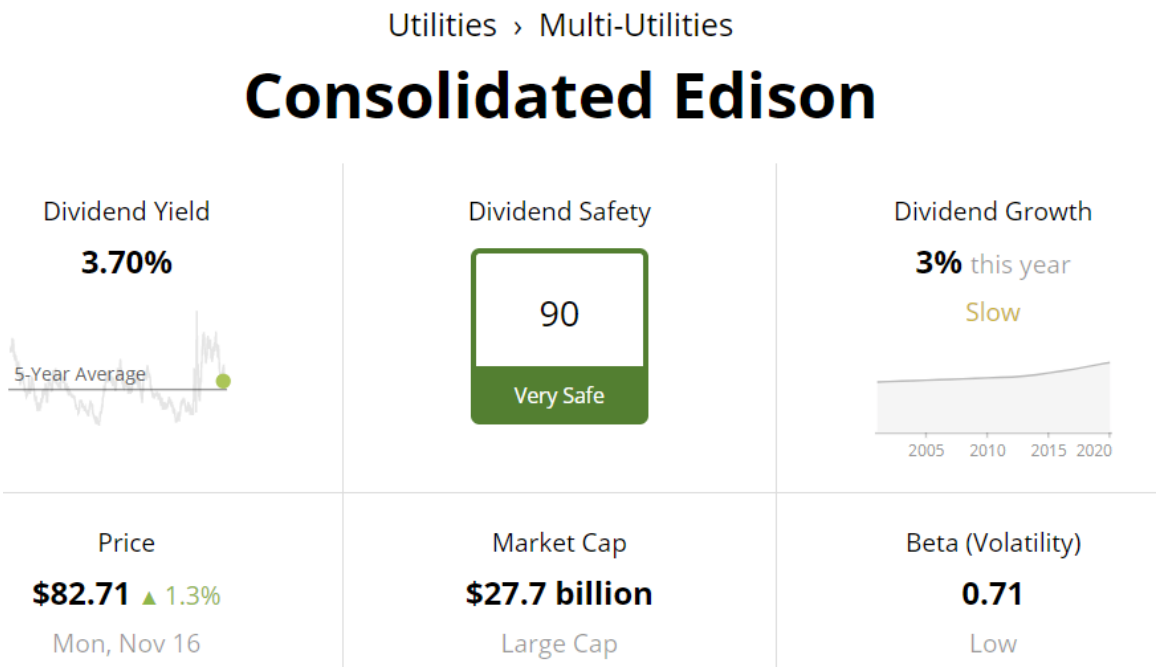
Maximum buy price = $49

CONSOLIDATED EDISON (ED)

CONSOLIDATED EDISON (ED)			
SECTOR: Utilities			
INDUSTRY: Multi-Utilities			
Link to ED Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
C	**C**	**C**	**Fairly valued**

Con Ed is a major utility in the NYC area. Its grades are average across the board. Given its decent yield, dividend safety, and long record of increases, it is a staple in many DG portfolios.

Dividend Record (Grade = C)



ED is a reliable, mid-yield, slow-growth DG stock. It has a long streak of increases (46 years) and a very safe dividend.

ED Dividend Summary		
Factor	**Data**	**Rating**
Yield	3.7%	Mid
Years of Increases	46 (Dividend Champion, Aristocrat)	B
5-year DGR	3% per year (Slow)	D
DGR Trend	Slow but steady	B
SSD Safety Rating	90 / 100 = Very safe	A
Total Dividend Grade = C		

Business Model and Company Quality (Grade = C)

Con Ed has been in business for nearly 200 years and delivers more than 40% of the electricity consumed within NY state. It is a holding company that owns:

- Consolidated Edison Company of New York, which provides electric service to ~3.3 million customers in NYC, gas service to ~1.1 million customers, and steam service in parts of Manhattan;
- Orange & Rockland Utilities, which provides electric service to >300,000 customers in southeastern NY and NJ and gas service to 130,000 customers in southeastern NY;
- Con Edison Clean Energy Businesses, which develops, owns and operates renewable and energy infrastructure projects and provides energy-related products and services to wholesale and retail customers;
- Con Edison Transmission, Inc., which invests in electric and gas transmission projects

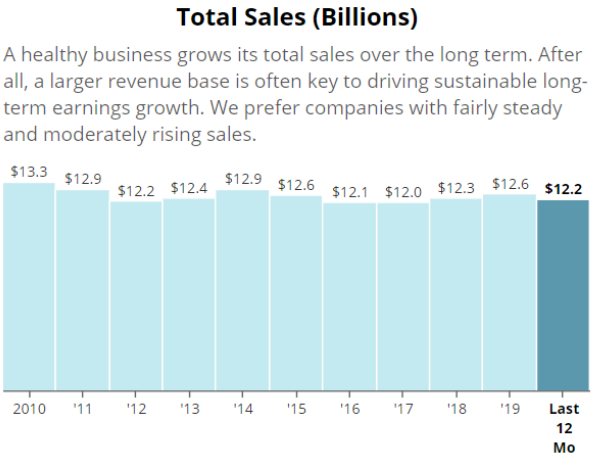
Con Ed's two utilities are regulated and provide substantially all of its earnings.

Con Ed faces a number of challenges from the pandemic including reduced power demand, higher bad debt expenses, and rockier credit markets. Con Ed's commercial electric delivery volumes fell nearly 20% early in the pandemic, somewhat offset by a 10% increase in residential demand. The company's earnings are somewhat protected by regulatory safeguards that allow rates to change with consumption to meet predetermined revenue targets.

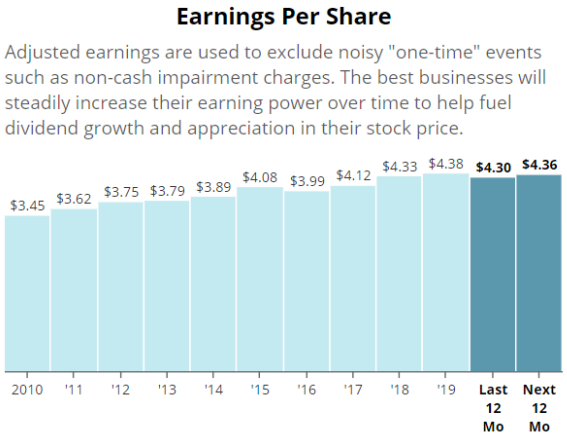
Morningstar awards no moat to Con Ed based on less-than-optimum regulation, political pressures, and the territory's very old infrastructure that is repeatedly at risk from storms and breakdowns.

Financials (Grade = C)

ED's revenues have been flat-to-declining for the past decade.



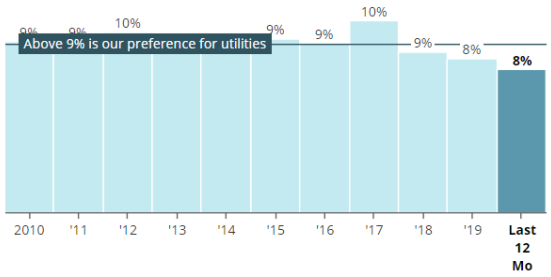
Its earnings, on the other hand, have been slowly but steadily rising. (Cash flow is not displayed, because it is not an insightful metric for utilities.)



ED's efficiency metrics are mediocre.

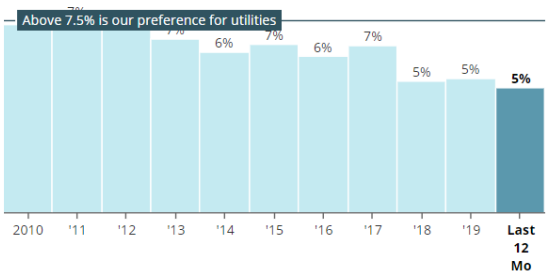
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



Return on Invested Capital

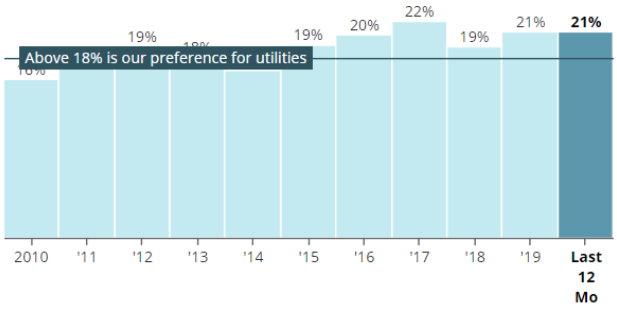
Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



ED's profitability has been good.

Operating Margin

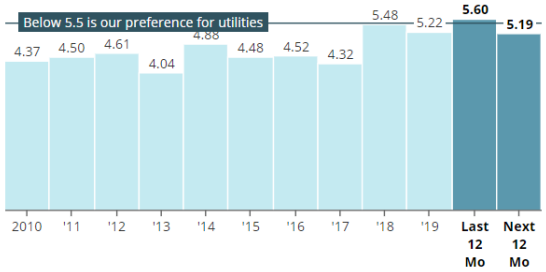
A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



ED's reliance on debt just about matches up with the benchmarks for utilities. The company has an A- mid-investment-grade credit rating.

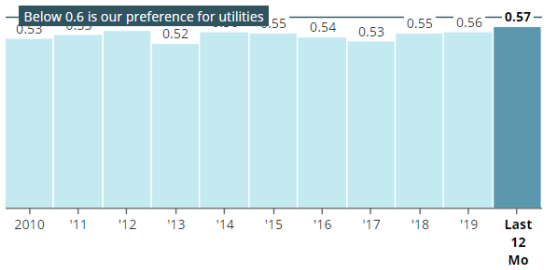
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.

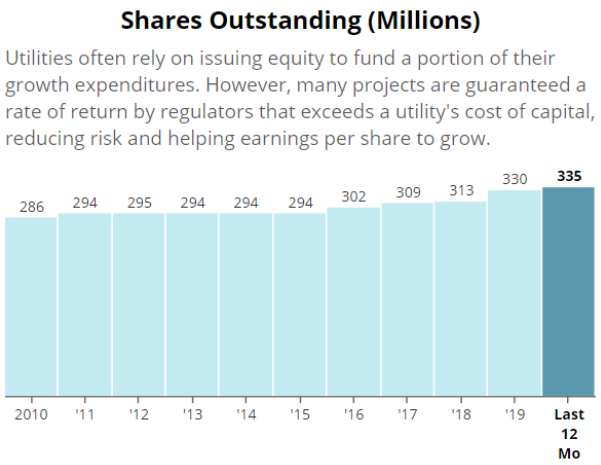


Net Debt to Capital

The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



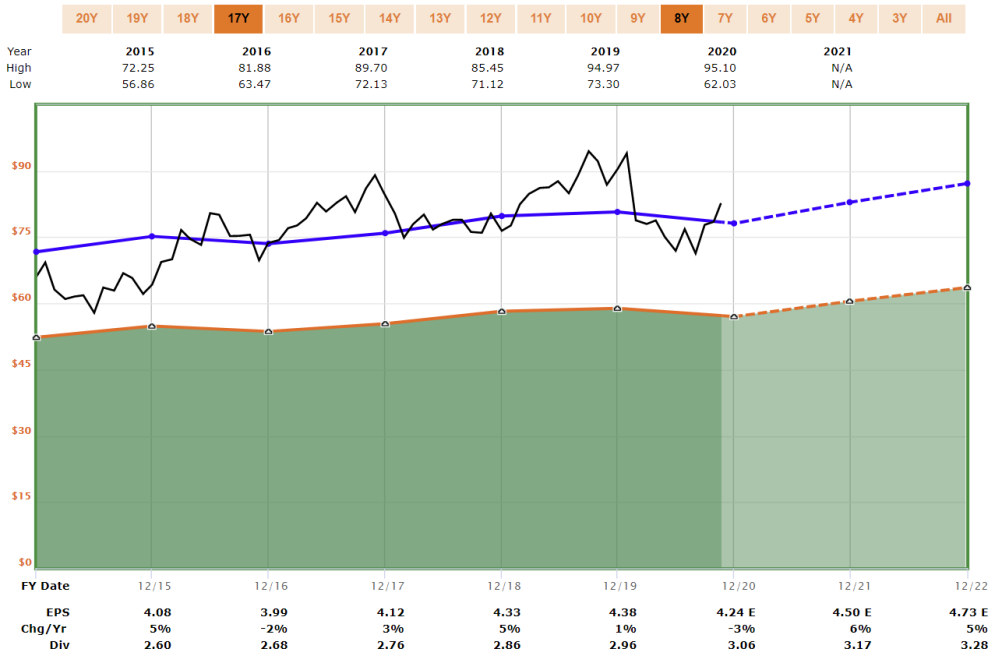
It is typical for utilities to have expanding share counts, as their capital-expenditure needs require large inflows of financing.



Overall, Con Ed's financials present an average record for a utility.

Valuation (Fairly valued)

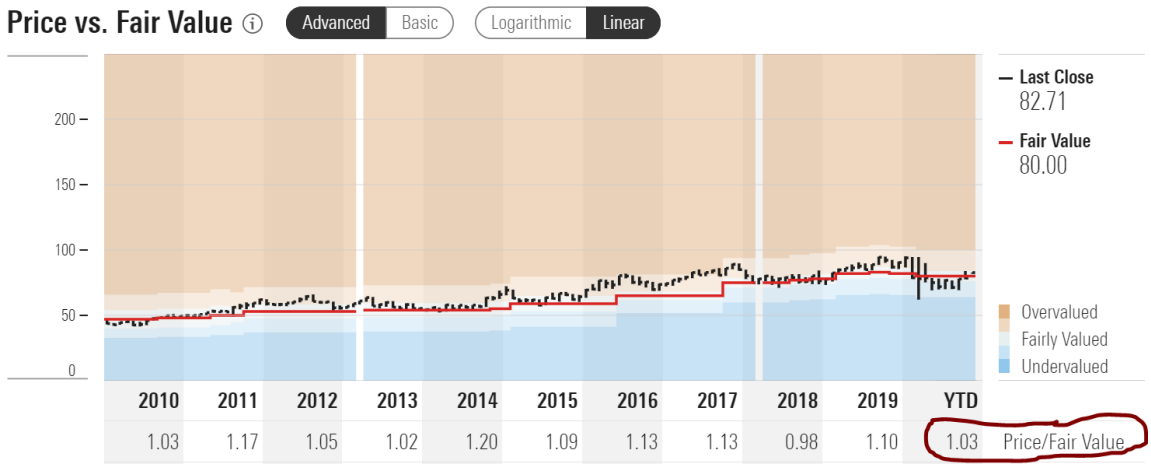
Models #1 & #2: P/E ratios (FASTGraphs)



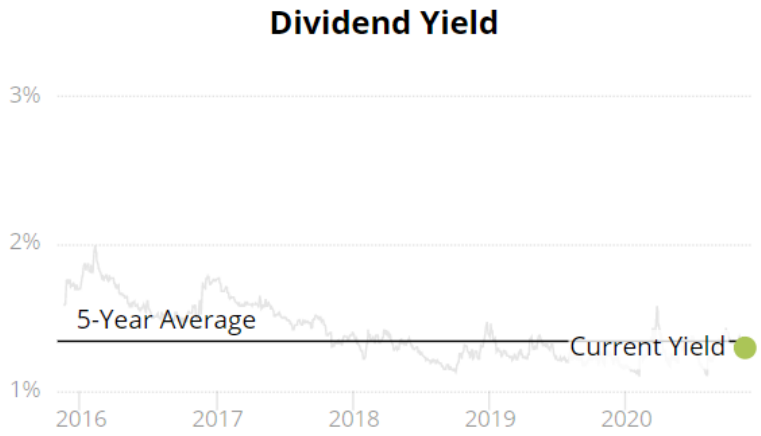
ED is overvalued using Model 1 and fairly valued using Model 2. ED's current P/E ratio is 19.4 and its 5-year average is 18.4. The orange line is drawn at a P/E of 13.5, reflecting ED's slow growth. The valuation ratio for Model 1 = 1.44 and Model 2 = 1.05

Model #3: DCF

Using its discounted cash flow (DCF) model, Morningstar calculates a valuation ratio of 1.03, which suggests that ED is fairly valued.



Model #4: Relative yields (Simply Safe Dividends)



ED's current yield of 3.7% is slightly above its 5-year average of 3.6%. That suggests fair valuation, with a valuation ratio of 0.97.

ED Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's adjusted historical average	1.44	Significantly overvalued
#2: P/E to Stock's 5-year average	1.05	Fairly valued
#3: DCF (from Morningstar)	1.03	Fairly valued
#4. Relative Yield 5-year comparison	0.97	Fairly valued
Average of Models: Valuation ratio = 1.12 = Overvalued		

Model #1 is way out of step with the others, so I toss it out.

ED Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#2: P/E to Stock's 5-year average	1.05	Fairly valued
#3: DCF (from Morningstar)	1.03	Fairly valued
#4. Relative Yield 5-year comparison	0.97	Fairly valued
Average of Models: Valuation ratio = 1.02 = Fairly valued		

That leads to this fair price:

Fair price = $81

ED's long record and dividend reliability justify paying up to the top of the fair-value range for its shares.

Maximum buy price = $89

That said, ED's price is pretty steady (beta = 0.7), so you should be able to obtain it at its calculated fair price or below.

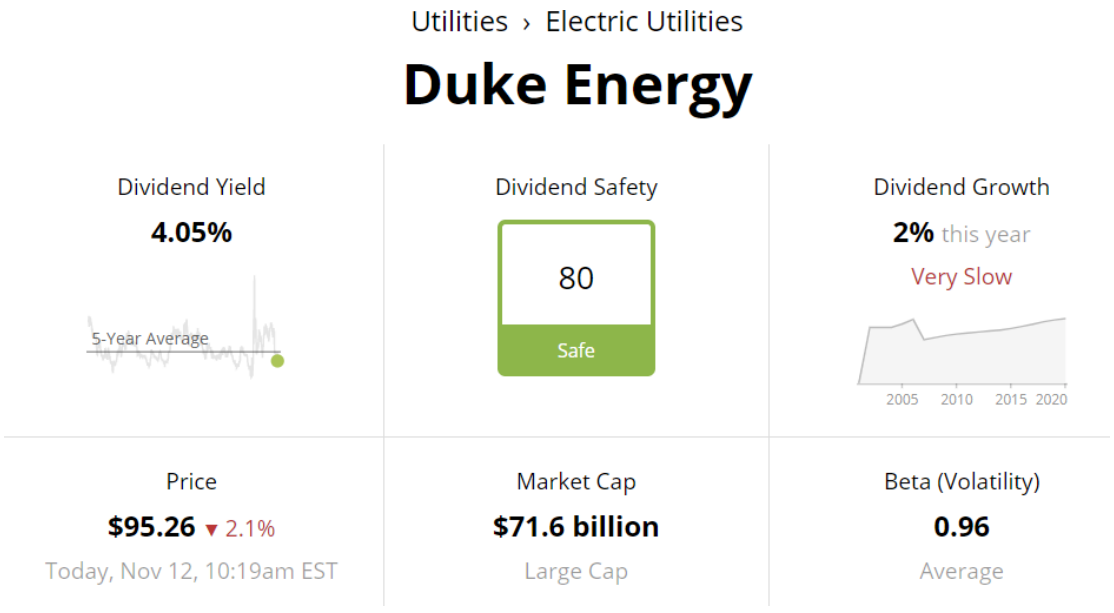
DUKE ENERGY (DUK)



DUKE ENERGY (DUK)			
SECTOR: Utilities			
INDUSTRY: Electric Utilities			
Link to DUK Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
B	**B**	**C+**	**Fairly valued**

Duke is the largest electric utility in the country. It is a high-yield, slow-growth DG stock with a safe dividend. It is a staple in many DG portfolios.

Dividend Record (Grade = B)



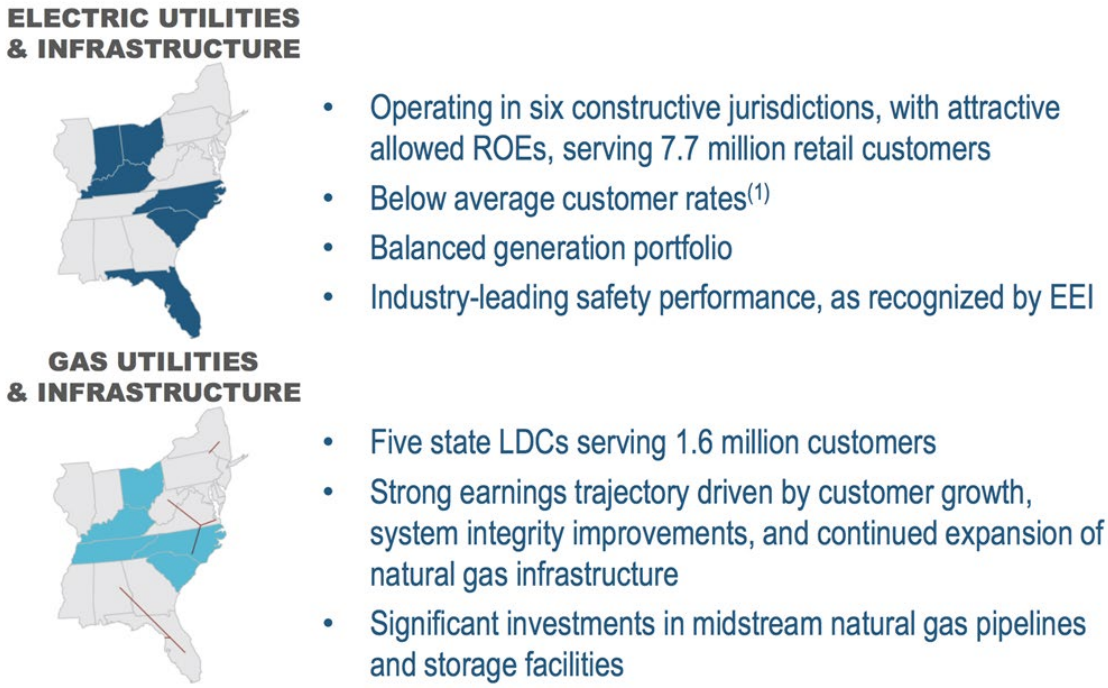
CCC and SSD show different lengths for Duke's dividend-increase streak, probably because of the way its dividend was apportioned in 2007 when it spun off Spectra Energy. The difference is not worth investigating. I went with the CCC designation in placing the badge above and in the number of years shown below. Duke has paid

dividends without interruption for 94 years. Simply Safe Dividends re-affirmed its "Safe" rating in July, 2020.

DUK Dividend Summary		
Factor	**Data**	**Rating**
Yield	4.1%	High
Years of Increases	16 (Dividend Contender 14+)	C
5-year DGR	3% per year (OK for high yield stock)	C
DGR Trend	Steadily in low single-digit range	B
SSD Safety Rating	80 / 100 = Safe	B
Total Dividend Grade = B		

Business Model and Company Quality (Grade = B)

Duke Energy is the USA's largest electric utility, serving about 7.7 million electric customers and 1.6 million gas customers across the Southeast and Midwest.



(Source: Duke Energy Investor Presentation)

Regulated electric utilities and infrastructure account for 85% of Duke's earnings. The company also has a fast-growing gas infrastructure and utilities business (9%) and a commercial portfolio of renewables (6%).

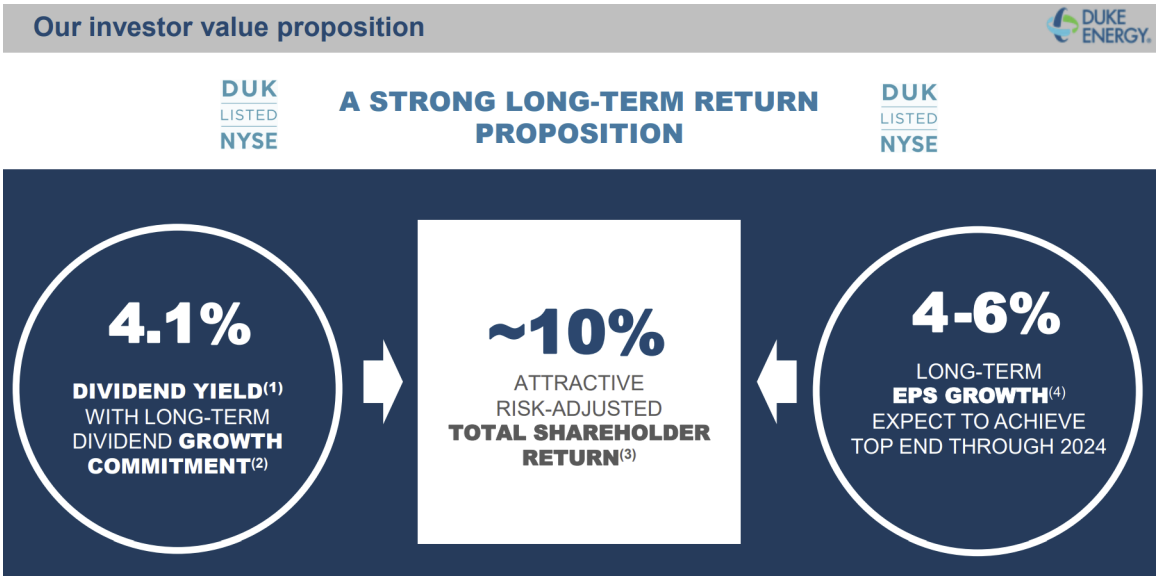
The company's customer mix is a blend of residential (32%), commercial (30%), industrial (21%), and wholesale (17%) customers.

Duke has been investing in cleaner power generation, which has helped reduce its fuel mix of coal and oil from 61% in 2005 to about 30% today. Management targets a 50% reduction in CO2 emissions by 2030 from 2005 levels.

Duke operates in generally "constructive" regions. Its efficient operations are supportive of its constructive relationship with regulators.

Utilities are capital-intensive businesses, as power plants, transmission lines, and distribution networks cost billions of dollars to build and maintain.

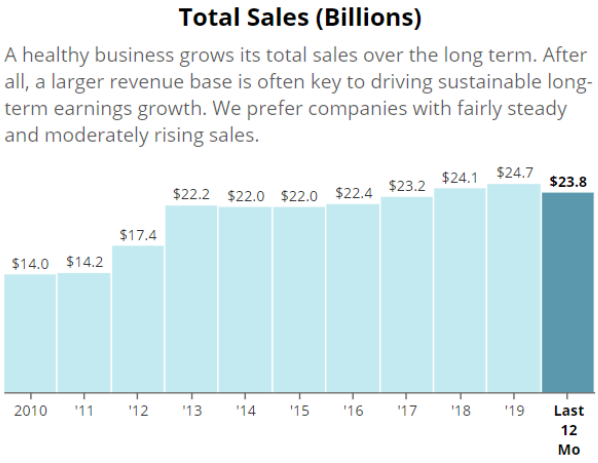
Going forward, Duke has $37 billion of growth projects planned through 2023 which are expected to drive 4% to 6% annual earnings growth (and a similar rate of dividend growth). Earlier in 2020, Duke and its building partner Dominion Energy announced plans to scrap construction of the Atlantic Coast Pipeline following years of delays, cost overruns, and regulatory headaches. Duke owned 47% of this $8 billion natural gas pipeline project.



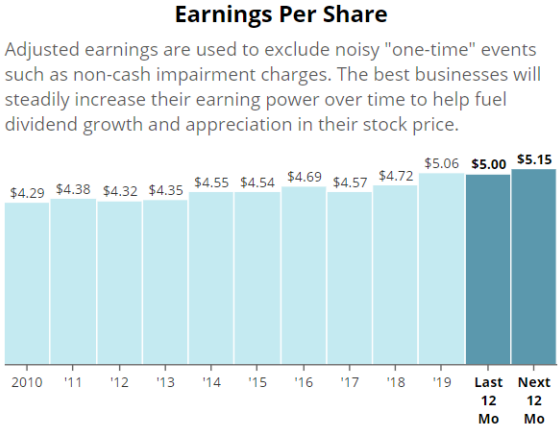
Morningstar awards Duke a Narrow moat rating, which is the best they will give to utilities in light of the ever-present possibility of adverse regulatory decisions. I give the business a B rating.

Financials (Grade = C+)

Like many regulated utilities, Duke is slow-growing on the top line. The reduced revenue for the last 12months shows the impact of Covid-19 on power demand in its service areas.



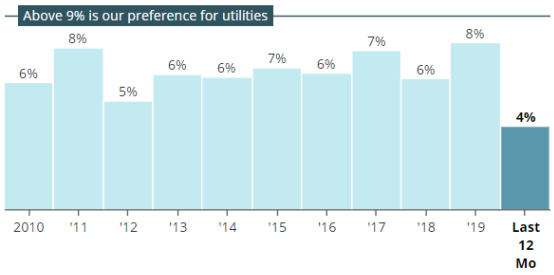
Duke's earnings reflect the same reliable but slow-growth characteristic. I don't display cashflow, because utilities' constant need to make capital investments paints a distorted picture.



Duke's efficiency metrics are both weak., but its operating margin is strong.

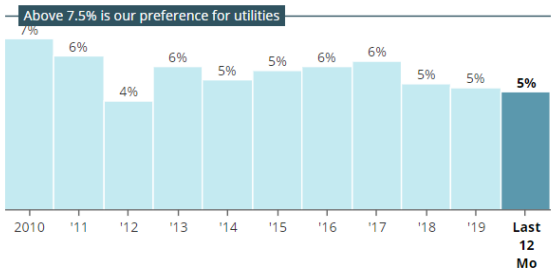
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



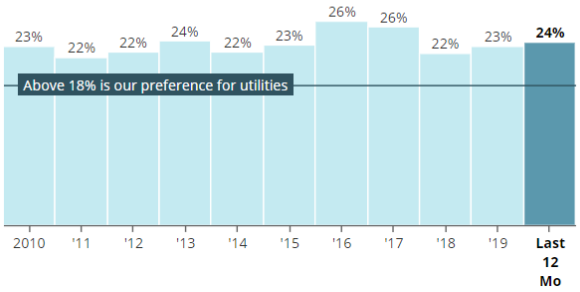
Return on Invested Capital

Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



Operating Margin

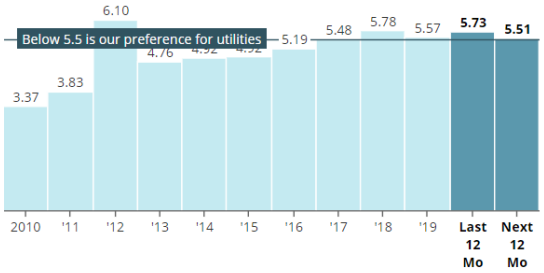
A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Like many utilities, Duke employs a lot of debt to meet its capital needs. Duke is right at the benchmarks.

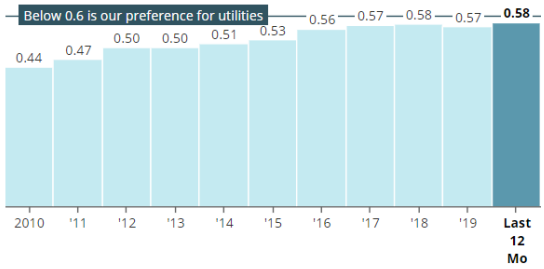
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.

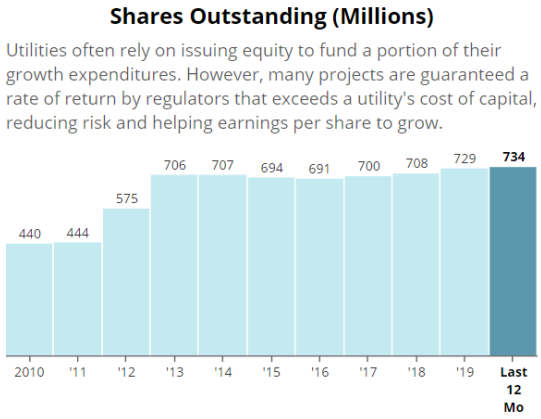


Net Debt to Capital

The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



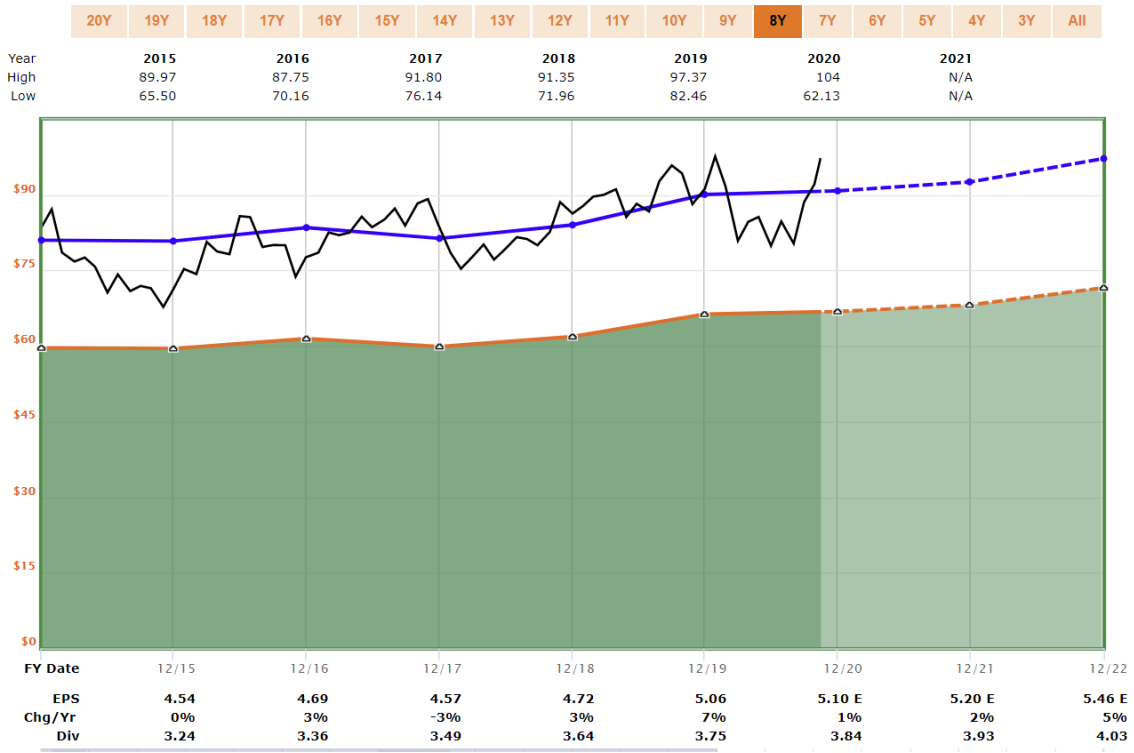
Share count is another area that is difficult for a utility to shine in. Utilities need to keep issuing shares to raise capital for their expensive projects.



Overall, I consider Duke's financials to be solid for a utility. I like the fact that most of its money comes from regulated (rather than competitive) businesses, and the constructive relationships with its regulators make it easier to give the company the benefit of the doubt when interpreting financial metrics. Grade = C+.

Valuation (Fairly valued)

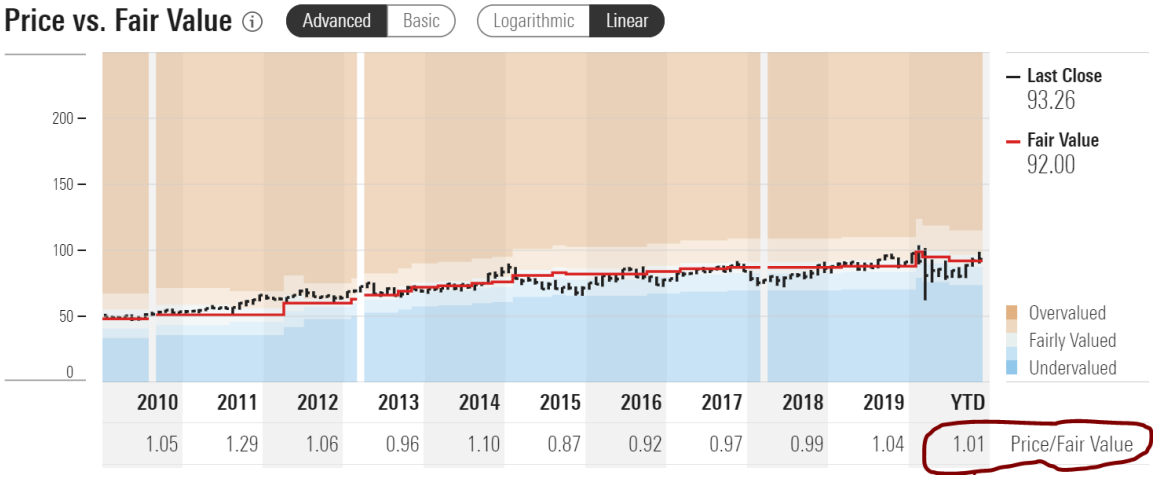
Models #1 & #2: P/E ratios (FASTGraphs)



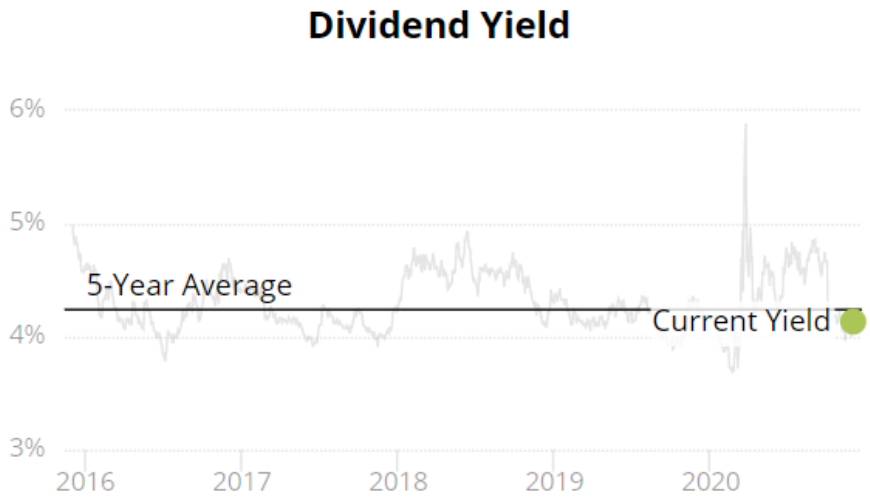
Duke is overvalued on Model 1 and fairly valued on Model 2. Duke's current P/E ratio is 18.3 and its 5-year average is 17.8. FASTGraphs' orange line, used in Model 1, is drawn at 13.2, rather than the usual 15, because Duke is a slow-growth company. Model 1's valuation ratio = 1.39. Model 2's valuation ratio = 1.03.

Model #3: DCF

Using its discounted cash flow (DCF) approach, Morningstar calculates a valuation ratio of 1.01, which suggests fair valuation.



Model #4: Relative yields (Simply Safe Dividends)



Duke's current yield of 4.1% is a little under its 5-year average of 4.3%. That makes this valuation ratio = 1.05.

DUK Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	1.39	Significantly overvalued
#2: P/E to Stock's 5-year average	1.01	Fairly valued
#3: DCF (from Morningstar)	1.06	Fairly valued
#4. Relative Yield 5-year comparison	1.05	Fairly valued
Average of Models: Valuation ratio = 1.13 = Overvalued		

Three of the four valuation models are so tightly bunched that the fourth (Model 1) stands out as an outlier. I am not going to toss out that model, because it reflects the plain fact that Duke is a slow-growth company. However, I am going to cap it at 1.20 rather than the calculated 1.39.

DUK Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	1.20 (capped)	Overvalued
#2: P/E to Stock's 5-year average	1.01	Fairly valued
#3: DCF (from Morningstar)	1.06	Fairly valued
#4. Relative Yield 5-year comparison	1.05	Fairly valued
Average of Models: Valuation ratio = 1.08 = Fairly valued		

That reduces the overall valuation ratio to 1.08, which is in fair-value territory.

Fair price = $86

Adding 10% to that defines the top of the fair-price range.

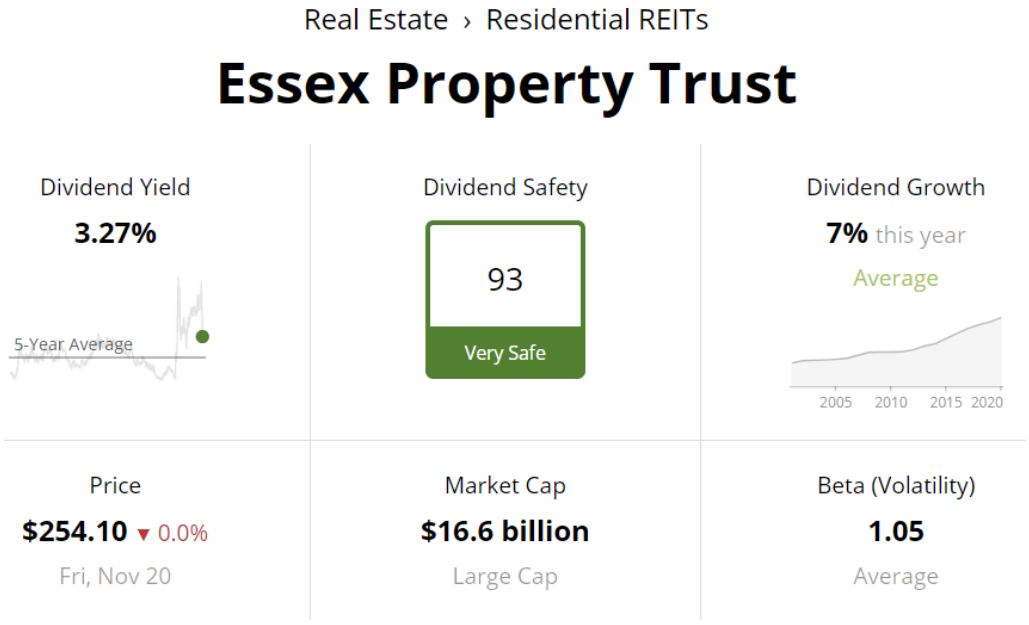
Maximum buy price = $95

ESSEX PROPERTY TRUST (ESS)

ESSEX PROPERTY TRUST (ESS)			
SECTOR: Real Estate			
INDUSTRY: Equity Real Estate			
Link to ESS Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
B	**B**	**B+**	**Fairly valued**

Essex is an equity REIT (multi-family dwellings) located in markets on the West Coast. The Covid-19 pandemic has brought some pressure on its tenants and ability to collect rents, and the company has made rent concessions to keep tenancy rates high. It is a Dividend Aristocrat with a safe dividend.

Dividend Record (Grade = B)

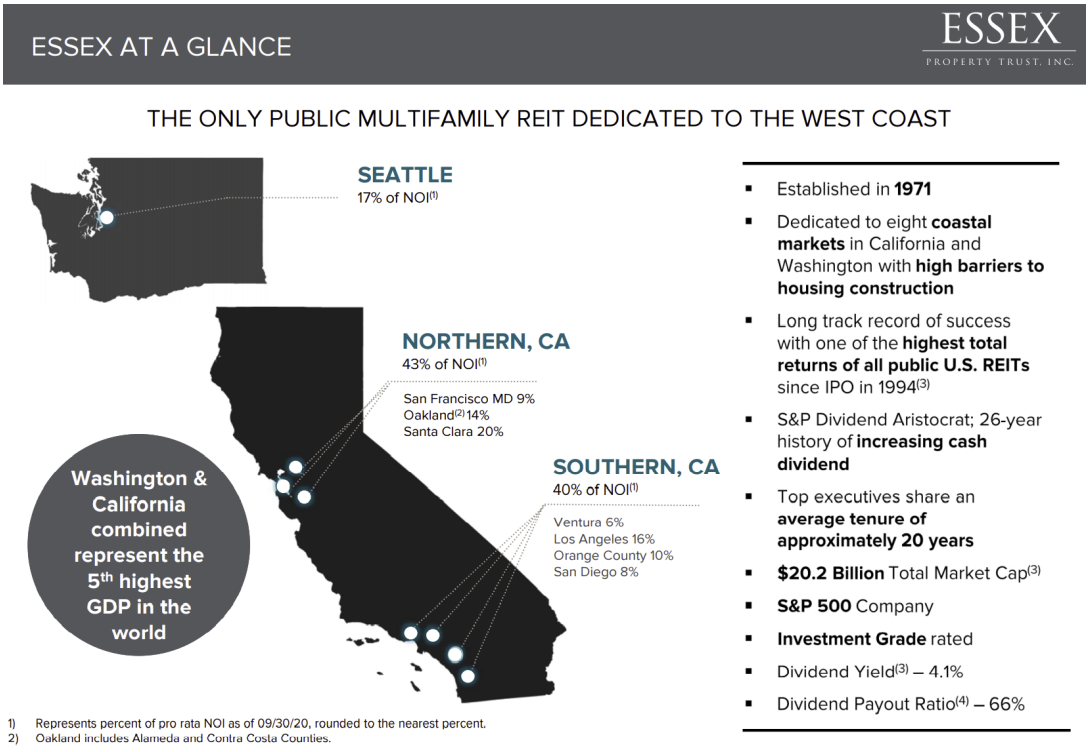


Essex is a rare REIT Dividend Aristocrat, with a mid-level yield, 26 straight years of dividend growth, and a very high dividend safety score. It is likely that its growth rate will go down for a year or two because of the pandemic.

ESS Dividend Summary		
Factor	**Data**	**Rating**
Yield	3.3%	Mid
Years of Increases	26 (Dividend Champion & Aristocrat)	B
5-year DGR	8% per year (Fast)	B
DGR Trend	Usually in mid-to-high single digits	B
SSD Safety Rating	93 / 100 = Very safe	A
Total Dividend Grade = B		

Business Model and Company Quality (Grade = B)

Essex Property Trust (ESS) is a geographically focused high-quality apartment REIT. Its portfolio of multifamily buildings is concentrated along the Pacific Coast, making it the only multifamily REIT focused on that area.



The strategy is that these markets have strong, long-term demographic characteristics such as job growth, high incomes, low home ownership, and attractive urban centers of

interest to younger populations. The high cost of home ownership creates a strong financial incentive to rent in Essex markets.

ESS acquires, develops, and redevelops properties to reposition its portfolio and improve its overall quality. It also devotes resources to make capital improvements and keep its units up-to-date and attractive.

Morningstar assigns a no-moat rating to ESS, primarily based on low profitability despite the high quality of its housing portfolio.

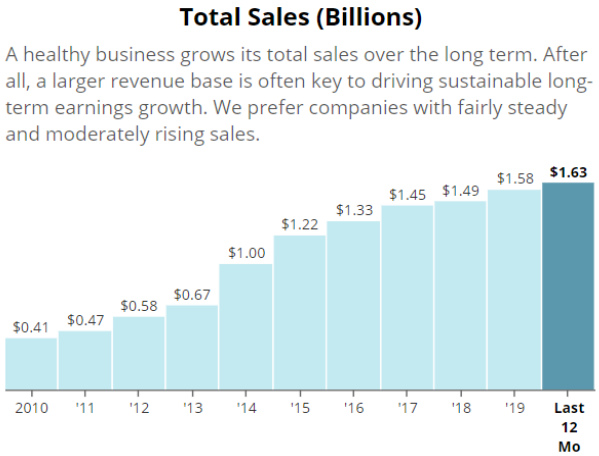
ESS' competition comes from options such as home ownership, rental homes, and condominiums. Such alternatives limit ESS' ability to command high initial rents or increase rents.

Covid-19 has impacted ESS. California imposed tight restrictions stemming from the pandemic. ESS' percentage of rents collected fell early in the year, and as it recently reported, it has made considerable rent concessions in order to keep its occupancy rate in the 90%+ range. It expects its markets to come back strong over the next few years as the pandemic recedes.

The pandemic's impact on ESS cannot be ignored, but on the expectation that its impact will recede, I give ESS' quality story a B.

Financials (Grade = B+)

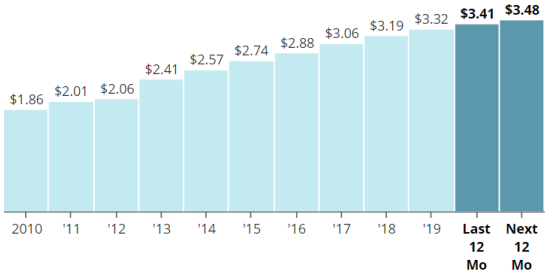
ESS' annual revenue shows steady growth, even in 2020. The doubling from 2013-2015 resulted from a major merger with a geographically similar REIT; the combination formed today's Essex.



With REITs, rather than looking at earnings, it is more instructive to look at a metric called FFO, which stands for funds from operations, because REITs have so many non-cash charges that GAAP earnings become misleading. ESS' FFO/share has shown steady growth over the past decade. Its free cash flow displays a similar pattern, with a dip in 2020 due to Covid-19.

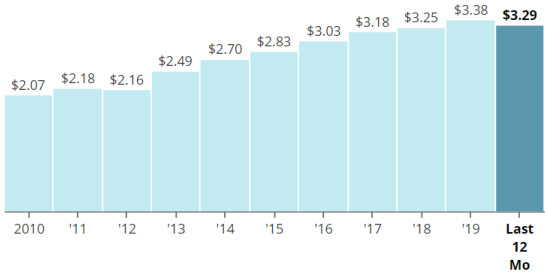
Adjusted FFO Per Share

AFFO adjusts net income for various non-cash charges, maintenance costs, and other items to approximate free cash flow for REITs. The best REITs increase their earning power over time to help fuel dividend growth and stock price appreciation.



Free Cash Flow Per Share

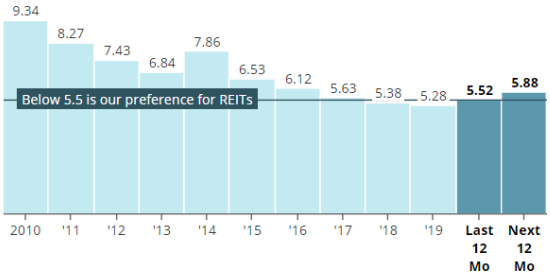
Adjusted funds from operations is a more meaningful metric for REITs than free cash flow. Free cash flow can be noisier and more volatile due to issues such as upfront rent payments, maintenance expenses, and deferred financing costs.



Most equity REITs carry high levels of debt, because the business is capital-intensive by nature. With that said, ESS' debt levels have stayed right around their benchmarks over the past few years.

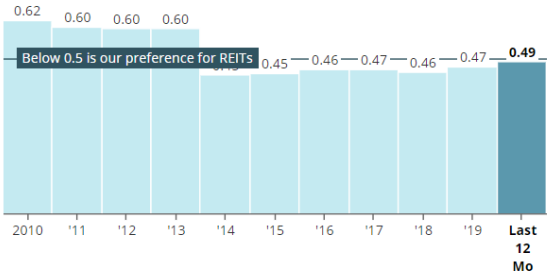
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.

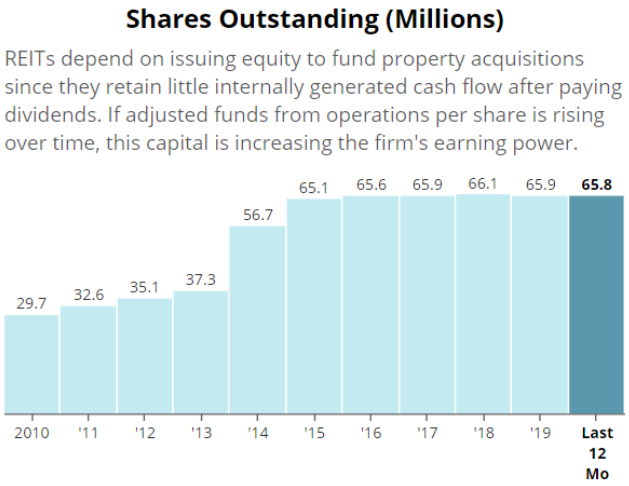


Net Debt to Capital

The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



Because of the inherent capital needs of their businesses, equity REITs tend to have increasing share counts. By law, they must distribute most of their profits to shareholders, so capital for expansion must come from new debt and equity. In light of that, ESS' shares outstanding have been surprisingly steady for the past 5 years.

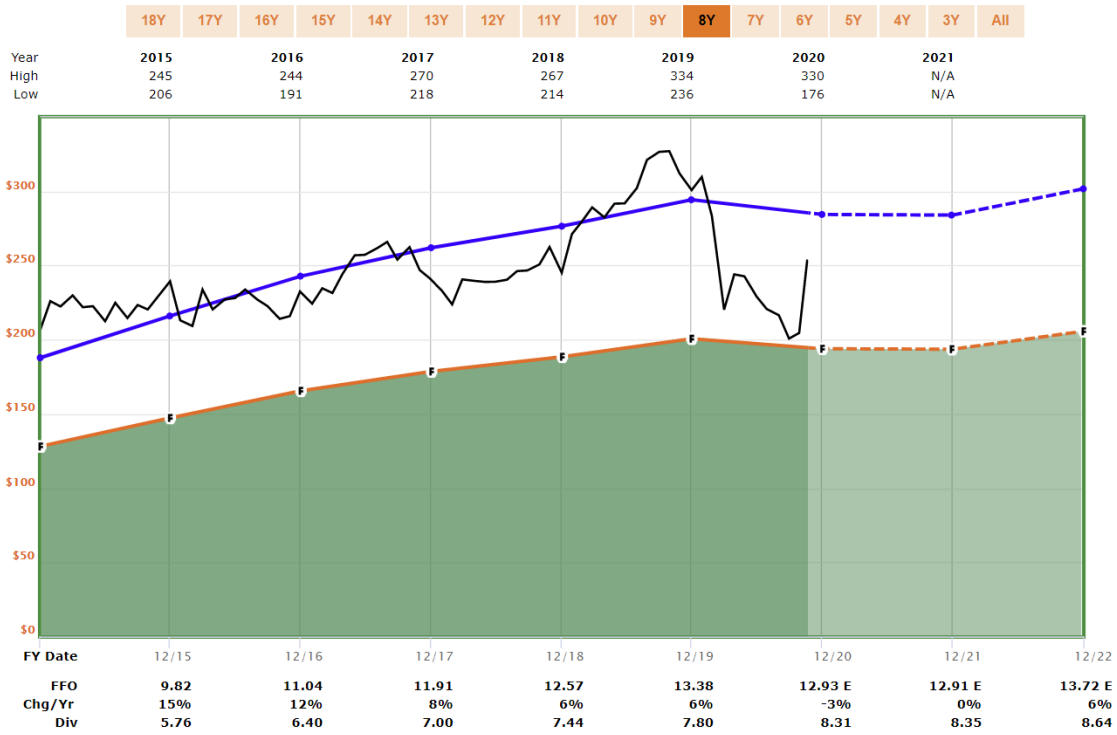


Overall, accounting for the vulnerability that Covid-19 has brought, I give Essex a B+ for its financials.

Valuation (Fairly valued)

Models #1 & #2: P/E ratios (FASTGraphs)

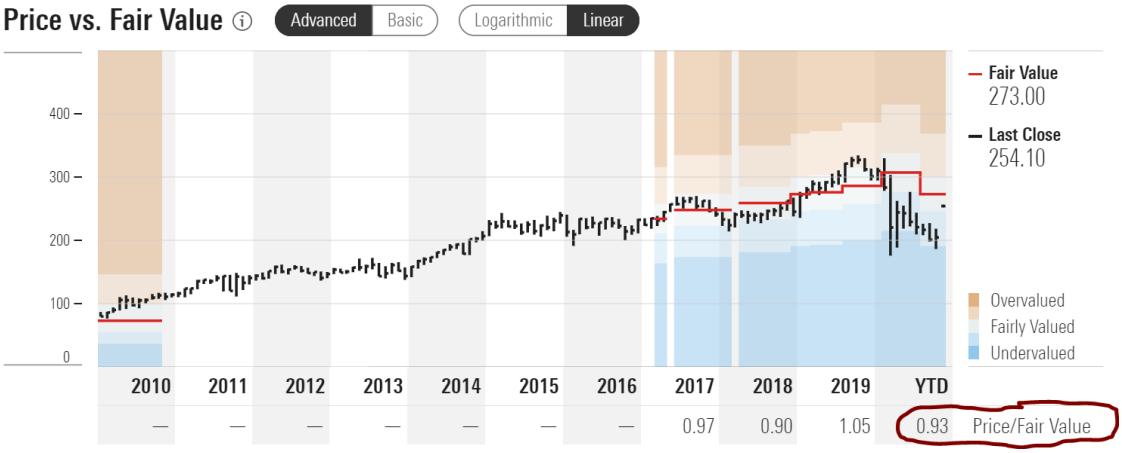
As mentioned in the previous section, FFO is a better measure of profitability for REITs than GAAP earnings, so I use FFO in valuation too. That's what the "F" stands for on the orange line in the following graph.



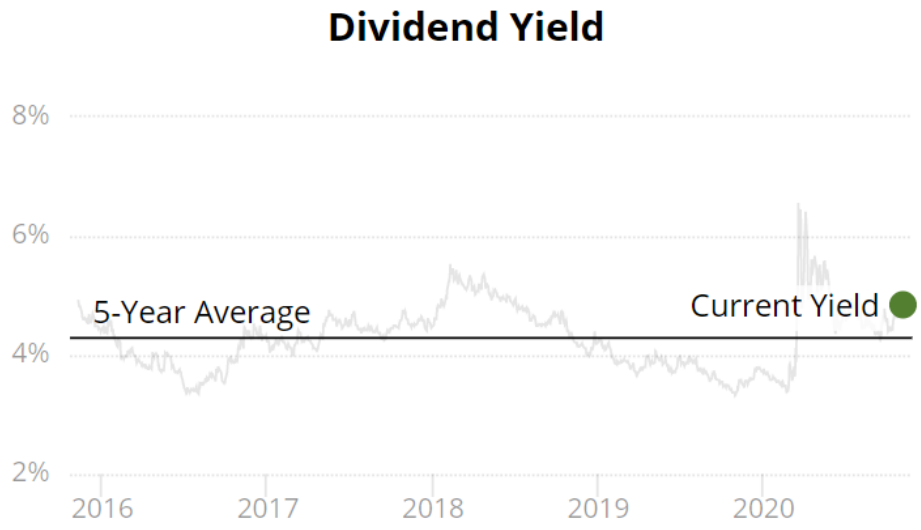
ESS' price recently shot up in response to positive Covid-19 vaccine reports, but it did not go into far-overvaluation territory. ESS is overvalued under Model 1 (orange line) and undervalued under Model 2 (blue line). Its current P/FFO ratio is 19.6 and its 5-year average is 22.0. That gives it these valuation ratios: Model 1 = 1.31 and Model 2 = 0.89.

Model #3: DCF

Using its discounted cash flow (DCF) methodology, Morningstar has ESS fairly valued with a valuation ratio of 0.93.



Model #4: Relative yields (Simply Safe Dividends)



Using the yield metric, ESS is undervalued. Its current yield is 3.3% and its 5-year average is 2.9%. That leads to a valuation ratio of 0.88.

ESS Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/FFO to Market's historical average	1.31	Very overvalued
#2: P/FFO to Stock's 5-year average	0.89	Undervalued
#3: DCF (from Morningstar)	0.93	Fairly valued
#4. Relative Yield 5-year comparison	0.88	Undervalued
Average of Models: Valuation ratio = 1.00 = Fairly valued		

Fair price = $254

If we were to eliminate Model 1 as an outlier from the other three, ESS would come across as about 10% undervalued. That coincides with the top of the fair-value range without eliminating the outlier, and I would be willing to pay that much for ESS shares.

Maximum buy price = $279

GENERAL DYNAMICS

GENERAL DYNAMICS (GD)			
SECTOR: Industrials			
INDUSTRY: Aerospace and Defense			
Link to GD Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
B	**B+**	**C+**	**Undervalued**

General Dynamics is a prime defense contractor, which almost automatically means that it has a good business model. Unfortunately, GD also owns Gulfstream, the business-jet producer, and that business has slowed down because of Covid-19. GD's dividend is very safe.

Dividend Record (Grade = B)



GD Dividend Summary		
Factor	**Data**	**Rating**
Yield	2.9%	Mid
Years of Increases	29 (Dividend Champion & Aristocrat)	B
5-year DGR	10% per year (Fast)	B
DGR Trend	Steadily in upper single-digits or 10% range	B
SSD Safety Rating	97 / 100 = Very safe	A
Total Dividend Grade = B		

Business Model and Company Quality (Grade = B+)

GD is a global aerospace and defense giant. Ranked by revenue, General Dynamics is the 5th-largest aerospace/defense company, just below fellow Top 30 selection Lockheed Martin.

GD has a broad portfolio of products and services in defense, including combat vehicles, weapons systems, munitions, IT, and ship building. As the owner of Gulfstream, it also has a position in business jets.

The company is organized into five segments, the last four of which are defense-related.

- Aerospace (Gulfstream business jets, jet aviation)
- Combat Systems (land systems, ordnance and tactical systems)
- Information Technology (large, secure IT networks and systems for US, state and local governments, and commercial customers)
- Mission Systems (secure communications systems, command-and-control systems, sensors, and cyber products)
- Marine Systems (naval ships, nuclear submarines, ships and ship repair); GD is one of only two major shipbuilders in the USA

As a prime defense contractor, GD has unusual vision into its long-term prospects. US defense spending generally is not correlated with national economic growth or recessions, budget deficits, debt, or the political parties in power. In 2019, 66% of GD's revenue was from the US government. GD's primary customer is the US Department of Defense.

Overall, GD has an order backlog of more than $85 billion, which is more than two years' worth of recent annual revenue, giving it a good basis for forecasting even under Covid-19 conditions.

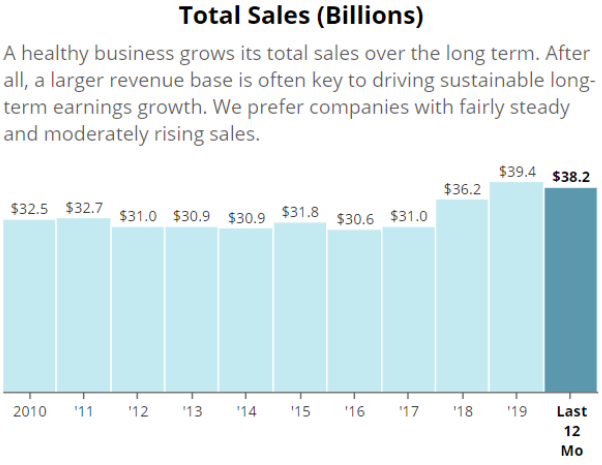
The only undertow in GD's business is that the Covid recession has all but stopped Gulfstream's deliveries of business jets. That causes me to lower GD's quality grade from A to B+. Morningstar recently lowered its fair value estimate for GD based on the slowdown in the business jet segment.

Morningstar awards GD a Wide moat rating, based primarily on the military portions of its business. Factors involved in GD's moat include:

- Product complexity and extended development times that make it difficult for new companies to enter the market
- Contract structures that favor incumbents
- Long product cycles that can last for decades
- Lack of alternative suppliers for arms and systems that meet the military's needs
- Switching costs that dissuade risk-averse defense and military agencies from looking elsewhere

Financials (Grade = C+)

GD's sales were flat from 2010 to 2017, then began growing in 2018-19. This year's sales show the impact of Covid-19, with essentially all of the slowdown coming from the business jet segment.



GD's earnings had been growing consistently until Covid-19. Its cash production has been solid, with up and down years but always very positive.

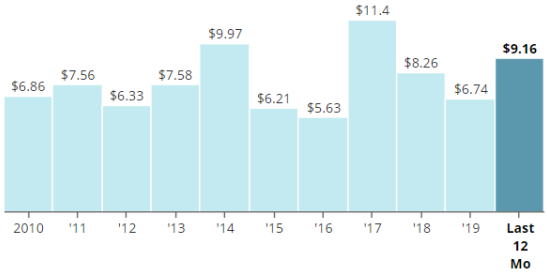
Earnings Per Share

Adjusted earnings are used to exclude noisy "one-time" events such as non-cash impairment charges. The best businesses will steadily increase their earning power over time to help fuel dividend growth and appreciation in their stock price.



Free Cash Flow Per Share

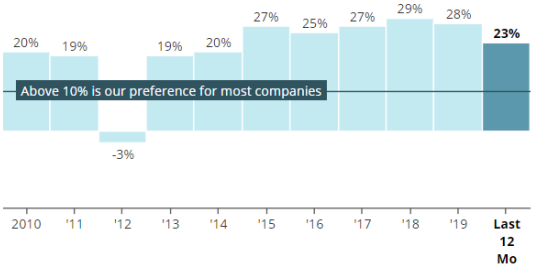
Free cash flow is what's left after a company has paid all of its bills and reinvested to maintain and grow its business. Advantaged businesses tend to generate stable, growing free cash flow over time, fueling sustainable and rising dividends.



GD's efficiency metrics (first pair of graphs below) are very good, well above the benchmarks. Its margins are (second pair of graphs) have been around average most of the time.

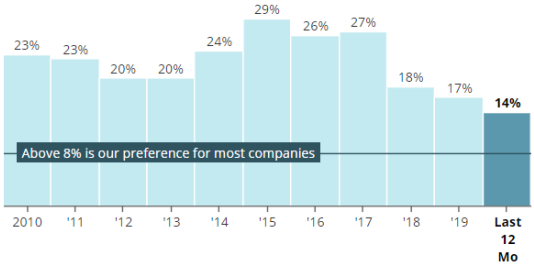
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



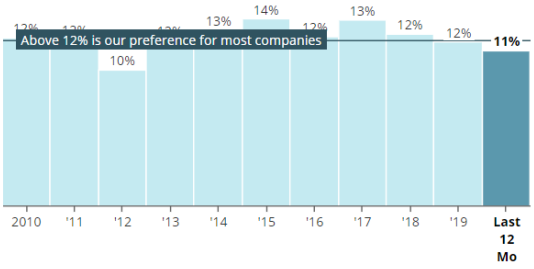
Return on Invested Capital

Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



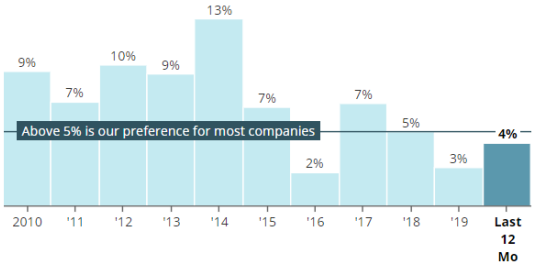
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

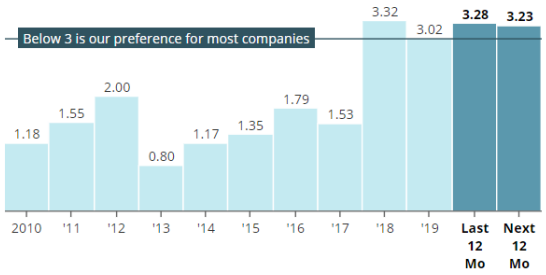
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



GD relies on debt more than I would like to see, with debt levels rising over the past 2-3 years. Its credit rating is A, which is solid, mid-investment-grade.

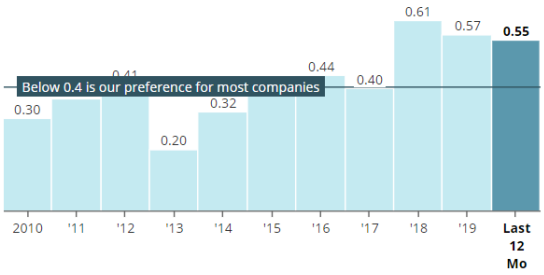
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.



Net Debt to Capital

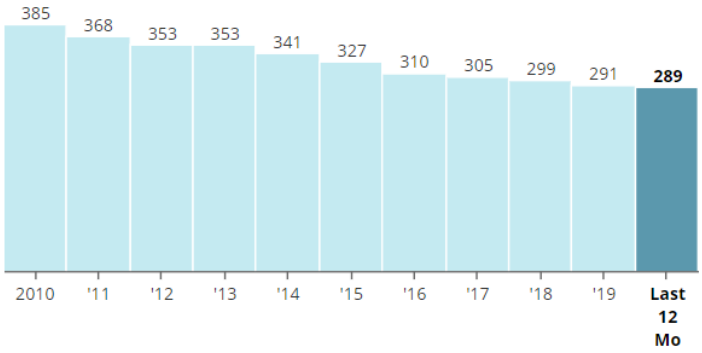
The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



GD had been reducing its share count steadily, but (again) that has slowed down with the pandemic, which seems like a prudent move. GD has 25% fewer shares outstanding than it did 10 years ago.

Shares Outstanding (Millions)

Some companies return excess cash to shareholders by buying their stock when they believe it is undervalued, increasing your ownership stake. Other firms issue shares to fund growth projects. Generally speaking, we prefer a declining share count.



Overall, I consider GD's financials to be a solid B except for the slowdown in the Gulfstream portion of its business. That lowers the grade to C+. Long-term, that business could normally be expected to recover, but there is unclear visibility on when that may happen. One must also account for the possibility that the business-jet market has shrunk permanently, as Covid-19 has induced many companies to cut back on in-person meetings. It is too soon to tell whether that is a permanent change or not.

Valuation (Undervalued)

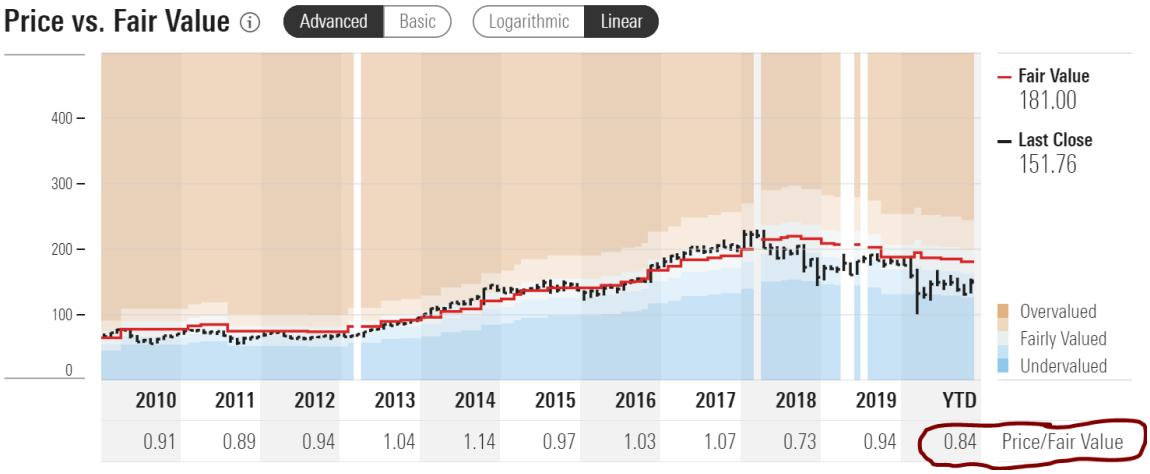
Models #1 & #2: P/E ratios (FASTGraphs)



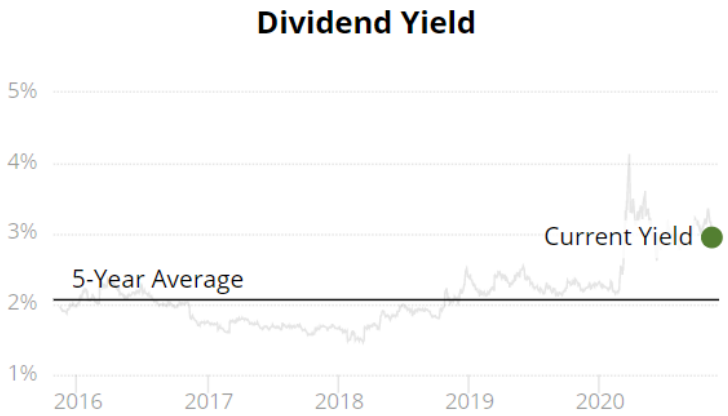
GD is fairly valued using the first model and undervalued using the second. Model 1's valuation ratio = 0.91 (price compared to orange line), and Model 2's valuation ratio = 0.80 (price compared to blue line). GD's current P/E ratio is 13.6 compared to its 5-year average of 16.9.

Model #3: DCF

Using its discounted cash flow (DCF) approach, Morningstar calculates a valuation ratio of 0.84, which suggests undervaluation. Note the slight recent lowering of its fair value estimate (red line on graph) associated with the slowdown in GD's jet business.



Model #4: Relative yields (Simply Safe Dividends)



GD's current yield of 2.9% is well above its 5-year average of 2.1%. When there is this much disparity, I put a floor under the valuation ratio at 0.80.

GD Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	0.91	Fairly valued
#2: P/E to Stock's 5-year average	0.80	Undervalued
#3: DCF (from Morningstar)	0.84	Undervalued
#4. Relative Yield 5-year comparison	0.80 (cut off)	Undervalued
Average of Models: Valuation ratio = 0.84 = Undervalued		

The valuation models are tightly bunched. They are nearly unanimous in pegging GD as undervalued.

Fair price = $180

Given that GD is already selling at an undervalued price, combined with the lack of clarity on the business jet portion of its business, I don't see any reason to pay more than that, even though the fair-value range goes up to $198.

Maximum buy price = $180

HORMEL FOODS (HRL)

HORMEL FOODS (HRL)			
SECTOR: Consumer Staples			
INDUSTRY: Food Products			
Link to Hormel Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
A	**B+**	**B**	**Overvalued**

Hormel is one of the few Dividend Kings (50+ year dividend-increase streaks). Many investors consider Hormel to be a quintessential DG stock, and I put it in the All-Star group. Unfortunately, its price is currently overvalued, making it the kind of high-quality stock to wait for a dip in price.

Dividend Record (Grade = A)



HRL Dividend Summary		
Factor	**Data**	**Rating**
Yield	2.1%	Mid
Years of Increases	54 (Dividend King, Aristocrat)	A
5-year DGR	13% per year (Very fast)	A
DGR Trend	Usually in low double-digits	B
SSD Safety Rating	99 / 100 = Very safe	A
Total Dividend Grade = A		

Hormel has an attractive long-term dividend record. It is a mid-yield, fast-growth DG stock. Its most attractive elements are its long streak of increases (54 years), very fast 5-year DGR of 13% per year, and top dividend safety rating (99). It recently announced an 8.9% increase for its first dividend in 2021.

Business Model and Company Quality (Grade = B+)

Hormel Foods (HRL) was founded in 1891 and is headquartered in Austin, MN. It is a leading global branded food company, with more than $9 billion in annual revenue from over 80 countries, although 90% comes from North America.

Hormel's revenue principally comes from:

- Perishable products (fresh meats, frozen items, refrigerated meals) – 56%
- Poultry -19%
- Shelf-stable goods (canned meats, peanut butter, hash, stews) – 19%

Hormel's key to success is favorable consumer perception, which has resulted in customer loyalty and significant brand strength. With many of its brands dating back over 50 years (SPAM and Dinty Moore were introduced in the 1930s) and supported by billions of advertising dollars over the years, many consumers have come to know and trust Hormel's products.

More than 40 of Hormel's brands have No. 1 or No. 2 market share in their categories, and they represent approximately 60% of Hormel's retail sales.

Hormel takes advantage of its brand names to launch new products. In 2020, it generated about 15% of revenue from products launched within the past five years. Example: Skippy Peanut Butter Bites (2017).

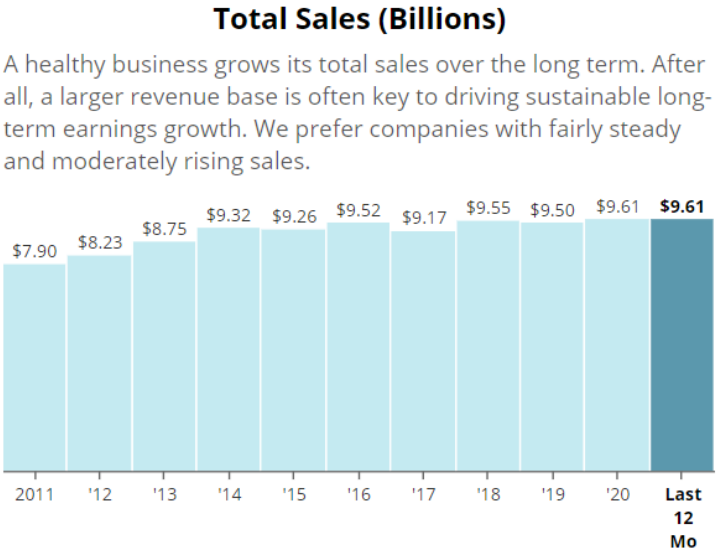
Hormel also benefits from economies of scale. As a large player, Hormel has relatively low production costs and is able to squeeze value from its large advertising budget.

Hormel has made a number of acquisitions in recent years to expand its business, including Wholly Guacamole (2012) and Skippy Peanut Butter (2013). Through its first-class distribution system, Hormel can sell new brands and products to its existing customers and improve the cost profile of each acquired company once they are integrated.

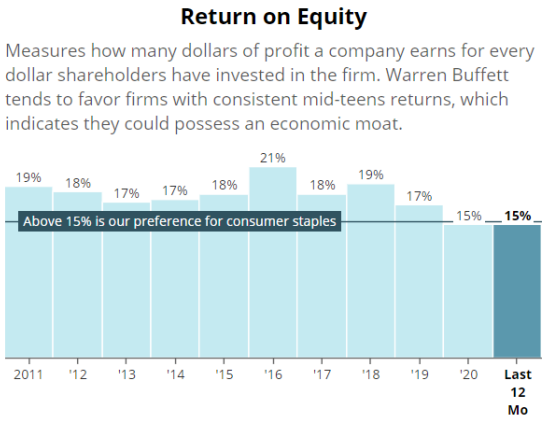
Morningstar awards Hormel a Narrow moat. My quality grade for Hormel is B+.

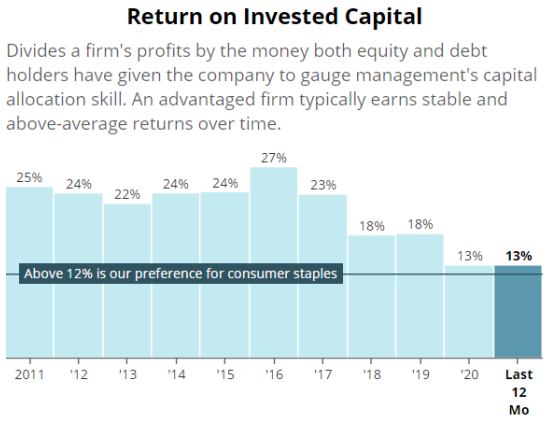
Financials (Grade = B)

HRL's total revenue has flattened over the past few years. 2020's revenue is little changed from 2016.



HRL has been an efficient company for years, although its efficiency statistics have declined over the past few years to values barely at or above the benchmarks.

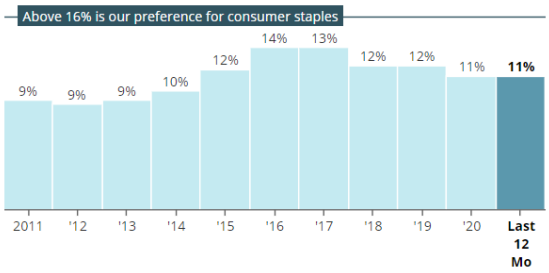




The company's profitablity has been below average.

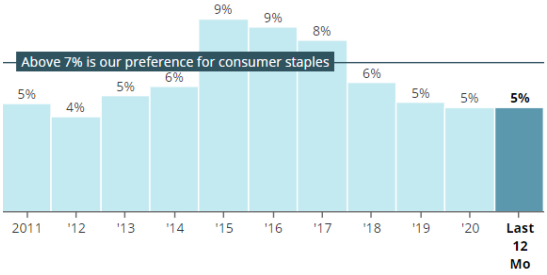
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

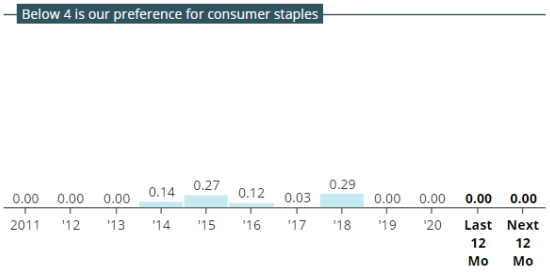
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



Hormel carries almost no debt, which is the strongest point in its financial record. It carries a stellar AA credit rating.

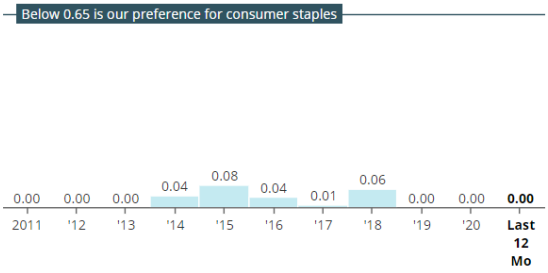
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.



Net Debt to Capital

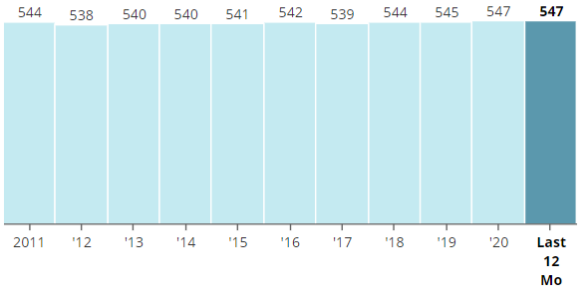
The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



HRL's share count has stayed flat for years.

Shares Outstanding (Millions)

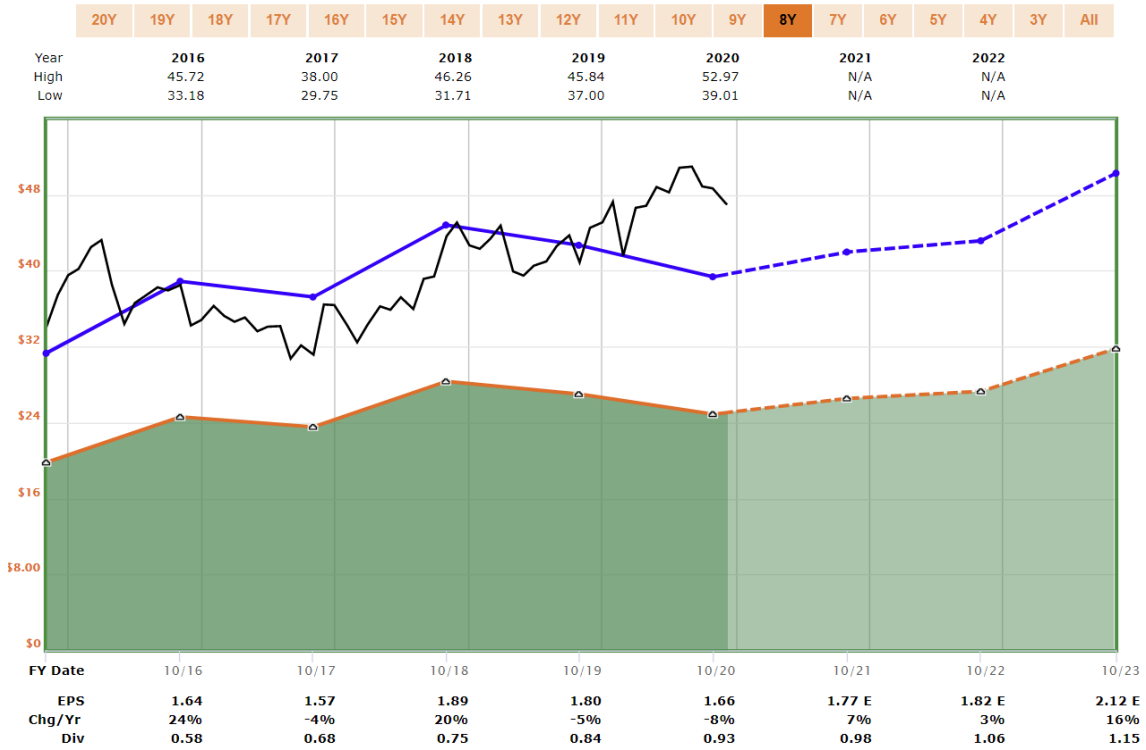
Some companies return excess cash to shareholders by buying their stock when they believe it is undervalued, increasing your ownership stake. Other firms issue shares to fund growth projects. Generally speaking, we prefer a declining share count.



Overall, I'd give HRL a B for its financials. Its lack of top line growth is concerning, but it's obviously run with great financial discipline.

Valuation (Overvalued)

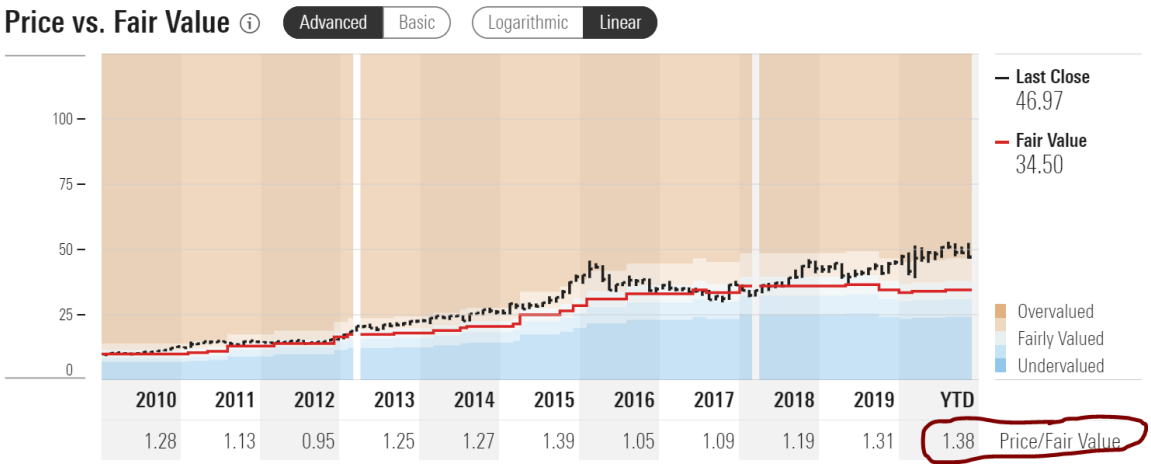
Models #1 & #2: P/E ratios (FASTGraphs)



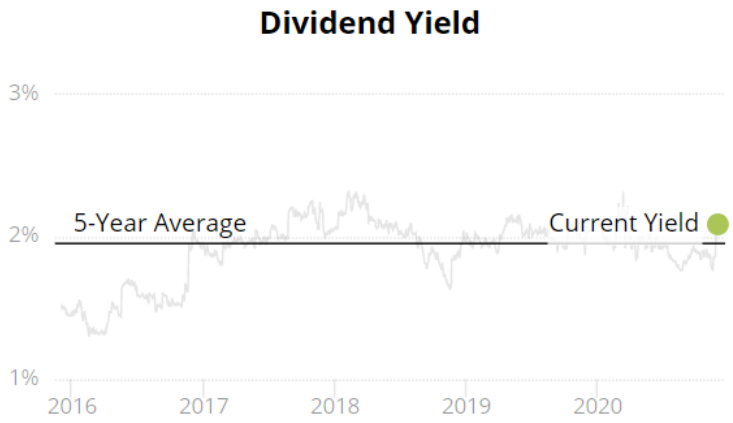
Hormel is overvalued under both P/E models. Its current P/E ratio of 28.1 is well above the basic reference fair value of 15 (orange line) and above its own 5-year average of 23.7 (blue line). Its valuation ratios are: Model 1 = 1.87 and Model 2 = 1.19.

Model #3: DCF

Using its discounted cash flow (DCF) techniques, Morningstar has Hormel as significantly overvalued with a valuation ratio of 1.38.



Model #4: Relative yield (Simply Safe Dividends)



Simply Safe Dividends shows that Hormel's current yield of 2.1% is a little higher than its 5-year average of 2.0%. That suggests that HRL is fairly valued with a valuation ratio of 0.95.

HRL Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	1.87	Very overvalued
#2: P/E to Stock's 5-year average	1.19	Overvalued
#3: DCF (from Morningstar)	1.38	Very overvalued
#4. Relative Yield 5-year comparison	0.95	Fairly valued
Average of Models: Valuation Ratio = 1.31 = Very overvalued		

Three of the four valuation models have HRL as overvalued or very overvalued. That said, Model 1 is an outlier in terms of degree, and I am inclined to toss out it out. Doing that, we get:

HRL Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#2: P/E to Stock's 5-year average	1.19	Overvalued
#3: DCF (from Morningstar)	1.38	Very overvalued
#4. Relative Yield 5-year comparison	0.95	Fairly valued
Average of Models: Valuation Ratio = 1.17 = Overvalued		

Fair price = $40

I personally would not pay any more than this for the stock, considering that we tossed one valuation model to get to this price, plus keeping in mind HRL's difficulty generating overall growth. However, for those who would pay up to the top of the fair-value range for Hormel, that upper limit would be 10% higher.

Top f fair-value range = $44

JOHNSON & JOHNSON (JNJ)

JOHNSON & JOHNSON (JNJ)			
SECTOR: Healthcare			
INDUSTRY: Pharmaceuticals			
Link to JNJ Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
B	**A**	**A**	**Fairly valued**

Johnson & Johnson is a DG All Star, based on its long, reliable record of dividend growth; solid standing in a traditionally defensive sector (Healthcare); and excellent financials. Its current valuation is fair.

Dividend Record (Grade = B)



JNJ has a stellar long-term dividend record. The most attractive elements are its long streak of increases (58 years) and top dividend safety rating (99). It has been consistent in terms of increases at around 6% per year. JNJ is a mid-yield, medium-growth DG stock.

JNJ Dividend Summary		
Factor	**Data**	**Rating**
Yield	2.7%	Mid
Years of Increases	58 (Dividend King, Champion, Aristocrat)	A
5-year DGR	6% per year	C
DGR Trend	Steady at decent rate	B
SSD Safety Rating	99 / 100 = Very safe	A
Total Dividend Grade = B		

Business Model and Company Quality (Grade = A)

Founded in 1885, Johnson & Johnson (JNJ) is the world's largest medical conglomerate. With more than 250 subsidiaries in over 60 countries, JNJ's three major business units provide a diversified mix of revenue, earnings, and cash flow that makes it resilient to economic cycles.

- **Pharmaceuticals (50% of sales, 61% of profits):** Dozens of patented drugs and vaccines for diabetes, oncology, cardiovascular, immunological, neurological, and infectious diseases.
- **Medical Devices (33% of sales, 29% of profits):** Surgical, orthopedic, endo-mechanical (i.e. hip replacements), and sterilization equipment.
- **Consumer Products (17% of sales, 10% of profits):** Over-the-counter consumer medical and beauty products including more than a dozen mega-brands with over $1 billion in annual sales, such as Johnson & Johnson, Neutrogena, Splenda, Listerine, Tylenol, Motrin, Sudafed, Band-Aid, Aveeno, Pepcid, Benadryl, and Zyrtec.

J&J also offers investors broad international exposure, with 48% of sales coming from outside the USA.

Thanks to its diversified business model, J&J grew its adjusted operating earnings for 35 consecutive years prior to the 2020 pandemic.

Approximately 70% of J&J's sales are from markets in which it has No. 1 or No. 2 global market share, and management has shown a willingness to divest underperforming or non-core parts of the business from time to time.

25% of JNJ's sales are from new products launched in the past five years, amounting to new products coming online at the rate of about $4 billion per year. Such results are a testament to JNJ's innovation, brand strength, scale advantages, and R&D processes. J&J's R&D budget is among the 10 largest of any company in the world.

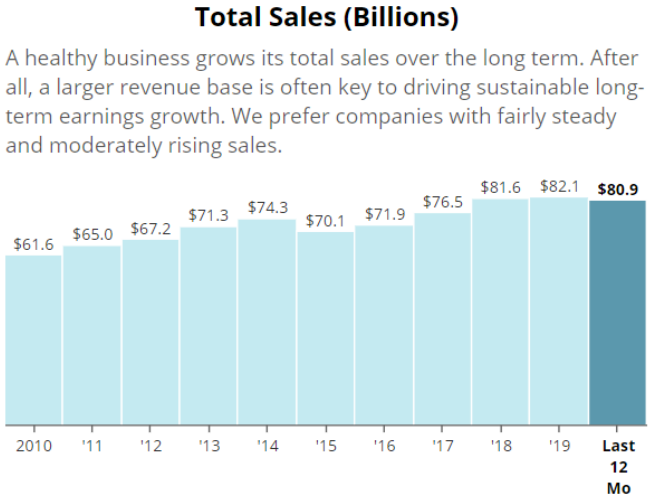
The off-patent nature of the consumer products means that they generally cost very little for JNJ to produce at large scale, providing excellent cash flow. JNJ's size also allows it to invest large amounts into advertising to support its brands.

JNJ's pharmaceuticals are not overly concentrated in any single drug or treatment area. Remicade, the company's largest drug, accounts for less than 15% of the pharma segment's sales and under 7% of company-wide sales.

Overall, JNJ ranks as one of the highest quality companies in the world. Morningstar awards it a Wide economic moat. It is one of only two companies with a triple-A credit rating (Microsoft is the other). Quality grade = A.

Financials (Grade = A)

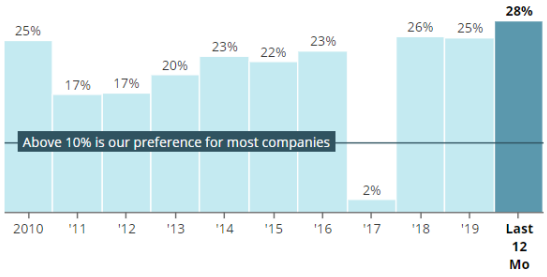
JNJ rates high on practically all financial metrics. Its revenues show a record of strong, steady growth until Covid-19 slowed things down a little.



JNJ's efficiency is consistently well above average (top two graphs) as are its profitability margins (lower two graphs).

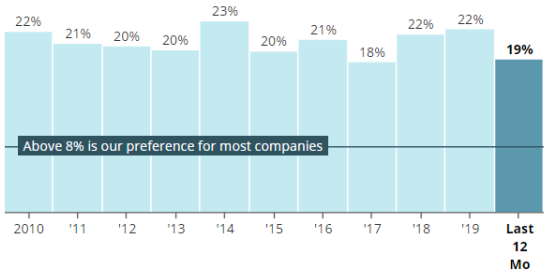
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



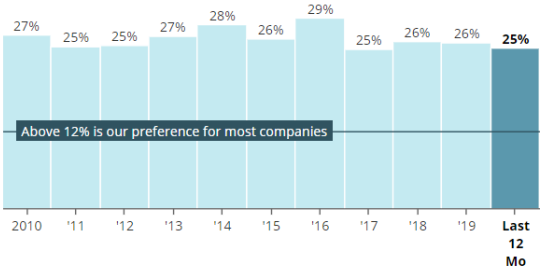
Return on Invested Capital

Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



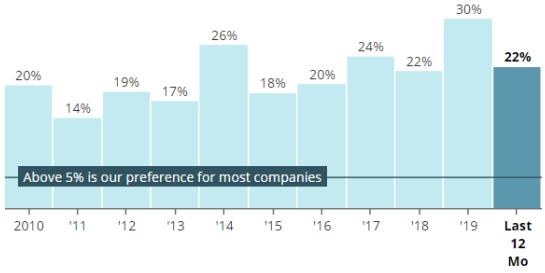
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

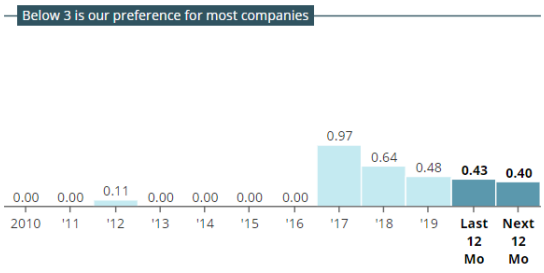
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



JNJ's debt (net of cash) is very low, sometimes zero. It bumped up in 2017 in connection with a major acquisition, but the debt has been getting paid off since. JNJ's credit rating is the highest in S&P's system: AAA. The company has over $20 B in cash on hand.

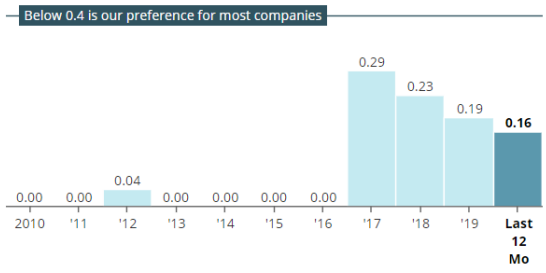
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.

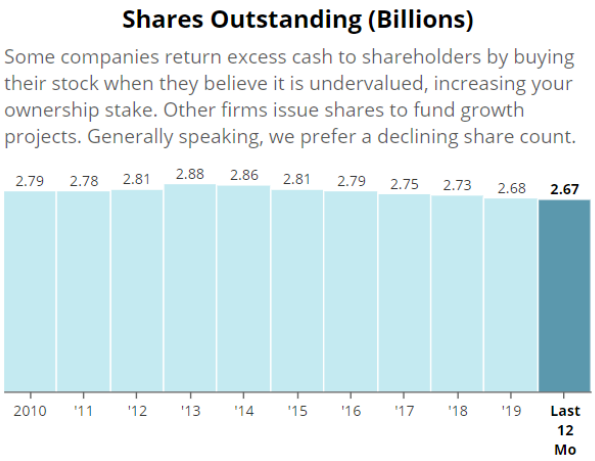


Net Debt to Capital

The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.

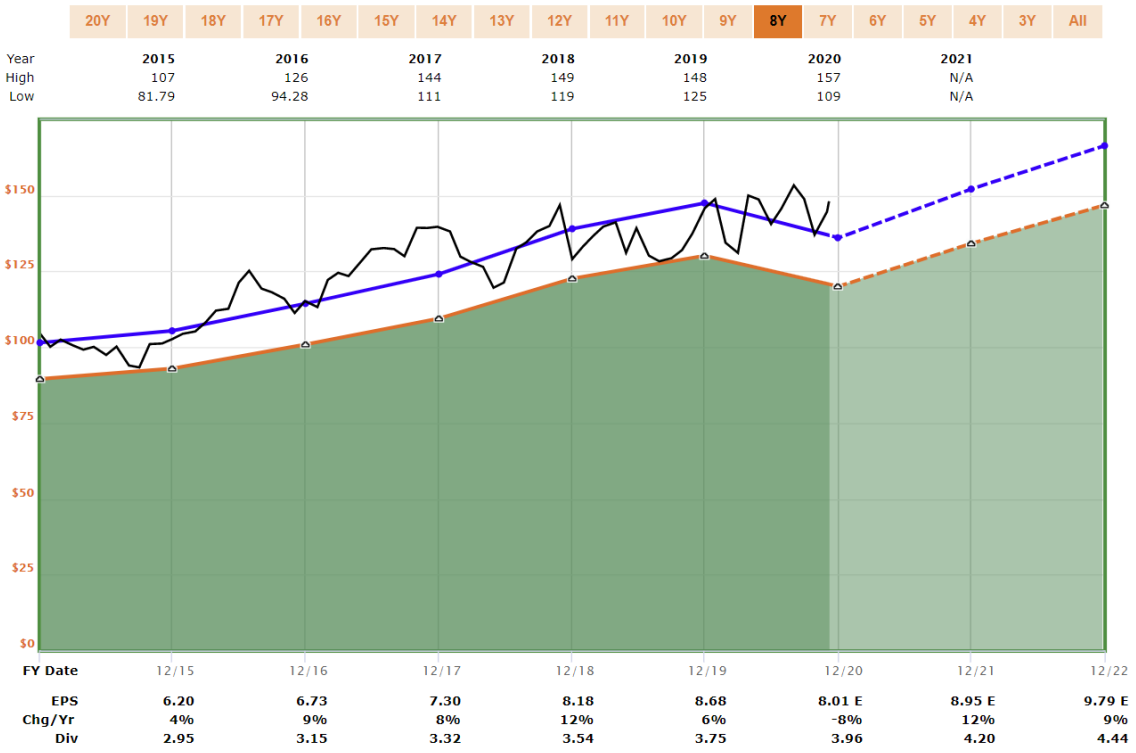


JNJ has been slowly reducing its shares outstanding since 2013. It has 8% fewer shares now than then.



Valuation (Fairly valued)

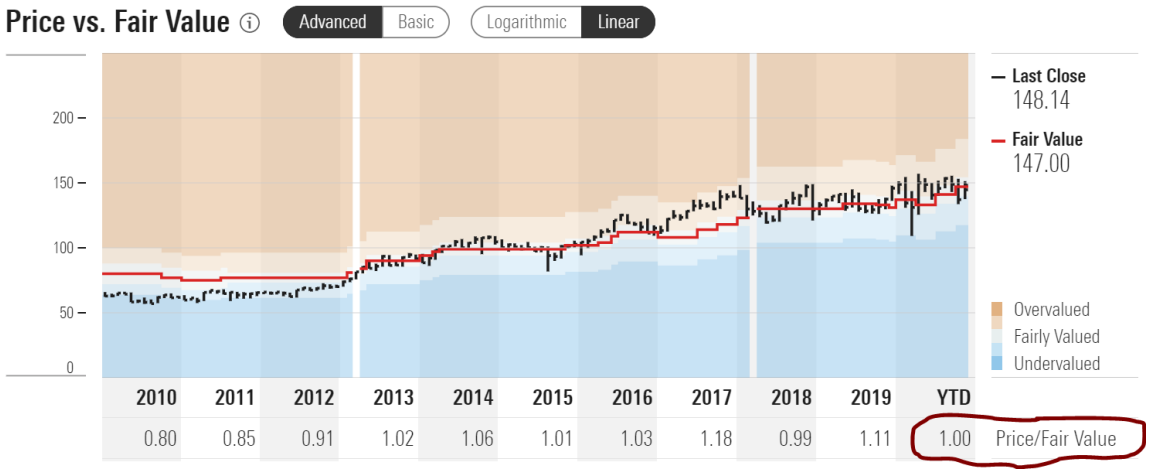
Models #1 & #2: P/E ratios



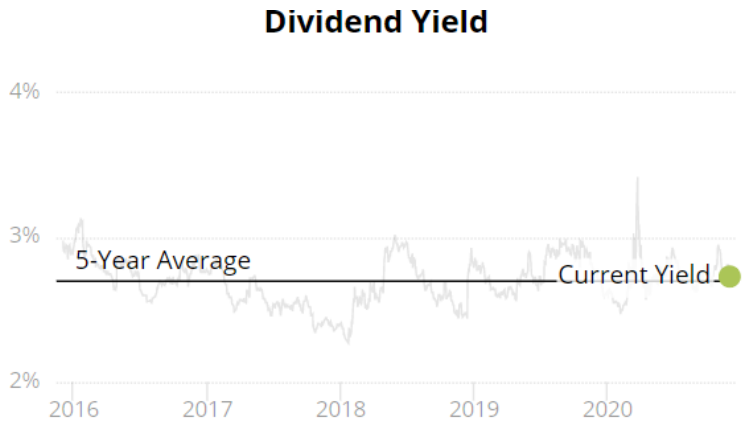
JNJ is overvalued under the first PE model and fairly valued under the second. Its current P/E ratio of 18.4 compares to its 5-year average of 17.0. Its valuation ratios are Model 1 = 1.23 and Model 2 = 1.08.

Model #3: DCF

Using its discounted cash flow (DCF) techniques, Morningstar has JNJ as fairly valued with a valuation ratio of 1.00.



Model #4: Relative yields



JNJ's current yield and its 5-year average both round to 2.7%. That results in a valuation ratio of 1.00.

JNJ Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	1.23	Very overvalued
#2: P/E to Stock's 5-year average	1.08	Fairly valued
#3: DCF (from Morningstar)	1.00	Fairly valued
#4. Relative Yield 5-year comparison	1.00	Fairly valued
Average of Models: Valuation ratio = 1.08 = Fairly valued		

JNJ is fairly valued at its current price of about $148.

Fair price = $137

For such an extremely high-quality stock, I would be willing to pay to the very top of JNJ's fair value range, which is fair price + 10%.

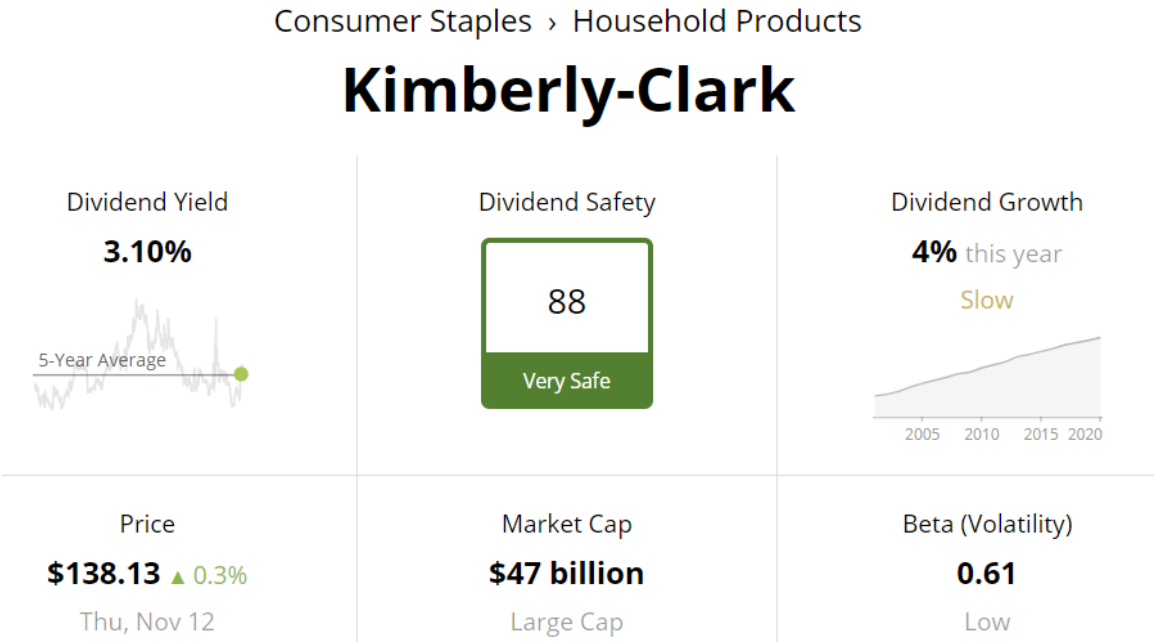
Maximum entry price = $151

KIMBERLY-CLARK (KMB)

KIMBERLY-CLARK (KMB)			
SECTOR: Consumer Staples			
INDUSTRY: Household Products			
Link to KMB Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
B	**B**	**B**	**Fairly valued**

Kimberly-Clark is a classic "widows and orphans" stock: Moderate yield, moderate growth, and safe dividend. The company itself is growing very slowly.

Dividend Record (Grade = B)



Kimberly-Clark combines a mid-range yield with a long record of increases, steady but moderate growth, and a high safety score. Its rate of dividend growth is at the low end of "OK" for its yield.

KMB Dividend Summary		
Factor	**Data**	**Rating**
Yield	3.1%	Mid
Years of Increases	48 (Dividend Champion & Aristocrat)	B
5-year DGR	4% per year (OK for its yield)	C
DGR Trend	Steady and consistent in 3-5% range	B
SSD Safety Rating	88 / 100 = Very safe	A
Total Dividend Grade = B		

Business Model and Company Quality (Grade = B)

Kimberly-Clark (KMB), based in Dallas, was founded in 1872 and has grown into one of the largest manufacturers of tissue and hygiene products. The company's products are used by one-quarter of the world's population.

KMB's well-known brands include five billion-dollar brands: Huggies, Kleenex, Cottonelle, Scott, and Kotex. It sells primarily to supermarkets, mass merchandisers, drugstores, and other retail outlets.

KMB segments its products in this way:

- Personal Care (diapers, training pants, wipes, feminine and incontinence care) accounts for about 50% of the firm's sales and profits.
- Consumer Tissue (facial tissue, bathroom tissue, paper towels) contributes roughly 30% of KMB's mix.
- K-C Professional (facial tissue, bathroom tissue, paper towels for away-from-home use, safety products) accounts for nearly 20%.

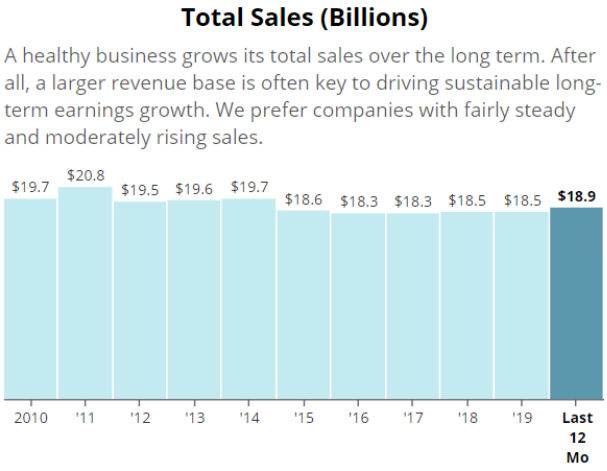
Just over half of sales and more than 70% of operating profit come from North America. Developing and emerging markets account for about 30% of sales, up from 14% in 2003.

Morningstar assigns KMB a Narrow moat. KMB's marketing scope and brand equity are arguably its strongest advantages. It spends heavily on advertising, and its marketing budget allows it to respond aggressively to smaller players' efforts to compete on price or with new products. KMB can leverage its well-known brands to maintain its top position. Furthermore, in categories like diapers, customers want products that are known to be reliable and trustworthy, making them less likely to switch brands.

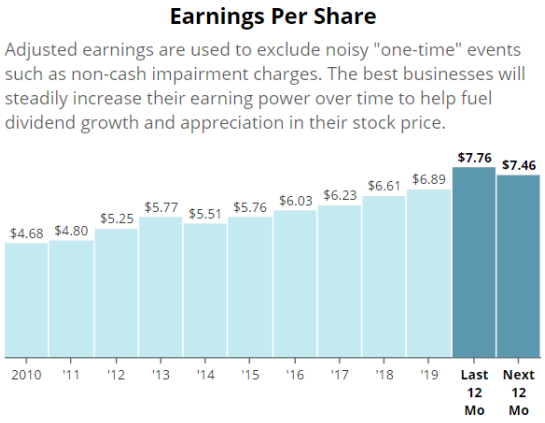
As a result, the company enjoys #1 or #2 market share positions in 80 countries. Management believes the business can achieve 1-3% annual organic sales growth and mid-single digit EPS growth.

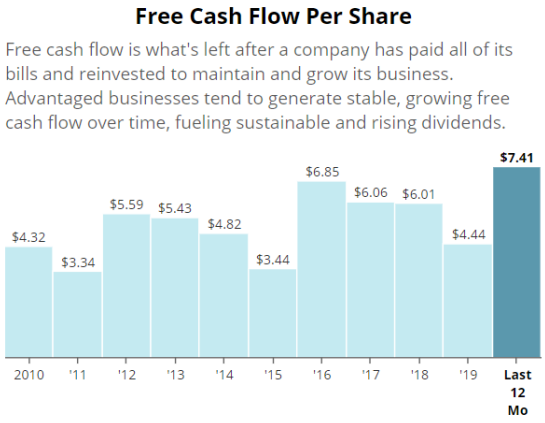
Financials (Grade = B)

KMB is a slow-growing, mature business, as shown by the glacial pace of revenue growth.



The upside to maturity is solid earnings and cash flow.

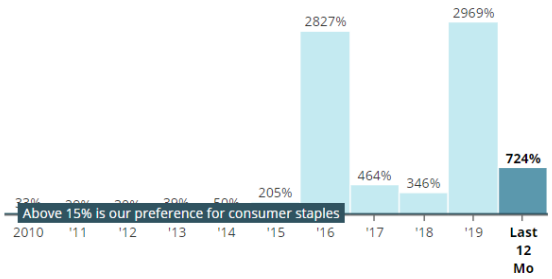




KMB's efficiency metrics are very good (first two graphs below), and its profitability is solid (second two graphs).

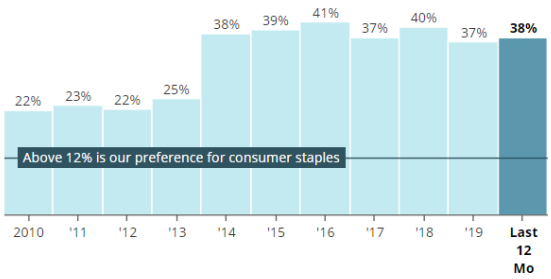
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



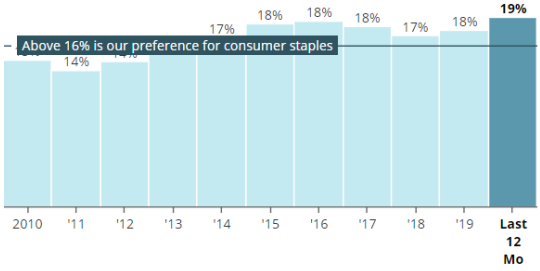
Return on Invested Capital

Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



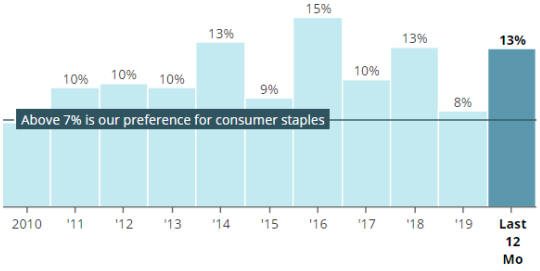
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

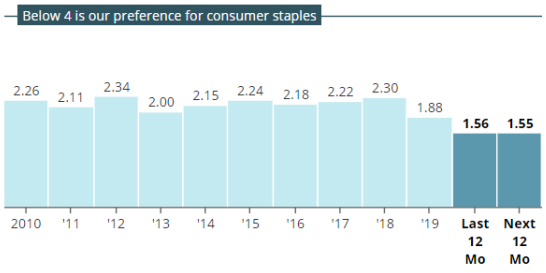
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



KMB's debt-to-capital ratio is rather high, which helps explain its very high ROE shown above. The company's credit rating is A, which is mid-investment grade.

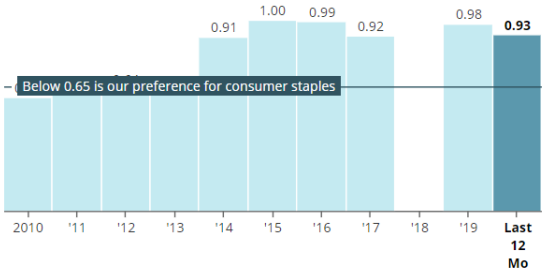
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.

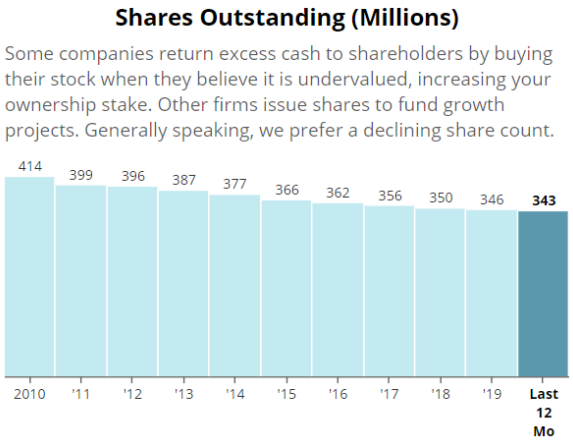


Net Debt to Capital

The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



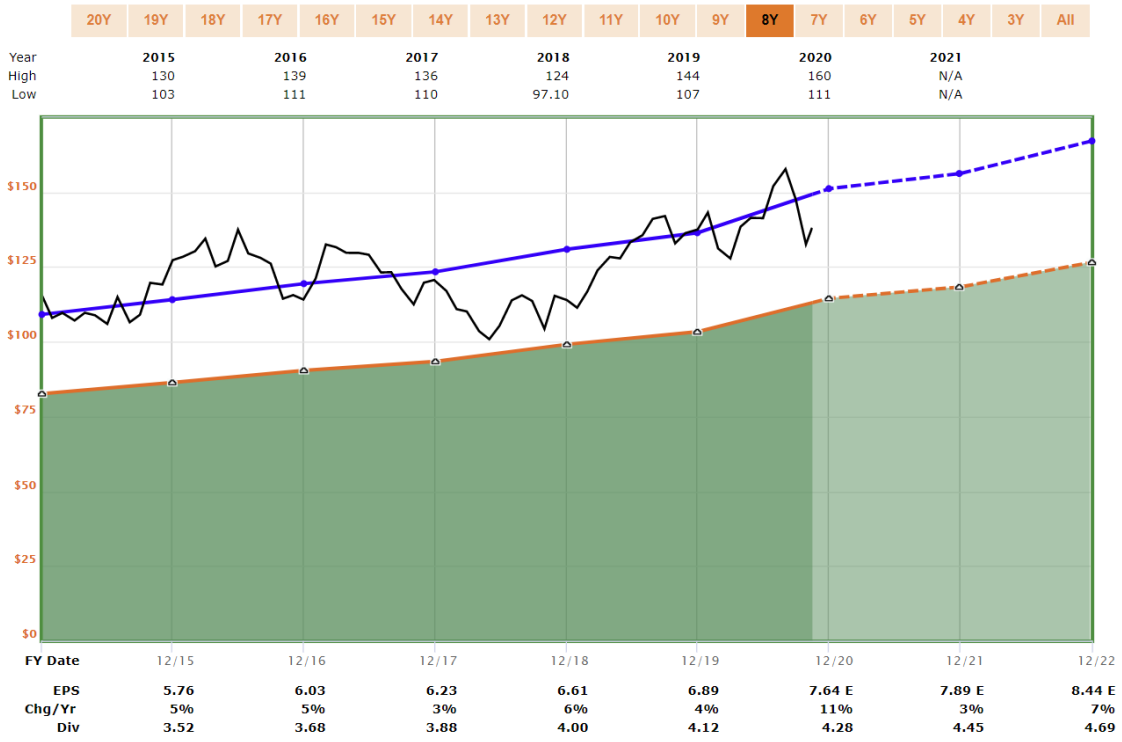
KMB has been reducing its share count steadily. It has 17% fewer shares outstanding than it did 10 years ago.



Overall, I give KMB's financials a B. It is a slow-growing but profitable company. In my opinion, it uses too much debt for no apparent reason.

Valuation (Fairly valued)

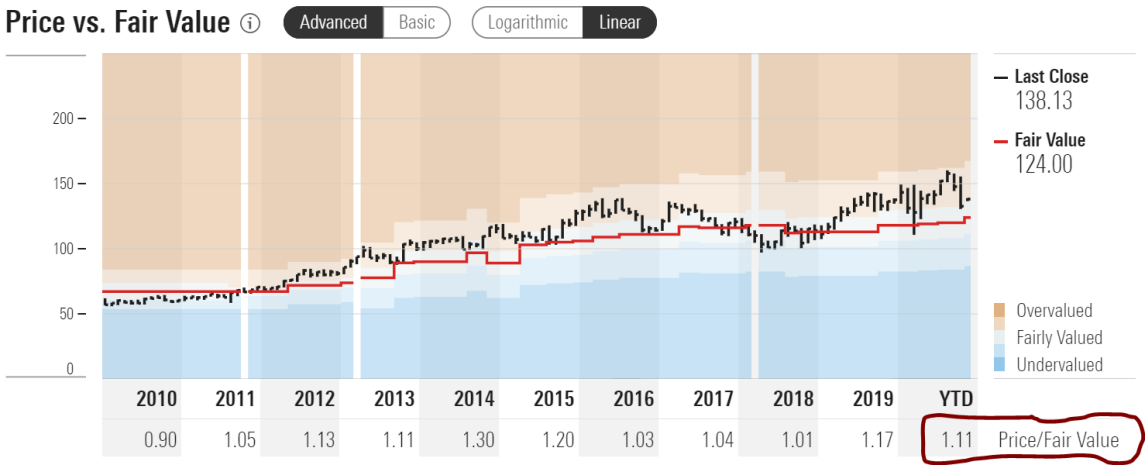
Models #1 & #2: P/E ratios (FASTGraphs)



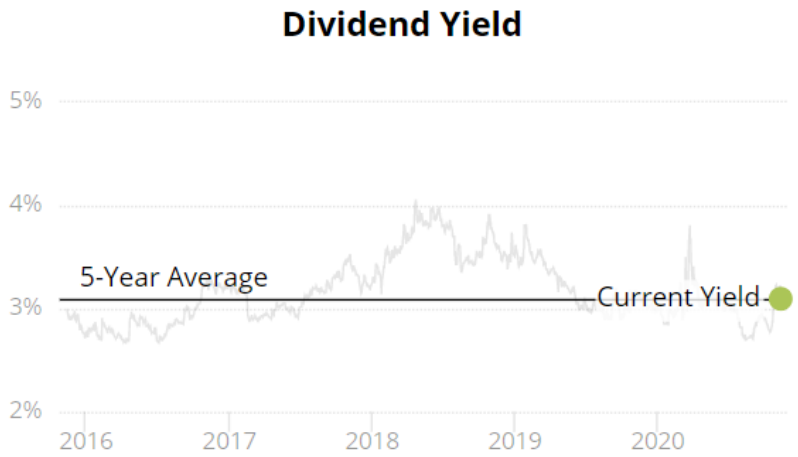
KMB's price lies between the two reference lines. KMB's current P/E is 18.3 compared to its 5-year average of 19.8. Model 1's valuation ratio = 1.22 and Model 2's = 0.92.

Model #3: DCF

Using its discounted cash flow (DCF) techniques, Morningstar calculates a valuation ratio of 1.11, which suggests slight overvaluation.



Model #4: Relative yields (Simply Safe Dividends)



KMB's current yield is right on its 5-year average of 3.1%. That makes this valuation ratio = 1.0.

KMB Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	1.22	Significantly overvalued
#2: P/E to Stock's 5-year average	0.92	Fairly valued
#3: DCF (from Morningstar)	1.11	Overvalued
#4. Relative Yield 5-year comparison	1.00	Fairly valued
Average of Models: Valuation ratio = 1.06 = Fairly valued		

The valuation models are not that far apart, despite Model 1 tipping over into the red zone. The average of the models suggests that KMB is in the fair-value range.

Fair price = $130

The upper edge of the fair-value range is that price + 10%, which I personally think KMB is worth.

Maximum buy price = $143

LOCKHEED MARTIN (LMT)

LOCKHEED MARTIN (LMT)			
SECTOR: Industrials			
INDUSTRY: Aerospace and Defense			
Link to LMT Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
B	**A**	**B**	**Undervalued**

Lockheed Martin scores well across the board. It has a good dividend record with strong safety; a superb business model as a major defense contractor; strong financials; and it is selling for an undervalued price.

Dividend Record (Grade = B)



LMT is a mid-yield, fast-growth stock with a strong safety rating and consistent 9-10% raises for the past several years. It grew its dividend through the Great Recession, but not through the 2000-2002 recession prior to that.

LMT Dividend Summary		
Factor	**Data**	**Rating**
Yield	2.8%	Mid
Years of Increases	17 (Dividend Contender 14+)	C
5-year DGR	10% per year (Fast)	B
DGR Trend	Consistent 9-10% raises each year	B
SSD Safety Rating	84 / 100 = Very safe	A
Total Dividend Grade = B		

Business Model and Company Quality (Grade = A)

Formed in 1995 through a merger, Lockheed Martin (LMT) is the world's largest defense contractor, headquartered in Bethesda, MD. It employs 110,000 people worldwide.

LMT principally engages in the research, design, development, and manufacture of advanced technology systems, products, and services focused on defense, space, and intelligence.

LMT operates in four business segments organized around its products and services:

- Aeronautics (40% of sales, 33% of profit)
- Missiles and Fire Control (18% of sales, 19% of profit)
- Rotary and Mission Systems (24% of sales, 19% of profit)
- Space (17% of sales, 12% of profit)

Over half of LMT's revenue comes from U.S government agencies. The F-35 (stealth fighter jet) program alone accounts for 27% of LMT's total net sales.

Being a prime defense contractor inherently is a highly defensible business model. There are only a handful of such companies. Factors that protect the business include product complexity, favorable long-term contracts, extremely long product cycles, and lack of alternative suppliers.

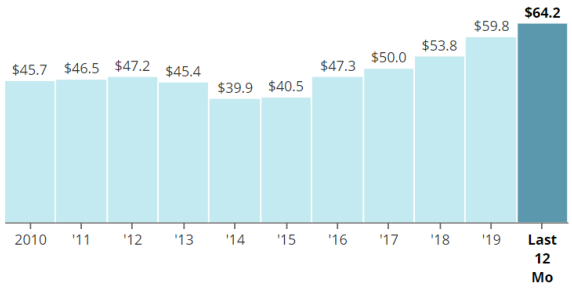
Morningstar accords LMT a Wide moat. I give its business model quality an A.

Financials (Grade = B)

LMT's revenue has shown consistent growth over the past several years. The defense business is not much affected by Covid-19.

Total Sales (Billions)

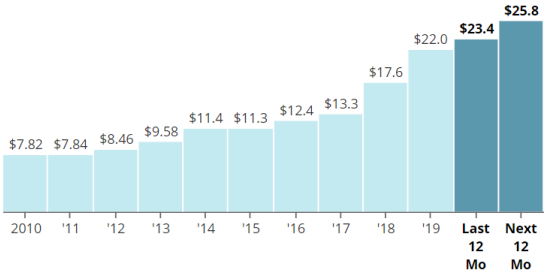
A healthy business grows its total sales over the long term. After all, a larger revenue base is often key to driving sustainable long-term earnings growth. We prefer companies with fairly steady and moderately rising sales.



LMT's earnings and cashflow records are very good (top two graphs), and so are its efficiency metrics (bottom two graphs). Its high ROE is explained largely by the company's high debt levels.

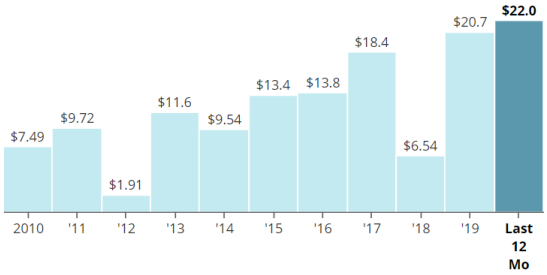
Earnings Per Share

Adjusted earnings are used to exclude noisy "one-time" events such as non-cash impairment charges. The best businesses will steadily increase their earning power over time to help fuel dividend growth and appreciation in their stock price.



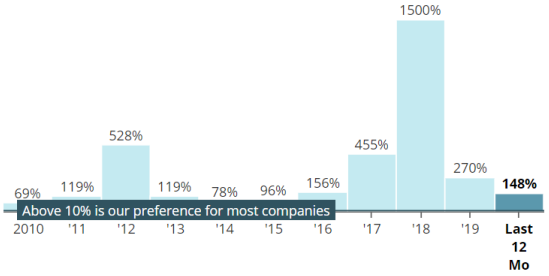
Free Cash Flow Per Share

Free cash flow is what's left after a company has paid all of its bills and reinvested to maintain and grow its business. Advantaged businesses tend to generate stable, growing free cash flow over time, fueling sustainable and rising dividends.



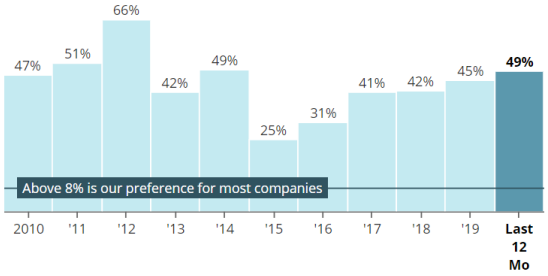
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



Return on Invested Capital

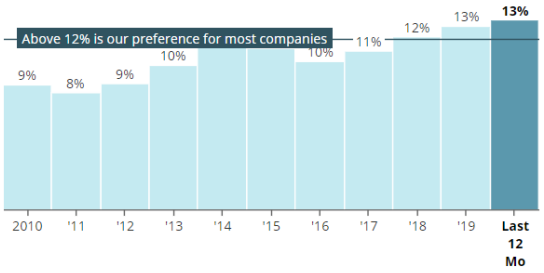
Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



LMT's profitability is somewhat above average.

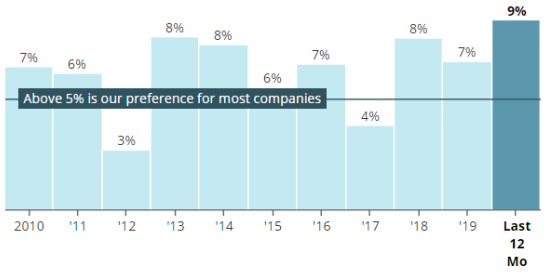
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

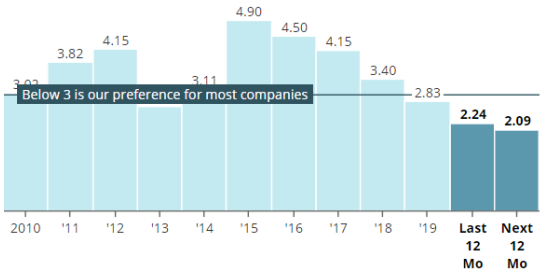
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



The only blemish on LMT's financials is its high use of debt. That said, it has no problem servicing the debt. It has an investment-grade credit rating of A- from S&P.

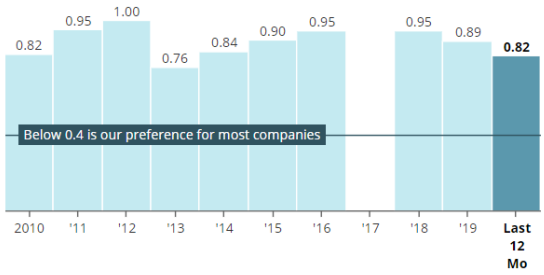
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.



Net Debt to Capital

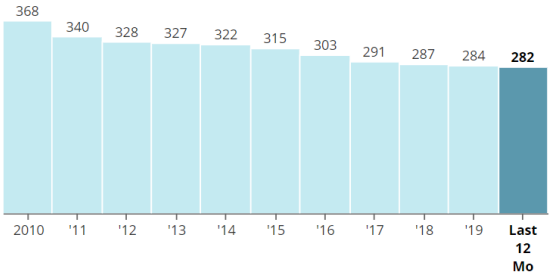
The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



LMT has a strong record of reducing its outstanding shares. It has 23% fewer shares now than it had 10 years ago.

Shares Outstanding (Millions)

Some companies return excess cash to shareholders by buying their stock when they believe it is undervalued, increasing your ownership stake. Other firms issue shares to fund growth projects. Generally speaking, we prefer a declining share count.

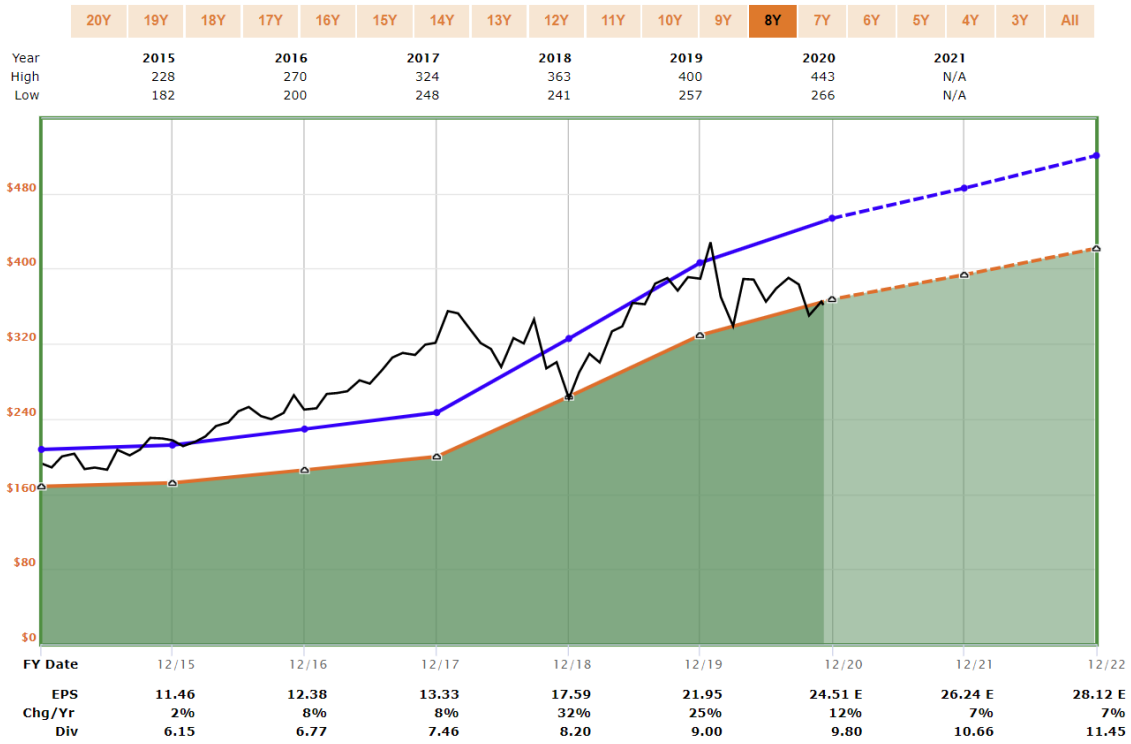


Overall, I give LMT a B for its financials.

Valuation (Undervalued)

Models #1 & #2: P/E ratios (FASTGraphs)

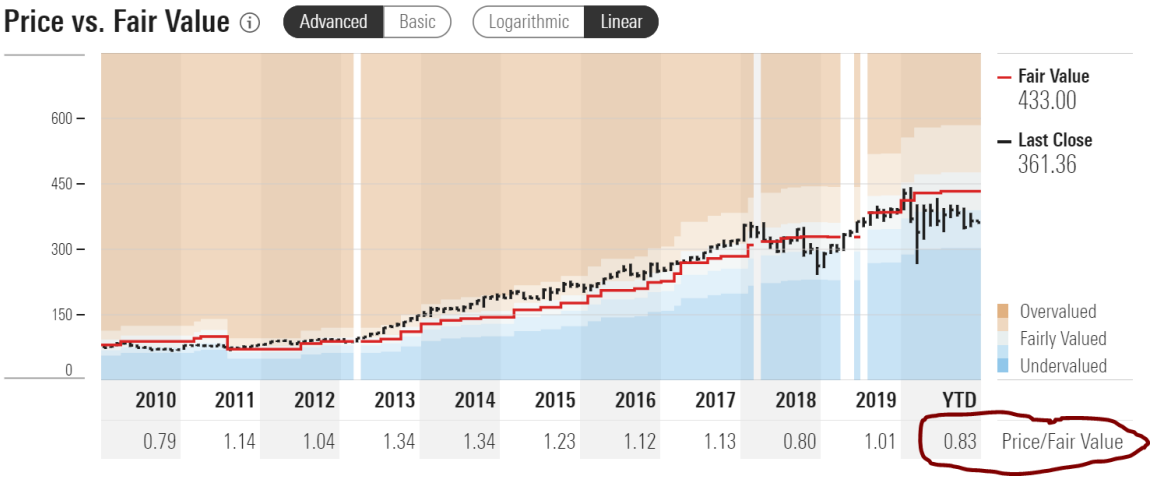
LMT's price has generally declined through 2020. That sets up a good valuation opportunity.



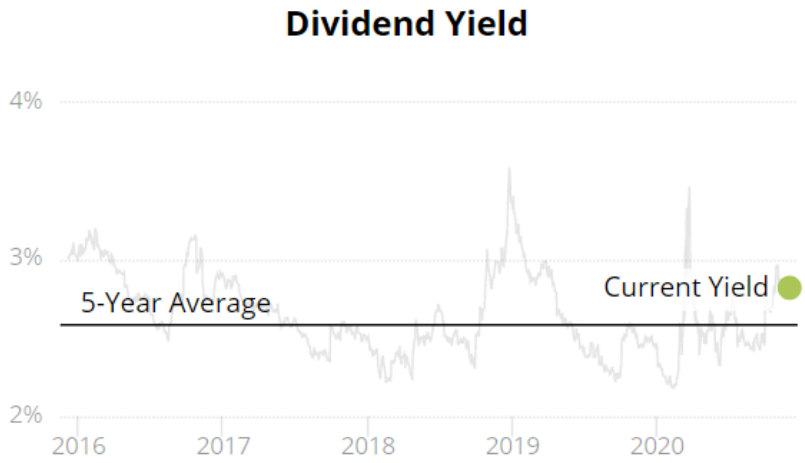
LMT is fairly valued under Model 1 (orange line) and undervalued using Model 2 (blue line). Its current P/E ratio is 14.9 and it 5-year average P/E ratio is 18.5. That leads to these valuation ratios: Model 1 = 0.99 and Model 2 = 0.81.

Model #3: DCF

Using its discounted cash flow (DCF) approach, Morningstar calculates a valuation ratio of 0.83 (undervalued).



Model #4: Relative yields (Simply Safe Dividends)



The relative yield metric suggests that LMT is fairly valued. The stock's 5-year average yield of 2.6%, when compared to its current yield of 2.8%, suggests a valuation ratio of 0.93.

LMT Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	0.99	Fairly valued
#2: P/E to Stock's 5-year average	0.81	Undervalued
#3: DCF (from Morningstar)	0.83	Undervalued
#4. Relative Yield 5-year comparison	0.93	Fairly valued
Average of Models: Valuation ratio = 0.89 = Undervalued		

LMT is undervalued at its current price of about $361. For this high-quality stock, I would pay up to 10% over my calculated fair-value price.

Fair price = $406

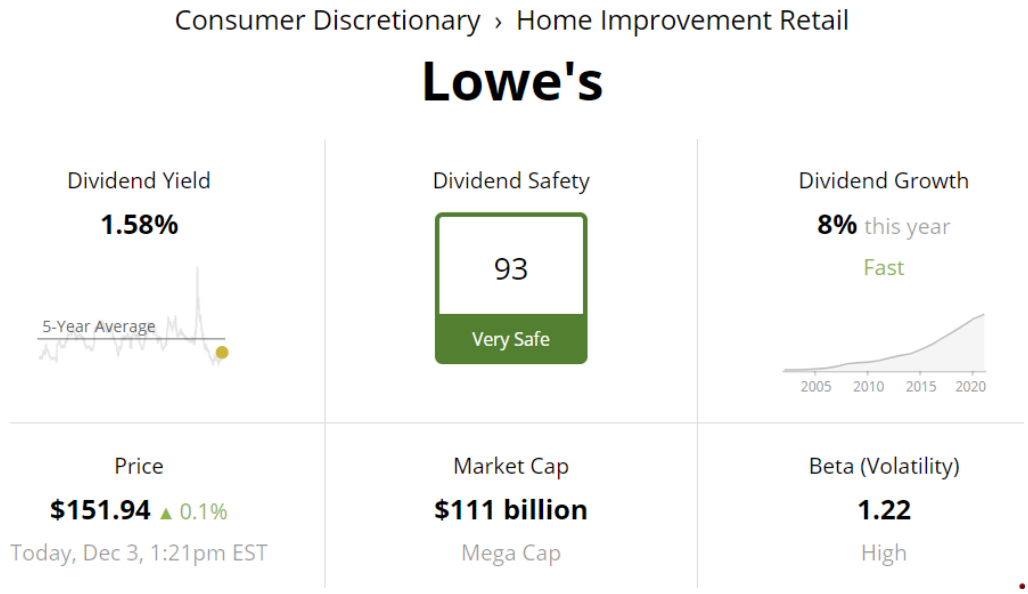
Maximum buy price = $446

LOWE'S (LOW)

LOWE'S (LOW)			
SECTOR: Consumer Discretionary			
INDUSTRY: Specialty Retail			
Link to LOW Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
B	**B**	**B**	**Fairly valued**

Lowe's would have probably earned All-Star status except that its dividend growth rate has been dropping in recent years. It is a low-yield, fast-growth DG stock with a 58-year streak of dividend increases.

Dividend Record (Grade = B)



Lowe's has increased its dividend for 57 years (which covers the housing-induced Great Recession). Over the past few years, it has slowed its rate of annual increases, dropping into single-digit this year for the first time since 2009.

MR% Inc	DGR 1-y	DGR 3-y	DGR 5-y	DGR 10-y
9.09	15.7	17.8	20.2	19.4

LOW Dividend Summary		
Factor	**Data**	**Rating**
Yield	1.6%	Low
Years of Increases	58 years (Dividend King, Champion, Aristocrat)	A
5-year DGR	17% per year (Very fast)	A
DGR Trend	Fast increases, although annual rate has been slowing	C
SSD Safety Rating	93 / 100 = Very safe	A
Total Dividend Grade = B		

Business Model and Company Quality (Grade = B)

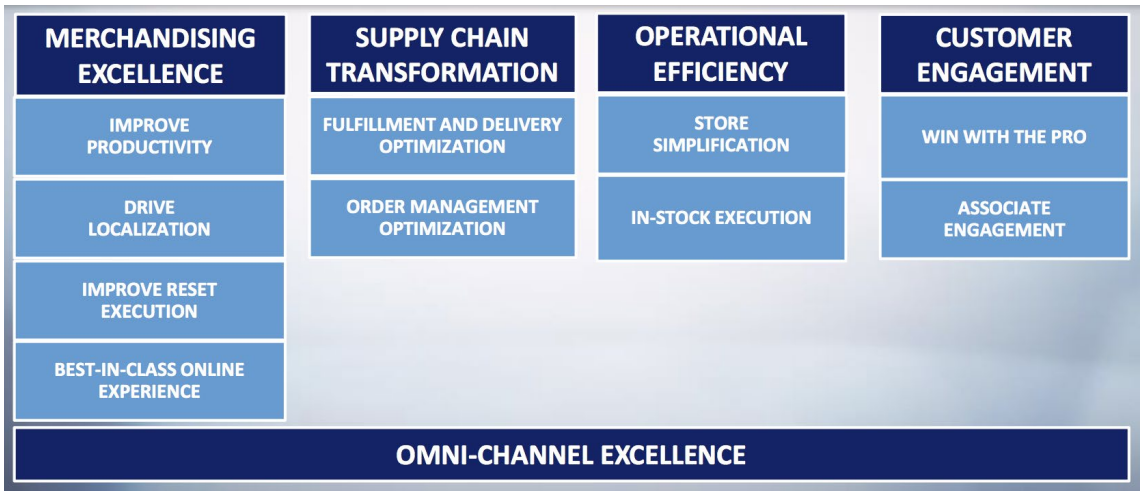
Founded in 1946 and public since 1961, Lowe's (LOW) is the world's second largest home improvement retailer (behind Home Depot). It operates over 2,100 home improvement and hardware stores (almost all in the U.S.) and helps homeowners, renters, and other customers complete a wide array of projects.

LOW sells mostly to do-it-yourself customers (75-80% of revenue), with the rest of its revenue coming from professional contractors. A typical Lowe's store stocks more than 34,000 products across virtually every home improvement product category (lumber, paint, appliances, flooring, tools, cabinets, etc.).

Only about 5% of Lowe's sales are online, but the company is strategically focused on improving omni-channels sales.

The home-improvement niche has proven to be relatively Covid-proof and Amazon-proof.

In addition to focusing on online sales, LOW is also aiming to improve in-store experiences and increasing sales to contractors.

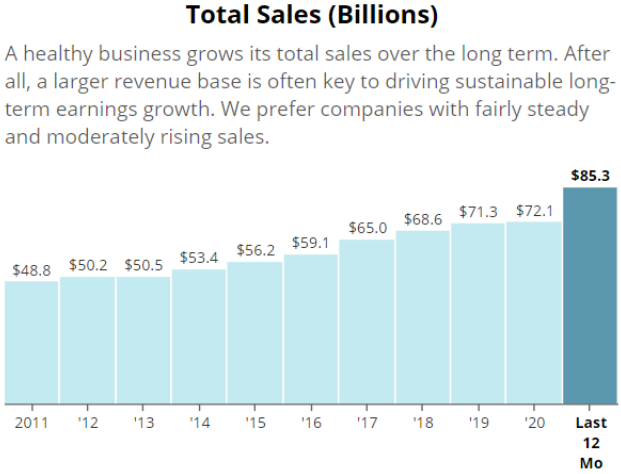


Morningstar awards LOW a Wide moat, based primarily on:

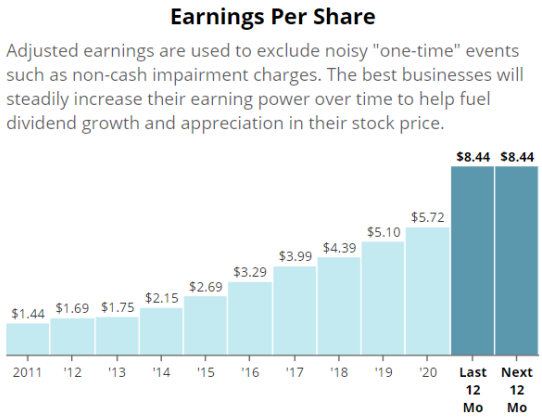
- Advantages of scale
- Improving information technology platform and distribution/logistics network
- Significant bargaining power with vendors that enables lower everyday pricing
- Specialized nature of its products (protects it from mass merchants)
- Brand strength and private-label offerings

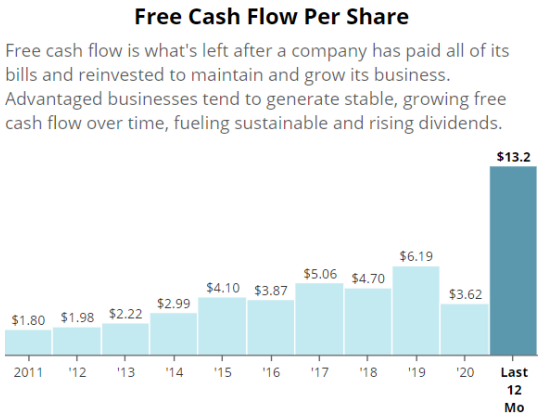
Financials (Grade = B)

LOW's revenue record is outstanding, with increases every year for 10 years in a row. Unlike many companies, LOW's revenue has jumped with the pandemic. Note that fiscal 2020 ended at the end of April, 2020.

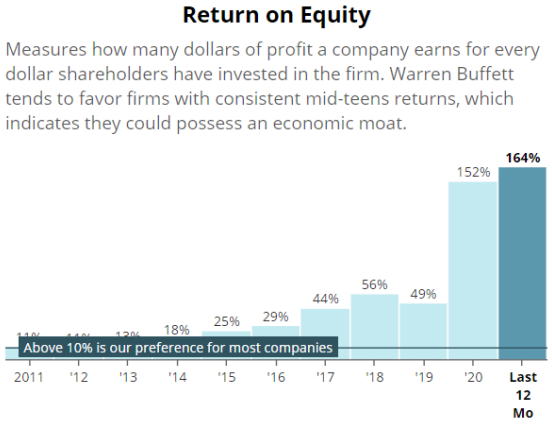


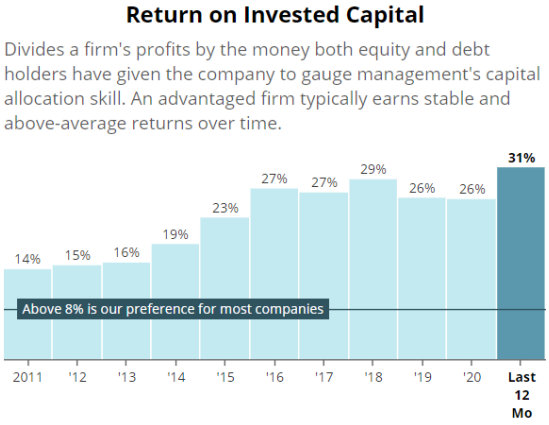
LOW's earnings, like its revenue, have grown every year for the past decade. Its free cash flow has taken a huge jump in calendar year 2020 ("last 12 months" on the chart below).





LOW's efficiency metrics are very high, although its ROE has been goosed by heavy leverage.

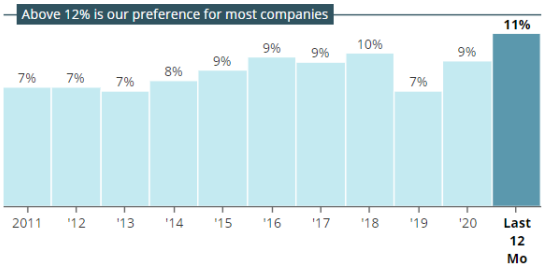




LOW's profitability has not been especially good, which is an issue that new management is working on.

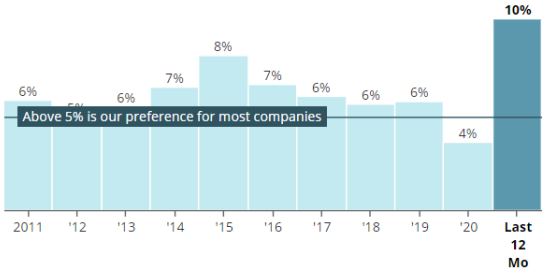
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

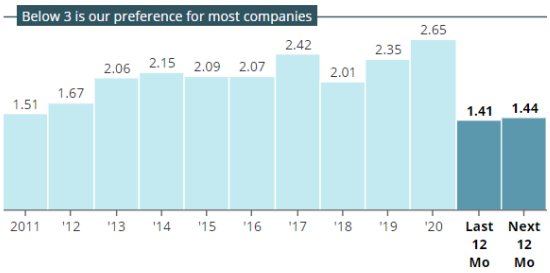
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



LOW has been heavily reliant on debt. Its debt-to-capital ratio is unusually high. That is the major negative point in its financials, and it is an issue that management is focusing on improving. Its credit rating is BBB+ (low investment grade).

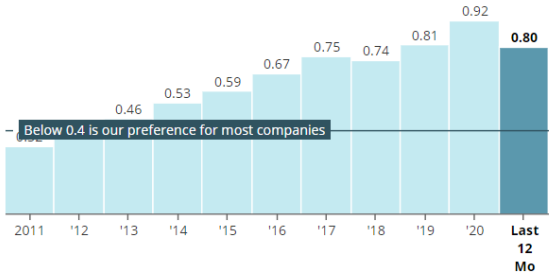
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.



Net Debt to Capital

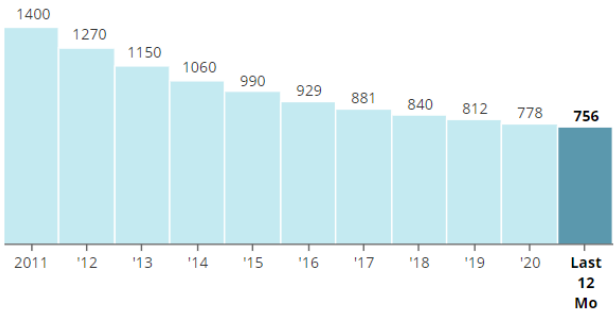
The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



At its recent Q3 2020 earnings presentation, LOW announced that it was reinstating its share repurchase program. Its shares outstanding are a massive 46% less than a decade ago.

Shares Outstanding (Millions)

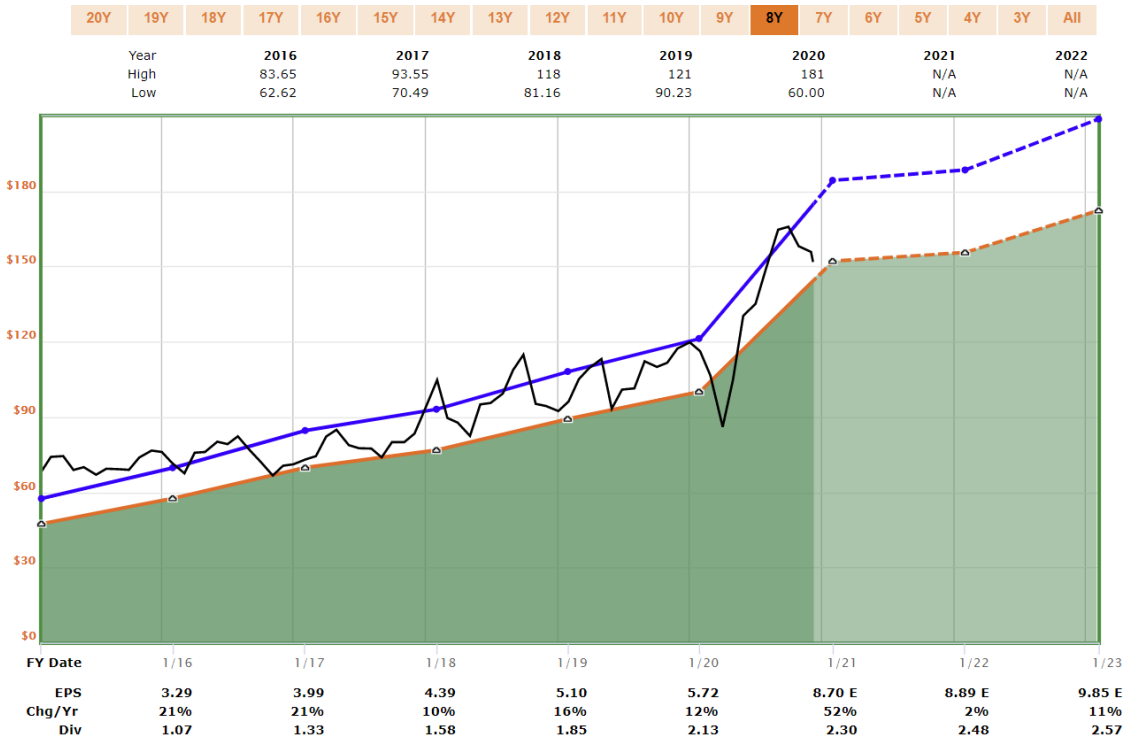
Some companies return excess cash to shareholders by buying their stock when they believe it is undervalued, increasing your ownership stake. Other firms issue shares to fund growth projects. Generally speaking, we prefer a declining share count.



Overall, LOW's financials are very strong, with the only blemish being its reliance on debt and accompanying low-investment-grade credit rating. Those items knock its financials score down to a B.

Valuation (Fairly valued)

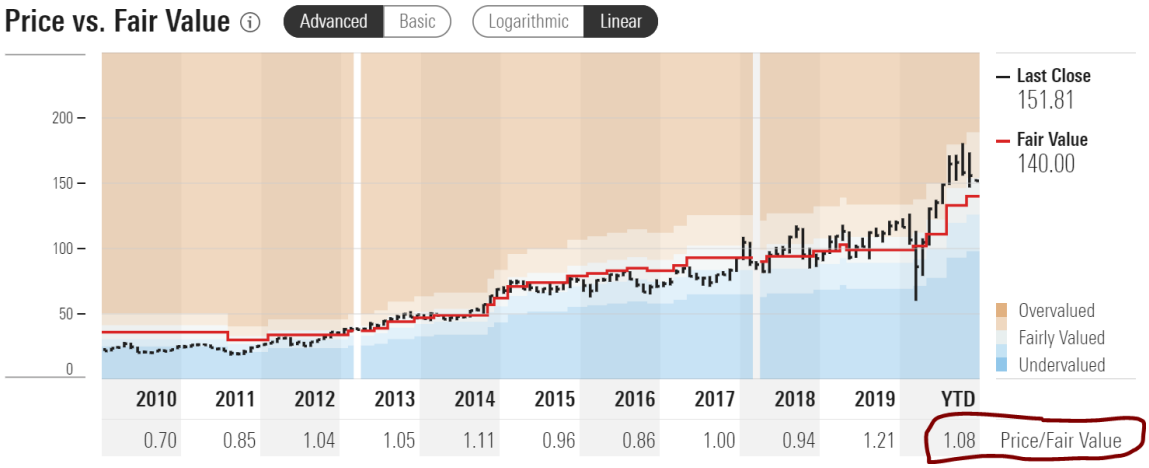
Models #1 & #2: P/E ratios (FASTGraphs)



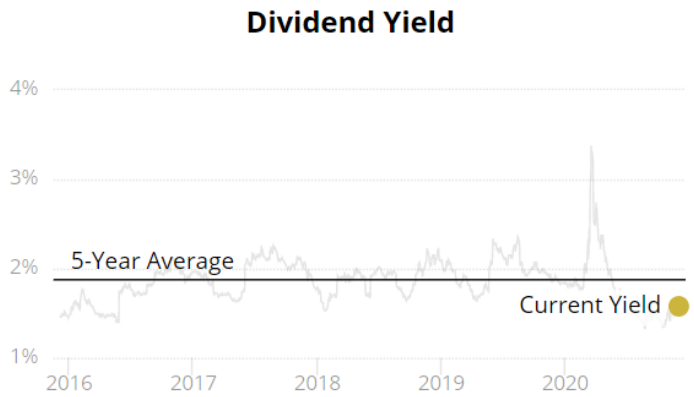
With a current P/E of 18.5 and a 5-year average of 21.2, LOW is fairly valued under Model 1 and undervalued under Model 2. (The orange Model 1 line is drawn at 17.5 instead of 15, reflecting LOW's fast growth.) The Model 1 valuation ratio = 1.06 and the Model 2 ratio = 0.87.

Model #3: DCF (Morningstar)

Using its discounted cash flow (DCF) model, Morningstar calculates a valuation ratio of 1.08, which suggests fair valuation.



Model #4: Relative yields (Simply Safe Dividends)



LOW's current yield is 1.6% compared to its 5-year average of 1.9%. That suggests overvaluation, with a valuation ratio of 1.19.

PM Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's adjusted historical average	1.06	Fairly valued
#2: P/E to Stock's 5-year average	0.87	Undervalued
#3: DCF (from Morningstar)	1.08	Fairly valued
#4. Relative Yield 5-year comparison	1.19	Overvalued
Average of Models: Valuation ratio = 1.05 = Fairly valued		

The valuation models are fairly tightly bunched. When they are combined, they suggest that LOW is fairly valued.

Fair price = $145 Top of fair-value range = $159

MCDONALD'S (MCD)

MCDONALD'S (MCD)			
SECTOR: Consumer Discretionary			
INDUSTRY: Hotels, Restaurants & Leisure			
Link to MCD Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
C	**B**	**B**	**Fairly valued**

McDonald's has a 45-year record of dividend growth, which has weathered Covid-19 in 2020. For decades, McDonald's has proved to be resilient and adaptive to changes in consumer tastes and behaviors, as well as slow economic conditions. However, Covid has hit the business hard and its bounce-back period is uncertain, depending on the course of the pandemic.

Dividend Record (Grade = C)



MCD had some lean years in the early part of the decade, then found its mojo again mid-decade until Covid-19 hit in 2020. Its dividend growth percentage had risen 3 straight years until it fell back this year to 3.2%. The smaller increase was directly related to Covid-19.

MCD has an impressive long-term dividend record, having raised its dividend for 45 straight years despite its highly competitive industry and multiple changing conditions over the years. MCD is a very resilient company.

MCD Dividend Summary		
Factor	**Data**	**Rating**
Yield	2.4%	Mid
Years of Increases	45 (Dividend Champion, Aristocrat)	B
5-year DGR	8% per year (fast)	B
DGR Trend	Rose 2016-19, but dropped in 2020 to 3.2% (Covid-19)	C
SSD Safety Rating	77 / 100 = Safe	B
Total Dividend Grade = C		

Business Model and Company Quality (Grade = B)

Founded in 1940, McDonald's is the world's largest fast-food chain, with more than 38,000 locations in over 100 countries. About 64% of revenue comes from outside the USA.

Several years ago, MCD changed its business model to make almost all of its restaurants franchised, meaning they are owned and operated by independent business owners. Under a typical franchise arrangement, McDonald's owns or leases the property while the franchisee pays for equipment, signs, seating, and décor.

MCD's non-ownership of the restaurants enables the company to achieve restaurant performance levels that are among the highest in the industry. Franchisees are responsible for reinvesting capital in their businesses over time, and McDonald's frequently co-invests with them to help maintain the company's brand value.

A typical franchise term is 20 years and requires franchisees to meet rigorous standards, helping ensure consistency and high quality at all McDonald's restaurants. Franchisees pay initial fees to start up, then pay rent and royalties based upon a percent of sales. This structure enables McDonald's to generate significant levels of cash flow while franchisees benefit from the company's brand and marketing.

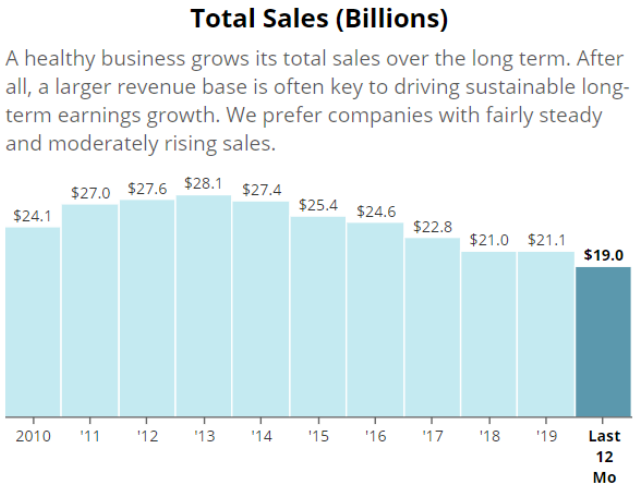
McDonald's is one of the largest real estate owners in the world, with thousands of

property locations along highways and within busy cities. MCD also has scale in food products, being one of the largest purchasers of beef, chicken, and potatoes.

MCD fell on hard times a few years ago due to the rise of fast-casual competitors, shifting consumer tastes, and managerial missteps such as declining service, complex menus, etc. In 2015, MCD brought in a new CEO, who doubled down on its franchising model by selling company-owned stores to independent operators, simplifying the menu, investing heavily in McCafé (beverages), introducing all-day breakfast, in-store ordering kiosks, fresh (not frozen) beef, and a more modern store design.

Covid has hit MCD hard, as it has all restaurants to some extent. However, its business is forecast to spring back in 2021, although of course that will depend on the pandemic, restaurant seating restrictions, and customer willingness to sit inside.

Financials (Grade = B)

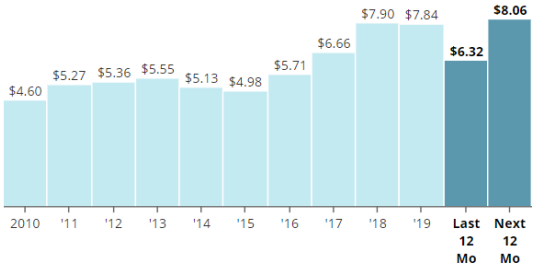


McDonald's revenues can be misleading. The steady decline from 2013 is largely a result of MCD's move to franchise almost all stores, which means that operational revenue reported by the parent company fell even as profitability improved. Revenue was finally leveling off in 2018-19, but Covid-19 hurt in 2020 as shown in the final bar.

MCD has solid earnings and cashflow records, although both display an obvious hit from Covid-19.

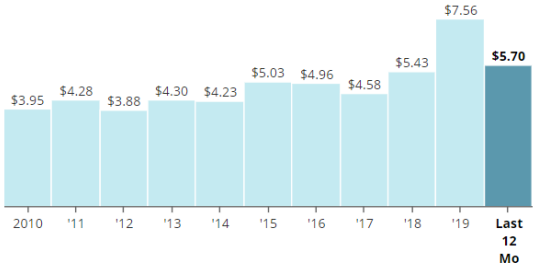
Earnings Per Share

Adjusted earnings are used to exclude noisy "one-time" events such as non-cash impairment charges. The best businesses will steadily increase their earning power over time to help fuel dividend growth and appreciation in their stock price.



Free Cash Flow Per Share

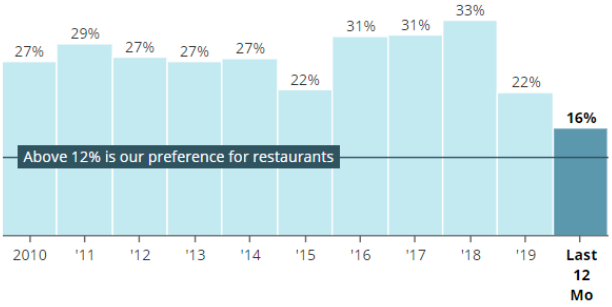
Free cash flow is what's left after a company has paid all of its bills and reinvested to maintain and grow its business. Advantaged businesses tend to generate stable, growing free cash flow over time, fueling sustainable and rising dividends.



I am just displaying the efficiency metric of ROIC (return on invested capital), since ROE (return on equity) has been distorted by the franchising model in recent years. ROIC is very good.

Return on Invested Capital

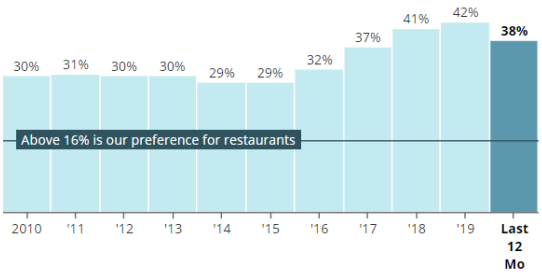
Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



Profitability is well above benchmarks, showing improvement under the franchising model. Again note the Covid impact.

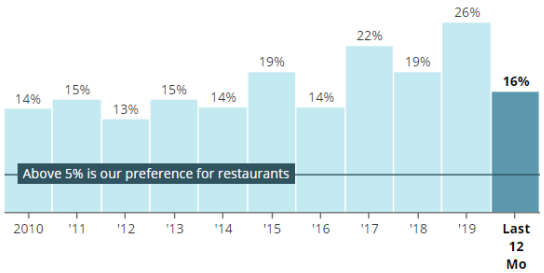
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.

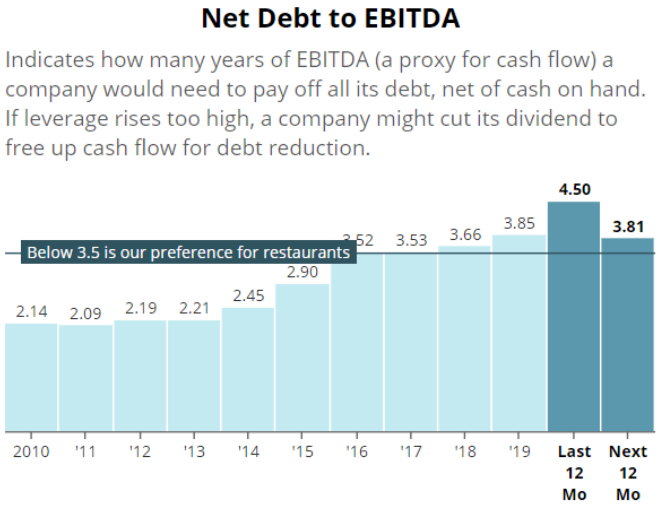


Free Cash Flow Margin

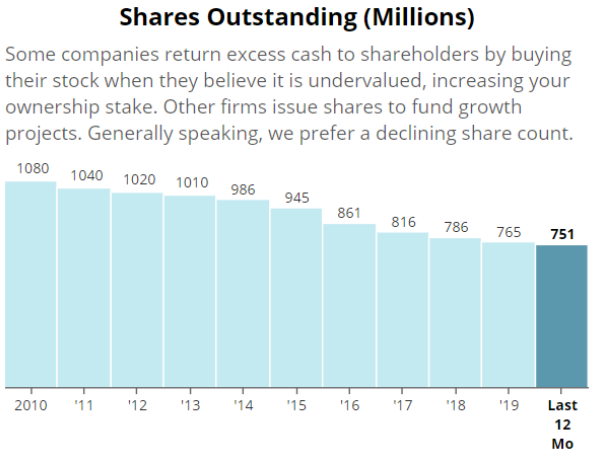
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



MCD is quite dependent on debt, which has risen since emphasizing the franchising model, although the company is working on bringing it back down.



MCD has steadily decreased its shares outstanding over the past decade. It has 30% fewer shares than 10 years ago.



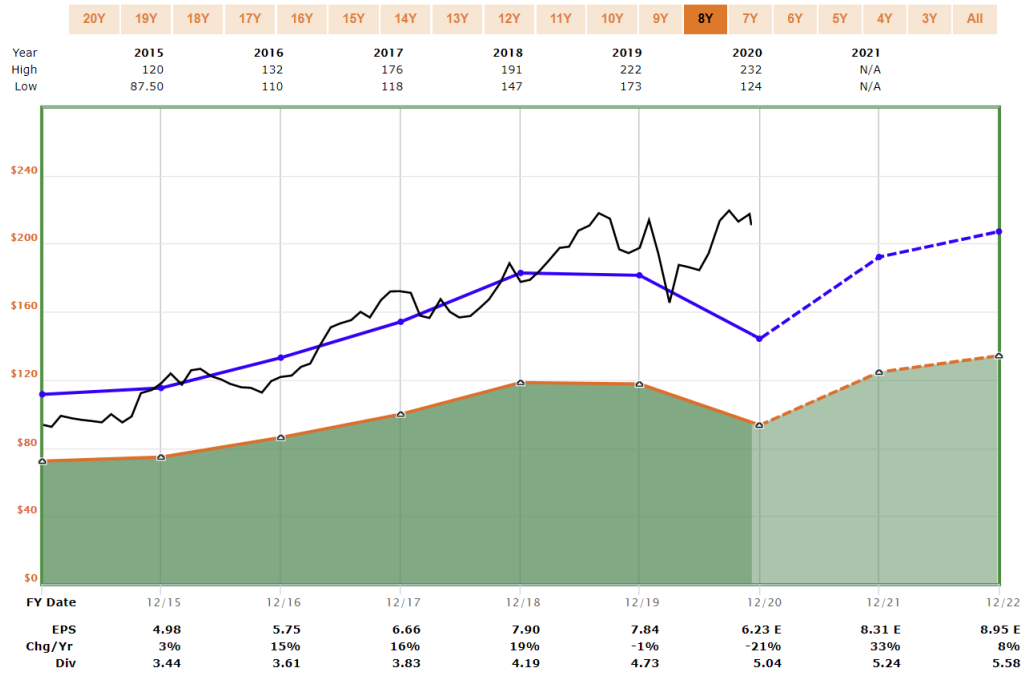
Taking everything into account, I give MCD a B for its financials. Over time, the franchising model amy improve that grade.

Valuation (Fairly valued)

Models #1 & #2: P/E ratios (FASTGraphs)

MCD's price climbed steadily when the new CEO took over in 2015, into overvalued territory. It took off even more when the market began to appreciate its turnaround plans in 2018. Covid-19 had only a temporary impact on the market price trajectory, but

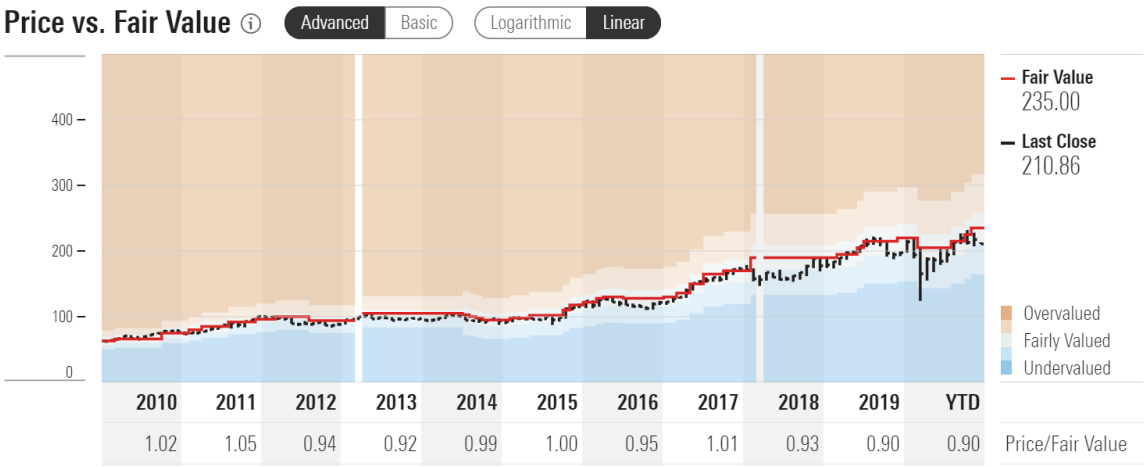
the 21% dip in EPS forecast for 2020 results in significant overvaluation under these models.



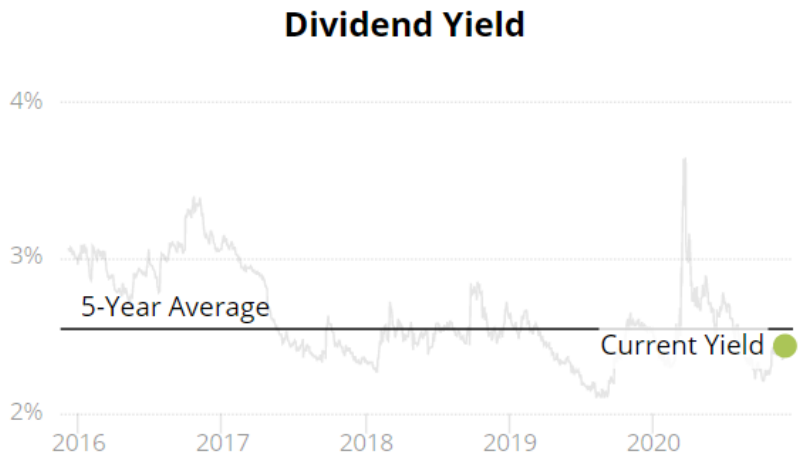
MCD's current P/E ratio of 33.2 is well above the basic reference fair value of 15 (orange line) and its own 5-year average of 23.1 (blue line). Its valuation ratios are Model 1 = 2.21 and Model 2 = 1.43.

Model #3: DCF

Using its discounted cash flow (DCF) techniques, Morningstar derives a 0.90 valuation ratio for MCD, which is just on the edge of undervaluation.



Model #4: Relative yields (Simply Safe Dividends)



The relative yield metric suggests that MCD is slightly overvalued, with a valuation ratio of 1.05.

MCD Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	2.21	Very overvalued
#2: P/E to Stock's 5-year average	1.43	Very overvalued
#3: DCF (from Morningstar)	0.90	Fairly valued
#4. Relative Yield 5-year comparison	1.05	Fairly valued
Average of Models: Valuation ratio = 1.40 = Very overvalued		

The two valuation models based on P/E ratios suggest that MCD is very overvalued, but they are significantly out of step with the two other models and dominate the overall calculations.

For more insight, I consulted some other sources:
Credit Suisse: Blue sky $255, target $230, grey sky $190
Argus: $245 target price
CFRA: $199 fair value price

All those calculations suggest that the two P/E models are too pessimistic. Looking at them visually, they don't capture the bounce-back from MCD's big EPS drop that is forecast for 2021.

My judgement is to not drop the two P/E models, but to cap them at 1.20, which is what I do with the yield model when it is at extreme values. That gives us this:

MCD Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	1.20 (capped)	Overvalued
#2: P/E to Stock's 5-year average	1.20 (capped)	Overvalued
#3: DCF (from Morningstar)	0.90	Fairly valued
#4. Relative Yield 5-year comparison	1.05	Fairly valued
Average of Models: Valuation ratio = 1.09 = Fairly valued		

Fair price = $194

Top of fair-value range = $213

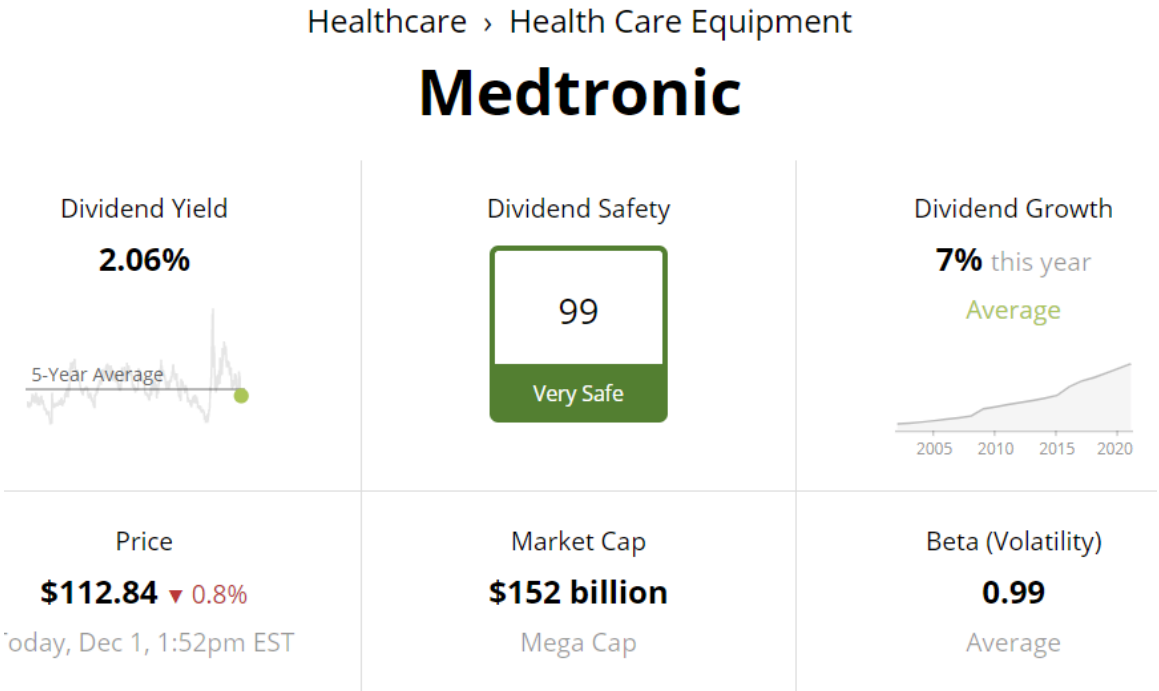
MEDTRONIC (MDT)



MEDTRONIC (MDT)			
SECTOR: Healthcare			
INDUSTRY: Health Care Equipment			
Link to MDT Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
B	**A**	**B**	**Fairly valued**

Medtronic is a DG All Star based on its long, reliable dividend record, outstanding business quality, and good financials. Its DG streak is 43 years.

Dividend Record (Grade = B)



MDT's yield is just 2.1%, but its growth rate helps compensate and makes it a mid-yield, mid-growth DG stock. At 43 years, MDT's dividend growth has been reliable, and its dividend is very safe.

MDT Dividend Summary		
Factor	**Data**	**Rating**
Yield	2.1%	Mid
Years of Increases	43 (Dividend Champion & Aristocrat)	B
5-year DGR	9% per year (OK for yield)	C
DGR Trend	Steadily 7-10% most of last decade	B
SSD Safety Rating	99 / 100 = Very safe	A
Total Dividend Grade = B		

For tax purposes, Medtronic's domicile is Ireland. Therefore, Irish dividend withholding tax rules apply. Under these rules, MDT shareholders that are residents of the U.S. and have filed relevant information with their broker are entitled to an exemption from Irish withholding. Medtronic states that the vast majority of its shareholders are entitled to an exemption from the Irish dividend withholding tax.

Business Model and Company Quality (Grade = A)

MDT is the world's largest manufacturer of implantable biomedical devices. That market has been impacted by Covid-19, because many such procedures are deferrable, and they have slowed down with the pandemic. However, that market will surely recover as Covid-19 gets brought under control.

Founded in 1949, Medtronic has become a global leader in medical technology. In 1957, MDT invented the world's first battery-operated pacemaker. One year later, it produced the first implantable pacemaker.

By the 1970s, Medtronic was establishing itself in overseas markets. Today, Medtronic has operations in 150 countries. Its customers include hospitals, clinics, third-party healthcare providers, distributors, governmental healthcare programs, and group purchasing organizations. In the 2020 fiscal year (ended in April), international sales accounted for nearly half of overall revenue.



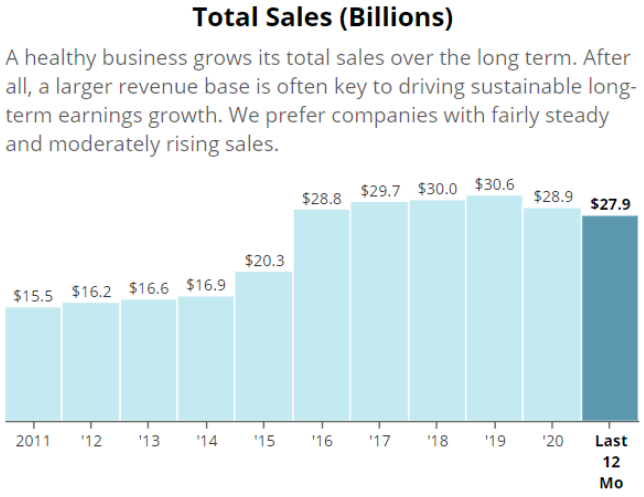
MDT's products treat 70 health conditions and include cardiac devices, cranial and spine robotics, insulin pumps, surgical tools, and patient monitoring systems. Its revenues come from these 4 segments: Cardiac and Vascular (38% of revenue); Minimally Invasive Therapies (28%); Restorative Therapies (27%); Diabetes: 8%.

The Minimally Invasive Therapies Group is the former Covidien, an Irish company acquired in 2015. With that acquisition, MDT formed a new holding company in Ireland (Medtronic PLC), where it maintains executive offices, while its operational headquarters remain in Minneapolis.

Medtronic has stated that its business goals are for 8% EPS growth over its long-range planning period. Morningstar confers a Wide moat rating on MDT. I confer a grade of A on its business quality.

Financials (Grade = B)

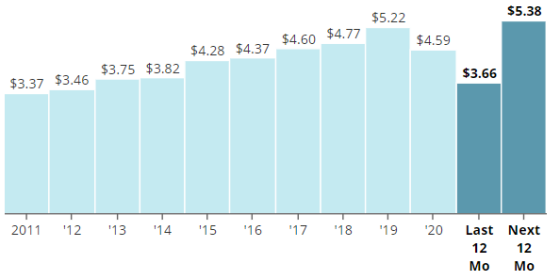
MDT's revenue shows general growth, with a jump in 2016 from the Covidien acquisition, then the slowdown in 2020 from Covid-19.



MDT's earnings and cashflow records are strong, again noting the impact of the pandemic.

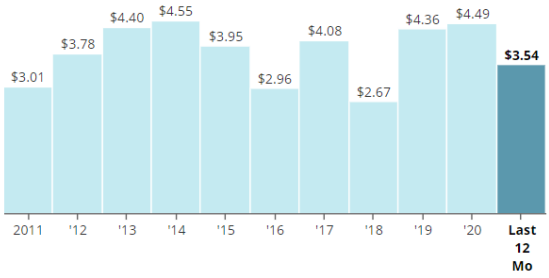
Earnings Per Share

Adjusted earnings are used to exclude noisy "one-time" events such as non-cash impairment charges. The best businesses will steadily increase their earning power over time to help fuel dividend growth and appreciation in their stock price.



Free Cash Flow Per Share

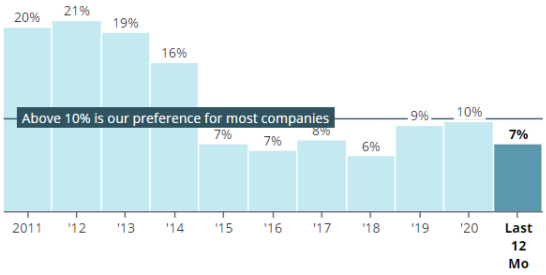
Free cash flow is what's left after a company has paid all of its bills and reinvested to maintain and grow its business. Advantaged businesses tend to generate stable, growing free cash flow over time, fueling sustainable and rising dividends.



MDT's efficiency metrics (shown in the first pair of graphs below) are mediocre since the Covidien acquisition, while its profitability metrics (shown in the second pair) are above the benchmarks.

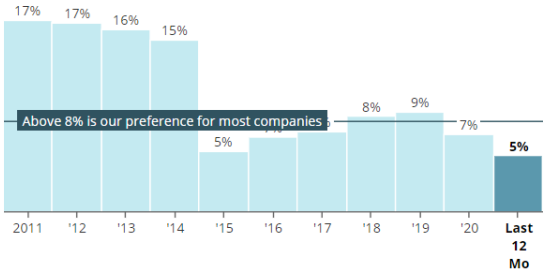
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



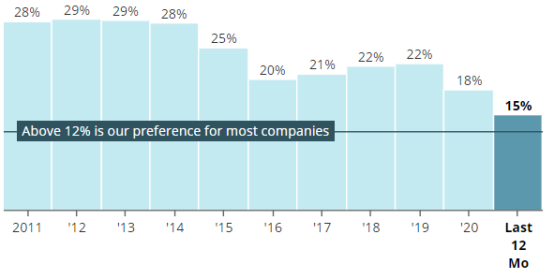
Return on Invested Capital

Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



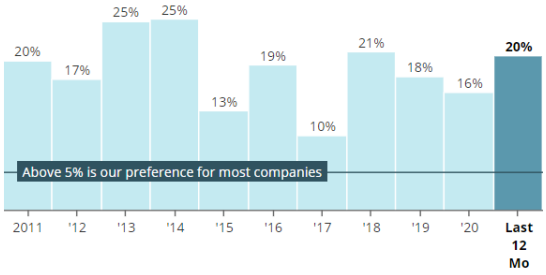
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

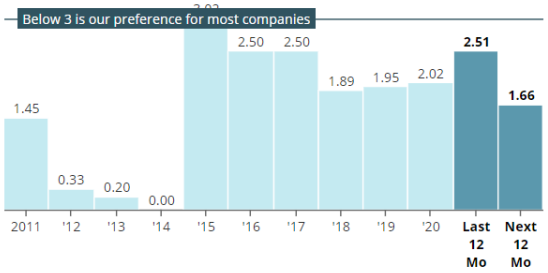
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



MDT's debt metrics jumped up with the Covidien acquisition. That said, the metrics have mostly stayed below the benchmarks, and leverage is slowly being lowered over the past few years. MDT has a mid-level investment-grade credit rating of A.

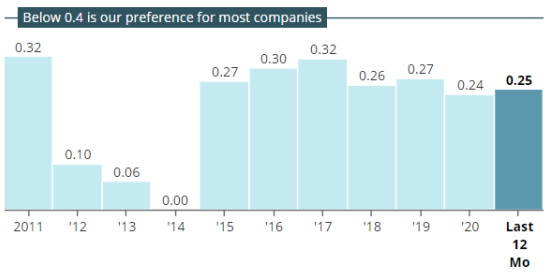
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.



Net Debt to Capital

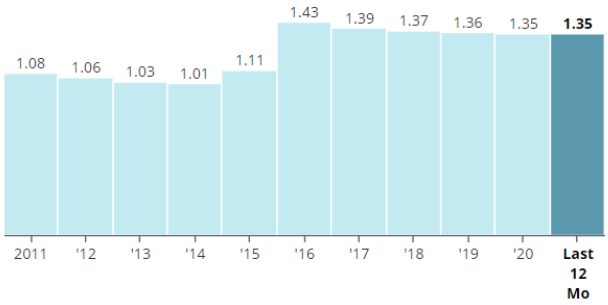
The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



The Covidien acquisition caused a jump in MDT's share count, and the company has been gradually lowering it since then, as it had been before the acquisition.

Shares Outstanding (Billions)

Some companies return excess cash to shareholders by buying their stock when they believe it is undervalued, increasing your ownership stake. Other firms issue shares to fund growth projects. Generally speaking, we prefer a declining share count.

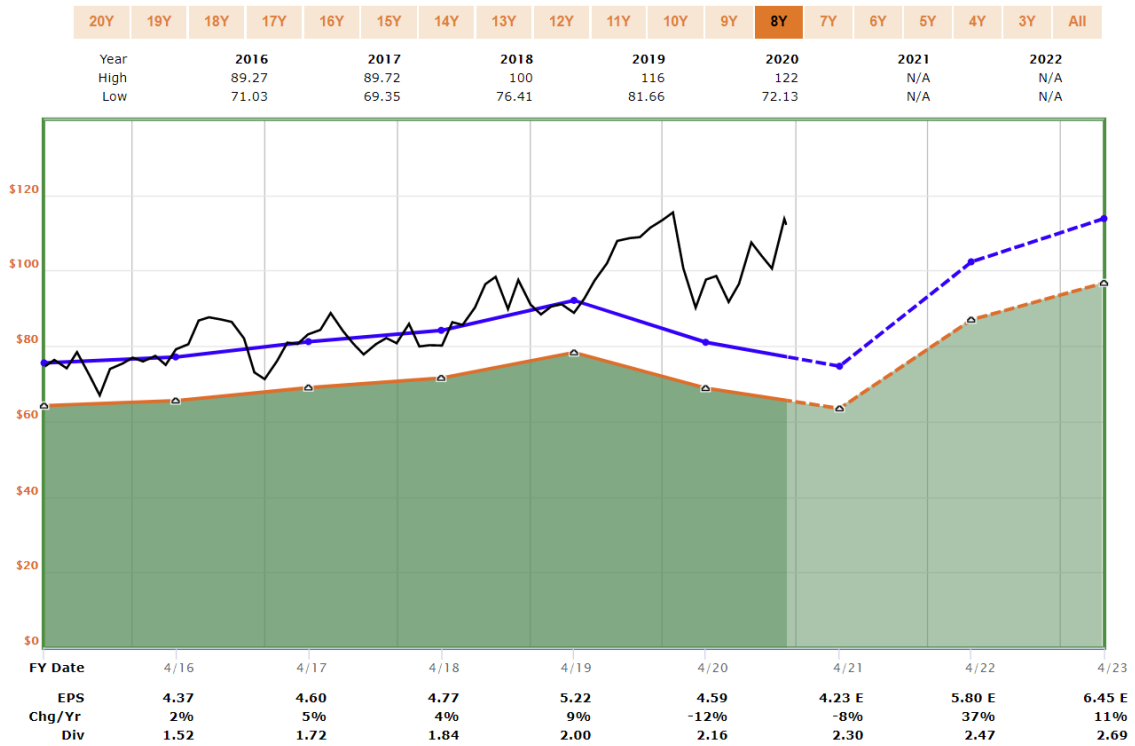


Overall, MDT's financial record is strong. I give it a B instead of B+ or A, mostly for the lack of clarity on the timing of the bounce-back from the pandemic slowdown.

(Analysis continues on next page.)

Valuation (Fairly valued)

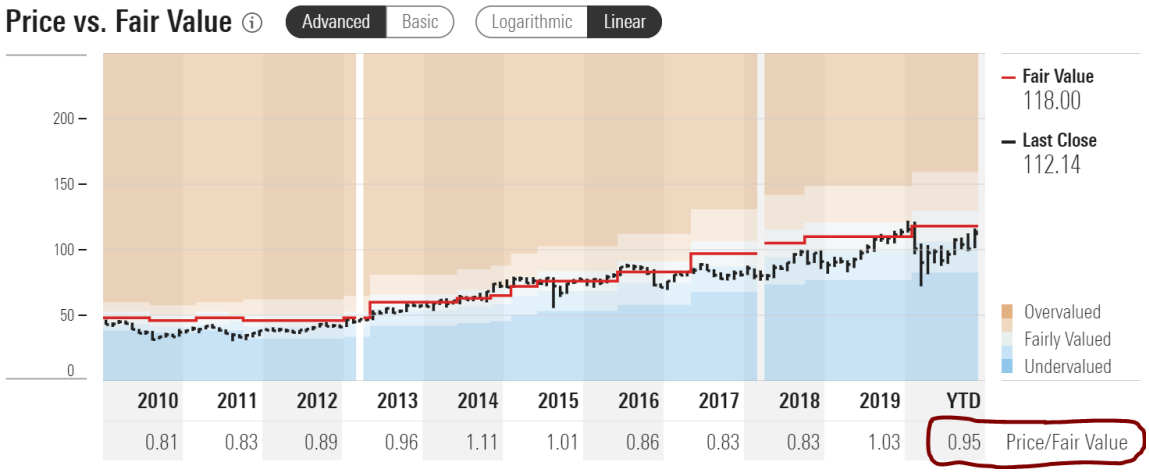
Models #1 & #2: P/E ratios (FASTGraphs)



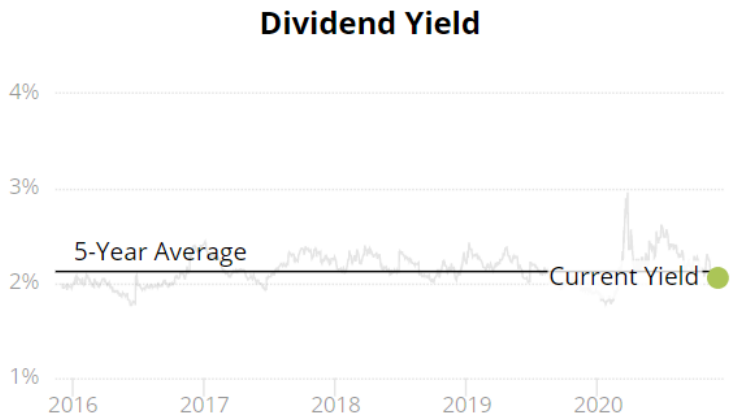
MDT is overvalued using both PE-based valuation models. MDT's current P/E ratio is 25.6 and its 5-year average is 17.7. The valuation ratios are Model 1 = 1.71 and Model 2 = 1.45. The stock's share price has recovered from the Covid-19 drop, but the fair-value reference lines reflect anticipated earnings drops followed by a strong recovery in fiscal 2021.

Model #3: DCF

Using its discounted cash flow (DCF) model, Morningstar calculates a valuation ratio of 0.95, which suggests fair valuation.



Model #4: Relative yields (Simply Safe Dividends)



MDT's current yield and its 5-year average both round to 2.1%. That suggests fair valuation and a valuation ratio of 1.00.

MDT Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	1.71	Very overvalued
#2: P/E to Stock's 5-year average	1.45	Very overvalued
#3: DCF (from Morningstar)	0.95	Fairly valued
#4. Relative Yield 5-year comparison	1.00	Fairly valued
Average of Models: Valuation ratio = 1.29 = Very overvalued		

Because the P/E-based valuation models are so clearly different from the other two, and dominate the calculations, I decided to look at other sources to see what they think:

Credit Suisse: Blue Sky $135, Grey Sky $92, Target $118
Refinitiv: Mean price target of 26 analysts $125, Lowest $100

Argus: Target $115

The consensus among analysts is clearly that MDT is not significantly overvalued as suggested by Models 1 and 2. Therefore, as I did with MCD, I cap models 1 and 2 at 1.20, which is what I do with the yield model when it is at extreme values. That gives us this:

MDT Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	1.20 (capped)	Overvalued
#2: P/E to Stock's 5-year average	1.20 (capped)	Overvalued
#3: DCF (from Morningstar)	0.95	Fairly valued
#4. Relative Yield 5-year comparison	1.00	Fairly valued
Average of Models: Valuation ratio = 1.09 = Fairly valued		

Applying the latter valuation to MDT's recent price of $112 leads to this fair price:

Fair price = $103

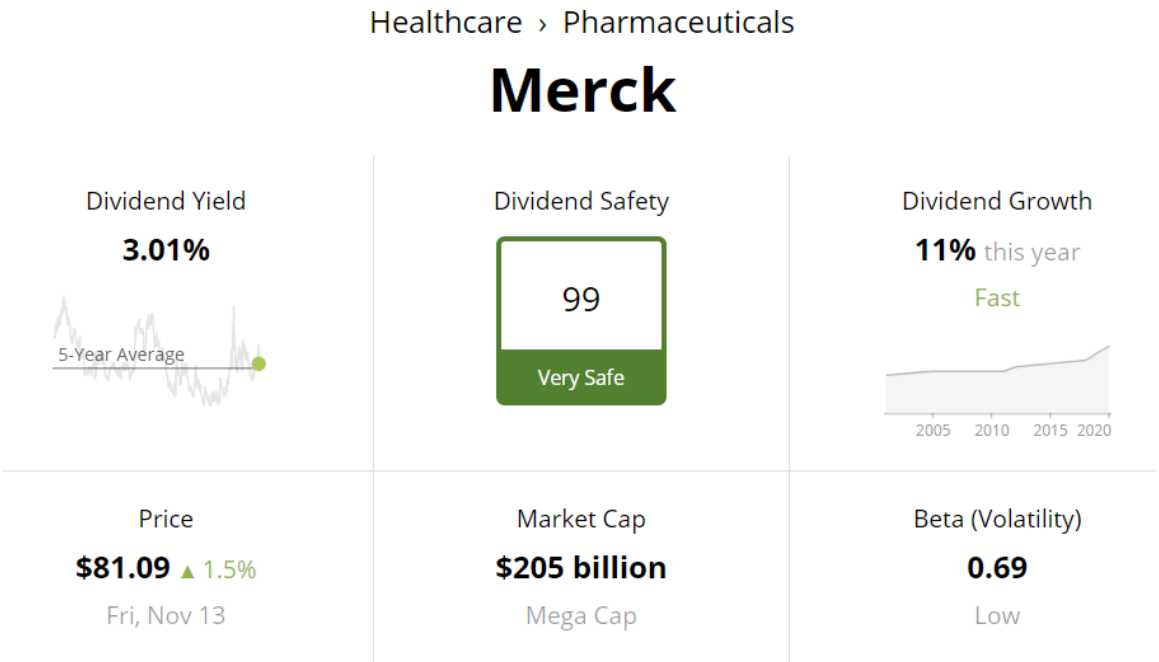
Top of fair-value range = $113

MERCK (MRK)

MERCK (MRK)			
SECTOR: Healthcare			
INDUSTRY: Pharmaceuticals			
Link to MRK Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
C	**B**	**B+**	**Fairly valued**

Merck is a high-quality pharmaceutical and vaccine company with strong financials. Its dividend is mid-range and probably mid-growth, as well as being very safe.

Dividend Record (Grade = C)



Merck has paid uninterrupted dividends for decades, but it froze its dividend from 2005-11. Then it began annual increases again, slowly at first, then into the 10% range the past two years. Currently it combines a 3%+ yield with a near-perfect safety score of 99. That overall record is mixed and does not lend itself to easy categorization. Management has committed to maintain the firm's current dividend after a spinoff (discussed below), with growth expected in 2021 and beyond.

MRK Dividend Summary		
Factor	**Data**	**Rating**
Yield	3.1%	Mid
Years of Increases	9 years (Short)	D
5-year DGR	6% per year (OK)	C
DGR Trend	Last 2 years in double-digits; preceding years in low single-digits	C
SSD Safety Rating	99 / 100 = Very safe	A
Total Dividend Grade = C		

Business Model and Company Quality (Grade = B)

Merck's operations are managed on a products basis with three operating segments:

- Pharmaceutical: Includes human health pharmaceuticals (sold primarily to drug wholesalers and retailers, hospitals, government agencies and managed health care providers) and vaccine products (sold primarily to physicians, wholesalers, physician distributors and government entities such as the CDC).

- Animal Health: Veterinary pharmaceutical and vaccine products, as well as health management solutions and services for livestock and companion animal species. These are sold to veterinarians, distributors and animal producers.

- The Healthcare Services segment has been sold off in pieces, with the plan for the remaining businesses announced in early 2020.

As to the latter, MRK announced plans to spin off its Women's Health and Biosimilar divisions along with various legacy branded drugs. Combined, these businesses account for nearly 15% of Merck's revenue. The spinoff will be completed in the first half of 2021, and shares in the new company will be distributed to current MRK shareholders.



After the spinoff, management expects the remaining business to improve its revenue growth by up to 1 percentage point annually through 2024, as well as improved operating margins.

In 2019, Merck's three largest drugs accounted for 39% of its revenue. After the spinoff, they will account for about 45% of revenue. Merck's biggest blockbuster drug, Keytruda (used to treat lung and other cancers) grew 58% in 2019 to represent 24% of the company's total sales. Keytruda's patent protection falls away in 2025 (Europe) and 2028 (USA).

MRK's other major brands include Gardasil (8% of revenue, protected until 2028) and Januvia (7% of revenue, protected until 2022).

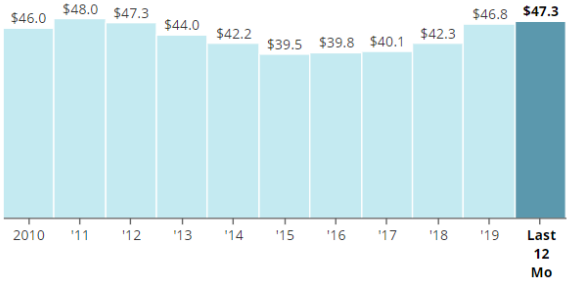
Morningstar awards MRK a Wide moat, based on its patents, economies of scale, strong cashflow supporting new-product development, and powerful salesforce. I give it a quality grade of B.

Financials (Grade = B+)

Merck's revenue has grown for the past four years, and is forecast to grow again in 2020. (The 2020 full-year earnings report will come in January 2021.)

Total Sales (Billions)

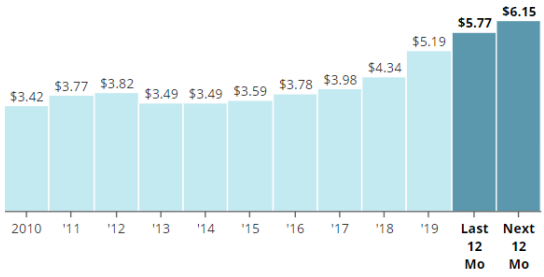
A healthy business grows its total sales over the long term. After all, a larger revenue base is often key to driving sustainable long-term earnings growth. We prefer companies with fairly steady and moderately rising sales.



MRK's earnings have been steadily rising for several years, and its cashflow is strong but tends to yo-yo up and down from year to year.

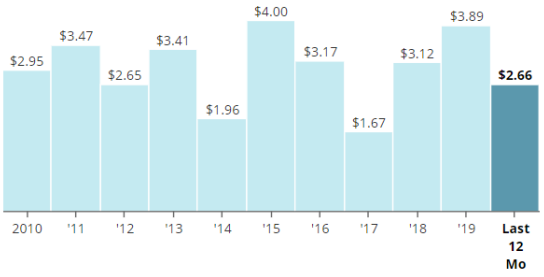
Earnings Per Share

Adjusted earnings are used to exclude noisy "one-time" events such as non-cash impairment charges. The best businesses will steadily increase their earning power over time to help fuel dividend growth and appreciation in their stock price.



Free Cash Flow Per Share

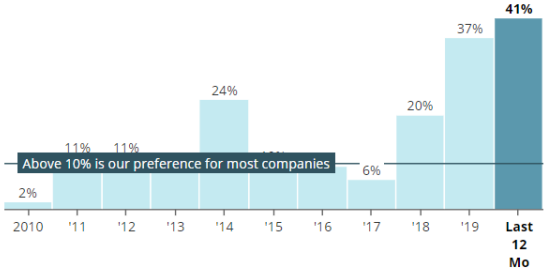
Free cash flow is what's left after a company has paid all of its bills and reinvested to maintain and grow its business. Advantaged businesses tend to generate stable, growing free cash flow over time, fueling sustainable and rising dividends.



MRK's efficiency metrics (top two charts) are very good, as are its profitability metrics (second two charts).

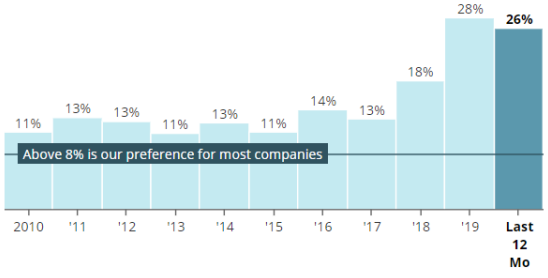
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



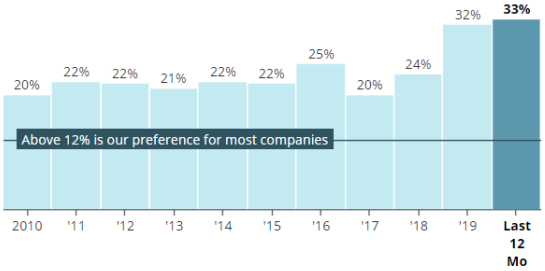
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Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



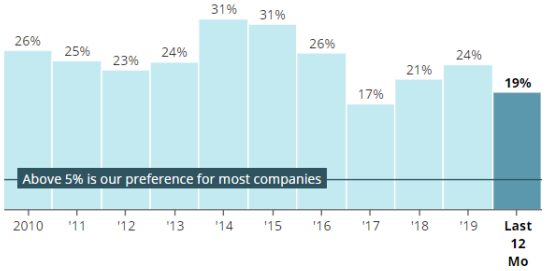
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

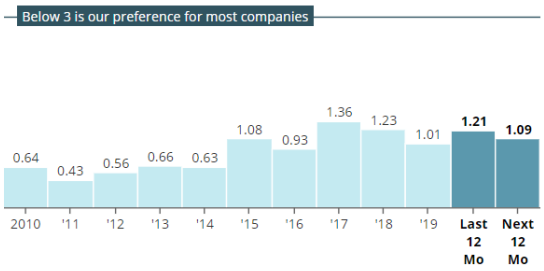
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



MRK's debt has been low until the past couple of years, when it has employed more leverage, although not to any alarming level. The company's credit rating is a high-investment-grade AA-, so debt is not a problem.

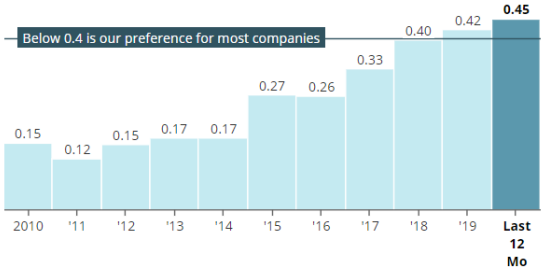
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.



Net Debt to Capital

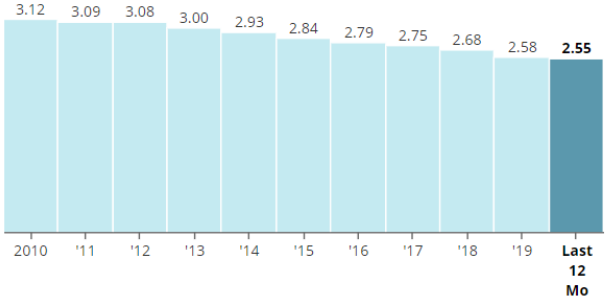
The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



MRK has been reducing its share count steadily. It has 17% fewer shares outstanding than it did 10 years ago.

Shares Outstanding (Billions)

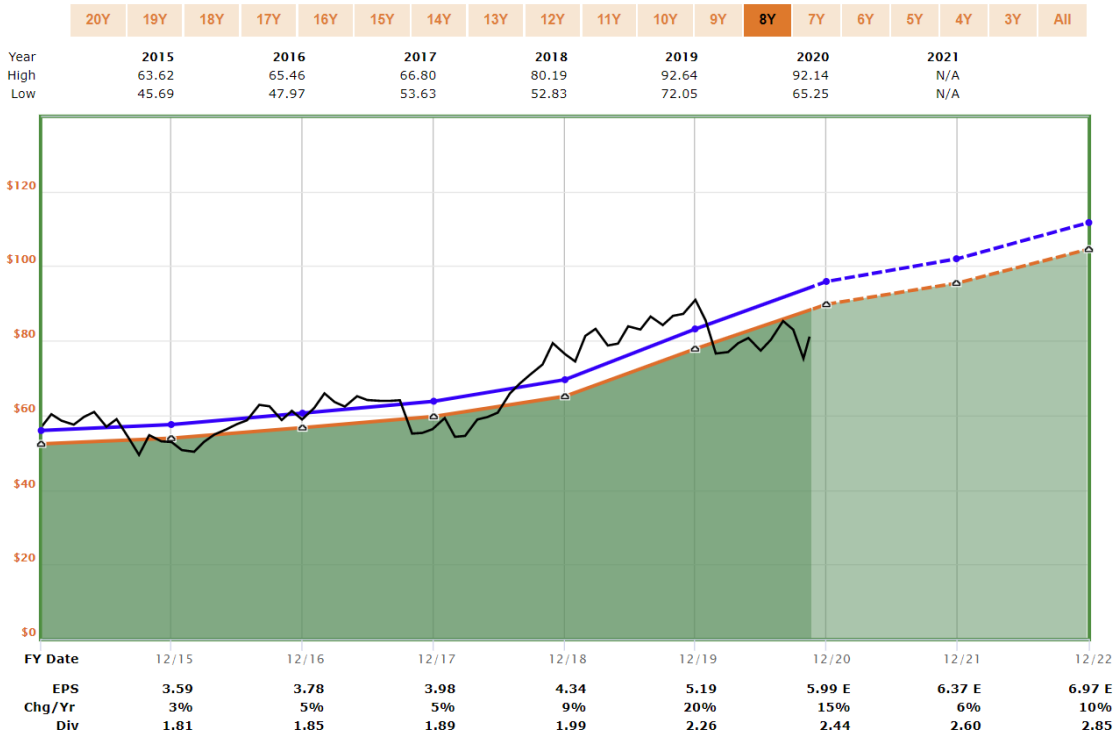
Some companies return excess cash to shareholders by buying their stock when they believe it is undervalued, increasing your ownership stake. Other firms issue shares to fund growth projects. Generally speaking, we prefer a declining share count.



Overall, I consider MRK's financials to be above average (Grade = B+). I considered an A grade, but the lumpiness of its cashflow combined with its seemingly unnecessary increase in leverage over the past couple years dissuaded me. Still a very good picture.

Valuation (Fairly valued)

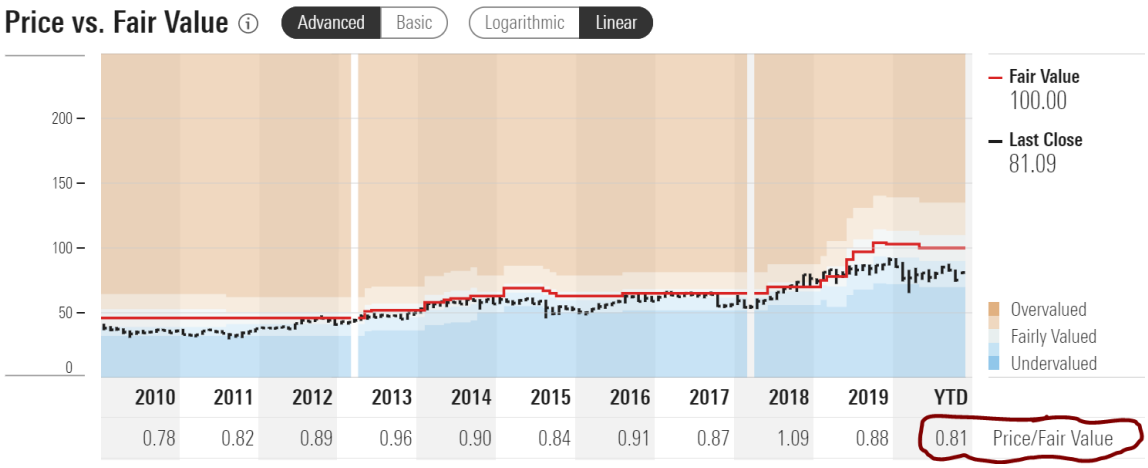
Models #1 & #2: P/E ratios (FASTGraphs)



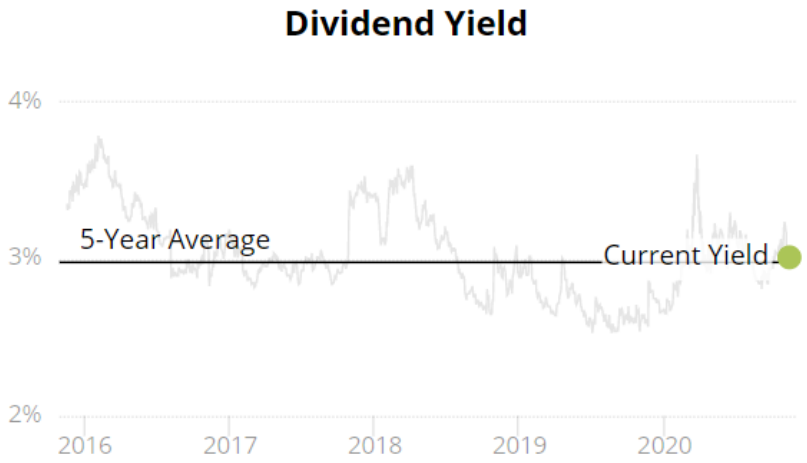
Merck is fairly valued using the first model and undervalued using the second. With a current P/E of 13.8 and a 5-year average of 16.0, Model 1's valuation ratio = 0.92 and Model 2's = 0.86.

Model #3: DCF

Using its discounted cash flow (DCF) techniques, Morningstar calculates a valuation ratio of 0.81, which suggests undervaluation.



Model #4: Relative yields (Simply Safe Dividends)



Merck's current yield and 5-year average both round to 3.0%, suggesting that Merck is fairly valued, with a valuation ratio of 1.00.

MRK Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	0.92	Fairly valued
#2: P/E to Stock's 5-year average	0.86	Undervalued
#3: DCF (from Morningstar)	0.81	Undervalued
#4. Relative Yield 5-year comparison	1.00	Fairly valued
Average of Models: Valuation ratio = 0.90 = Fairly valued		

The valuation models are pretty tightly bunched, and when they are combined, they suggest that Merck is right on the border between being fairly valued and undervalued.

Fair price = $90

Merck is a very high-quality company, so I would be willing to pay to the top of the +/- 10% fair-value range.

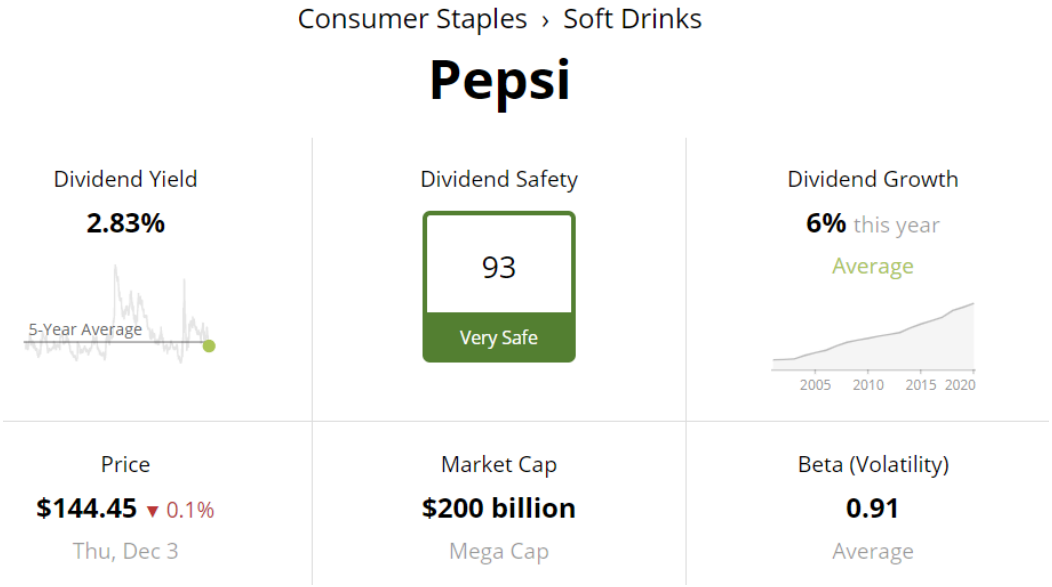
Maximum buy price = $99

PEPSICO (PEP)

PEPSICO (PEP)			
SECTOR: Consumer Staples			
INDUSTRY: Food & Beverage			
Link to PEP Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
B	**A**	**B+**	**Overvalued**

PepsiCo is a DG All Star based on its great business model, 48-year dividend growth streak, steady increases, and strong financials. Its dividend is very safe. Its price is just a few dollars over the top of its fair-value range.

Dividend Record (Grade = B)



PEP Dividend Summary		
Factor	**Data**	**Rating**
Yield	2.8%	Mid
Years of Increases	48 (Dividend Champion, Aristocrat)	B
5-year DGR	8% per year (OK for yield)	C
DGR Trend	Steadily in upper single-digits	B
SSD Safety Rating	93 / 100 = Very safe	A
Total Dividend Grade = B		

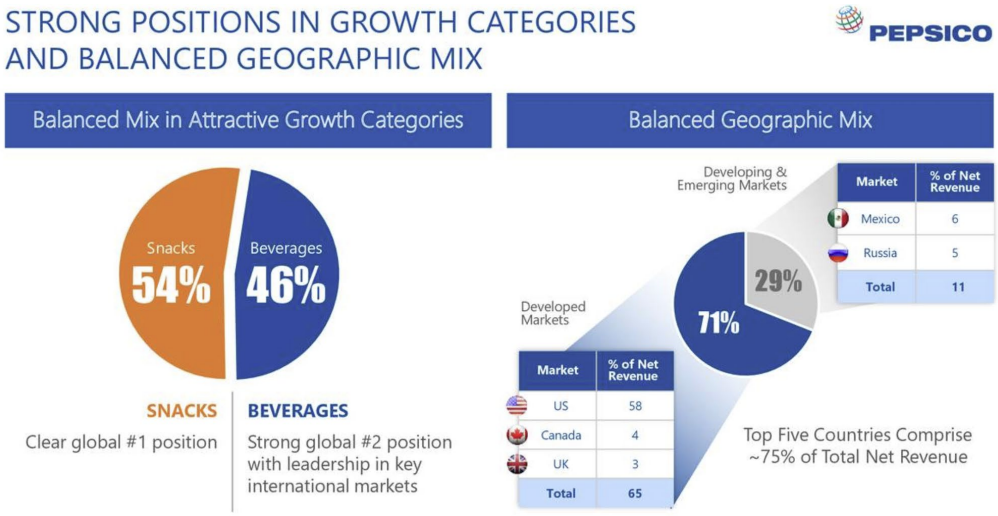
Business Model and Company Quality (Grade = A)

PepsiCo (PEP) traces its roots to 1898 when its original beverage formulation was created by a North Carolina pharmacist. The current beverage + snack company was formed by the 1965 merger with Frito-Lay (founded in 1932).

PepsiCo is a consumer powerhouse, as shown in the following slides from a 2020 presentation that sum up the business pretty well.







PEP is a wide-moat company. Aside from its brands, its competitive advantages include its large scale, balanced product portfolio, and extensive distribution network. By selling both snacks and beverages, Pepsi provides retailers an efficient means of sourcing much of what their customers want. Over half of consumers who buy salty snacks buy liquid refreshments in the same basket, according to analyst firm IRI.

Pepsi's large scale allows it to invest aggressively in marketing to stay in touch with consumers' evolving preferences. Pepsi routinely spends about $4 billion on advertising and marketing (over 6% of sales).

Pepsi also benefits from operating in industries that enjoy recurring consumer demand. If a new consumer trend emerges, Pepsi has the financial firepower and distribution necessary to develop relevant new products or acquire brands that move them quickly into new areas.

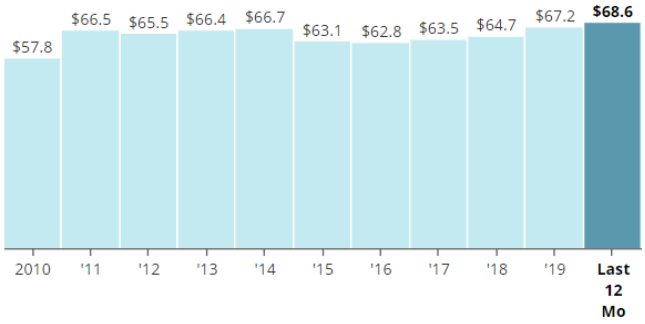
PEP has invested significantly in what it refers to as "Guilt-Free" products, meaning low sodium snacks or drinks with 70 calories per serving or less. Today, Guilt-Free products account for nearly half of sales. Furthermore, over 25% of the company's revenue is earned from "Everyday Nutrition" products such as grains, fruits and vegetables, or protein, plus those that are naturally nutritious like water and unsweetened tea.

Financials (Grade = B+)

PEP is a slowly growing business. Its revenues have increased in each of the past 4 full years.

Total Sales (Billions)

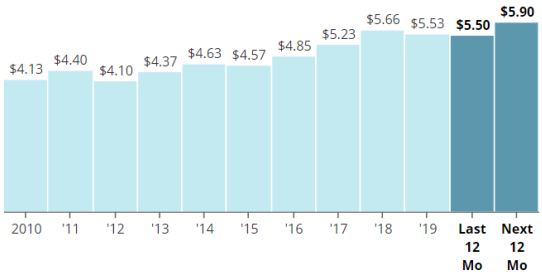
A healthy business grows its total sales over the long term. After all, a larger revenue base is often key to driving sustainable long-term earnings growth. We prefer companies with fairly steady and moderately rising sales.



PEP's earnings record is solid, always positive and growing slowly but steadily over the past 10 years, with only a slight decline from Covid-19. Its cash production is a little lumpy but plentiful.

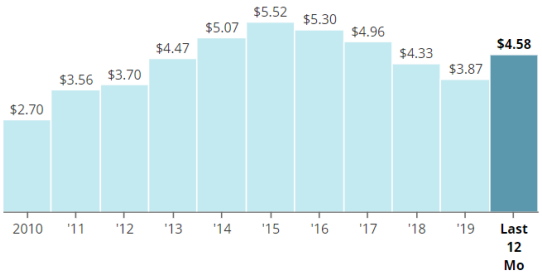
Earnings Per Share

Adjusted earnings are used to exclude noisy "one-time" events such as non-cash impairment charges. The best businesses will steadily increase their earning power over time to help fuel dividend growth and appreciation in their stock price.



Free Cash Flow Per Share

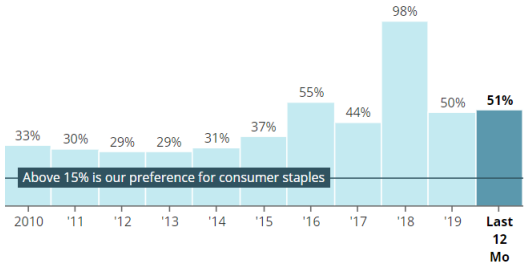
Free cash flow is what's left after a company has paid all of its bills and reinvested to maintain and grow its business. Advantaged businesses tend to generate stable, growing free cash flow over time, fueling sustainable and rising dividends.



PEP's efficiency metrics are very good.

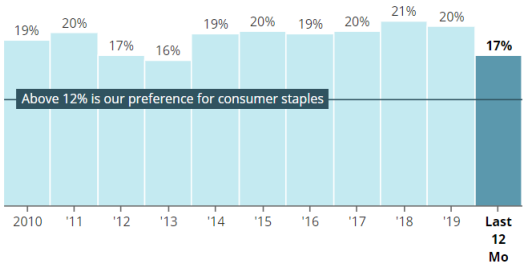
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



Return on Invested Capital

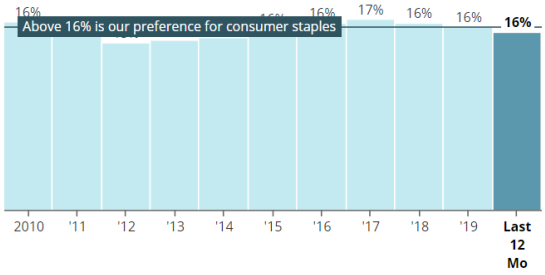
Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



PEP's profitablity is about average.

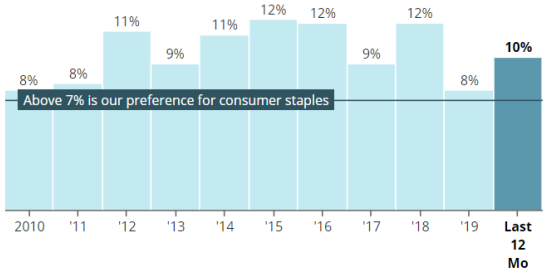
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

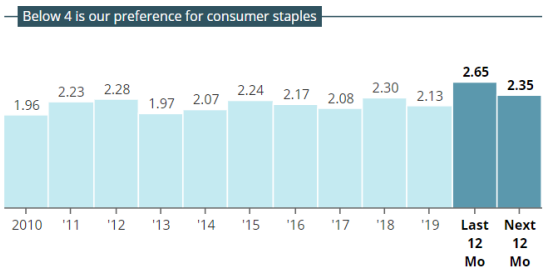
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



PEP uses debt at about average rates for large companies these days. The company's credit rating is a solid investment-grade A+, so debt is not a problem.

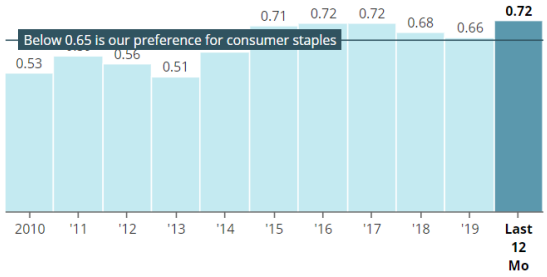
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.



Net Debt to Capital

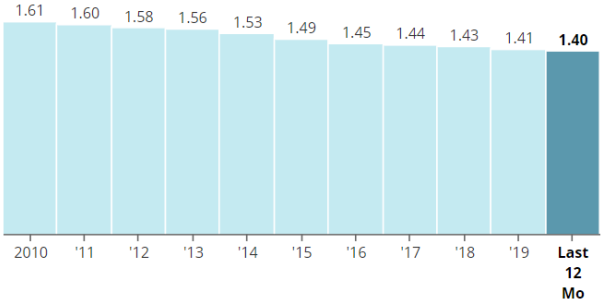
The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



PEP has been reducing its share count steadily. It has 13% fewer shares outstanding than it did 10 years ago.

Shares Outstanding (Billions)

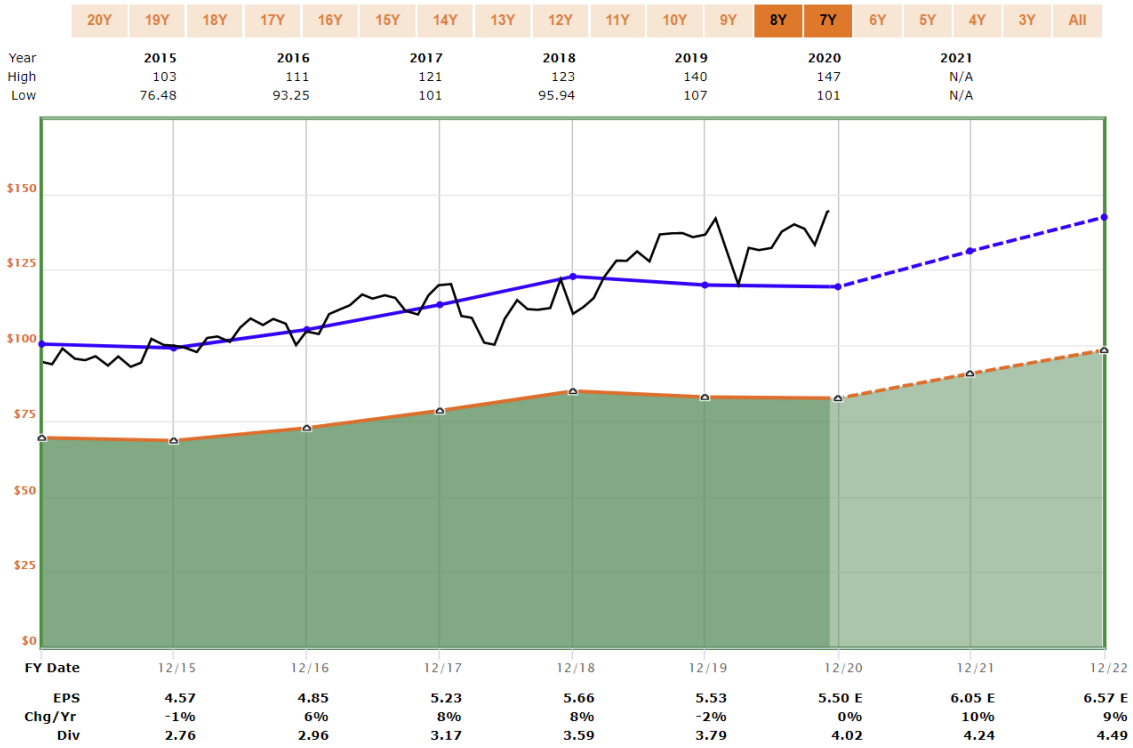
Some companies return excess cash to shareholders by buying their stock when they believe it is undervalued, increasing your ownership stake. Other firms issue shares to fund growth projects. Generally speaking, we prefer a declining share count.



Overall, I consider PEP's financials to be above average (Grade = B+).

Valuation (Overvalued)

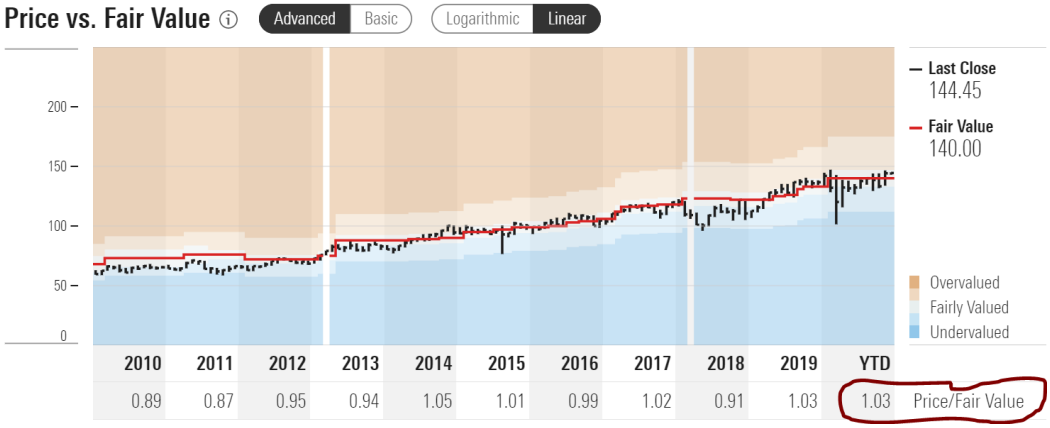
Models #1 & #2: P/E ratios (FASTGraphs)



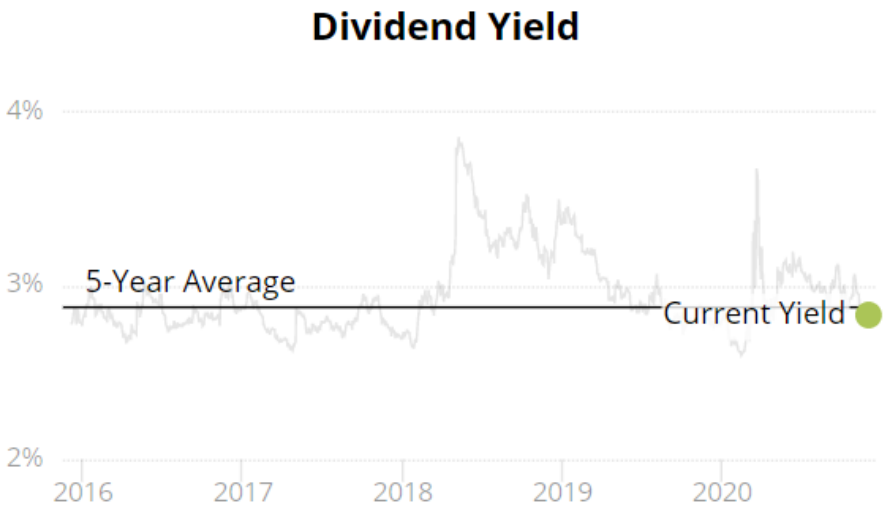
PEP is overvalued using both P/E valuation models. Model 1's valuation ratio = 1.75 and Model 2's = 1.21. PEP's current P/E ratio is 26.2 compared to its 5-year average of 21.7.

Model #3: DCF

Using its discounted cash flow (DCF) techniques, Morningstar calculates a valuation ratio of 1.03, which suggests fair valuation.



Model #4: Relative yields (Simply Safe Dividends)



PEP's current yield of 2.8% is just off its 5-year average of 2.9%. The yield comparison leads to a valuation ratio of 1.04, which suggests fair valuation.

PEP Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	1.71	Very overvalued
#2: P/E to Stock's 5-year average	1.21	Very overvalued
#3: DCF (from Morningstar)	1.03	Fairly valued
#4. Relative Yield 5-year comparison	1.04	Fairly valued
Average of Models: Valuation ratio = 1.25 = Very overvalued		

The valuation models are far apart. Using the aggregate of all four, fair price = $115.

Models 1 and 2 are outliers from the others and dominate the calculations. Therefore, I will cap them at 1.20 so they do not have such an extreme impact.

PEP Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	1.20 (capped)	Overvalued
#2: P/E to Stock's 5-year average	1.20 (capped)	Overvalued
#3: DCF (from Morningstar)	1.03	Fairly valued
#4. Relative Yield 5-year comparison	1.04	Fairly valued
Average of Models: Valuation ratio = 1.12 = Overvalued		

Fair price = $129

With PepsiCo being an All Star, I would pay to the top of the fair-value range for it.

Maximum buy price = $141

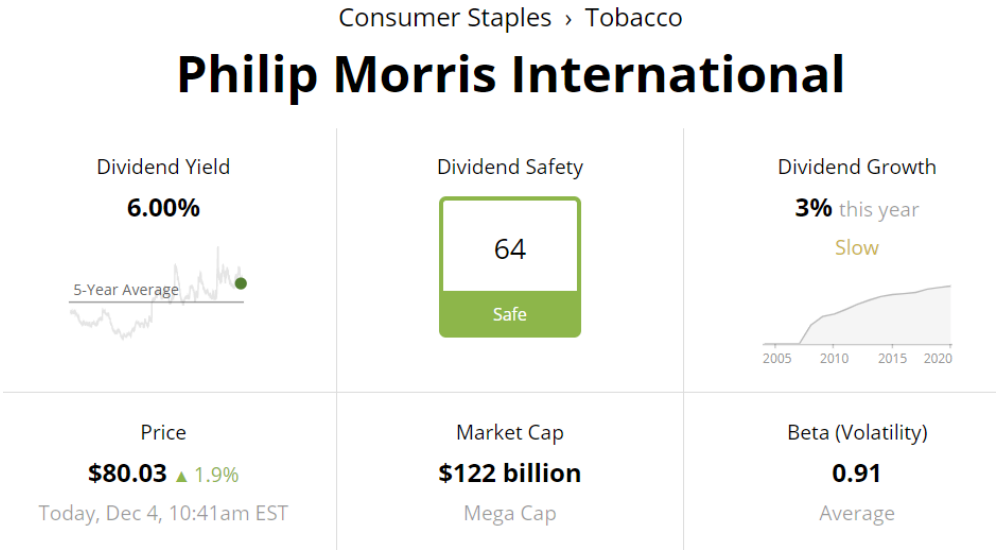
Pepsi's price is slightly above that now, so a slight dip would bring it into its buying range.

PHILIP MORRIS INTERNATIONAL (PM)

PHILIP MORRIS INTERNATIONAL (PM)			
SECTOR: Consumer Staples			
INDUSTRY: Tobacco			
Link to PM Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
C	**B**	**C+**	**Undervalued**

PM is a 12-year-old spinoff from Altria with responsibility for international markets for tobacco products. It is a high-yield, slow-growth DG stock.

Dividend Record (Grade = C)



PM has raised its dividend every year since it was spun off from Altria in 2008. While that streak is short, PM has Altria's DNA, and if it were credited with that, its dividend growth streak would be 51 years. PM is a high-yield, slow-growth stock.

PM Dividend Summary		
Factor	**Data**	**Rating**
Yield	6.0%	High
Years of Increases	12 years (Contender <14 years)	D
5-year DGR	3% per year (OK for high-yielder)	C
DGR Trend	Steadily in low-single digits	B
SSD Safety Rating	64 / 100 = Safe	B
Total Dividend Grade = C		

Business Model and Company Quality (Grade = B)

Philip Morris International (PM) was spun off from Altria in 2008, with PM owning the international rights to Altria's most famous brands.

While traditional tobacco products still generate most of the PM's profits, reduced-risk products (RRPs) account for about 15% of the firm's sales and are growing rapidly as smokers seek cigarette alternatives. By 2025 management aspires for RRPs to account for roughly 40% of the firm's revenue. Most RRPs also carry higher margins because they currently have low or no excise taxes.

PM sells its tobacco products to over 150 million customers in 180 countries. The European Union (31% of sales, 36% of income), Asia (35% of sales, 32% of income), and the Eastern Europe, Middle East and Africa region (24% of sales, 22% of income) are PM's largest markets.

PM has rights to six of the world's top 15 cigarette brands, including the world's No. 1 brand – Marlboro. These brands are considered premium, and studies show that their users are less likely to quit.

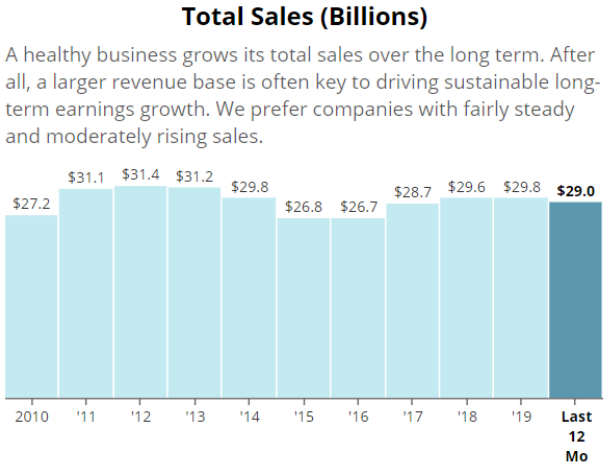
As a result of its brand strength and the addictive nature of tobacco, PM enjoys excellent pricing power. Since 2008, Philip Morris's annual pricing gains have ranged between 5% and 8, excluding excise taxes. That rate has exceeded the annual secular decline in smoking.

PM is at the front of the transition from cigarettes to other delivery systems. PM markets four RRPs: two that heat tobacco to produce a vapor, and two that produce a nicotine-containing vapor without tobacco (e-cigarettes). IQOS, a tobacco-heating product, is PM's biggest hit with more than 12 million global users in over 50 markets.

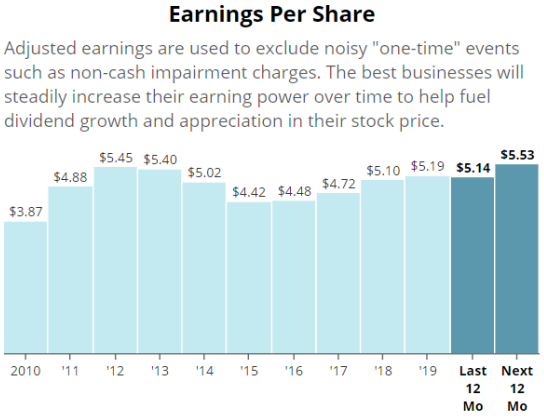
Morningstar accords PM a Wide moat. I give it a B grade for quality.

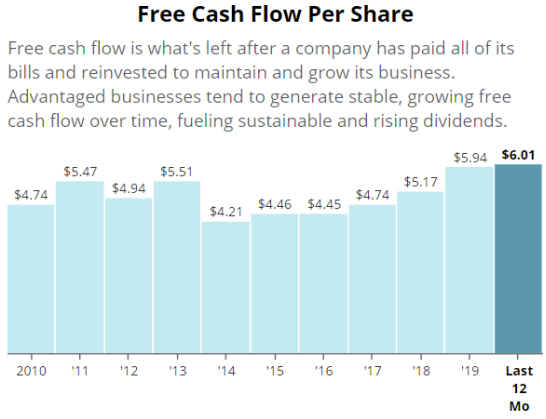
Financials (Grade = C+)

PM's revenue has been flat for several years. That reflects the secular annual decline in tobacco users offset by price increases and the adoption of newer products like RRPs.



PM's earnings have been positive every year for the past decade, and its cashflow is strong and pretty steady.

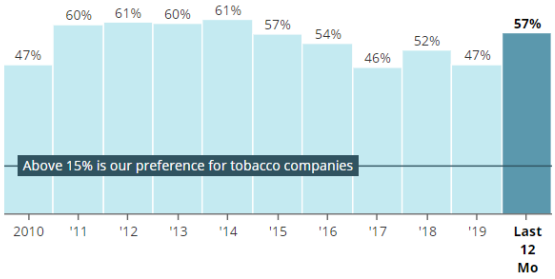




PM's ROE chart is not meaningful because of certain aberrations. Its ROIC is steadily 3-4 times higher than the benchmark. Its margins are very good to excellent.

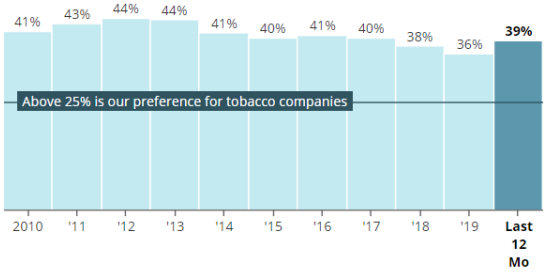
Return on Invested Capital

Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



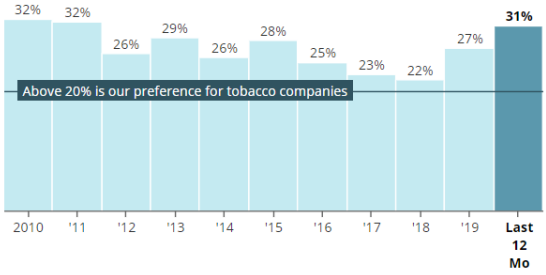
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

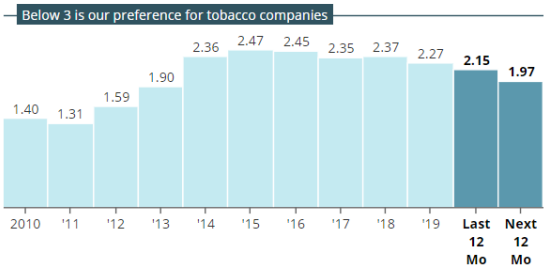
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



PM is not overly reliant on debt. Its credit rating is an investment-grade A.

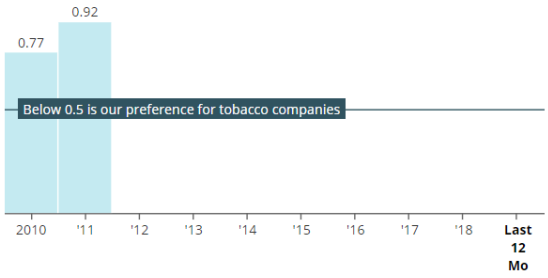
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.

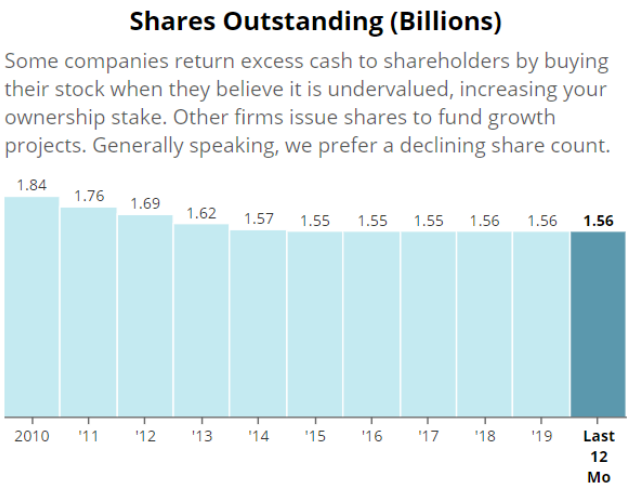


Net Debt to Capital

The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



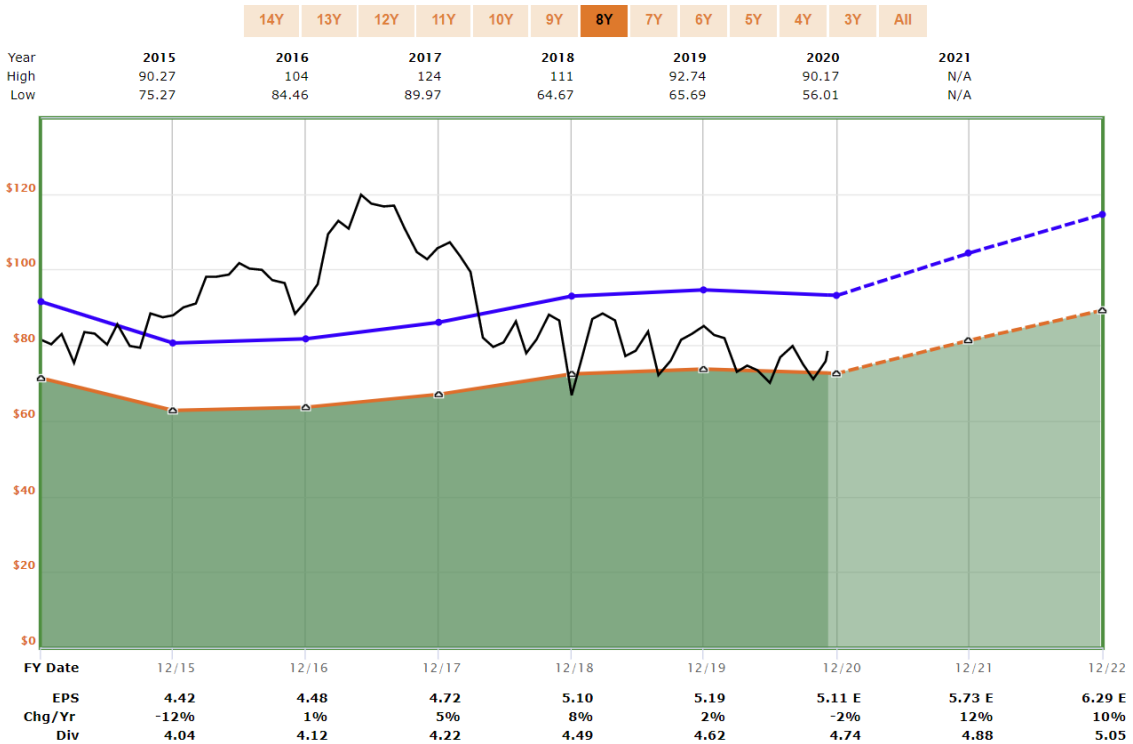
While PM reduced its share count annually for several years after the spinoff, over the past six years its float has remained practically unchanged.



Overall, PM's financials could be considered very strong, but the elephant in the room is lack of revenue growth. The secular decline in smoking pulls downward as new products, new markets, and price increases pull upward. The result has been a stalemate. Other financial metrics are solid. In the end, I give it a C+.

Valuation (Undervalued)

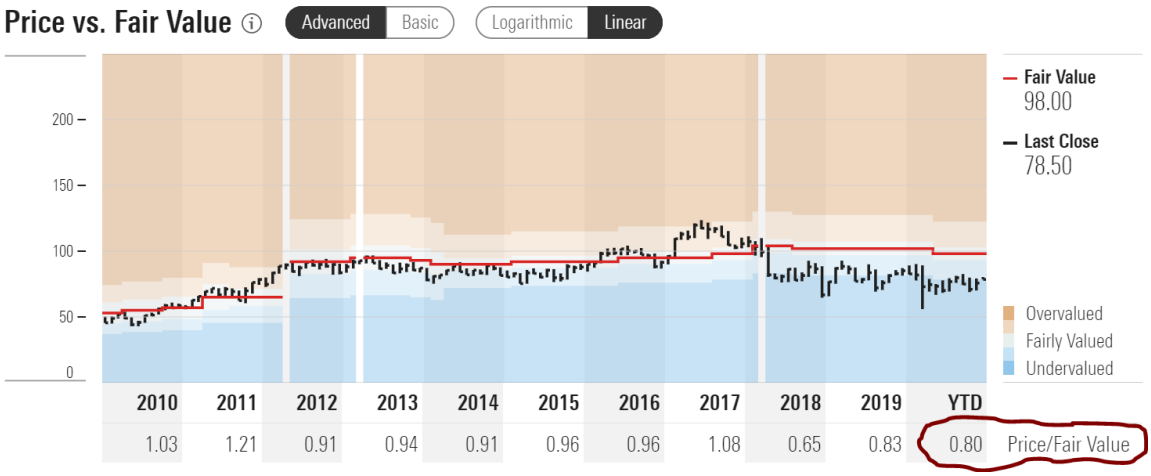
Models #1 & #2: P/E ratios (FASTGraphs)



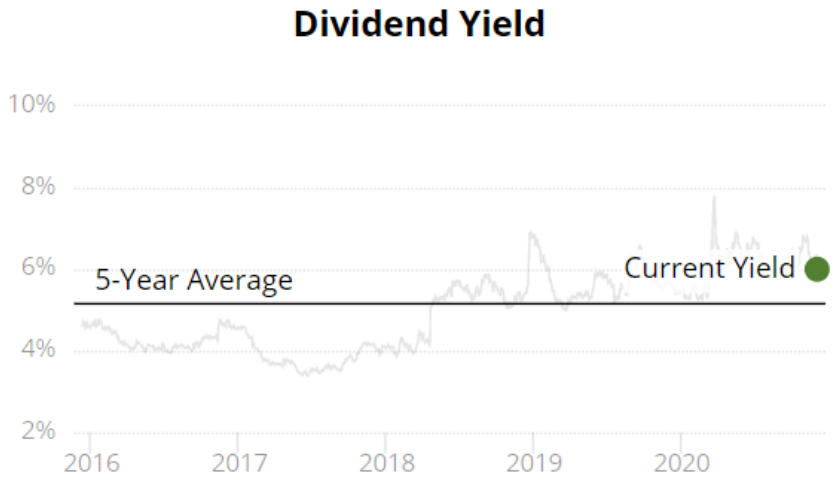
With a current P/E of 15.3 and a 5-year average of 18.2, PM is fairly valued under Model 1 and undervalued under Model 2. (The orange Model 1 line is drawn at 14.2 instead of 15, reflecting PM's slow growth.) The Model 1 valuation ratio = 1.08 and the Model 2 ratio = 0.84.

Model #3: DCF

Using its discounted cash flow (DCF) techniques, Morningstar calculates a valuation ratio of 0.80, which suggests undervaluation.



Model #4: Relative yields (Simply Safe Dividends)



PM's current yield is 6.0% compared to its 5-year average of 5.2%. That suggests undervaluation, with a valuation ratio of 0.87.

PM Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's adjusted historical average	1.08	Fairly valued
#2: P/E to Stock's 5-year average	0.84	Undervalued
#3: DCF (from Morningstar)	0.80	Undervalued
#4. Relative Yield 5-year comparison	0.87	Undervalued
Average of Models: Valuation ratio = 0.89 = Undervalued		

Fair price = $89

Since PM is currently available at an undervalued price, and its overall grades are mid-level, I do not see a reason to pay above fair price for the stock. For those who do, the top of its fair-value range, calculated as fair price + 10%, is shown here:

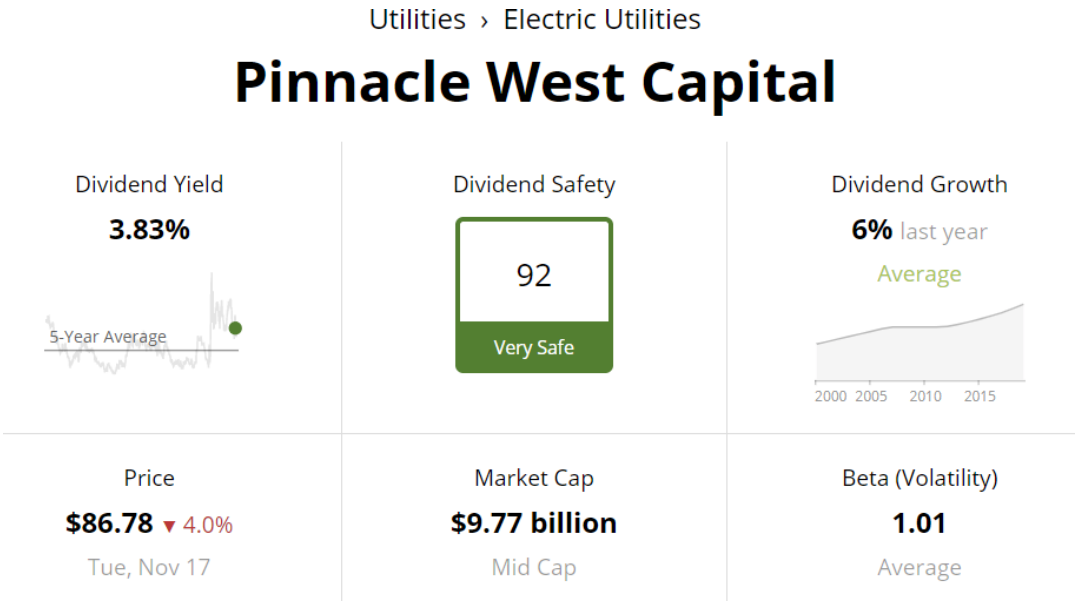
Top of fair-value range = $98

PINNACLE WEST CAPITAL (PNW)

PINNACLE WEST CAPITAL (PNW)			
SECTOR: Utilities			
INDUSTRY: Electric Utilities			
Link to PNW Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
C	**B**	**B**	**Fairly valued**

PNW is an electric utility serving most of Arizona. It is a mid-yield, mid-growth stock with a solid business and very safe dividend.

Dividend Record (Grade = C)



PNW is a solid mid-yield, mid-growth DG stock. The only thing pulling its dividend grade down is its short streak of increasing dividends. It froze its dividend 2008-11. It has paid uninterrupted dividends for 26 years and has a very high dividend safety score.

PNW Dividend Summary		
Factor	**Data**	**Rating**
Yield	3.8%	Mid
Years of Increases	8 years (Dividend Challenger)	Short
5-year DGR	5% per year (OK)	C
DGR Trend	Steady mid-single digit increases	B
SSD Safety Rating	92 / 100 = Very safe	A
Total Dividend Grade = C		

Business Model and Company Quality (Grade = B)

Pinnacle West Capital is a utility holding company based in Phoenix, AZ. Its roots trace back more than 125 years. As a holding company, PNW does business through its subsidiaries. It derives essentially all of its revenues and earnings from its wholly-owned regulated electric utility.

The utility provides both retail and wholesale electric service to most of Arizona, with a total of 1.3 million customers. The business is a traditional electric utility, covering electricity generation, transmission, and distribution to retail and wholesale customers.

PNW's generation facilities include nuclear, gas/oil, and coal. The company has adopted a "Clean Energy Commitment" that has an aspirational goal to generate electricity with zero-carbon emissions by 2050. Nearer-term, the company has a 2030 target of 65% clean energy, with 45% coming from renewable energy. The company has committed to eliminate coal-fired generation from its portfolio by 2031.

Morningstar awards PNW a Narrow moat rating, based on its service territory monopoly, efficient scale advantages, and regulated rates that have enabled the utility to earn a fair return on its investments. That's the highest rating Morningstar gives to utilities.

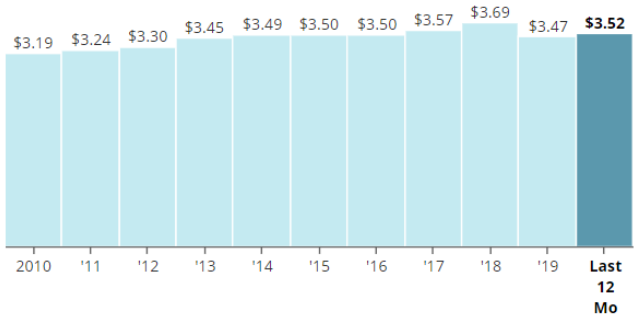
I rate its business quality as a "B."

Financials (Grade = B)

PNW's revenue record shows slow, gradual growth. PNW projects 1-3% growth in demand in its current service territory. There has been a slight reduction based on Covid-19.

Total Sales (Billions)

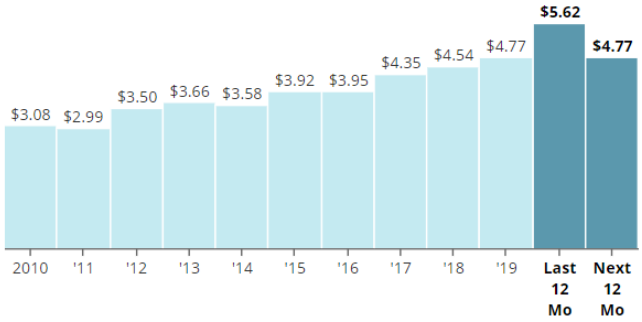
A healthy business grows its total sales over the long term. After all, a larger revenue base is often key to driving sustainable long-term earnings growth. We prefer companies with fairly steady and moderately rising sales.



PNW's earnings have been strong and mostly increasing over the past decade. Cashflow is not shown, because the numbers get distorted by PNW's capital spending typical for utilities. Again you can see the impact of Covid-19.

Earnings Per Share

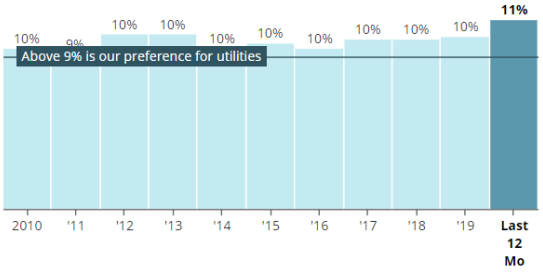
Adjusted earnings are used to exclude noisy "one-time" events such as non-cash impairment charges. The best businesses will steadily increase their earning power over time to help fuel dividend growth and appreciation in their stock price.



PNW's efficiency metrics are right about at the benchmarks. ROIC has fallen in the past couple of years.

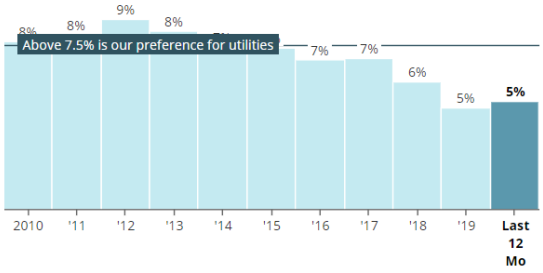
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



Return on Invested Capital

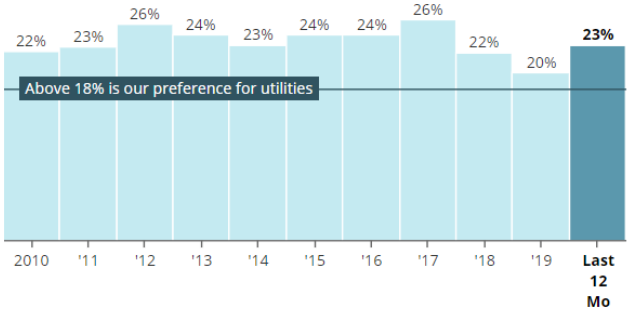
Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



PNW's profitability has been strong.

Operating Margin

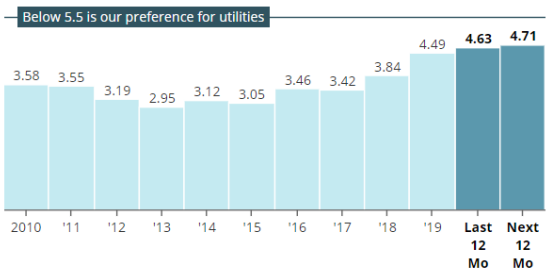
A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



PNW has not been over-reliant on debt. Both debt metrics have been consistently below their benchmarks.

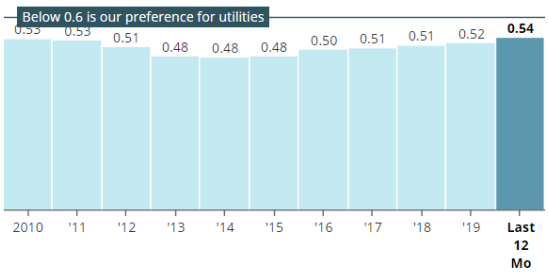
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.

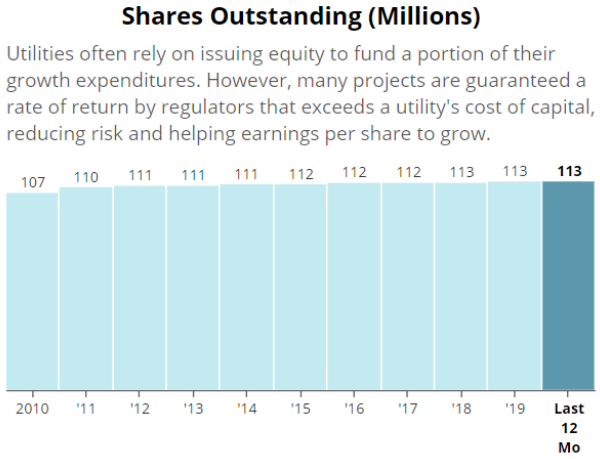


Net Debt to Capital

The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



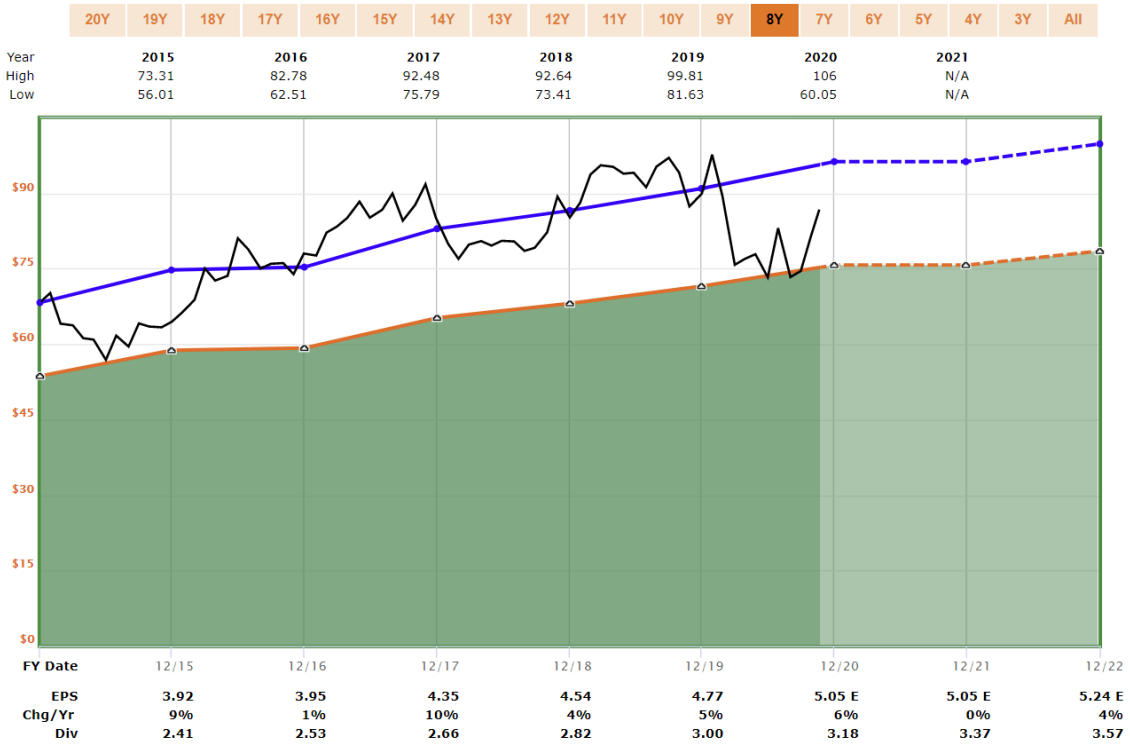
PNW has been holding its share count pretty flat. Utilities often issue shares repeatedly (to finance capital projects), so this is pretty good.



Overall, PNW's financials present a good picture for a utility. My overall grade is B.

Valuation (Fairly valued)

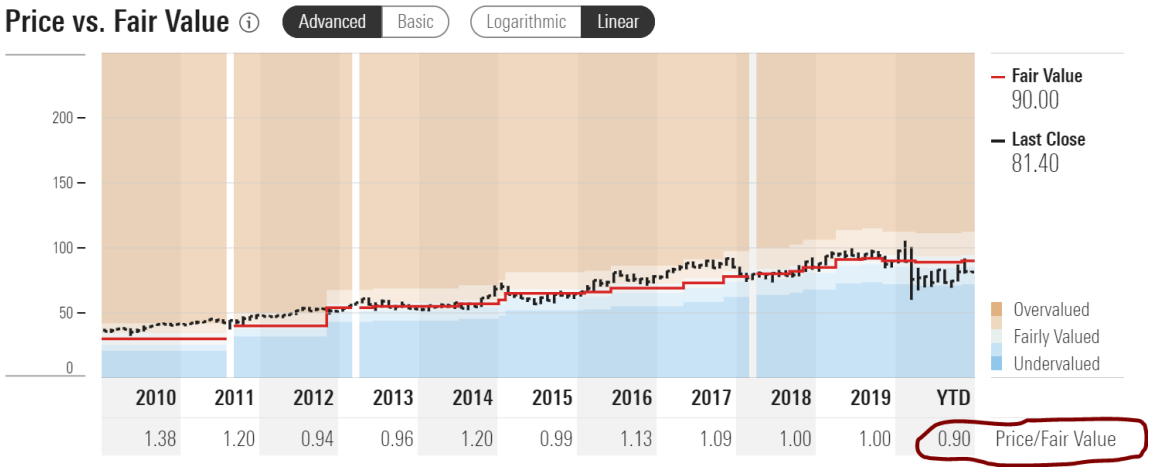
Models #1 & #2: P/E ratios (FASTGraphs)



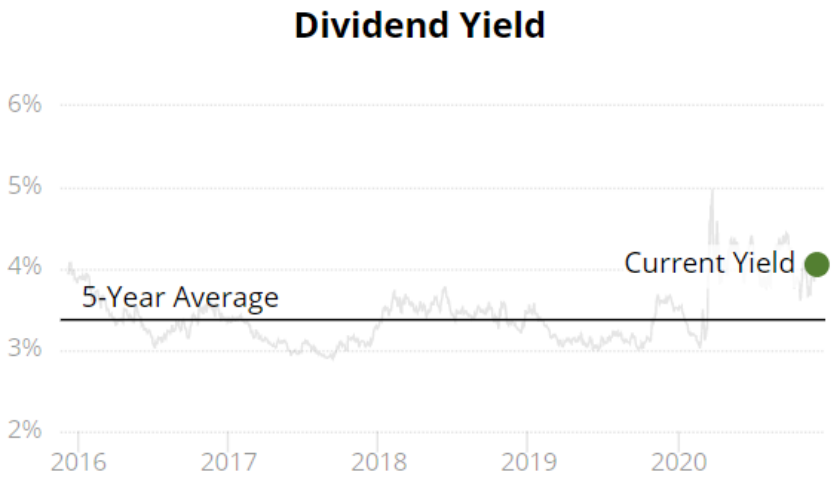
PNW is overvalued by one P/E model and fairly valued by the other. Its current P/E is 17.3 and its 5-year average is 19.1. The valuation ratios are Model 1 = 1.15 and Model 2 = 0.91.

Model #3: DCF

Using its discounted cash flow (DCF) model, Morningstar calculates a valuation ratio of 0.90, which suggests fair valuation.



Model #4: Relative yields (Simply Safe Dividends)



PNW's current yield of 4.1% is above its 5-year average of 3.4%. That suggests undervaluation, and the valuation ratio is 0.83.

PNW Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	1.15	Overvalued
#2: P/E to Stock's 5-year average	0.91	Fairly valued
#3: DCF (from Morningstar)	0.90	Fairly valued
#4. Relative Yield 5-year comparison	0.83	Undervalued
Average of Models: Valuation ratio = 0.95 = Fairly valued		

Fair price = $85

Top of fair-value range = $94

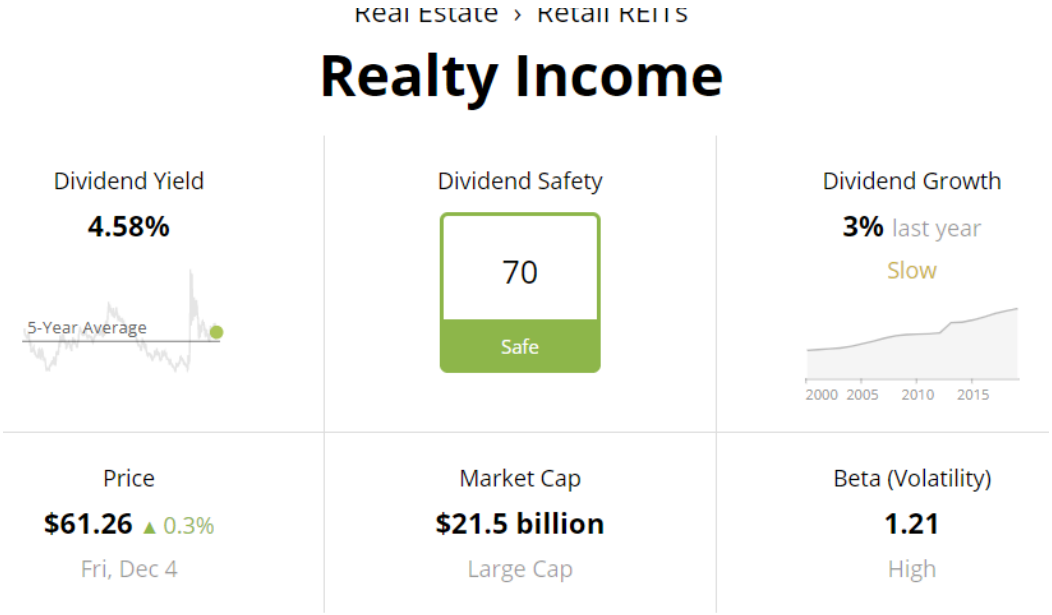
REALTY INCOME (O)



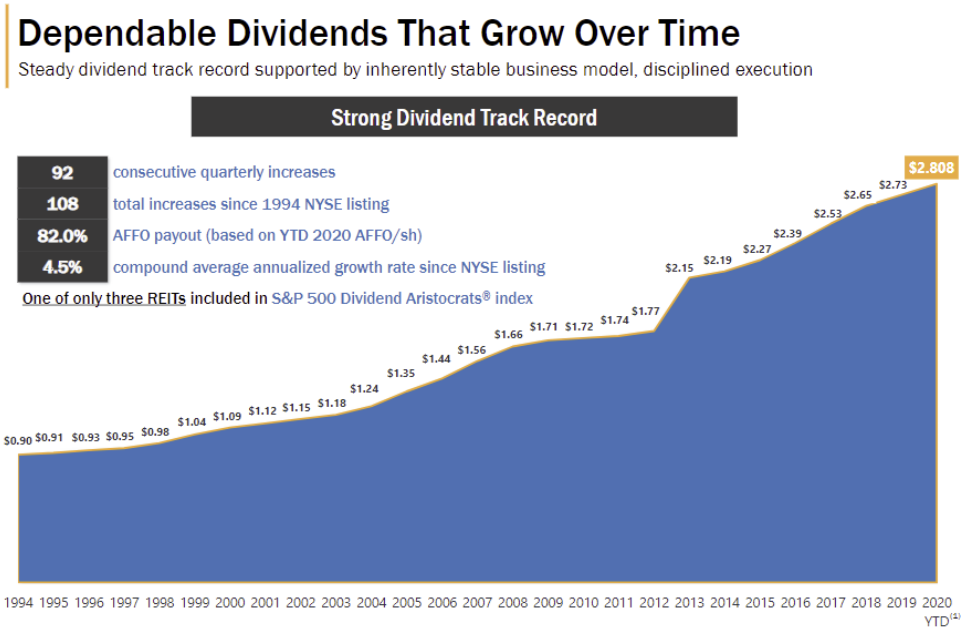
REALTY INCOME (O)			
SECTOR: Real Estate			
INDUSTRY: Equity Real Estate			
Link to O Investor Site			
DIVIDENDS	QUALITY	FINANCIALS	VALUATION
B	B	B+	Fairly valued

Realty Income is a staple in many DG portfolios. It has a long record of selecting good properties that generate good cashflows (rents), holding them, and expanding carefully. I went back and forth on whether O should be a DG All Star, and finally voted it in based on its relentless dividend culture.

Dividend Record (Grade = B)



Realty Income has raised its dividend every year, often more than one time per year, since 1994. Its dividend persistence and ability to raise it through the Great Recession – which was a real-estate recession – was impressive; it was as if the company wanted to prove it could do it. Covid-19 has forced its dividend safety grade lower (from 86 to 70 in May) due to drops in rent collections, but the company's ingrained dividend culture bodes well for continued dividend raises.



O Dividend Summary		
Factor	**Data**	**Rating**
Yield	4.6%	High
Years of Increases	27 (Dividend Champion, Aristocrat)	B
5-year DGR	4% per year (OK for high yielder)	C
DGR Trend	Reliable raises year after year	B
SSD Safety Rating	70 / 100 = Safe	B
Total Dividend Grade = B		

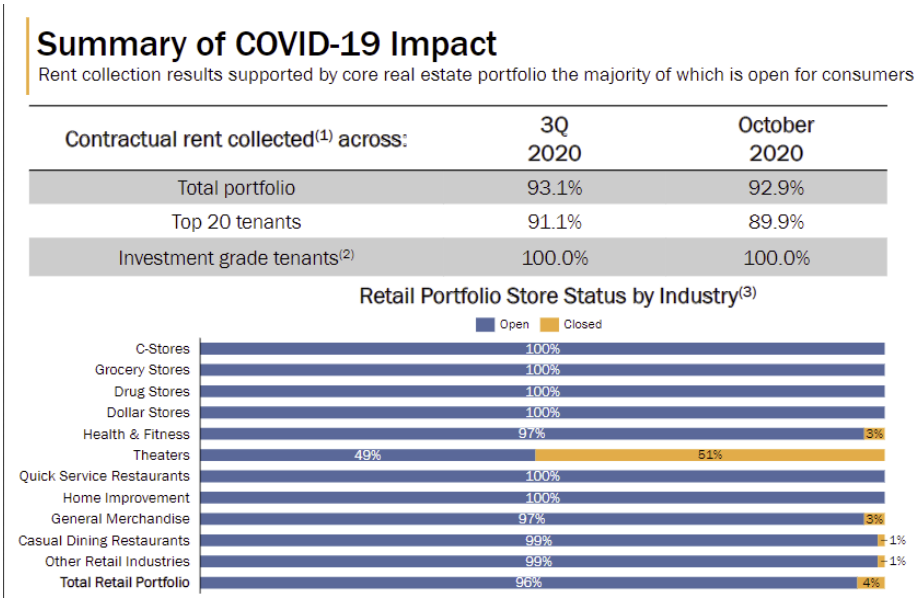
Business Model and Company Quality (Grade = B)

Realty Income brands itself The Monthly Dividend Company®. The dividend is its mission. Their business model is not unlike that of many DG investors: Buy and collect properties, collect rents (revenue), and reinvest to build the whole operation.

Realty Income was an early practitioner of the "net lease" REIT concept, under which the REIT owns the real estate, but the tenant pays operating costs, taxes, insurance, etc.

Over the years, as O has grown, it has improved the quality of its tenants and the terms of its leases. It owns about 6,500 properties, most of which are freestanding, net-leased retail properties. It selects properties and tenants carefully. O's occupancy levels have never been below 96%, no matter the prevailing economic conditions. O's properties are in 49 states and Puerto Rico, and it leases to 250 tenants from 47 industries. Beyond retail, about 18% of revenue comes from industrial, office, manufacturing, and distribution properties.

Covid-19 has hit real estate operators hard, some harder than others. As of Q3, this has been the impact on Realty Income. Rent collections have almost recovered back to pre-Covid levels.



Of the occupant categories, theaters have been hit the hardest, with more than half still closed. Many other categories, however, are 100% open or nearly all open. Bottom line, just 4% of Realty Income's properties remain closed.

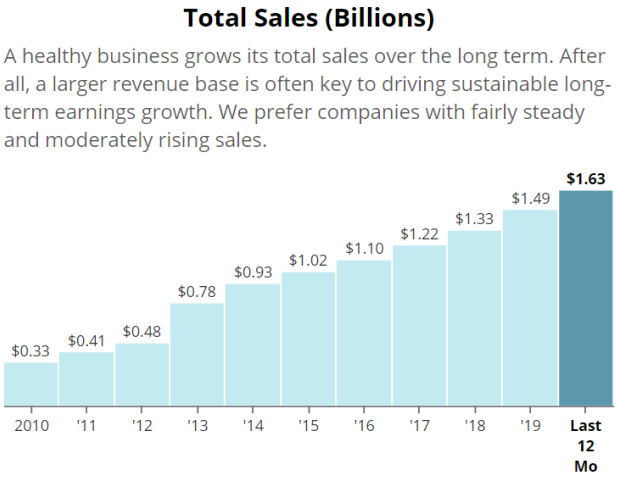
O's tenant base is comprised almost entirely of large national and retail operators. This is how O summarized its performance at the end of Q3:



Overall, I give O a grade of B on its quality. Covid-19 has exposed a vulnerability in its business model that even the Great Recession did not. Nevertheless, compared to (say) malls, O's free-standing buildings and predominance of Covid-resistant tenants have served it well.

Financials (Grade = B+)

Realty Income's annual revenue shows steady growth, even into the pandemic, showing great resilience.

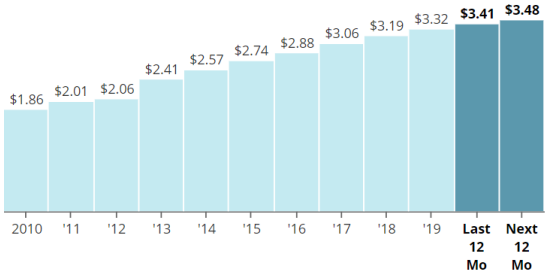


With REITs, instead of earnings, it is more instructive to look at a metric called FFO, which stands for funds from operations, because REITs have so many non-cash charges

that GAAP earnings become misleading. O's FFO/share has shown steady growth over the past decade. Its free cash flow displays a similar pattern, with a slight dip this year due to Covid-19.

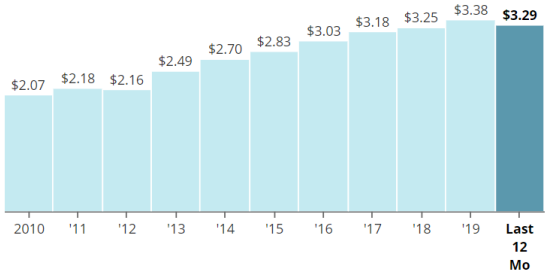
Adjusted FFO Per Share

AFFO adjusts net income for various non-cash charges, maintenance costs, and other items to approximate free cash flow for REITs. The best REITs increase their earning power over time to help fuel dividend growth and stock price appreciation.



Free Cash Flow Per Share

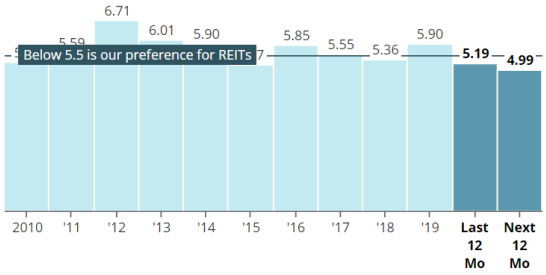
Adjusted funds from operations is a more meaningful metric for REITs than free cash flow. Free cash flow can be noisier and more volatile due to issues such as upfront rent payments, maintenance expenses, and deferred financing costs.



It is in the nature of REITs that they carry high debt, because the business is capital-intensive. With that caveat, O's debt levels fall below the benchmarks. The company has an investment-grade A- credit rating.

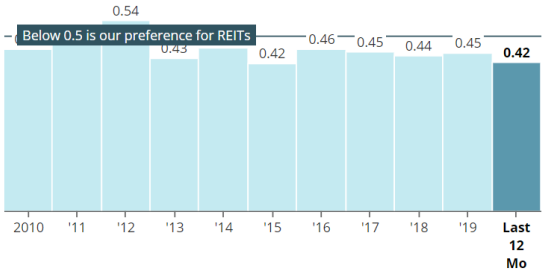
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.

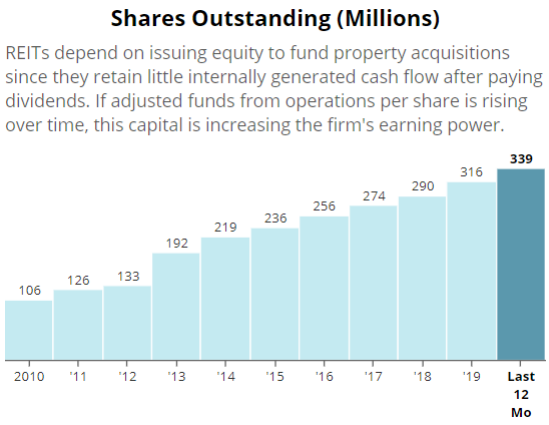


Net Debt to Capital

The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



Because of capital intensivity, REITs tend to have increasing share counts, because they regularly issue new shares. By law, they must distribute most of their profits to shareholders, so capital for expansion must come from new debt and equity.

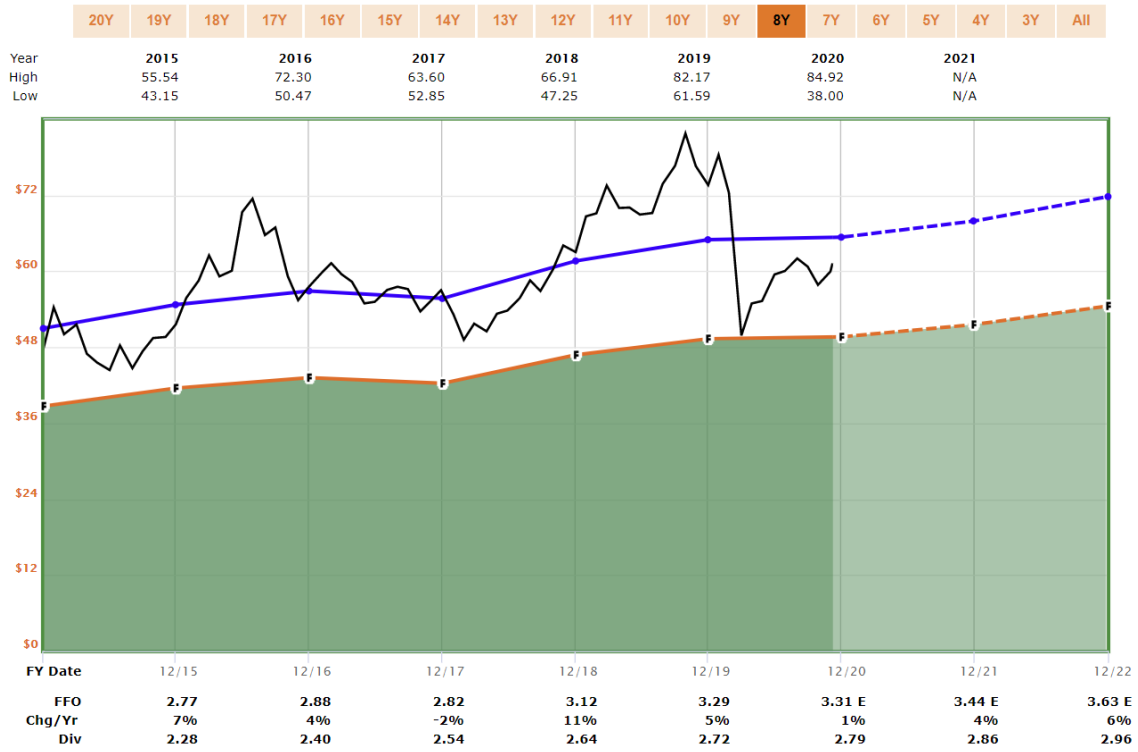


Overall, accounting for the vulnerability that Covid-19 exposed, but also recognizing the resilience it has displayed under that setback, I give Realty Income a B+ grade for its financials.

Valuation (Fairly valued)

Models #1 & #2: P/E ratios (FASTGraphs)

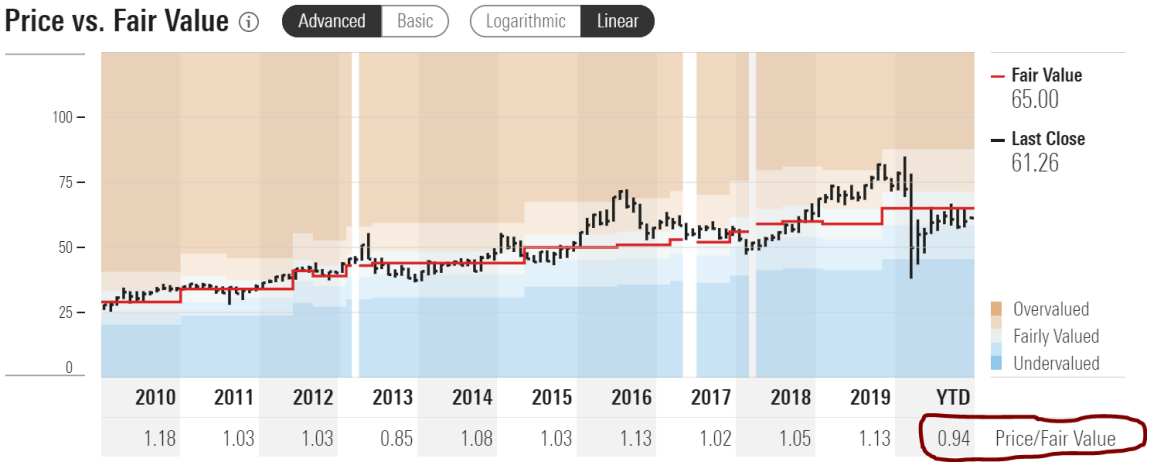
As mentioned in the previous section, FFO is a better measure of profitability for REITs than GAAP earnings, so I use those in valuation too. That is indicated by the "F" marking each data point on the orange line.



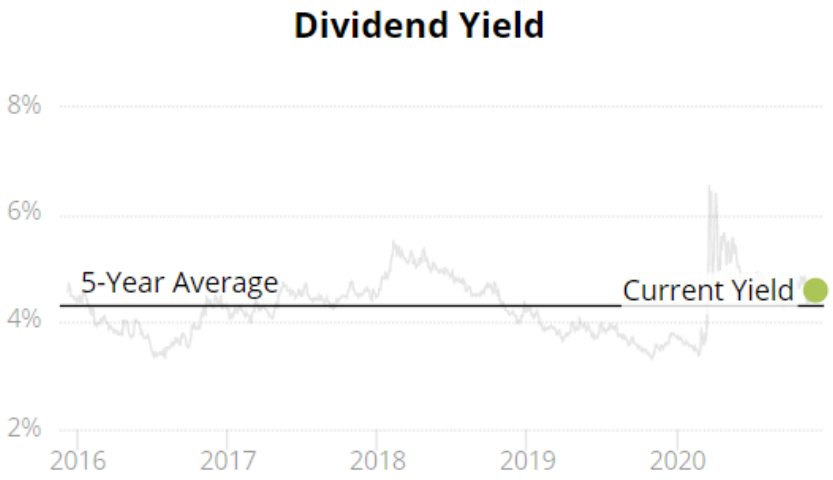
O is overvalued under Model 1 (orange line) and fairly valued under Model 2 (blue line). Its current P/FFO ratio is 18.5 and its 5-year average is 19.8. That gives it these valuation ratios: Model 1 = 1.23 and Model 2 = 0.93.

Model #3: DCF

Using its discounted cash flow (DCF) methodology, Morningstar has O fairly valued with a valuation ratio of 0.94.



Model #4: Relative yields (Simply Safe Dividends)



Using the yield metric, O is fairly valued. Its current yield is 4.6% and its 5-year average is 4.3%. That leads to a valuation ratio of 0.93.

O Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/FFO to Market's historical average	1.23	Very overvalued
#2: P/FFO to Stock's 5-year average	0.93	Fairly valued
#3: DCF (from Morningstar)	0.94	Fairly valued
#4. Relative Yield 5-year comparison	0.93	Fairly valued
Average of Models: Valuation ratio = 1.01 = Fairly valued		

In this calculation, I would drop Model 1 as being significantly out of step with the others. That gives this result:

O Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#2: P/FFO to Stock's 5-year average	0.93	Fairly valued
#3: DCF (from Morningstar)	0.94	Fairly valued
#4. Relative Yield 5-year comparison	0.93	Fairly valued
Average of Models: Valuation ratio = 0.93 = Fairly valued		

Fair price = $66

Given the entire picture, especially O's ingrained insistence on raising its dividend through difficult conditions, I would pay up to the top of the +/- 10% fair-value range for O.

Maximum buy price = $72

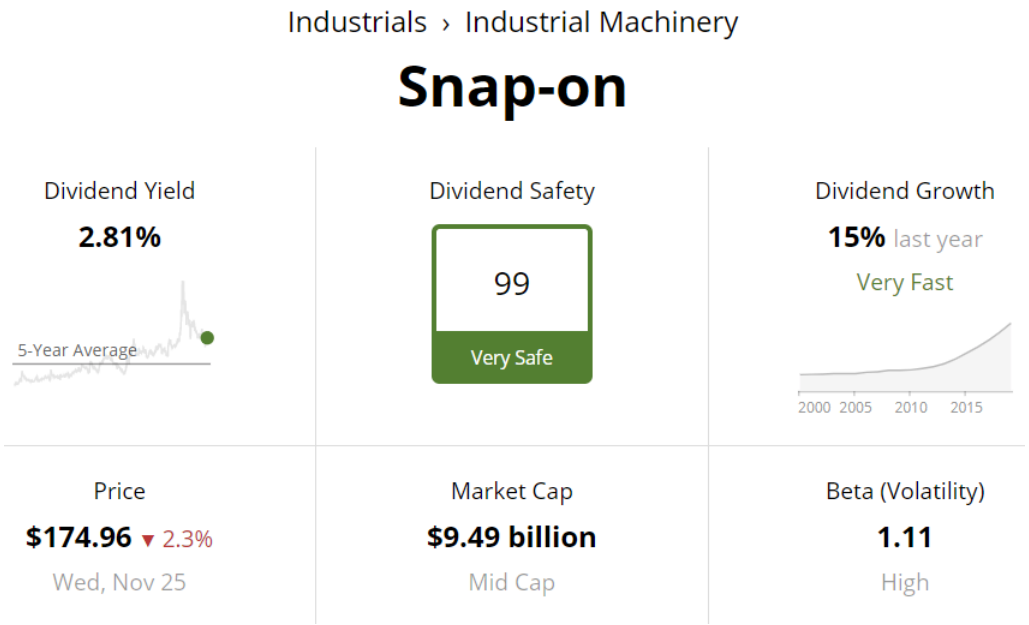
SNAP-ON (SNA)



SNAP-ON (SNA)			
SECTOR: Industrials			
INDUSTRY: Machinery			
Link to SNA Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
B	**B**	**B+**	**Fairly valued**

Snap-on is a DG stock that may surprise you. It has a nice dividend record, good straightforward business model, and very good financials.

Dividend Record (Grade = B)



SNA Dividend Summary		
Factor	**Data**	**Rating**
Yield	2.8%	Mid
Years of Increases	10 (Dividend Contender <14)	C
5-year DGR	16% per year (Very fast)	A
DGR Trend	Consistently around 20% per year	A
SSD Safety Rating	99 / 100 = Very safe	A
Total Dividend Grade = B		

Snap-on is a mid-yield, fast-growth dividend growth stock. It is not realistic to believe that its very fast recent pace of increases is sustainable over the long term, but it's off to a great start.

Business Model and Company Quality (Grade = B)

SNA began with the development of the original interchangeable socket set in 1920. It subsequently pioneered mobile tool distribution, where well stocked vans sell to professional vehicle technicians at their place of business.

Today, SNA's products and services include hand and power tools, tool storage, diagnostic software, information and management systems, shop equipment, and other solutions for vehicle dealerships and repair centers.

SNA sells to customers in vehicle repair, aviation and aerospace, agriculture, construction, government and military, mining, and other industries. It also derives income from various financing programs to facilitate the sales of its products. Products and services are sold through franchises, company-direct, distributors, and internet channels.

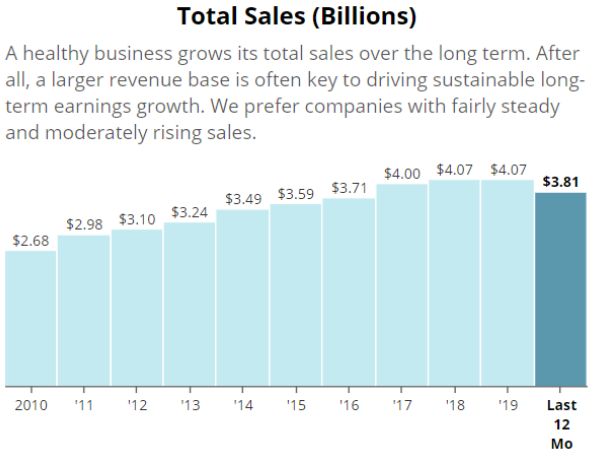
SNA's growth aspirations focus on expanding its professional customer base in its legacy automotive market, as well as adding adjacent markets, additional geographies, and critical industries where the cost and penalties for failure can be high.

SNA's Financial Services segment includes franchisees' customers (principally vehicle repair technicians), SNA-direct customers who require financing for the purchase or lease of tools and equipment, and franchisees who require financing for vehicle leases and business loans.

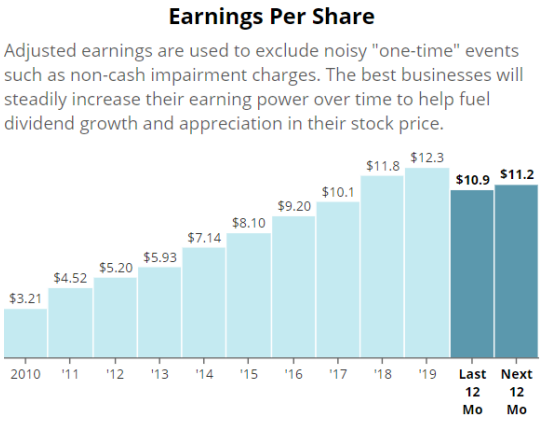
Morningstar awards SNA a narrow moat. I give it a B for its straightforward business model and strong brand recognition in its field.

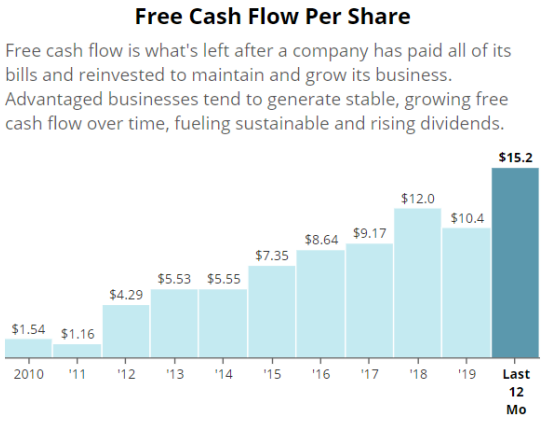
Financials (Grade = B+)

SNA's sales have been growing every year until Covid-19 hit in 2020. Analysts expect sales to bounce back when we get the pandemic behind us.



SNA's earnings show the same pattern as revenue: Consistent growth until 2020's pandemic. Cashflow, surprisingly, has increased in 2020, although when final numbers are reported in January, 2021, that might be muted. (The last bar includes the final quarter of 2019).

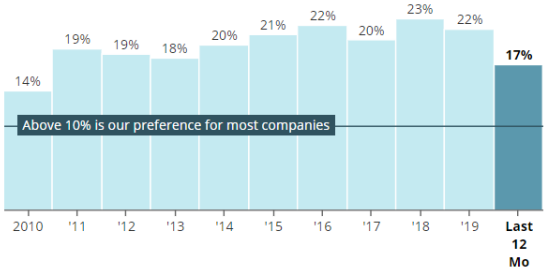




SNA's efficiency (top two graphs) and profitability (bottom two) are all very good, well above their benchmarks.

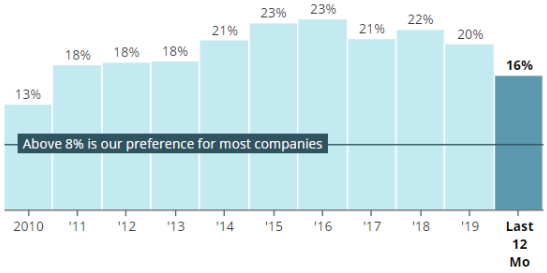
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



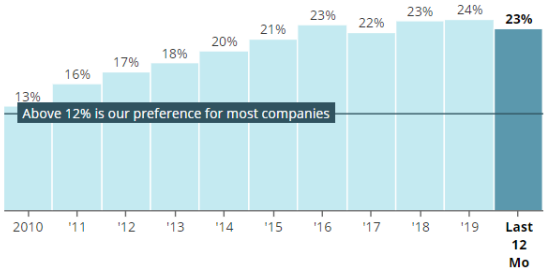
Return on Invested Capital

Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



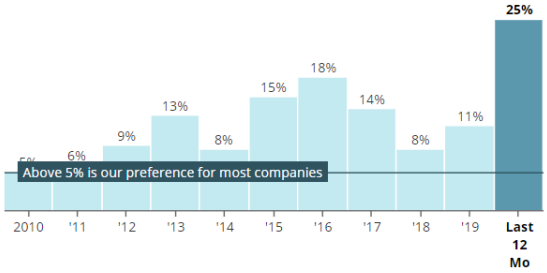
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

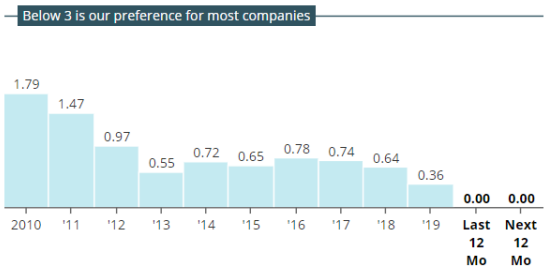
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



SNA does not rely much on debt, and it currently has a net-zero debt position (more cash on hand than debt). The company's credit rating is investment-grade A-.

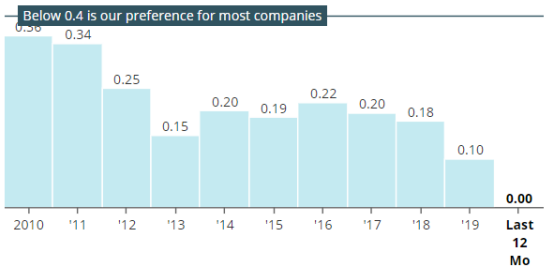
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.

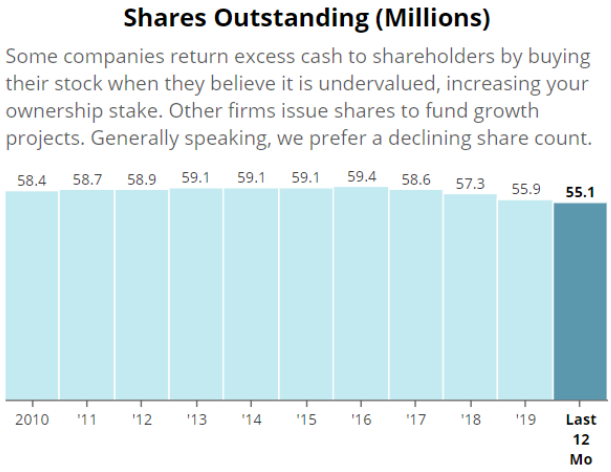


Net Debt to Capital

The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



SNA's share count is mostly flat, although outstanding shares have declined a bit each of the past four years.



Overall, SNA's financials are strong, with the only detractions being the impact of the pandemic and the flat share count (until recently). Overall, I give SNA a B+ for its financials.

Valuation (Fairly valued)

Models #1 & #2: P/E ratios (FASTGraphs)

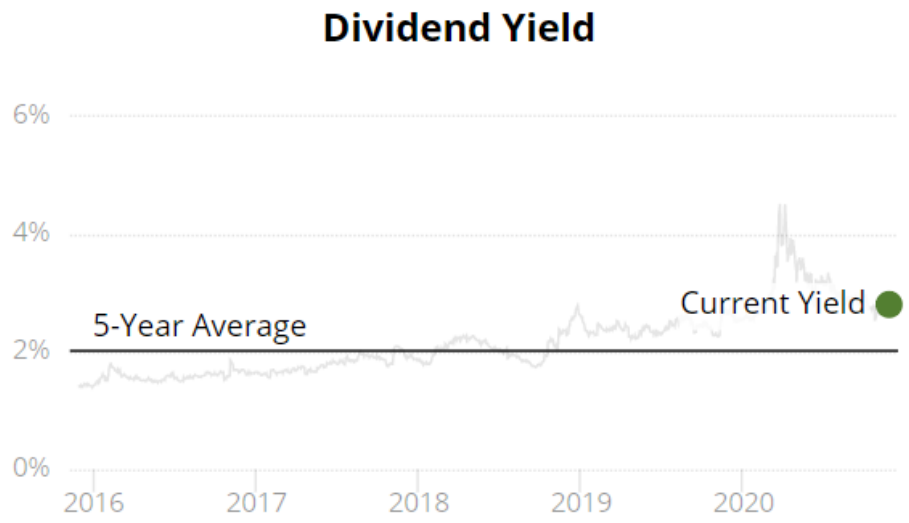


SNA's price falls between the first two valuation reference points. Its current P/E is 16.5 compared to its 5-year average of 17.2. Model 1's valuation ratio = 1.10 (price compared to orange line) and Model 2's is 0.96 (price compared to blue line).

Model #3: DCF (Morningstar)

Because of a change of analysts, Morningstar's most recent value calculation dates from August. Using that fair-value calculation, Morningstar shows a current valuation ratio of 1.21. However, I am not going to use this model, because the new analyst may change the fair-value reference point when he or she takes over.

Model #4: Relative yields (Simply Safe Dividends)



SNA's current yield is 2.8% compared to its 5-year average of 2.1%. That would translate to a valuation ratio of 0.75. However, for this model, I put a floor under the ratio at 0.80.

V Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	1.10	Fairly valued
#2: P/E to Stock's 5-year average	0.96	Fairly valued
#4. Relative Yield 5-year comparison	0.80	Undervalued
Average of Models: Valuation ratio = 0.95 = Fairly valued		

Fair price = $191

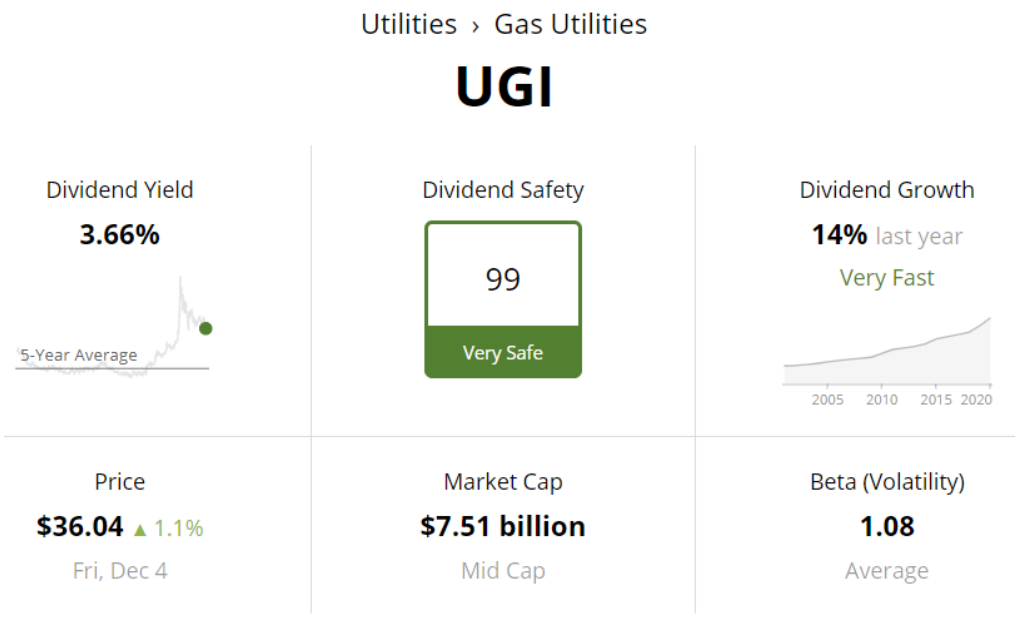
Top of fair value range = $210

UGI (UGI)

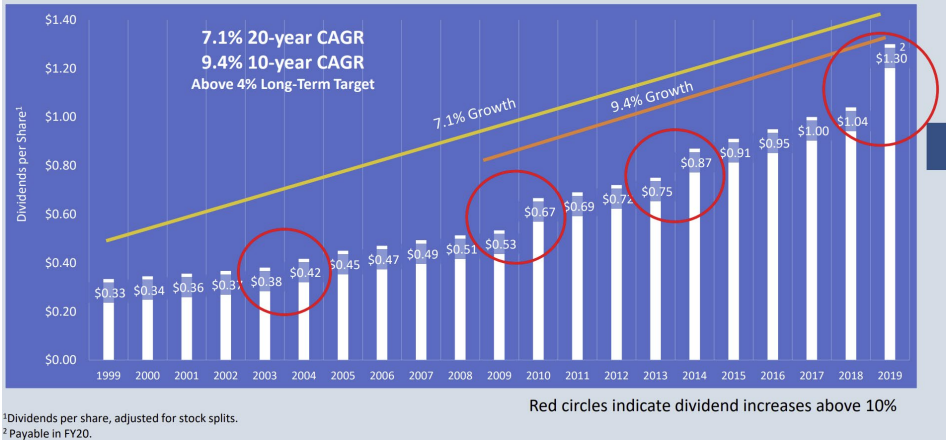
UGI (UGI)			
SECTOR: Utilities			
INDUSTRY: Gas Utilities			
Link to UGI Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
B	**B**	**C**	**Undervalued**

UGI is a holding company for a gas utility plus a variety of mostly gas-related businesses that operate in the Northeastern USA and Europe. It has a 33-year streak of dividend raises and a near-perfect 99 dividend safety score from Simply Safe Dividends.

Dividend Record (Grade = B)



UGI has been raising its dividend for 33 years. Most of its raises are around 3-4%, but it comes through with a big raise on occasion, as it did in 2020 with a 10% raise. Note the circled raises on the chart below.



UGI Dividend Summary		
Factor	**Data**	**Rating**
Yield	3.7%	Mid
Years of Increases	33 (Dividend Champion)	B
5-year DGR	8% per year (Fast)	B
DGR Trend	Usually in low-mid-single digits, with occasional ~10% raise	B
SSD Safety Rating	99 / 100 = Safe	A
Total Dividend Grade = B		

Business Model and Company Quality (Grade = B)

UGI is a holding company for four energy/utility businesses operating in distinct markets.

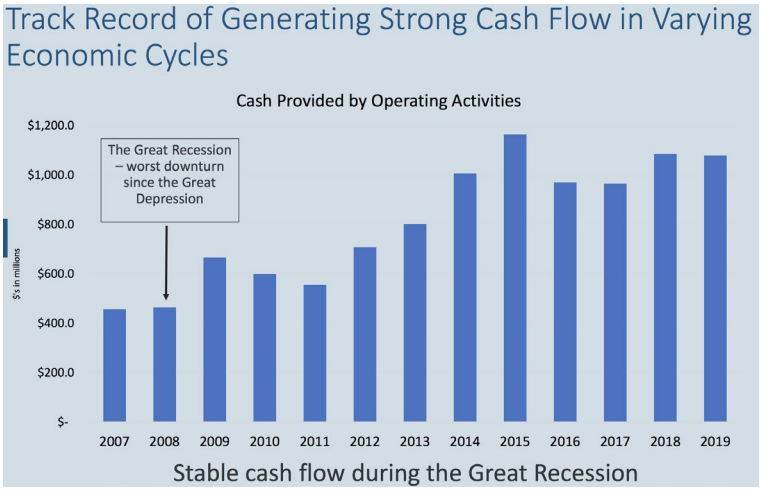


- UGI Utilities is a regulated gas utility in Pennsylvania (20% of earnings)
- UGI International distributes propane throughout Europe
- AmeriGas (acquired in 2019) distributes propane in the USA (the two propane units account for 60% of earnings)
- UGI Energy Services covers midstream assets and marketing (20% of earnings)

UGI's propane distribution companies are not regulated. They can experience volatility due to changes in weather (colder temperatures are better) and economic activity.

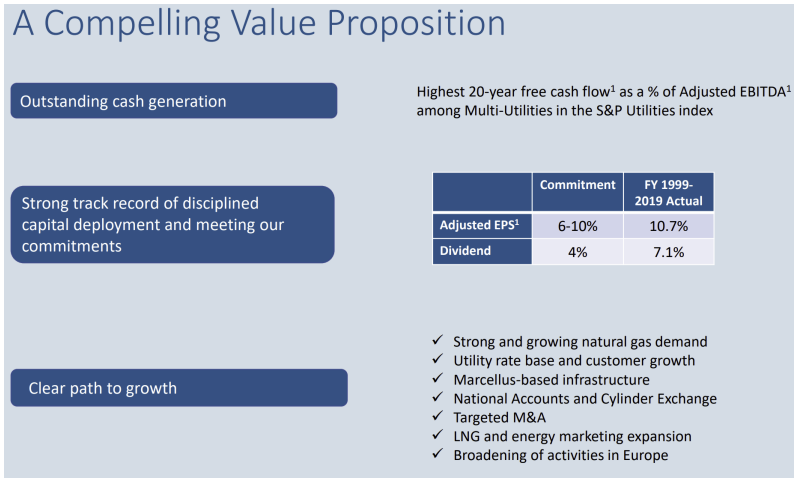
UGI Energy Services operates natural gas storage facilities, gas peaking plants, and gas pipelines, primarily serving northeastern USA with a heavy presence in Pennsylvania.

While Covid-19 has altered its normal distribution patterns, UGI points to the Great Recession to support the idea that it can generate strong cashflow in bad economic times.



The company serves about 700k customers, maintains about 12k miles of natural gas pipelines, and about 2k miles of electrical lines. The AmeriGas acquisition in 2019 caused UGI's leverage to jump; management has committed to a deleveraging program through 2023.

Management believes that UGI's value proposition for investors is based on its outstanding cash generation, disciplined record of capital investments, and a clear growth path.

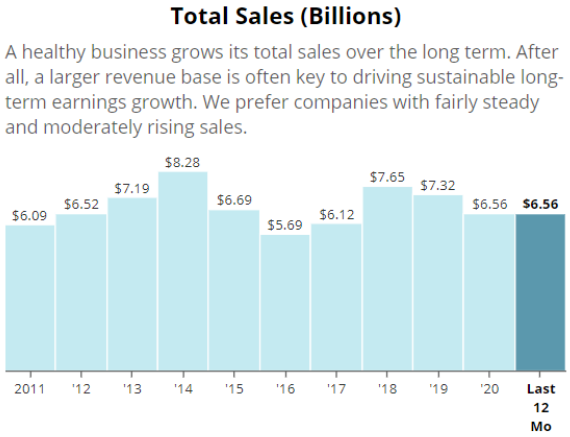


Utilities are capital-intensive businesses, as power plants, transmission lines, and distribution networks cost billions of dollars to build and maintain.

Morningstar awards UGI a Narrow moat rating, which is as high as it goes for utilities.

Financials (Grade = C)

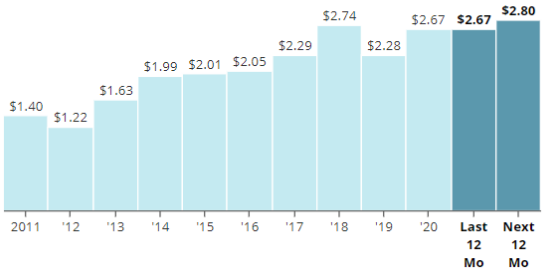
UGI's revenue growth has been erratic over the past decade. The 2020 bar at the right shows the impact of Covid-19 on its business.



UGI's earnings are solidly positive and show a general growth uptrend. I would not normally display its cashflow, but since the company touts it, I show it here. It is generally more positive than most utilities, reflecting fewer capital-investment demands than most utilities.

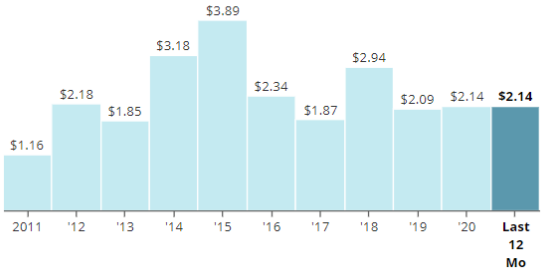
Earnings Per Share

Adjusted earnings are used to exclude noisy "one-time" events such as non-cash impairment charges. The best businesses will steadily increase their earning power over time to help fuel dividend growth and appreciation in their stock price.



Free Cash Flow Per Share

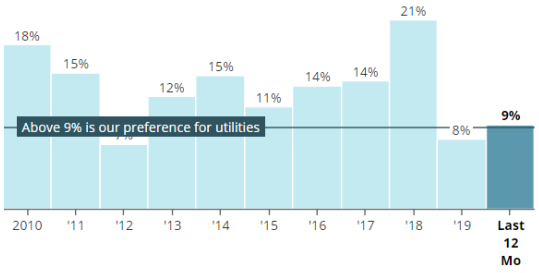
A utility's earnings are more meaningful than its free cash flow. Free cash flow is usually low or negative due to utilities' capital-intensive investments which have long payback periods. They issue debt and equity to fund these projects.



UGI's efficiency metrics are decent, but with variations from year to year.

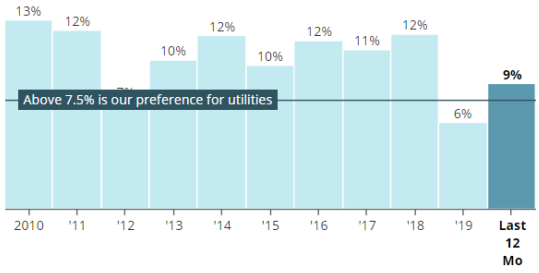
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



Return on Invested Capital

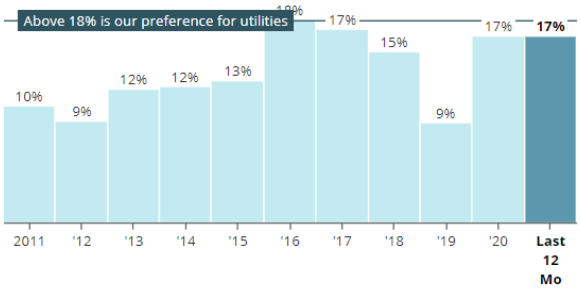
Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



UGI's operating margin (showing its profitability) is a little below par.

Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.

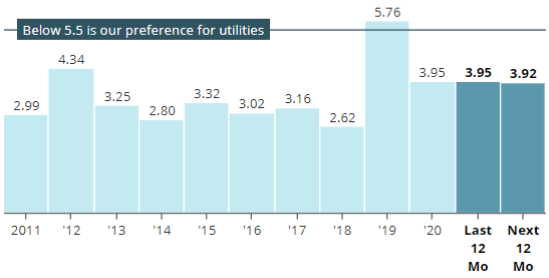


Despite the AmeriGas acquisition, UGI's debt metrics don't look too bad. UGI does not have a credit rating from S&P. UGI Utilities has an A2 (investment grade) credit rating from Moody's, which recently stated that the rating reflects the company's low business

risk profile as a fully regulated primarily-gas utility operating in the supportive Pennsylvania regulatory jurisdiction.

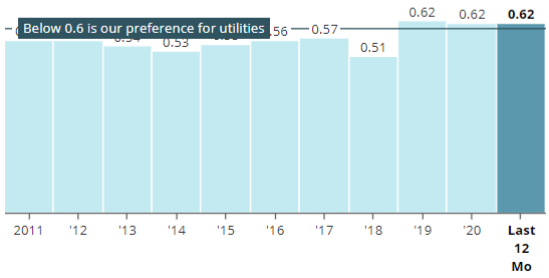
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.



Net Debt to Capital

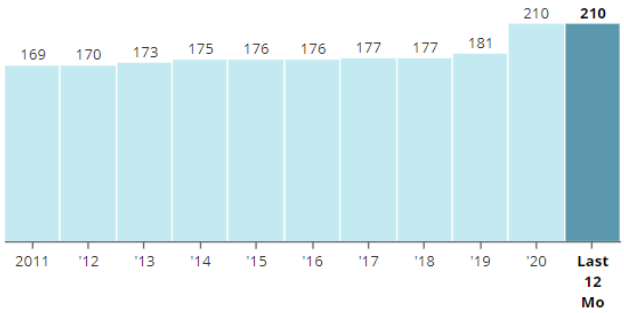
The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



As with many other utilities, UGI's share count rises as it raises money for its capital needs.

Shares Outstanding (Millions)

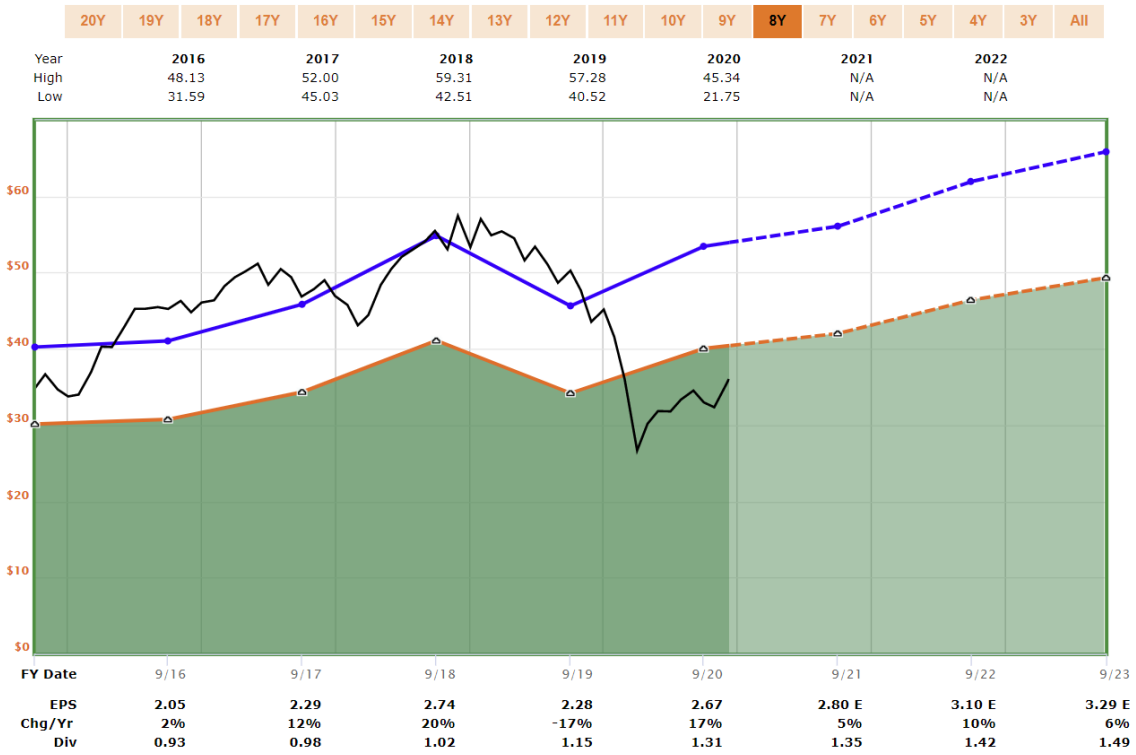
Utilities often rely on issuing equity to fund a portion of their growth expenditures. However, many projects are guaranteed a rate of return by regulators that exceeds a utility's cost of capital, reducing risk and helping earnings per share to grow.



Overall, I view UGI's financials to be solid. I would note that only about 20% of its businesses are regulated, so the company operates in competitive environments without enjoying a legal monopoly. Grade = C.

Valuation (Undervalued)

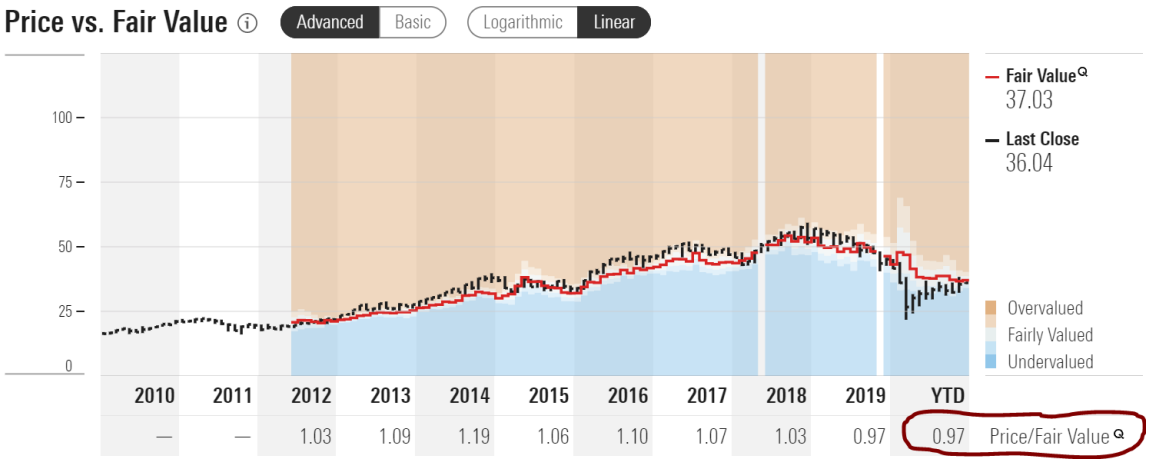
Models #1 & #2: P/E ratios (FASTGraphs)



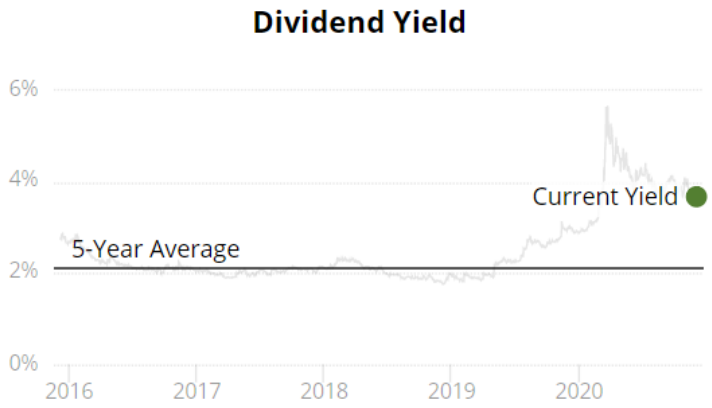
Just looking visually, we can see that UGI is undervalued by both P/E models. UGI's current P/E ratio is 13.4 and its 5-year average is 20.0. Model 1's valuation ratio = 0.89 (orange line), and Model 2's valuation ratio = 0.67.

Model #3: DCF

Using its discounted cash flow (DCF) approach, Morningstar calculates a valuation ratio of 0.97, which suggests fair valuation.



Model #4: Relative yields (Simply Safe Dividends)



UGI's current yield of 3.7% is well above its 5-year average of 2.2%. The valuation ratio would be 0.59, but I put a floor under it of 0.80.

UGI Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	0.89	Undervalued
#2: P/E to Stock's 5-year average	0.67	Significantly undervalued
#3: DCF (from Morningstar)	0.97	Fairly valued
#4. Relative Yield 5-year comparison	0.80 (min. used)	Undervalued
Average of Models: Valuation ratio = 0.83 = Undervalued		

Fair price = $43

Adding 10% to that defines the top of the fair-price range, which I would pay if I had to.

Maximum buy price = $48

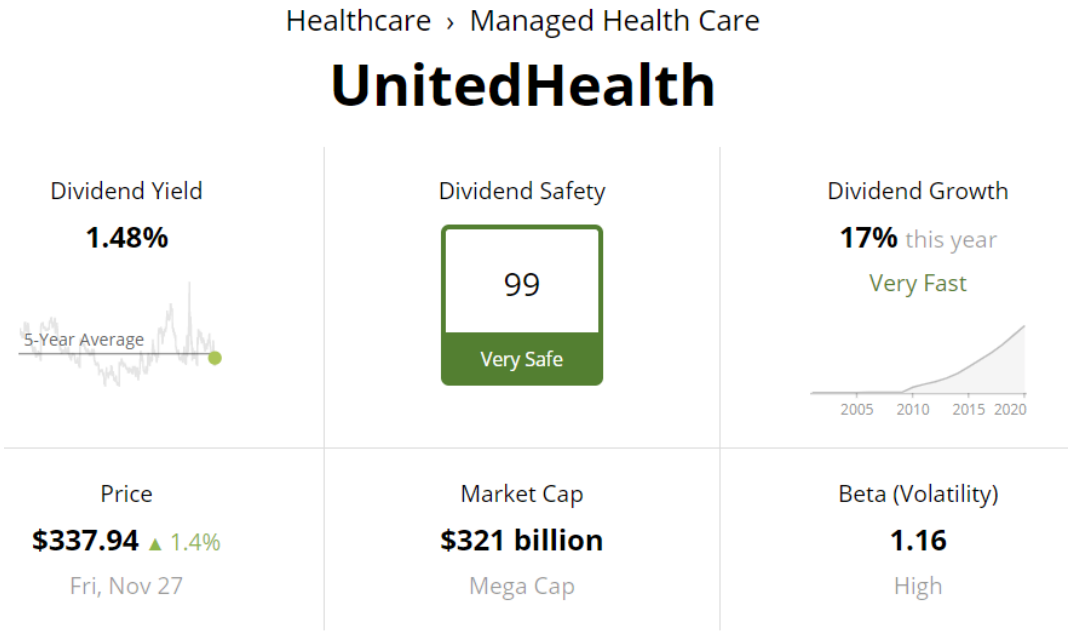
UNITEDHEALTH GROUP (UNH)



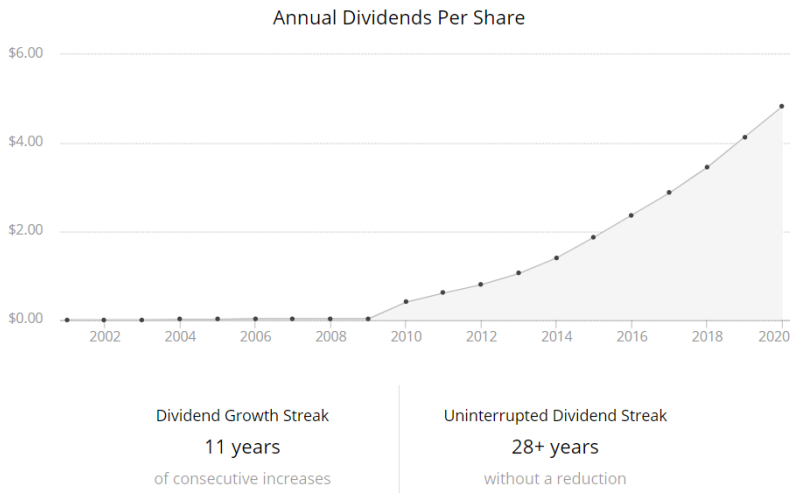
UNITEDHEALTH GROUP (UNH)			
SECTOR: Health Care			
INDUSTRY: Health Care Providers & Services			
Link to UNH Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
C	**B+**	**A**	**Fairly valued**

UnitedHealth is a comprehensive medical insurance and medical services provider. Its yield is low and its streak is short, but its dividend has been growing at double-digit rates and is very safe.

Dividend Record (Grade = C)



UNH changed gears from a dividend company to a DG company in 2010. Since then, it has been raising its dividend at breakneck speed. It is impossible to know how long that is sustainable.



UNH Dividend Summary		
Factor	**Data**	**Rating**
Yield	1.5%	Low
Years of Increases	11 years (Dividend Contender <14)	Short
5-year DGR	21% per year (Very fast)	A
DGR Trend	No increase under 16%	B
SSD Safety Rating	99 / 100 = Very safe	A
Total Dividend Grade = C		

Business Model and Company Quality (Grade = B+)

UNH is a diversified health care company. It offers health care coverage and benefits through UnitedHealthcare, and information and technology-enabled health services through Optum. UNH employs more than 300,000 individuals and is headquartered in Minnetonka, MN.

UNH's two businesses are distinct but strategically aligned. UnitedHealthcare is the largest private health insurer. It provides health care benefits to an array of customers and markets, including private employers of all sizes, public sector employers, and individual consumers. Services include health benefits for Medicare beneficiaries and retirees, health care benefit programs for Medicaid recipients, and health and dental benefits and hospital and clinical services to employer groups and individuals in South America.

Optum includes a large PBM (pharmacy benefits manager) along with a respected health analytics provider. It applies market-leading information, data analytics, technology and clinical insights to help improve overall health system performance. It

serves payers, care providers, employers, governments, life sciences companies, and consumers. It leverages distinctive capabilities in data and analytics, pharmacy care services, health care delivery, and health care operations.

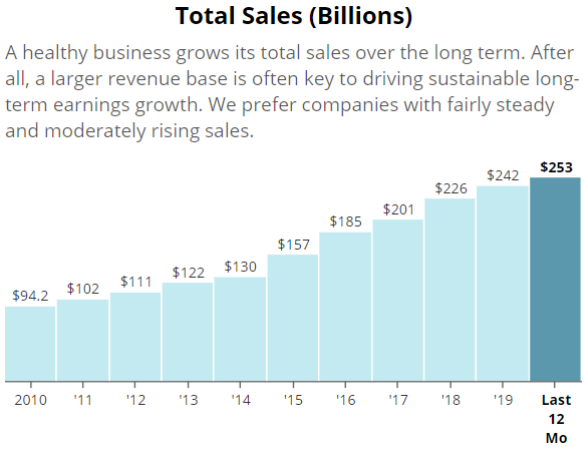
UNH's revenues are derived from premiums on risk-based products; fees from management, administrative, technology, consulting and managed outsourced services; sales of a wide variety of products and services related to the broad health care industry; and investment and other income.

Morningstar gives UNH a Narrow moat, which is the widest moat rating that it gives to health insurers and PBMs due to long-range regulatory uncertainty. UNH's moat is largely predicated on its scale and cost advantages, combined with network effects that result from the cost advantages.

I would give UNH a quality grade of A but for the long-term regulatory uncertainties. I lower the grade to B+ in light of those.

Financials (Grade = A)

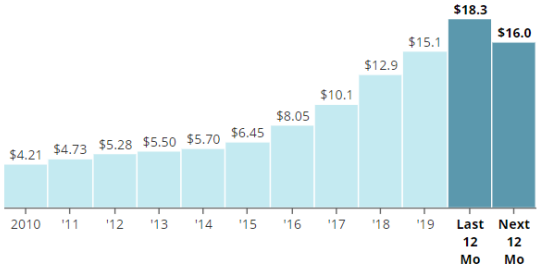
UNH's revenues have grown every year for the past decade.



UNH's EPS and FCF/S have had 10-year increase streaks of their own. The SSD graph below shows an earnings decline forecast for 2021, but FASTGraphs shows a 10% forecast increase.

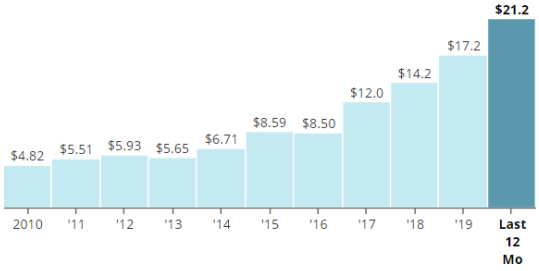
Earnings Per Share

Adjusted earnings are used to exclude noisy "one-time" events such as non-cash impairment charges. The best businesses will steadily increase their earning power over time to help fuel dividend growth and appreciation in their stock price.



Free Cash Flow Per Share

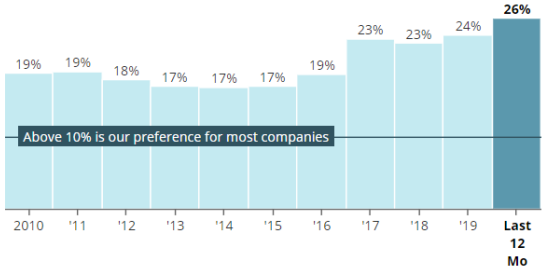
Free cash flow is what's left after a company has paid all of its bills and reinvested to maintain and grow its business. Advantaged businesses tend to generate stable, growing free cash flow over time, fueling sustainable and rising dividends.



UNH's efficiency metrics are both well above their benchmarks.

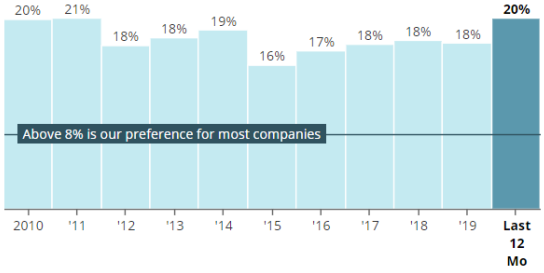
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



Return on Invested Capital

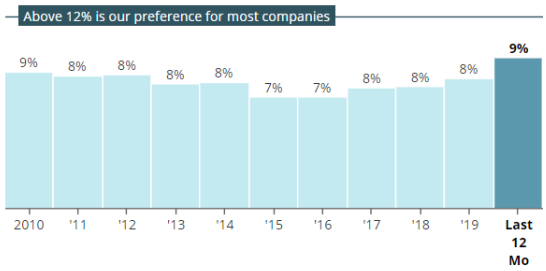
Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



UNH's profitability metrics are just OK.

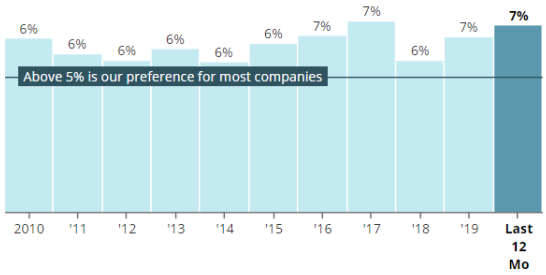
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

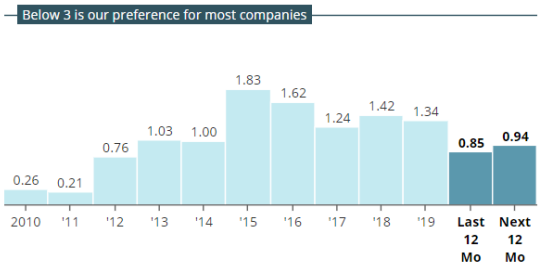
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



UNH is not highly reliant on debt. It has a mid-level investment-grade credit rating of A-. The jump in debt in 2016 corresponds to when Optum closed its $12.8 billion acquisition of Catamaran, a major PBM. UNH has been paying the debt down since then,

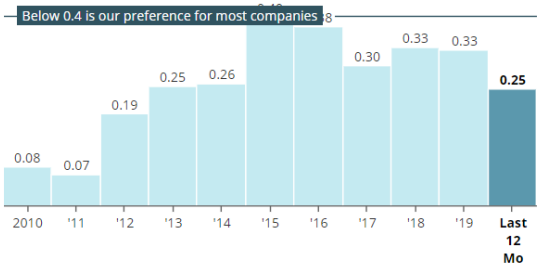
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.



Net Debt to Capital

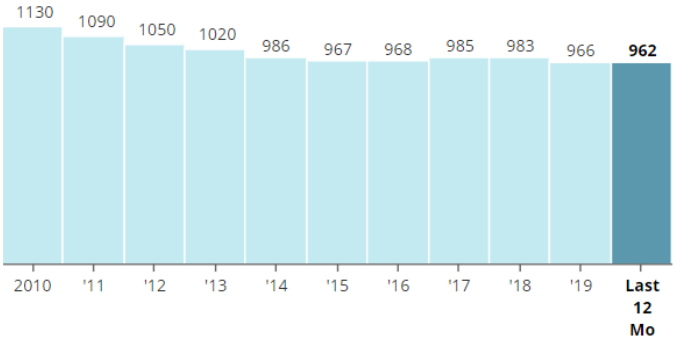
The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



UNH has been steadily decreasing its outstanding shares over the past 10 years. Share count rose only slightly during the Catamaran acquisition, but it has since headed back downward. UNH has 15% fewer shares outstanding now than a decade ago.

Shares Outstanding (Millions)

Some companies return excess cash to shareholders by buying their stock when they believe it is undervalued, increasing your ownership stake. Other firms issue shares to fund growth projects. Generally speaking, we prefer a declining share count.

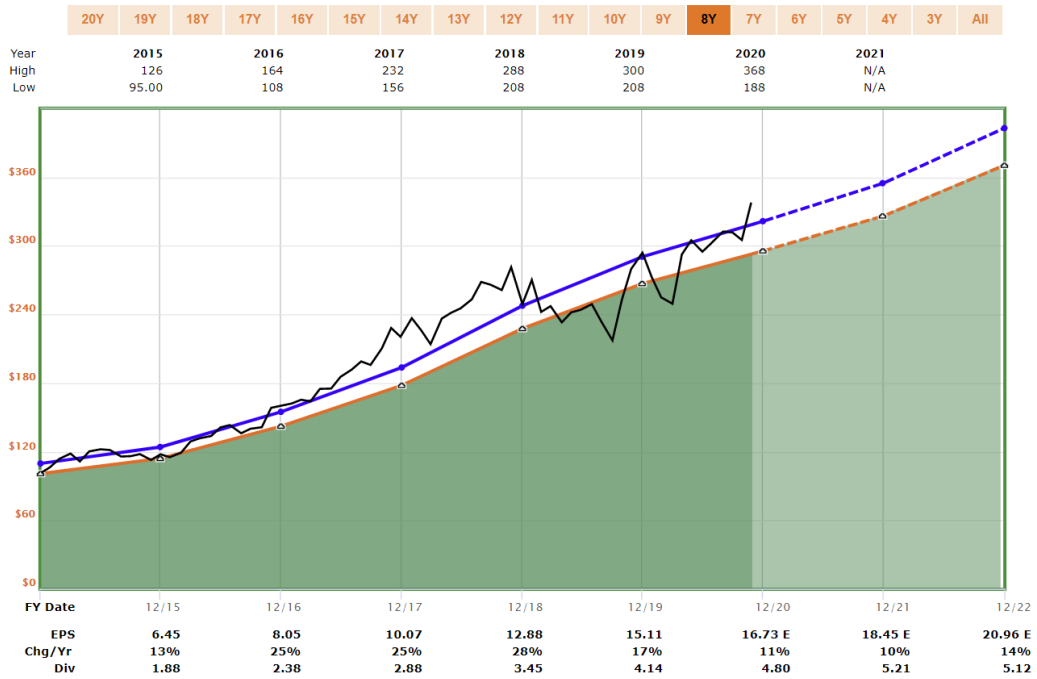


Overall, UNH's financials are very strong. I give them a grade of A.

(Text continues on next page.)

Valuation (Fairly valued)

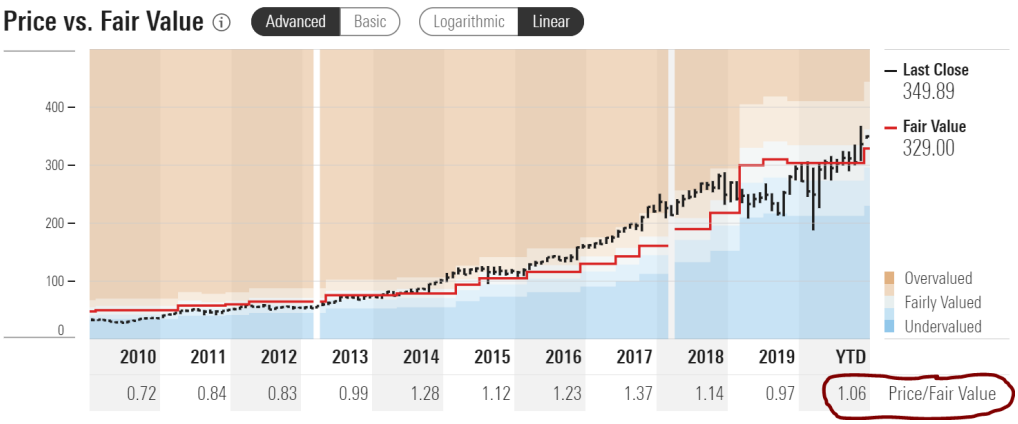
Models #1 & #2: P/E ratios (FASTGraphs)



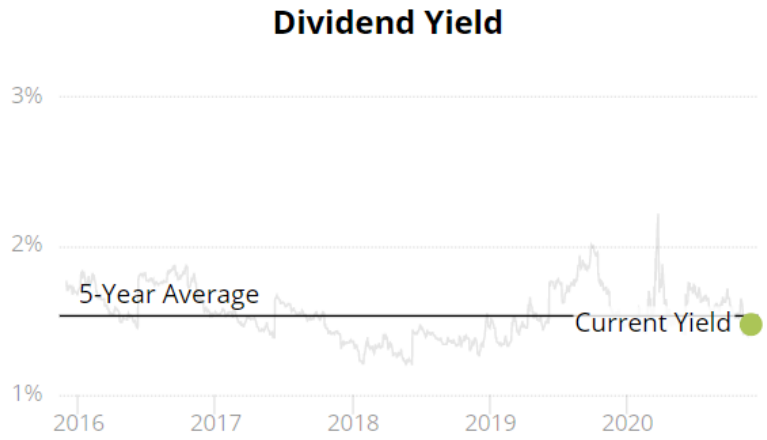
UNH is overvalued under one P/E model and fairly valued under the other. Its current P/E is 20.4, its 5-year average is 19.2, and its orange Model 1 fair-value line is drawn at 17.7 (rather than 15) in light of its fast growth. The valuation ratios are Model 1 = 1.15 and Model 2 = 1.06.

Model #3: DCF

Using its discounted cash flow (DCF) model, Morningstar calculates a slight overvaluation, with a valuation ratio of 1.11.



Model #4: Relative yields (Simply Safe Dividends)



UNH's current and 5-year average yield both round to 1.5%, which results in a valuation ratio of 1.0.

UNH Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's adjusted historical average	1.15	Overvalued
#2: P/E to Stock's 5-year average	1.06	Fairly valued
#3: DCF (from Morningstar)	1.06	Fairly valued
#4. Relative Yield 5-year comparison	1.00	Fairly valued
Average of Models: Valuation ratio = 1.07 = Fairly valued		

The models are all tightly bunched showing fairly to slightly overvalued. Applying the valuation ratio to UNH's recent price gives this fair price.

Fair price = $327

Given UNH's high quality and great financials, I would have no problem paying 10% more than that.

Maximum buy price = $360

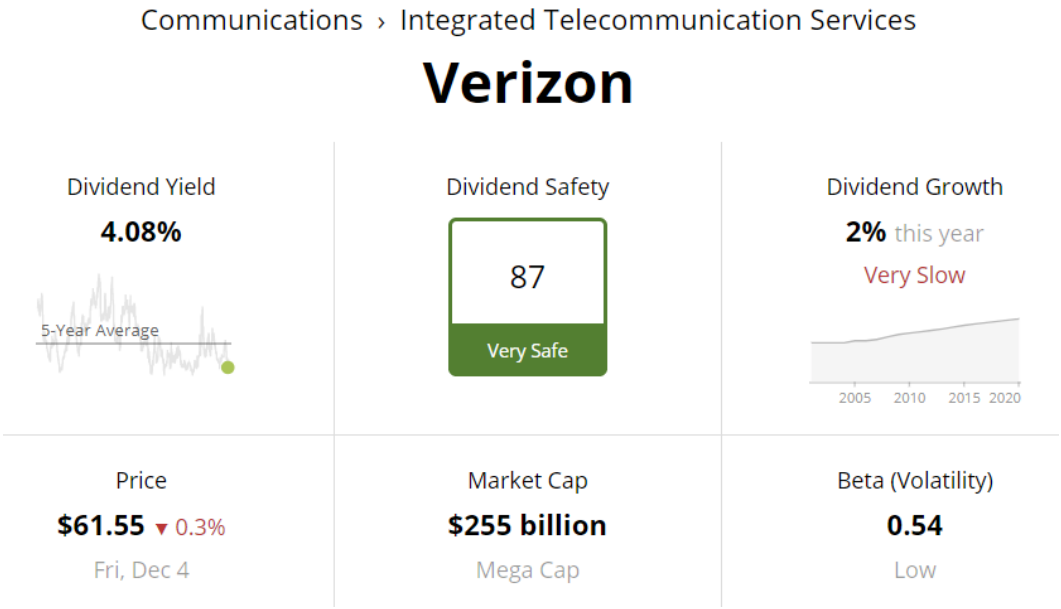
VERIZON COMMUNICATIONS (VZ)



VERIZON COMMUNICATIONS (VZ)			
SECTOR: Communication Services			
INDUSTRY: Diversified Telecommunications Services			
Link to VZ Investor Site			
DIVIDENDS	QUALITY	FINANCIALS	VALUATION
B	B	C	Fairly valued

Verizon is good high-yield, slow-growth DG stock. For many investors, it is a core holding for its steady investor cash flow. It is quite often available at a fair price.

Dividend Record (Grade = B)



Verizon is a high-yield, slow-growth DG stock. It has paid dividends without interruption for more than 30 years and raised them for the past 14 years. Its annual increase has been in the 2% range for several years. Its slow growth is balanced by its high yield.

VZ Dividend Summary		
Factor	**Data**	**Rating**
Yield	4.1%	High
Years of Increases	14 (Dividend Contender 14+)	OK
5-year DGR	2% per year (slow)	D
DGR Trend	Consistently in 2% range	B
SSD Safety Rating	87 / 100 = Very safe	A
Total Dividend Grade = B		

Business Model and Company Quality (Grade = B)

Verizon Communications (VZ) was created in 2000 via the merger of Bell Atlantic (one of the Baby Bells spun out of the breakup of the original AT&T in the 1980s) with GTE in one of the largest mergers in U.S. business history. Verizon is the largest wireless service provider in the USA. The company's 4G LTE network is available to more than 98% of the U.S. population.

VZ's operating structure is divided into three Groups:

- Consumer Group: Wireless (includes voice and data services, equipment sales) and wireline operations (traditional voice, pay-TV, and internet services); accounts for about 67% of revenue
- Business: Services to businesses of all sizes and governments; accounts for about 24% of revenue
- Media: "The intersection of media, advertising, and technology"; about 6% of revenue.

Verizon's growth strategies include strengthening and growing its core businesses plus driving 5G infrastructure buildout and adoption.



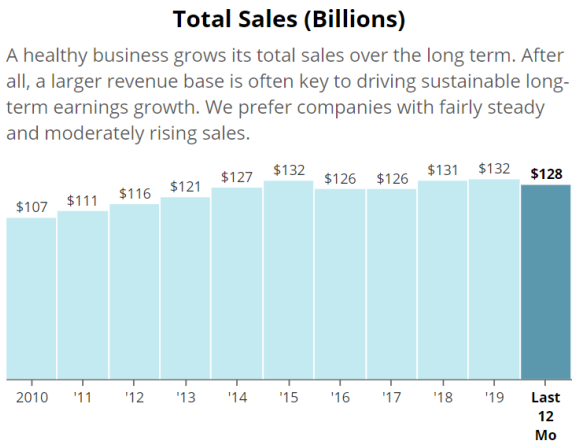
VZ routinely invests more than $16 billion annually to increase the capacity and reliability of its wireless network. Its 4G LTE network covers more than 320 million Americans today. The company often touts its network as the best, which is backed up by some independent ratings.

VZ's massive base of satisfied customers provides it with a sustainable business model. Morningstar awards VZ a Narrow moat, based on cost advantages in its wireless business plus efficient scale characteristics. Growth in wireless subscriptions has slowed considerably, with smartphone adoption now widespread. Much of the competition in the industry comes from the "big 3" carriers (Verizon, AT&T, and T-Mobile) fighting over existing customers.

Moreover, Verizon's large subscriber base provides it with the cash flow needed to support and enhance its existing wireless network. As a result, Verizon's post-paid monthly churn rate (i.e. the percentage of customers who leave) in its wireless business has been stable near 1% or lower. The business is recession-resistant, as many customers consider mobile connectivity to be a necessary product for life today. Its revenues in 2020 have bounced back quickly from the Covid-19 dip.

Financials (Grade = C)

Verizon's business is characterized by slow but steady revenue growth most years.



Verizon has had solid earnings and cashflow returns over the years, although there are annual jumps both up and down.

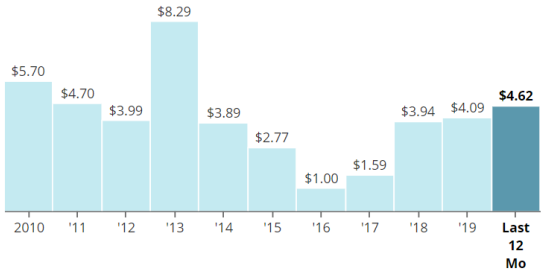
Earnings Per Share

Adjusted earnings are used to exclude noisy "one-time" events such as non-cash impairment charges. The best businesses will steadily increase their earning power over time to help fuel dividend growth and appreciation in their stock price.



Free Cash Flow Per Share

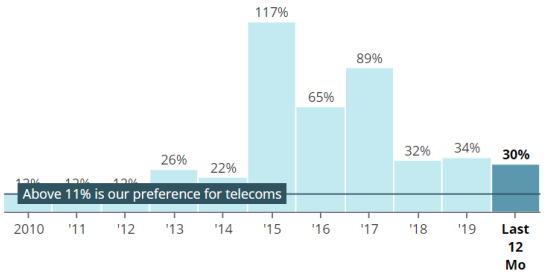
Free cash flow is what's left after a company has paid all of its bills and reinvested to maintain and grow its business. Advantaged businesses tend to generate stable, growing free cash flow over time, fueling sustainable and rising dividends.



Verizon's efficiency metrics (first pair of graphs below) and profitability metrics (second pair) have been above the benchmarks for almost all of the past 10 years.

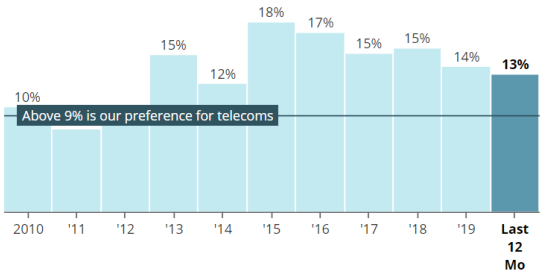
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



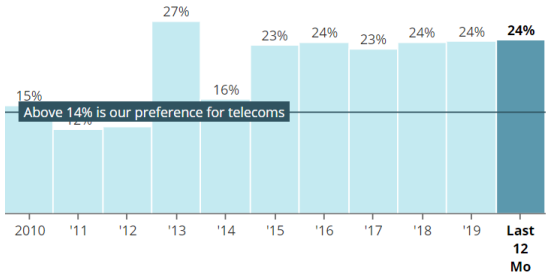
Return on Invested Capital

Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



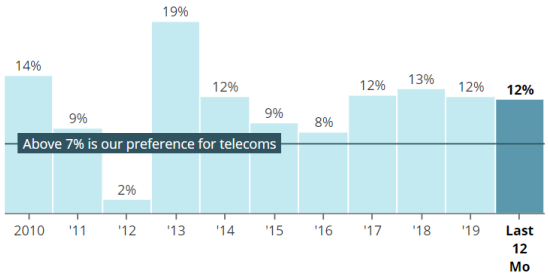
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

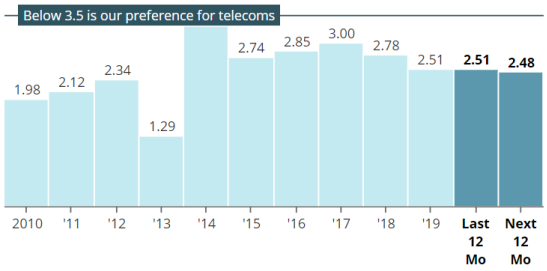
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



VZ's debt situation is a little weaker than its other strong financial metrics. While the payoff margin (net debt to EBITDA) on the left is fine, the debt load itself (right graph) is a little steep. That said, VZ has been reducing that load since 2015, and it is almost in a green area. VZ's credit rating from S&P is BBB+, which is low investment-grade.

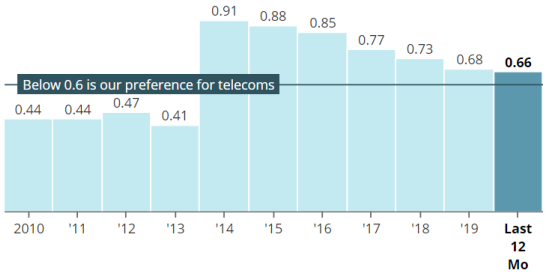
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.



Net Debt to Capital

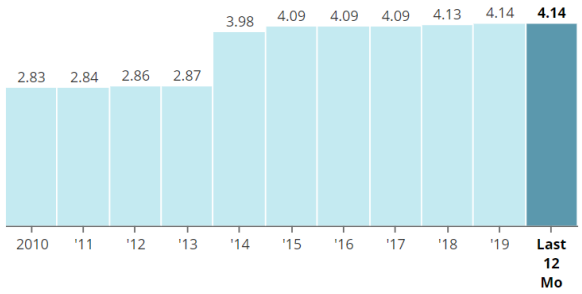
The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



Finally, Verizon does not have the steadily shrinking share count that we prefer. The count took a big jump in 2014 and has gradually risen since then, meaning that the company has been a net issuer – not shrinker – of shares.

Shares Outstanding (Billions)

Some companies return excess cash to shareholders by buying their stock when they believe it is undervalued, increasing your ownership stake. Other firms issue shares to fund growth projects. Generally speaking, we prefer a declining share count.

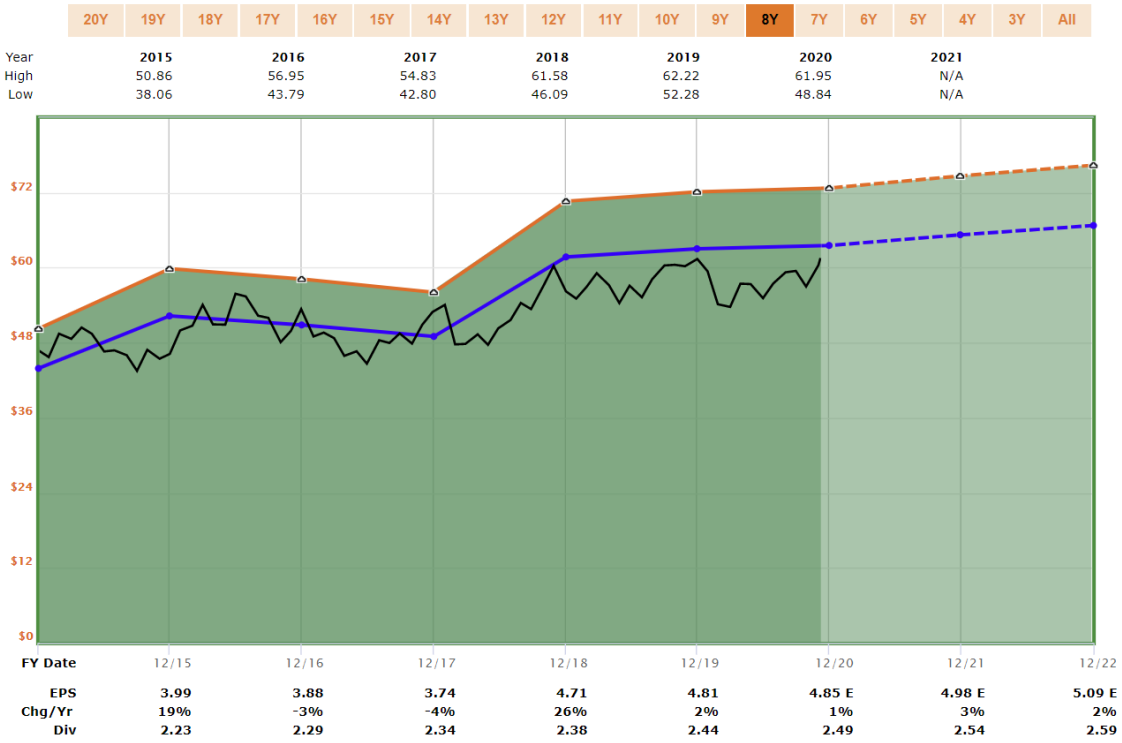


Overall, taking into account VZ's stronger metrics (earnings, cash flow, efficiency and profitability) as well as its weaker ones (flat revenue, slight overleverage, credit rating, and share issuance), I give Verizon a mid-level grade of C for its financials.

(Text continues on next page.)

Valuation (Fairly valued)

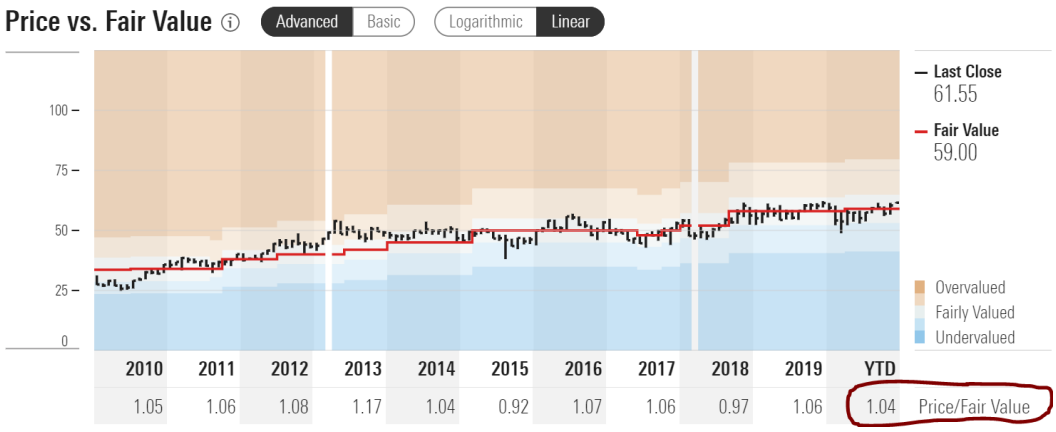
Models #1 & #2: P/E ratios (FASTGraphs)



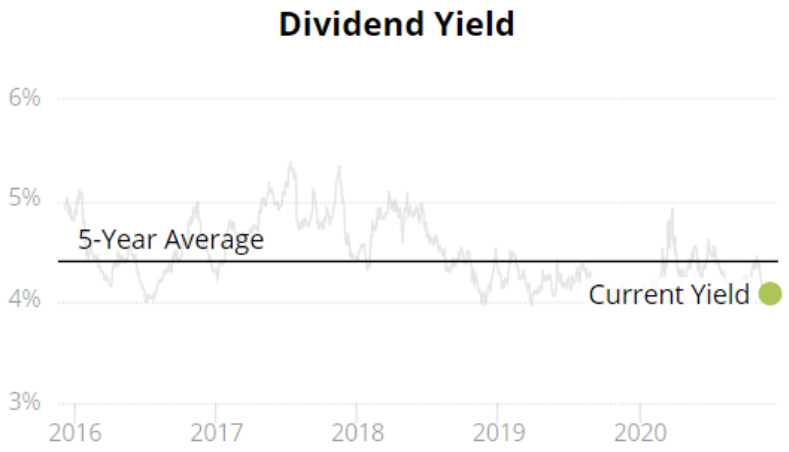
Verizon is undervalued under Model 1 and fairly valued under Model 2. Its current P/E is 12.7 and its 5-year average is 13.1. That produces these valuation ratios: Model 1 = 0.85 and Model 2 = 0.97.

Model #3: DCF

Using its discounted cash flow (DCF) approach, Morningstar has VZ fairly valued with a valuation ratio of 1.04.



Model #4: Relative yields (Simply Safe Dividends)



VZ's current yield of 4.1% is just below its 5-year average 4.4%. That leads to a valuation ratio of 1.07, which is in the fair value range.

VZ Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	0.85	Undervalued
#2: P/E to Stock's 5-year average	0.97	Fairly valued
#3: DCF (from Morningstar)	1.04	Fairly valued
#4. Relative Yield 5-year comparison	1.07	Fairly valued
Average of Models: Valuation ratio = 0.98 = Fairly valued		

Fair price = $63

Given the whole picture, including that VZ's stock price does not have much volatility compared to the market, I personally wouldn't pay much over the calculated fair value for the stock, maybe up to 5% more.

Maximum buy price = $66

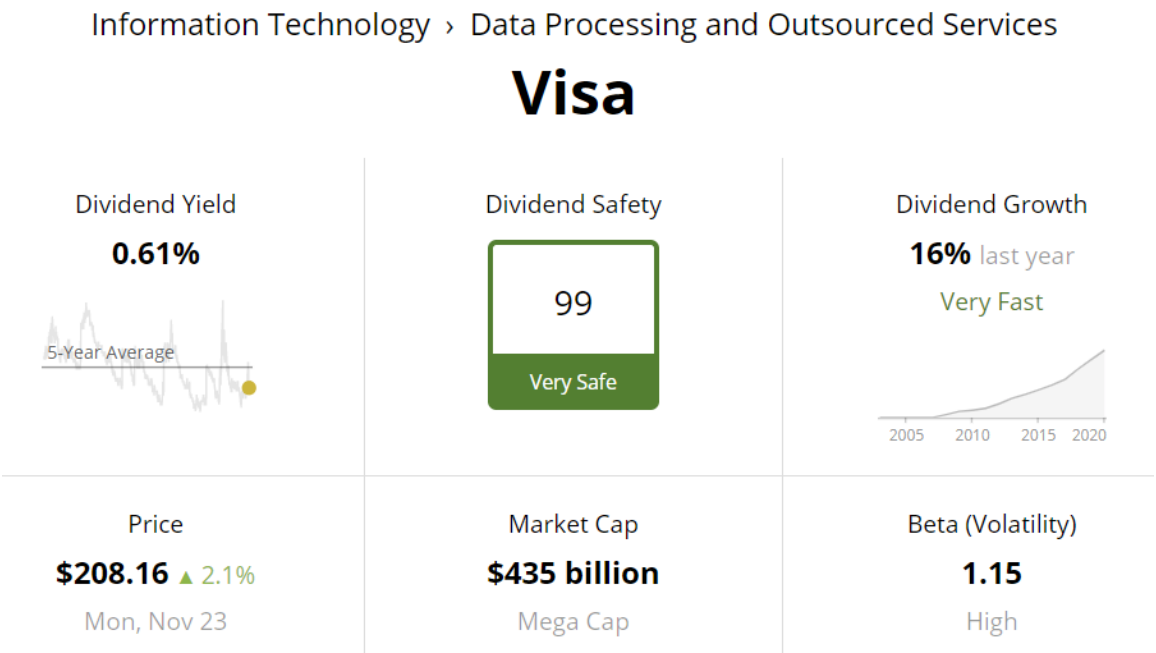
Top of fair-value range = $70

VISA (V)

VISA (V)			
SECTOR: Information Technology			
INDUSTRY: IT Services			
Link to V Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
C	**A**	**A**	**Overvalued**

Visa is the leading domestic credit payment processor. It has a bulletproof business model and stellar financials. Its low yield may not make it a great candidate for investors who need income now, but its long-term growth potential is certainly of interest to many DG investors.

Dividend Record (Grade = C)



Visa is a low-yield, fast-growth DG stock. It paid its first dividend in 2008 and has been raising it ever since. SSD's safety rating is 99, the highest score available.

V Dividend Summary		
Factor	**Data**	**Rating**
Yield	0.7%	Very low
Years of Increases	12 (Dividend Contender < 14 years)	Short
5-year DGR	20% per year (Very fast)	A
DGR Trend	Consistently around 20% per year	A
SSD Safety Rating	99 / 100 = Very safe	A
Total Dividend Grade = C		

Business Model and Company Quality (Grade = A)

Founded in 1958 as BankAmericard, Visa helped pioneer modern credit. V was the first to offer credit cards to middle-class consumers and cater to small-to-medium size merchants. It introduced the debit card in 1975.

Visa went public in 2007. In 2016, it completed the acquisition of Visa Europe.

Visa is one of the world's leaders in digital payments. V facilitates digital payments across more than 200 countries and territories, serving a global set of consumers, merchants, financial institutions, businesses, and government entities.

Visa is a technology company, not a financial institution. It provides transaction processing services to clients. It does not issue cards, extend credit, or set rates for account holders on Visa products. V simply takes a fee for each transaction.

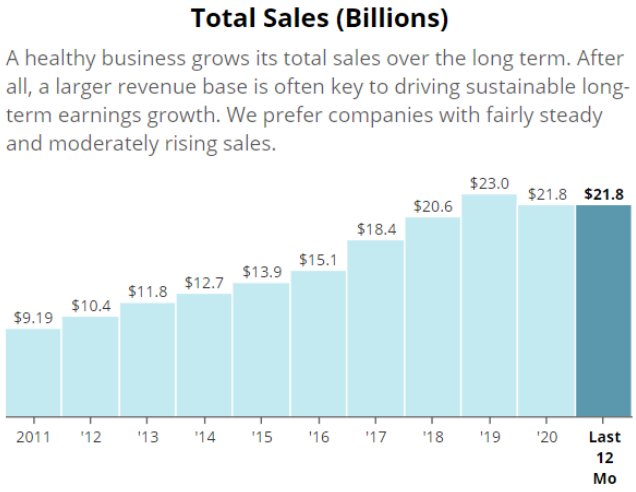
In fiscal 2020, V processed an average of 559 million transactions per day. During fiscal 2020, Visa's total payments and cash volume was $11.3 trillion, and 3.5 billion credentials were available worldwide to be used at nearly 70 million merchant locations.

Visa dominates credit and debit processing in the USA. Its transactions more than double Mastercard's and dwarf American Express and Discover. Visa holds over 50% market share (by purchase volume) in the U.S., Europe, Latin America, and the Middle East/Africa. The company's popularity with consumers is helped by strong branding, supported by billions of dollars in advertising over the decades. Visa routinely ranks as having one of the top 100 most valuable brands in the world.

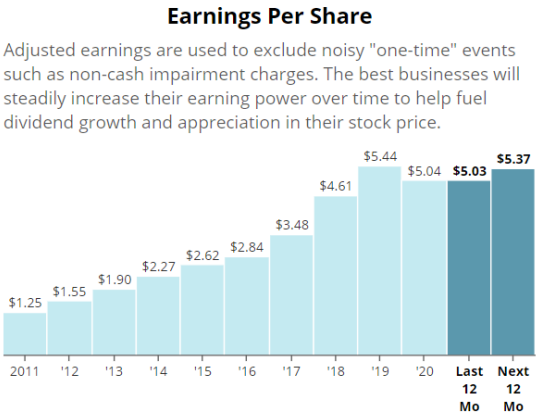
Morningstar awards Visa a Wide moat, based on the network effect (Visa has reached essentially universal acceptance in most developed markets), scalability, cost advantages, and its capital-light business model.

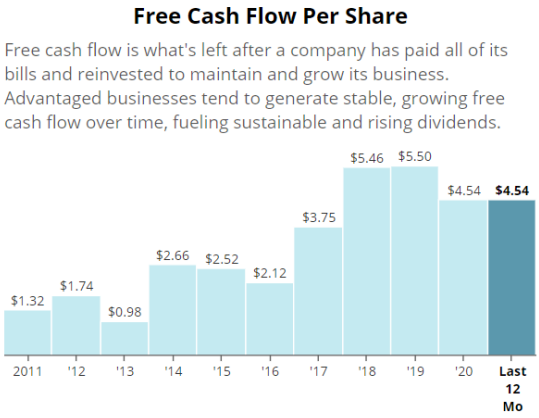
Financials (Grade = A)

Visa's sales have been growing every year, until Covid-19 took a bite in 2020 (the fiscal year is complete). Expect sales growth to resume when we get the pandemic behind us.



Visa's earnings show the same pattern as revenue: Consistent growth until 2020's pandemic effect. Cashflow is a little erratic from year to year, but strong.

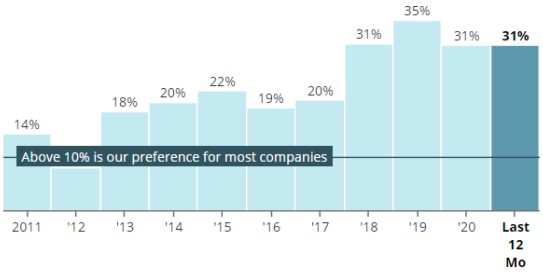




Visa's efficiency (top two graphs) and profitability (bottom two) are all but off the charts. These are some of the finest operating results that you will see anywhere.

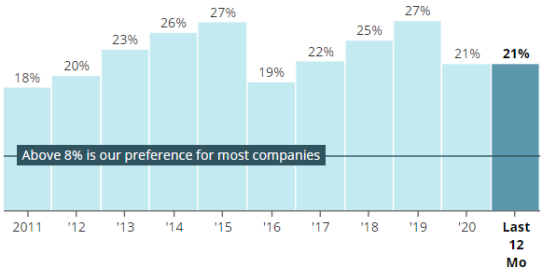
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



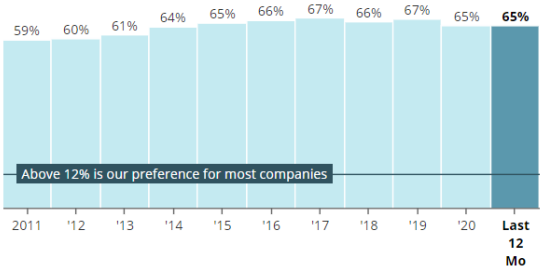
Return on Invested Capital

Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



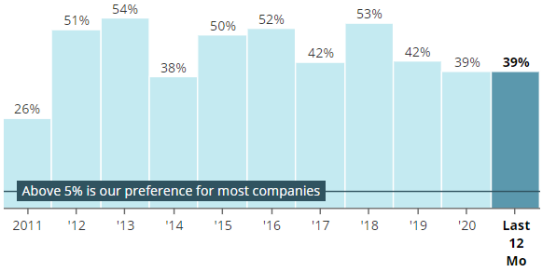
Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

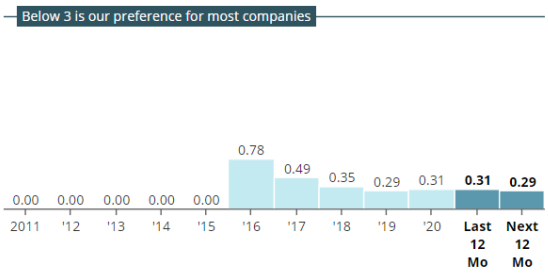
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



Visa does not rely much on debt, having a net-zero debt position in many years. The leverage jump in 2016 coincides with the acquisition of Visa Europe; it's been dropping back down since then. The company has a high-investment-grade credit rating of AA-.

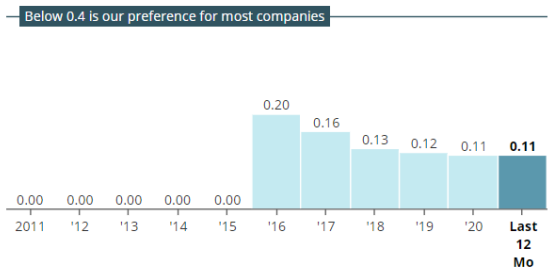
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.

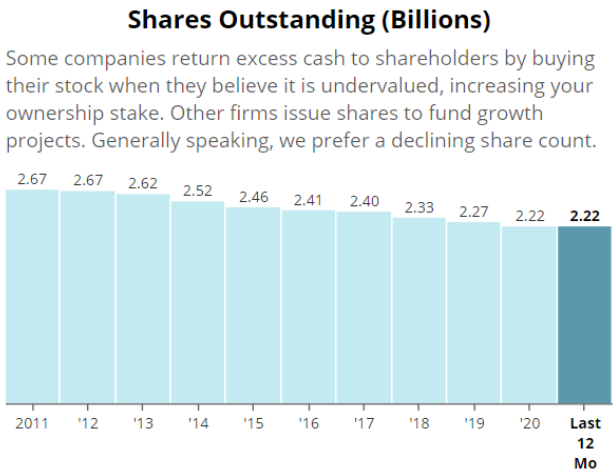


Net Debt to Capital

The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



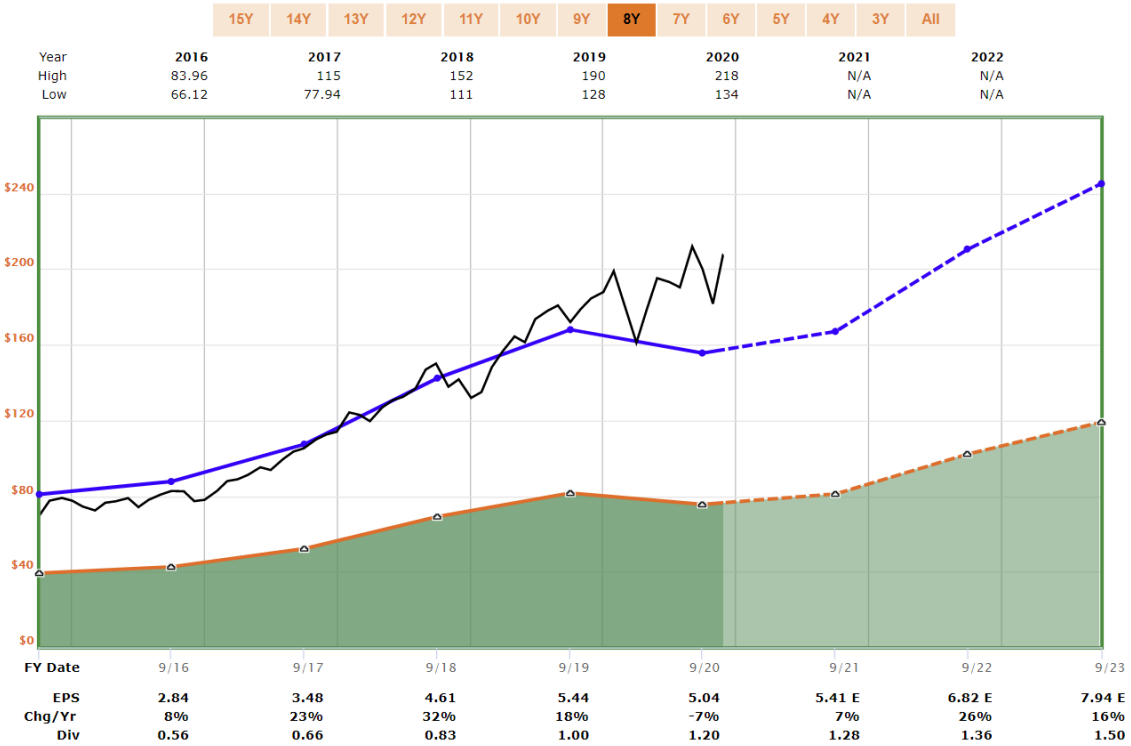
Visa has been reducing its share count steadily, even a little bit when it acquired Visa Europe. It has 17% fewer shares outstanding than it did 10 years ago.



Overall, Visa's financials are very strong, the only chink being the impact of the pandemic. The grade is easily an A.

Valuation (Overvalued)

Models #1 & #2: P/E ratios (FASTGraphs)

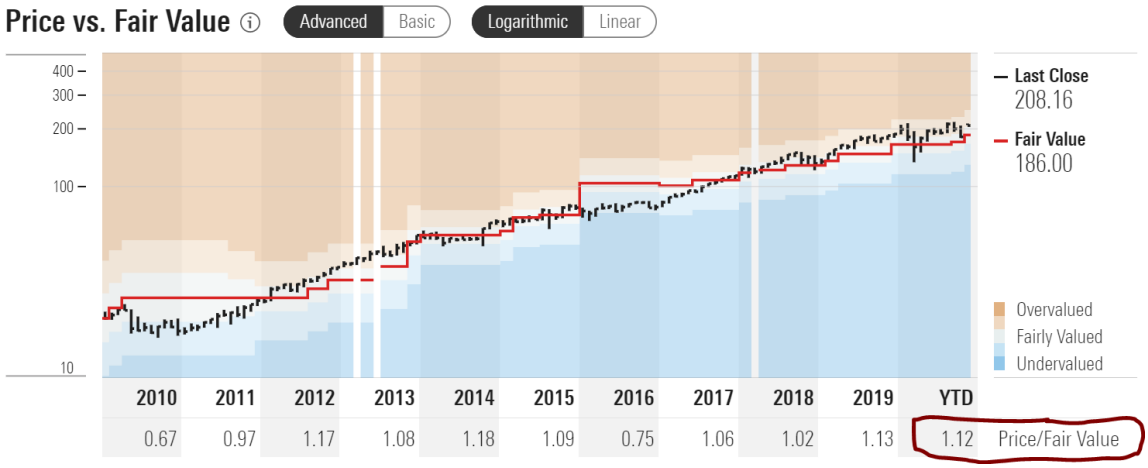


Visa is overvalued by the two P/E models. Its current P/E is 40.9 compared to its 5-year average of 30.9. The orange line is (surprisingly) drawn at 15; I expected it to be higher

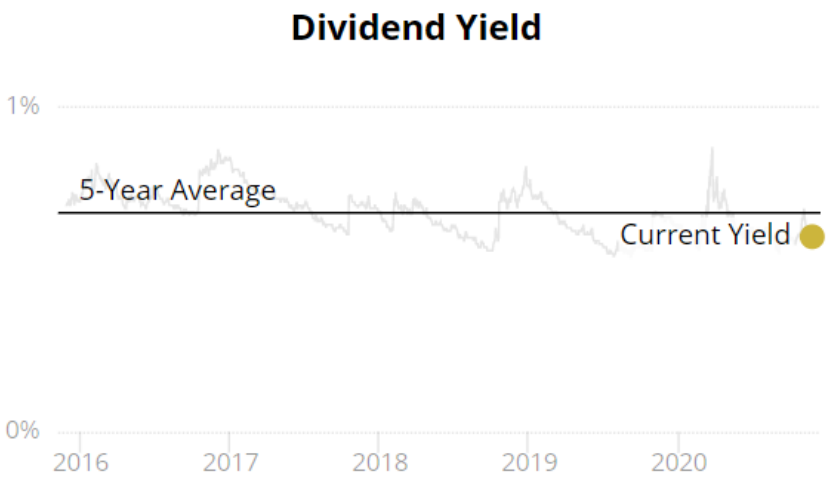
to reflect Visa's fast growth. Model 1's valuation ratio = 2.72 (price compared to orange line), is well out of line with Model 2 at 1.32 (price compared to blue line).

Model #3: DCF (Morningstar)

Using its discounted cash flow (DCF) approach, Morningstar calculates a valuation ratio of 1.12, which suggests Visa is just a little overvalued.



Model #4: Relative yields (Simply Safe Dividends)



Visa's yield (0.6%) is a little under its 5-year average (0.7%). That produces a valuation ratio of 1.17.

Given that Model 1 is a severe outlier from the others and does not seem to account for Visa's likely growth trajectory, I will just use the other three models.

V Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#2: P/E to Stock's 5-year average	1.32	Very overvalued
#3: DCF (from Morningstar)	1.12	Overvalued
#4. Relative Yield 5-year comparison	1.17	Overvalued
Average of Models: Valuation ratio = 1.20 = Overvalued		

Fair price = $173

Given Visa's high business quality and stellar financials, I would willingly pay up to the high end of its fair-price range.

Maximum buy price = $191

I fully understand why some younger investors, or those who think the valuation of Visa is doomed to be "too high" under any model, would pay more, up to and including Visa's current price of around $208.

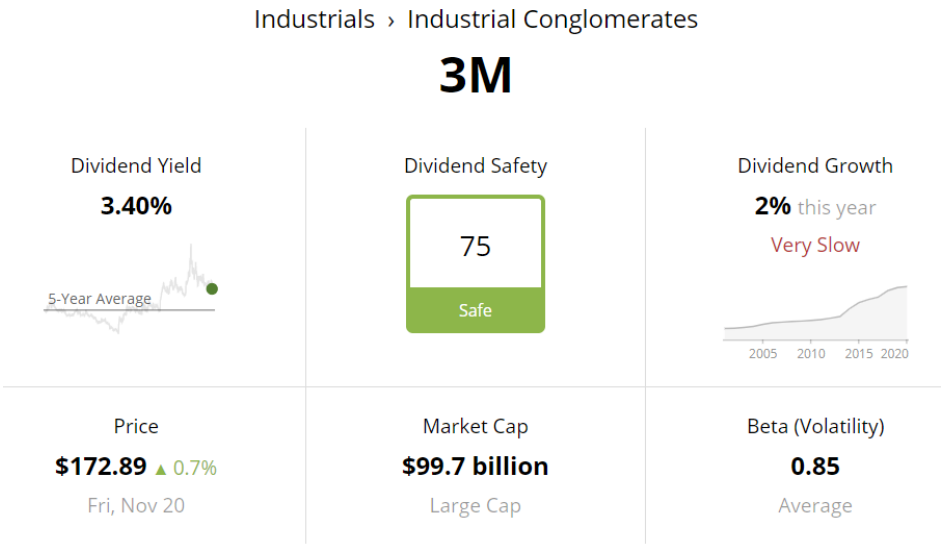
3M (MMM)



3M (MMM)			
SECTOR: Industrials			
INDUSTRY: Industrial Conglomerate			
Link to MMM Investor Site			
DIVIDENDS	**QUALITY**	**FINANCIALS**	**VALUATION**
C	**B**	**C+**	**Fairly valued**

3M is classified as industrial, but it sells into a wide range of markets, including consumers. Its business returns have suffered in recent years, partly due to issues with China. It is a mid-yield, slow-to-mid-growth DG stock.

Dividend Record (Grade = C)



MMM's dividend performance stalled out for a few years, with a declining growth pattern that I don't like to see.

MR% Inc	DGR 1-y	DGR 3-y	DGR 5-y	DGR 10-y
2.08	5.9	9.1	11.0	10.9

However, I think MMM deserves some benefit of the doubt here, based on its long record of dividend increases (>60 years). Its other dividend metrics are good, and I believe that the company's basic business quality, combined with its commitment to the dividend, will result in a turnaround of MMM's dividend growth.

MMM Dividend Summary		
Factor	**Data**	**Rating**
Yield	3.4%	Mid
Years of Increases	62 (Dividend King, Champion, Aristocrat)	A
5-year DGR	7% per year (OK for yield)	C
DGR Trend	Mostly declining last few years	D
SSD Safety Rating	75 / 100 = Safe	B
Total Dividend Grade = C		

Business Model and Company Quality (Grade = B)

Founded more than a century ago as a mining venture, 3M today offers more than 60,000 products used in homes, businesses, schools, hospitals and other industries.

MMM has operations in 70 countries and sales in 200. It reaches a wide variety of end markets, including many cyclical industries like automotive, electronics, transportation, and industrial products. The cyclical nature of such markets has had an impact on MMM's ability to grow during the pandemic.

In efforts to restore profitable growth, MMM has consolidated its structure (down to four segments) and cut costs.

Renowned for its innovation, 1/3 of MMM's sales come from products invented in the past five years. MMM employs thousands of researchers and scientists and spends about 6% of sales on R&D. 3M has been awarded >9,000 U.S. patents since 2001.

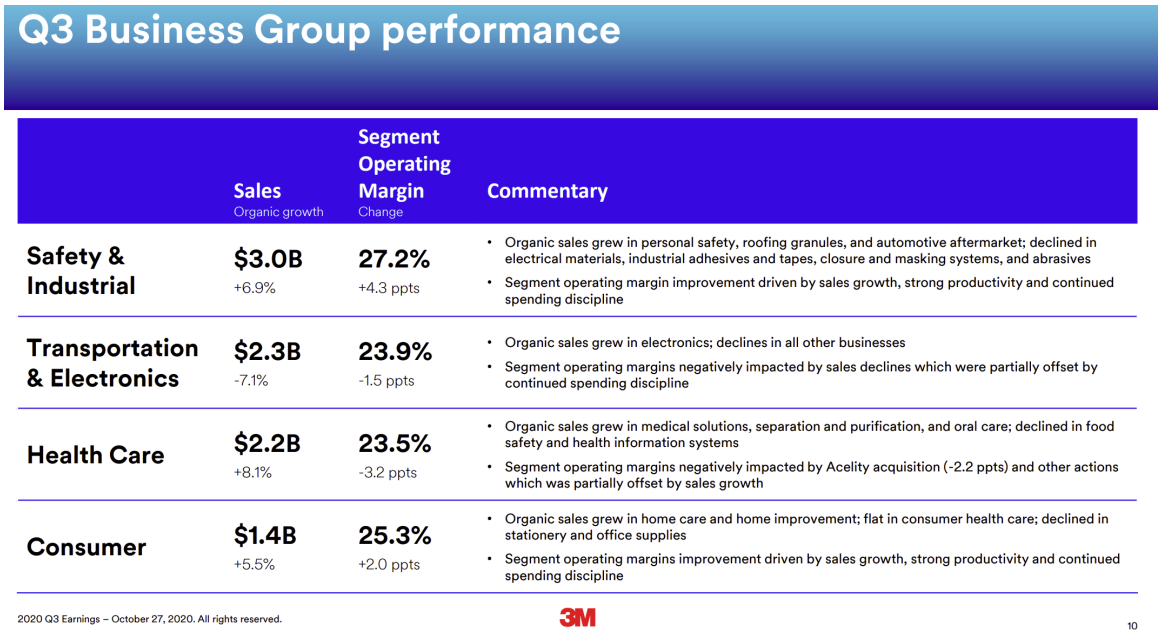
3M rarely grants licenses, keeping its proprietary technologies to itself. That allows it often to charge price premiums. It also provides economies of scale, as the uses of existing technologies are expanded into additional applications. These strengths show up in its high margins.

MMM has run into headwinds based on slowing growth; weakness in auto, semiconductor, and Chinese markets; and environmental and health liability risks related to PFAS (a chemical compound manufactured beginning in the 1950s).

MMM has been moving more into the secularly growing healthcare market, propelled both by its own innovations and acquisitions.

Morningstar accords MMM a Wide moat, based on intangible assets such as patents and brands, culture of innovation, and cost (scale) advantages.

MMM's recent Q3 earnings report showed encouraging growth in three of its four segments and reflects MMM's strong profitability in all segments.



Q3 Business Group performance

	Sales Organic growth	Segment Operating Margin Change	Commentary
Safety & Industrial	**$3.0B** +6.9%	**27.2%** +4.3 ppts	• Organic sales grew in personal safety, roofing granules, and automotive aftermarket; declined in electrical materials, industrial adhesives and tapes, closure and masking systems, and abrasives • Segment operating margin improvement driven by sales growth, strong productivity and continued spending discipline
Transportation & Electronics	**$2.3B** -7.1%	**23.9%** -1.5 ppts	• Organic sales grew in electronics; declines in all other businesses • Segment operating margins negatively impacted by sales declines which were partially offset by continued spending discipline
Health Care	**$2.2B** +8.1%	**23.5%** -3.2 ppts	• Organic sales grew in medical solutions, separation and purification, and oral care; declined in food safety and health information systems • Segment operating margins negatively impacted by Acelity acquisition (-2.2 ppts) and other actions which was partially offset by sales growth
Consumer	**$1.4B** +5.5%	**25.3%** +2.0 ppts	• Organic sales grew in home care and home improvement; flat in consumer health care; declined in stationery and office supplies • Segment operating margins improvement driven by sales growth, strong productivity and continued spending discipline

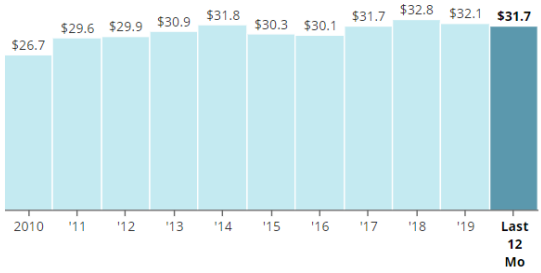
Overall, I grade MMM's business model and quality as a B. I think that it will prevail over the headwinds that it faces now.

Financials (Grade = C+)

MMM's revenue record is basically flat. The pandemic has had a relatively small impact.

Total Sales (Billions)

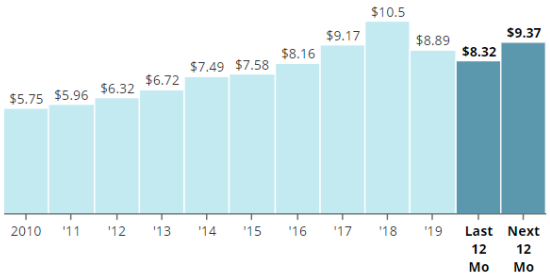
A healthy business grows its total sales over the long term. After all, a larger revenue base is often key to driving sustainable long-term earnings growth. We prefer companies with fairly steady and moderately rising sales.



MMM's earnings and cashflow metrics are very strong. MMM generates a lot of cash.

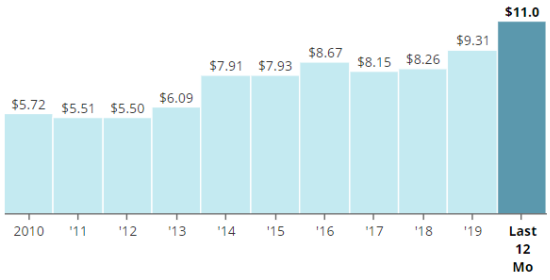
Earnings Per Share

Adjusted earnings are used to exclude noisy "one-time" events such as non-cash impairment charges. The best businesses will steadily increase their earning power over time to help fuel dividend growth and appreciation in their stock price.



Free Cash Flow Per Share

Free cash flow is what's left after a company has paid all of its bills and reinvested to maintain and grow its business. Advantaged businesses tend to generate stable, growing free cash flow over time, fueling sustainable and rising dividends.



MMM's efficiency (top two graphs) and profitability (bottom two) are very good, far above the benchmarks.

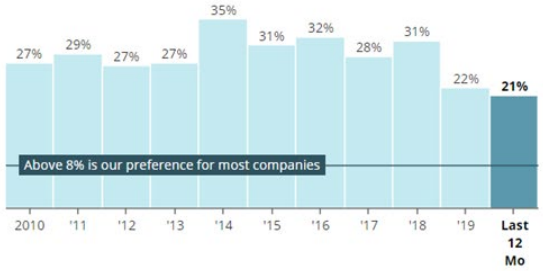
Return on Equity

Measures how many dollars of profit a company earns for every dollar shareholders have invested in the firm. Warren Buffett tends to favor firms with consistent mid-teens returns, which indicates they could possess an economic moat.



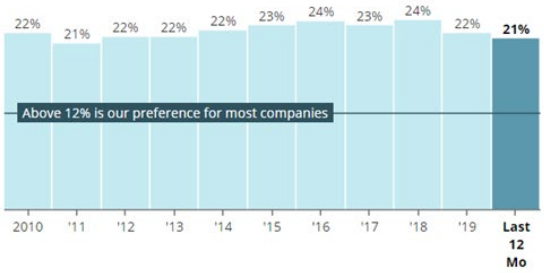
Return on Invested Capital

Divides a firm's profits by the money both equity and debt holders have given the company to gauge management's capital allocation skill. An advantaged firm typically earns stable and above-average returns over time.



Operating Margin

A measure of profitability that divides operating income (what's left after a company deducts its cost of goods sold and operating expenses) by total sales. Higher, more stable operating margins can be a sign of an advantaged business.



Free Cash Flow Margin

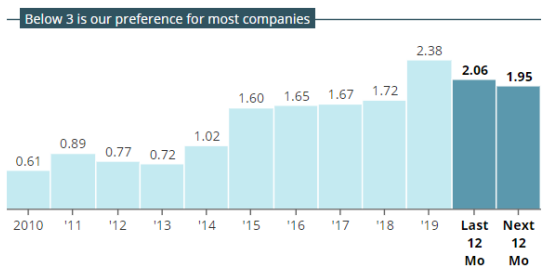
Free cash flow is the amount of cash a company generates after paying all of its expenses and investing to maintain and expand its business. This profitability metric divides free cash flow by sales. The best companies generate high and stable margins.



MMM's debt metrics tell a mixed story. Paying back the debt is not a problem (left graph), but MMM's ratio of debt to capital (right graph) is high. Debt was bumped up in connection with its 2019 acquisition of healthcare company Acelity for $6.7 billion, MMM's largest acquisition ever. MMM has a very strong AA- credit rating.

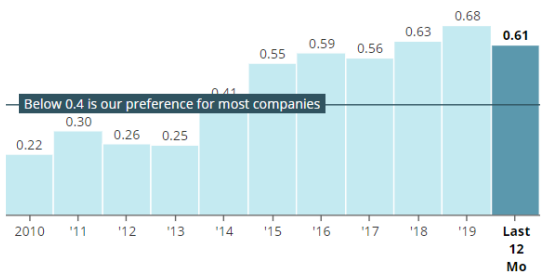
Net Debt to EBITDA

Indicates how many years of EBITDA (a proxy for cash flow) a company would need to pay off all its debt, net of cash on hand. If leverage rises too high, a company might cut its dividend to free up cash flow for debt reduction.

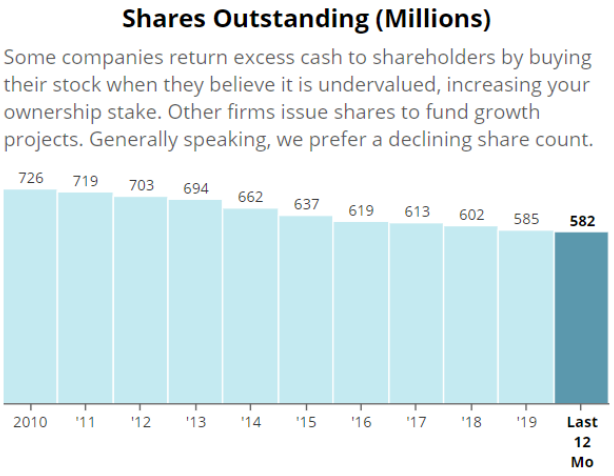


Net Debt to Capital

The proportion of a company's financing that is from debt (net of cash) rather than equity. Companies with a high dependence on debt to fund their operations can be more likely to run into trouble if business conditions weaken.



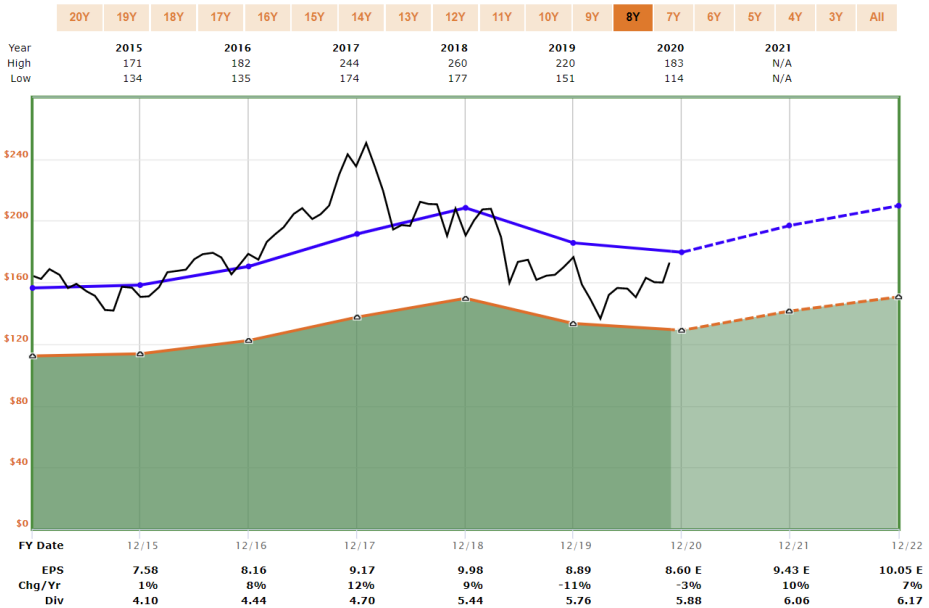
MMM has been steadily reducing its share count over the past decade. It has 20% fewer shares outstanding than it did 10 years ago. That's where some of the borrowed money went. MMM recently suspended its share repurchase program in a nod to Covid-19's impact on the company.



Overall, MMM has strong financials, with two concerns: lack of revenue growth and high debt levels. If you believe that its business can regain its traditional growth trajectories, the revenue growth will be corrected. The use of debt is a choice, and I would prefer to see it reduced, even though it does not seem to be a particular burden on the company. Blending everything together, I give 3M a C+ on its financials.

Valuation (Fairly valued)

Models #1 & #2: P/E ratios (FASTGraphs)

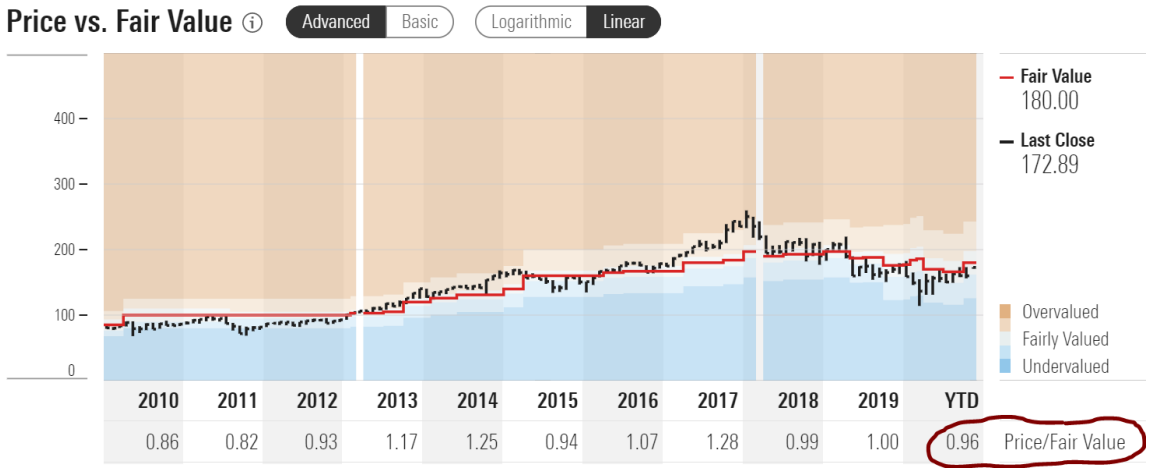


MMM's price has begun to climb from the pandemic lows, but it is still below its peak in early 2018. MMM is overvalued on Model 1 and fairly valued on Model 2. Its current P/E

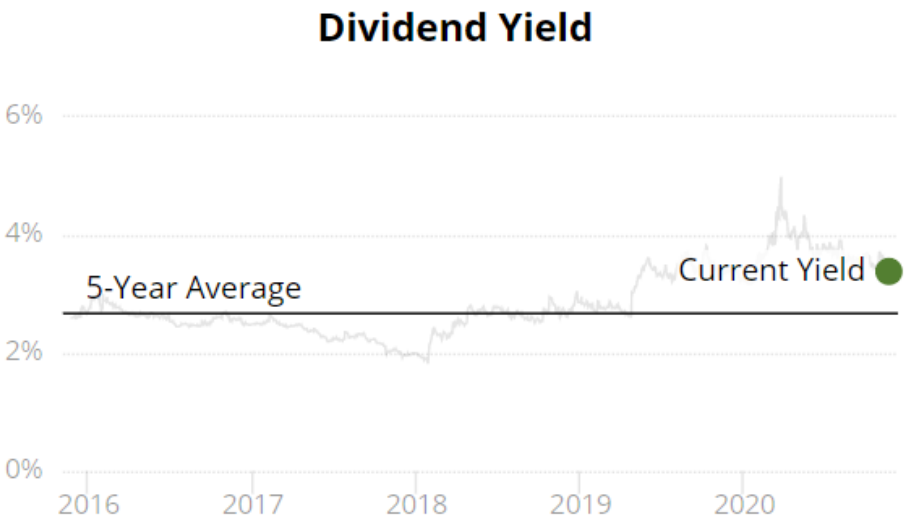
ratio is 20 compared to its 5-year average of 20.9. Its valuation ratios are Model 1 = 1.33 and Model 2 = 0.96.

Model #3: DCF

Using its discounted cash flow (DCF) techniques, Morningstar has MMM fairly valued with a valuation ratio of 0.96.



Model #4: Relative yields (Simply Safe Dividends)



MMM is currently yielding 3.4% compared to its 5-year average of 2.7% The relative yield metric is beyond 20%, so I cut it off at 0.80.

MMM Valuation Summary		
Model	**Valuation Ratio**	**Interpretation**
#1: P/E to Market's historical average	1.33	Very overvalued
#2: P/E to Stock's 5-year average	0.96	Fairly valued
#3: DCF (from Morningstar)	0.96	Fairly valued
#4. Relative Yield 5-year comparison	0.80	Undervalued
Average of Models: Valuation ratio = 1.01 = Fairly valued		

MMM is fairly valued. In a nod to the challenges that face it in terms of restoring revenue growth, I don't think I would pay much (or anything) above that. If you have confidence in MMM's prospects going forward, the top (+10%) of its fair-value range is also shown.

Fair price = $173

Top of fair-value range = $190

CHAPTER 16

REAL-LIFE INVESTING: MY DIVIDEND GROWTH PORTFOLIO

I initiated my public Dividend Growth Portfolio (DGP) in 2008 to demonstrate real dividend growth (DG) investing.

The DGP is not a huge portfolio, but it is large enough to demonstrate basic dividend growth investing principles. Those principles operate the same at any portfolio size. Principles are scalable.

The DGP is an illustration of real-life investing. I do not hold it out as best-of-type, but rather as a **real-time, real-money, sensible example** of what an investor can achieve through DG investing.

I report monthly on the DGP, and it reflects real decisions. These are not back-tested examples of what might have been. Rather, this portfolio reflects what has really happened, including my mistakes.

The Portfolio

Here is the DGP in a nutshell:

Purpose of the DGP →	*DEMONSTRATE DIVIDEND GROWTH INVESTING IN REAL LIFE*
Inception date	June 1, 2008
Held at	E-Trade
Amount invested	Initial amount = $46,783 No outside money added since inception.
Primary goal	Build a reliable, steady stream of dividends over many years that will eventually be used in retirement
Portfolio management	Managed in real time. Results are actual, not hypothetical.
Holdings	20-30 dividend growth stocks
Portfolio turnover	Low, usually less than 10% per year
Dividend reinvestment	Dividends are collected until they total $1000. Then they are reinvested.

The portfolio is shown on the next page. The remainder of the chapter after that will discuss salient features, the mechanics of how things work, and some learnings over the years.

Updated December 1, 2020:

DAVE VAN KNAPP'S DIVIDEND GROWTH PORTFOLIO (DGP)							
Company	Year First Bought	GICS Sector	Current Yield %	Shares	Value $	% of Port.	Annual Income $
3M (MMM)	2019	Industrials	3.4%	18	$3109	2.2%	$106
Alliant Energy (LNT)	2010	Utility	2.9%	200	$10520	7.4%	$304
Altria (MO)	2018	Consumer Staples	8.6%	72	$2868	2.0%	$248
Amgen (AMGN)	2018	Healthcare	2.9%	15	$3331	2.3%	$96
AT&T (T)	2009	Comm Svc	7.2%	232	$6670	4.7%	$483
Chevron (CVX)	2008	Energy	5.9%	30	$2615	1.8%	$155
Cisco (CSCO)	2016	Info Tech	3.4%	118	$5076	3.6%	$170
Coca-Cola (KO)	2014	Consumer Staples	3.2%	109	$5624	3.9%	$179
Digital Realty Trust (DLR)	2015	Real Estate	3.3%	23	$3099	2.2%	$103
Enbridge (ENB)	2019	Energy	8.0%	111	$3464	2.4%	$267
General Dynamics (GD)	2020	Industrials	3.0%	14	$2091	1.5%	$62
Hasbro (HAS)	2012	Consumer Disc	2.9%	52	$4838	3.4%	$141
Johnson & Johnson (JNJ)	2010	Healthcare	2.8%	75	$10851	7.6%	$303
Lockheed Martin (LMT)	2020	Industrials	2.9%	3	$1095	0.8%	$31
Lowe's (LOW)	2017	Consumer Disc	1.5%	13	$2026	1.4%	$31
McDonald's (MCD)	2008	Consumer Disc	2.4%	48	$10437	7.3%	$247
Microsoft (MSFT)	2014	Info Tech	1.1%	62	$13272	9.3%	$139
PepsiCo (PEP)	2008	Consumer Staples	2.8%	77	$11106	7.8%	$315
Philip Morris (PM)	2013	Consumer Staples	6.3%	49	$3028	2.1%	$235
Pinnacle West Capital (PNW)	2020	Utility	4.1%	37	$3028	2.1%	$122
Procter & Gamble (PG)	2014	Consumer Staples	2.3%	48	$6666	4.7%	$152
Qualcomm (QCOM)	2017	Info Tech	1.8%	36	$5298	3.7%	$94
Realty Income (O)	2008	Real Estate	4.7%	139	$8336	5.8%	$390
Smucker (SJM)	2017	Consumer Staples	3.1%	15	$1758	1.2%	$54
Southern (SO)	2016	Utility	4.3%	45	$2693	1.9%	$115
Texas Inst. (TXN)	2018	Info Tech	2.5%	27	$4354	3.1%	$110
Verizon (VZ)	2018	Comm Svc	4.2%	78	$4712	3.3%	$196
Cash					$171	<1%	
TOTAL – 27 Companies			3.4%		$142,820	100%	$4858
		Yield on Cost →	**10.4%**				

Real Time, Real Money

My Dividend Growth Portfolio is not a hypothetical back-test or model portfolio without any money in it. The DGP is a real-time, real-money portfolio.

All decisions about it – what to buy, hold, or sell – have been made and continue to be made in actual life. There is no 20-20 hindsight involved.

The DGP's inception date was June 1, 2008. At inception, the DGP's dollar value was $46,783. (The odd number is a result of it being real.) It began with 10 stocks, roughly equal-weighted.

No new outside money has been added since creation.

Of course, dividends have flowed into the portfolio from the beginning. I call those dividends *organic* because they are produced by the portfolio itself. They are not infusions of capital from the outside that would distort the investing results achieved by the original capital.

Goal 1: Optimize Income

As discussed in Chapter 12, all investing should start with your goals. Here is my main goal as stated in the DGP's business plan (all blue-highlighted text in this chapter is from the DGP's business plan).

> **Primary Goal of the Dividend Growth Portfolio**
>
> Build a reliable, steadily increasing stream of dividends over many years that can eventually be used as income for retirement.

Investment goals are personal. They vary from investor to investor, and they also change during the course of a single investor's life. Goals are important, because they are the reason you choose particular strategies, tactics, and actions to reach your goals.

Often in investing, and in practically all academic studies about investing, it is assumed that amassing the most wealth or beating the market are everyone's goals. But you should think about what your goals really are.

My principal goal for the DGP is not to maximize wealth, but rather to optimize income for eventual use in retirement.

That income-centric goal leads to a variety of financial and psychological differences that influence a whole spectrum of areas, from what stocks to buy to how I react to market-price plunges.

At some point in the future, I will use this portfolio's income to help fund my retirement. I'm already retired, but I have kept this portfolio going as an accumulation example, because it is such a great illustration of so many investing principles.

When the time comes to use it for living income, it will (ideally) generate enough extractable cash flow that I don't need to sell a single share of anything.

Here are key elements to notice about the DGP's general goal stated earlier:

1. **The goal is long-term.** "Long term" means years or decades. My intent when buying a stock is to hold it for years. Some stocks in the DGP have been there since 2008. The income flow builds up over a long period of time. In 2009, the first full year of the portfolio's existence, I collected $1568 in dividends. In 2020, I estimate that I will collect $4757, which is about 200% more. That build-up took 11 years.

2. **The income should be reliable**, with little negative volatility from year to year.

3. **The income should be generally increasing**, with a growth rate that surpasses inflation. Using the income numbers from point #1 above, the DGP has registered a dividend CAGR (compound annual growth rate) of 10.6%. That has handily beaten inflation.

4. **The income should be of a sufficient amount** that it fills the gap between other sources of income (like Social Security or a pension) and the total amount needed in retirement.

5. **Optimizing income may be different from maximizing it.** That's because investment decisions need to account not only for the immediate income amount, but also for reliability, safety, and long-term growth.

The latter factor impacted the management of the DGP. I originally had a numerical goal of achieving 10% yield on cost in 10 years. It actually took just under 12 years to get to the target amount. I could have "forced" the result by adding a couple of high-yield stocks just before the 10-year mark, but I chose not to do that, because I did not want to disturb longer-term goals such as quality and reliability.

Why Does Dividend Income Grow over Time?

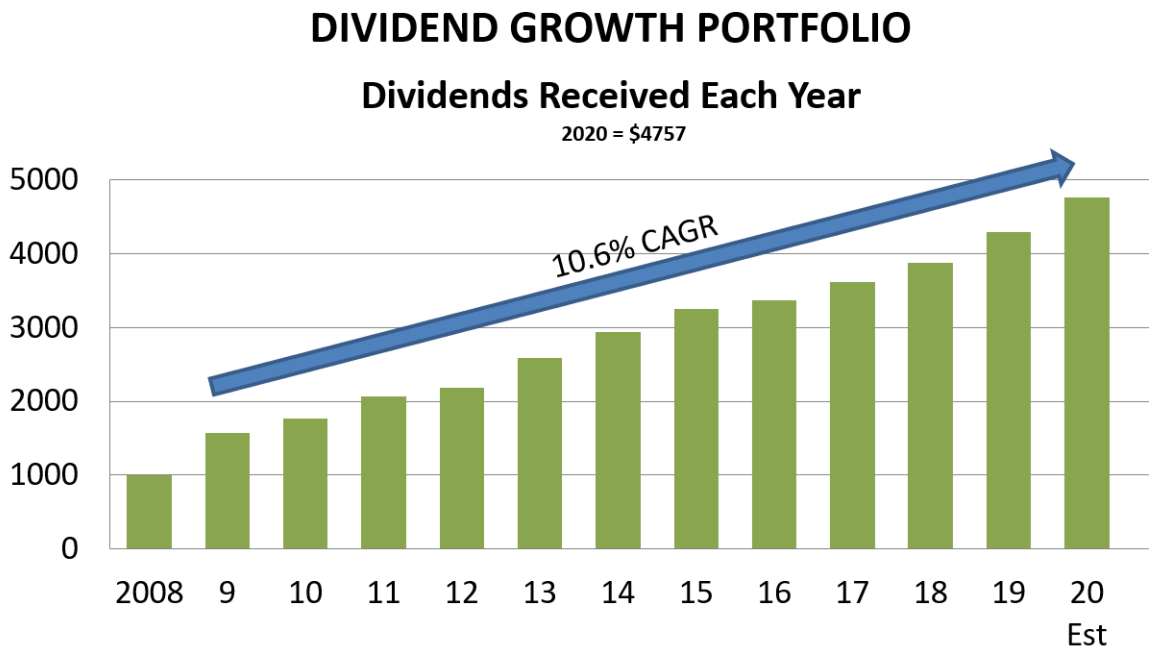
There are three main reasons that a dividend growth portfolio's cashflow rises as the years pass:

Companies increase their dividends. Some stocks in the DGP have increase streaks of over 40 or 50 years.

Dividends are reinvested to buy more shares. This triggers compounding, because the additional shares pay dividends themselves, which obviously accelerates how fast the portfolio's dividend stream increases.

Occasional portfolio changes may increase the income. For example, trimming an overvalued low-yield stock and purchasing a better-valued, higher-yielding stock in its place will cause the portfolio's income stream to rise.

Here is the dividend record of the DGP since its inception in 2008 through the end of 2020.



To be conservative, I go into each year expecting 6%-8% income growth in that year. Then as the year goes on, I adjust my year-end estimate to reflect both how fast my companies are actually increasing their dividends that year as well as the impact of reinvesting the dividends to buy more shares.

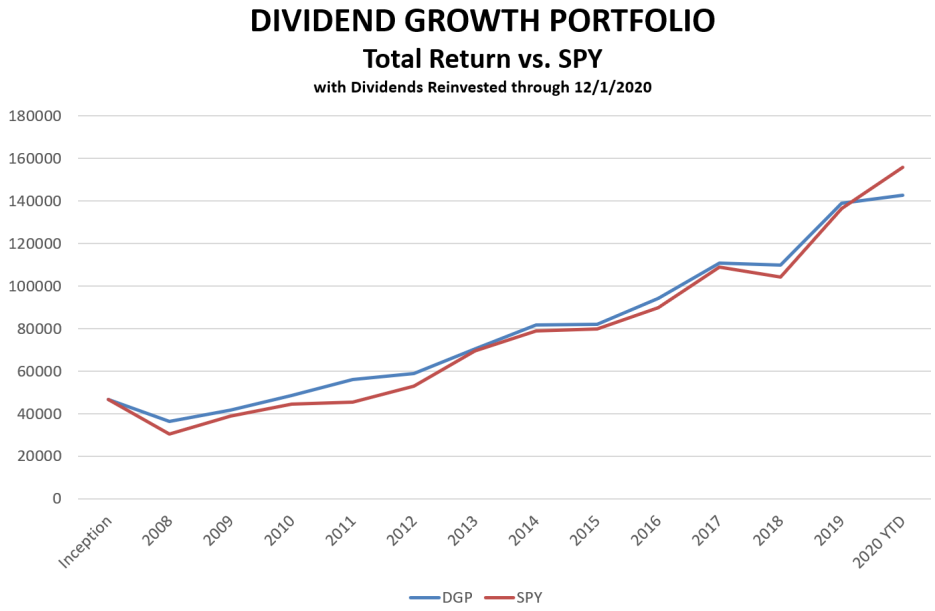
Goal 2: Achieve Competitive Total Returns

The DGP has a secondary goal, which is to achieve **competitive total returns**.

> **Secondary Goal**
>
> Deliver total returns that are competitive with the general stock market as measured by the S&P 500 with dividends reinvested.

I use the ETF SPY for the comparison. SPY (full name: SPDR S&P 500 ETF Trust) seeks to mimic the investment results of the S&P 500 index. Since I reinvest dividends in the DGP, I compare my results to SPY with its dividends reinvested.

Below are the comparative results through this writing (December 4, 2020).



As you can see, my portfolio ran generally even with or a bit ahead of SPY until this year. The explosive growth in 2020 of tech stocks has pulled SPY 's total returns ahead of my portfolio.

The contribution of the S&P 500 Index's largest five stocks – Apple, Microsoft, Amazon, Facebook and Alphabet – reached almost 24% in August, 2020 (source). I own Microsoft, but it comprises just 9% of the DGP.

I should point out, in keeping with my income focus, that the DGP's yield is usually about twice that of the S&P 500. As of this writing, the DGP's current yield is 3.4% compared to the index's yield of 1.6% (source).

How I Pick Stocks

The stocks that I select for the DGP are picked using the principles discussed in this book. I won't bother repeating that section of the business plan here.

Over the years, I have paid particular attention to these factors:

1. **Protection from inflation**. I want the income from this portfolio to go up faster than inflation. As shown earlier, it has done that with room to spare.

2. **Income sufficiency**. When I began the portfolio, I aimed for approximately a 4% current yield. I made the assumption that when I used the portfolio for retirement, my income needs would be about 4% of the portfolio's value at that time.

Now, after 12+ years, the actual current yield is usually about 3.5%. Partly that's because the value of the portfolio has risen so much since inception. A portfolio's yield and value move in opposite directions.

But the dollars-and-cents income from the portfolio is directly related to its yield on cost, which after years of growth has reached 10.4%. The income today has surpassed an annual run-rate of $4800, and barring disastrous dividend cuts, it will continue to go up from here.

3. **Dividend safety.** I want reliable dividends that go up each year. Obviously, no one can guarantee that any company will maintain annual dividend increases forever, but a well-diversified portfolio, filled with quality companies that have demonstrated the ability and willingness to increase their dividends, has a decent shot at achieving that goal across the whole portfolio.

I don't buy stocks in the hopes of giant price increases. I buy them for decent yields from reliable dividends that I expect will be increased every year.

Reinvesting Dividends

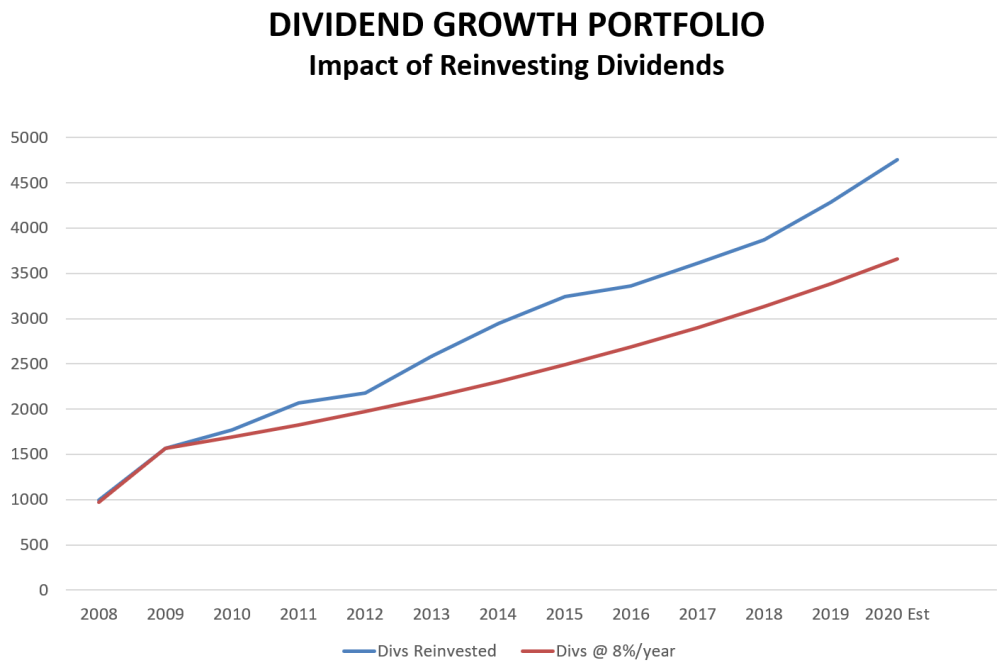
One element in how I manage the DGP deserves special attention: Dividend reinvestment.

I accumulate incoming dividends in cash until they reach $1000. Then I make a purchase.

Through this writing, more than $36,000 has been reinvested. That's more than ¾ of the value of the original portfolio. Dividends do pile up over the years.

When I reinvest dividends, I might buy more of a stock that I already own. Or I might buy a wholly new stock. Overall, I want the portfolio to hold 20-30 positions. It has 27 now, three of which were started in 2020.

This graph shows the approximate effect on the DGP's income of reinvesting dividends over the years.



The blue line shows actual total dividends received each year, so it reflects the effect of all the reinvestments. The red line shows 2009's dividends incremented at 8% growth per year but not reinvested. (The 8% is my guess at the DGP's average annual dividend growth rate for all stocks blended together.)

The 2020 actual dividend total is 30% higher with reinvestment than without it, and the gap widens in most years.

The point is not the precision of my estimates. The point is that the blue line pulls away from the red line, because reinvestment accelerates the income growth rate.

Portfolio Management

The DGP is mainly a buy-and-hold portfolio. There are only a few transactions every year.

Most of the transactions are the receipt of dividends. Simply Safe Dividends has a portfolio function with many cool features. Per SSD's portfolio tool, I'm getting well over 100 payments per year (see table on next page):

The Year Ahead

Export

	DEC	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	Total
AMGN	$24			$24			$24			$24			$96
CSCO		$42			$42			$42			$42		$169
CVX	$38			$38			$38			$38			$154
DLR		$25		$25			$25			$25			$103
ENB	$68			$68			$68			$68			$273
GD			$15			$15			$15			$15	$61
HAS			$35			$35			$35			$35	$141
JNJ	$75			$75			$75			$75			$303
KO	$44				$44			$44			$44		$178
LMT	$7			$7			$7			$7			$31
LNT			$76			$76			$76			$76	$304
LOW			$7			$7			$7			$7	$31
MCD	$61			$61			$61			$61			$247
MMM	$26			$26			$26			$26			$105
MO		$61			$61			$61			$61		$247
MSFT	$34			$34			$34			$34			$138
O	$32	$32	$32	$32	$32	$32	$32	$32	$32	$32	$32	$32	$390
PEP		$78		$78			$78			$78			$314
PG			$37			$37			$37			$37	$151
PM		$58			$58			$58			$58		$235
PNW	$30			$30			$30			$30			$122
QCOM	$23			$23			$23			$23			$93
SJM	$13			$13			$13			$13			$54
SO	$28			$28			$28			$28			$115
T			$120			$120			$120			$120	$482
TXN			$27			$27			$27			$27	$110
VZ			$48			$48			$48			$48	$195
Total	$511	$300	$402	$571	$240	$402	$571	$240	$402	$571	$240	$402	$4.8k

Most of the remaining transactions are dividend reinvestments. At the current rate that the portfolio is producing dividends, I make four or five reinvestments per year of about $1000 each.

Occasionally, I trim or swap out stocks to improve the portfolio.

For example, I don't want any position to exceed 10% of the portfolio's total value. Thus in 2017, for example, I trimmed McDonald's, because it had grown to more than 12% of the portfolio. I used the proceeds from selling some McDonald's shares to buy shares in two other stocks.

Unlike many investors, I do not pay a great deal of attention to the weights of each position, other than to follow the 10%-max guideline. I do not routinely rebalance the portfolio.

As a result, the current weights of each stock are the outcomes of years of individual stock performance, selective reinvestments of dividends, and portfolio improvement decisions.

No one bats 100% in investing. Some of the stocks in the portfolio have cut their dividends over the years. When that has happened, I have usually replaced them with other, hopefully better companies.

The DGP's business plan may inspire you to write your own plan, which I recommend to all investors. Maybe you want to tilt your portfolio to fast growers or high yielders. The written plan is a good place to flesh out how you will achieve goals like that.

The DGP is not meant to tilt in any particular direction. It contains a mixture of stocks drawn from the spectrum of DG stocks. It is diversified across sectors, industries, yields, and growth rates. If there is a tilt, it is toward high quality and dividend safety.

Obviously, since I am reinvesting the dividends, the DGP is managed as one would manage a portfolio when they are in the accumulation stage of life. Later on, in the retirement or distribution phase, the dividends would be taken out as cash to spend.

Why Ever Sell?

Although the ideal holding time for a stock may be "forever," there are times that making a change will improve the portfolio.

In my business plan, I have guidelines that help me make decisions whether to sell or trim a stock.

> **Selling Guidelines**
>
> 1. This portfolio is expected to have a low turnover rate. Unless there is a strong reason to sell or trim a position, the default action is to hold. The underlying strategy is to buy, collect, and hold good dividend growth stocks for long periods of time.
>
> 2. However, selling or trimming will be seriously considered if any stock or fund:
>
> (a) Cuts, freezes, or suspends its dividend.
> (b) Bubbles or becomes seriously overvalued.
> (c) Is impacted by significant fundamental changes.
> (d) Is going to be acquired.
> (e) Announces plans to split itself into 2 companies or spin off a significant portion of its operations into a separate company.
> (f) Sees its current yield rise above 9% or drop below 2%.
> (g) Grows to where it is beyond 10% of the portfolio.

Note the flexibility in the selling guidelines denoted by the phrase "seriously considered." Even when one of the guidelines applies, selling is not automatic. Instead, I make an investigation that leads to a decision.

Remember how, in selecting stocks to buy, I suggested that you place the burden of proof on the company to convince you that it is worthy of a place

in your portfolio? The same idea applies here: I place the burden on the company to convince me why I shouldn't sell it or trim the position. Then I reach a verdict and pronounce sentence.

Portfolio Reviews

I aim to give my portfolio a formal review twice per year. I must admit that I am less diligent about this than I used to be. Experience has given me confidence that a moderate amount of monitoring, combined with the attention required to make intelligent reinvestment decisions, is sufficient.

When I do a formal review, this is my checklist:

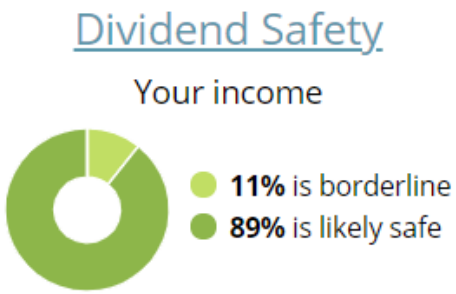
- Summarize what has happened since the previous review. I compute statistics for the whole portfolio as well as each holding.

- Go through each stock, one-by-one, and assess how it is doing from a performance and strategic point of view. Is it filling its role?

- Establish any action items resulting from the review.

At a review, I may make decisions to redress overvaluations or position-size problems. Some people regularly rebalance their portfolios, say every six or 12 months. My approach is instead focused on addressing oversized positions that grew above 10%. I usually catch those on the fly and don't need a formal review to notice them.

Simply Safe Dividends totes up the dividend safety scores for each holding, weights them as in your portfolio, and gives you a read-out of your overall dividend safety. Here's the read-out for the DGP.



If you click on “Dividend Safety,” it takes you to a stock-by-stock review. Overall, I’m satisfied with the 89% “safe” score. None of my stocks are orange or red.

I don't want to be trading all the time. By far, the majority of decisions are to continue to *hold* each stock. Making the decision to hold a stock is an active decision, and it may be driven by different considerations than a decision to buy a stock.

One example of that difference is valuation. I only buy stocks when they are fairly valued or undervalued. Every stock in the DGP was purchased when it had a decent valuation. In a review a few years later, I might determine that a stock has become overvalued. In that case, unless the overvaluation has caused the position to grow beyond the 10%-max guideline, I would usually hold the stock but not buy more of it.

If the stock is meeting my other goals for it, there's no reason to sell it based solely on the overvaluation. I know that some DGI investors regularly trim price-outperformers to collect some profits and put the money to better use elsewhere. I’m more complacent about that, plus I don’t like to keep my nose in my portfolio all the time.

Psychological Benefits

I treat DG investing as a collection strategy: I collect stocks, and I collect dividends.

I have observed that the adoption of DG investing often has an interesting effect on investors. Their attention swings away from the frenetic daily media coverage of price movements to the more relaxed production of dividends. That has certainly been the case for me.

Many DG investors report that instead of panicking, they often see market drops as buying opportunities rather than fearsome calamities. They learn patience in the face of negative short-term price results.

When prices fall, you are still collecting dividends while you wait for prices to rise back up. And historically, they always have risen back up. In the meantime, if you have money to invest, you get to enjoy buying shares at depressed prices to add to your collection.

Because I am primarily focused on the income stream, I am insulated from at least some of the behavioral mistakes that have become a dominant topic of investment conversation over the last few years.

I don't *anchor* on recent prices and base decisions on, say, the fact that a stock's price is now at its 52-week high or low. Someone anchored on price might think that those would be reasons to sell or buy the stock. Instead of anchoring on prices, I focus on each company's business fundamentals, dividend characteristics, and valuation. Despite the stock's price rise or fall, its valuation may not have changed. The price taken out of context really tells you little useful about the stock from a long-term perspective.

I think that I'm pretty much insulated from *herding.* The herd instinct in finance is where investors follow what they perceive other investors are doing. The driving force behind herd behavior is often a fear of missing out (known as *FOMO)* on a profitable investment idea.

Herd behavior may cause an investor to repeatedly buy and sell their assets in pursuit of hot investment trends. DG investing, for me anyway, is about

as opposite from that as you can get. It tends to lead me away from fads into areas that have lots of staying power. Some might call it contrarian as opposed to following the herd.

I like to think that DG investing helps make me confident without falling into the behavioral trap of *overconfidence.* Overconfidence can involve both overconfidence in the quality of your information and in your ability to act on that information at the right time for maximum gain. Studies show that overconfident traders trade more frequently. (Source)

There is a fine line between confidence and overconfidence. Confidence implies realistically trusting one's abilities, while overconfidence implies an unrealistically optimistic assessment of one's knowledge or control over a situation. For myself, DG investing definitely helps keep me from overtrading: I buy businesses so that I can benefit from their long-term success, not so that I can flip the shares. I stay within my areas of expertise: If I cannot explain to myself how a company makes money and why it should continue to do so, I will not buy it.

I don't think that I *overreact* to market events, as I don't follow the market much anymore.

I don't believe that I suffer from *loss aversion*, at least not in regard to falling prices. My eye is on the dividend stream, not so much on prices. I don't regret unrealized price losses very much; if anything, I look at the bright side, which is that the stocks have a higher current yield and better valuations. If I have money to invest, the price decline may provide a nice buying opportunity. I hardly pay attention to price other than when looking for bargains. Valuation has replaced price in almost all of my thinking about the cost of stocks.

CHAPTER 17

GUIDE TO FURTHER READING

I have written many articles on dividend growth (DG) investing over the years. Here is a guide to relevant articles that have been published on *Daily Trade Alert* and *Seeking Alpha*.

The articles are arranged according to the chapters in the book. I discarded many older articles on account of staleness or because I treated the same subject better in a later article.

Because articles about particular stocks go out of date, I have only included articles about the Top 30 stocks that were published in 2020.

Chapter 1: Introduction

An Introduction to Dividend Growth Investing

Investing Is Not A Game of Perfect

Chapter 2: How and Why Dividend Growth Investing Works

Why REIT Dividends Are Not A Mirage. Countering statements that REITs are a house of cards.

Can Dividend Growth Investing Be Reconciled with Modern Portfolio Theory?
Compares and contrasts DG investing with MPT on several factors, including goals, risk, and diversification.

The Rational Case for Dividend Growth Investing (Part 1). I was interviewed by *Seeking Alpha's* Jonathan Liss in this two-part article. Fundamentals are presented in a Q&A format.

The Rational Case for Dividend Growth Investing (Part 2). The rest of the interview.

Modern Dividend Theory Explained Part One. My effort to create a formal framework for thinking about dividend growth investing, on a parallel with Modern Portfolio Theory.

Modern Dividend Theory Explained Part 2: Risk and Diversification. Continuing the effort to create a formal framework for dividend growth investing.

Chapter 3: The "Big Five" Definitions

DGI Lesson 1: What Is a Dividend?. One of my lessons in DG investing on *Daily Trade Alert*.

DGI Lesson 2: Dividend Growth. One of my lessons in DG investing on *Daily Trade Alert*.

DGI Lesson 4: The Power of Compounding. One of my lessons in DG investing on *Daily Trade Alert*.

DGI Lesson 5: The Power of Reinvesting Dividends. One of my lessons in DG investing on *Daily Trade Alert*.

DGI Lesson 6: Yield and Yield on Cost. One of my lessons in DG investing on *Daily Trade Alert*.

DGI Lesson 10: Two Ways to Reinvest Your Dividends to Enhance Your Returns. One of my lessons in DG investing on *Daily Trade Alert*.

How Yield on Cost Works

Chapter 4: 17 Reasons That I Like Dividend Growth Investing

DGI Lesson 9: My Top 14 Reasons Why Dividend Growth Investing Makes Sense. One of my lessons in DG investing on *Daily Trade Alert*.

DGI Lesson 7: Dividends are Independent from the Market. One of my lessons in DG investing on *Daily Trade Alert*.

Dividend Growth Stocks Are Success Outliers. It takes a *great* company to be a dividend champion.

Has Dividend Growth Kept Up with Inflation? In a word, *yes.*

Chapter 5: Drawbacks and Oddities of Dividend Growth Investing

12 Things to Dislike About Dividend Investing. The other side of the coin.

Chapter 6: Selecting Stocks – Overview

DGI Lesson 14: Grading Dividend Growth Stocks to Find the Best Ones for Your Portfolio. This lesson on DG investing on *Daily Trade Alert* covers the gamut of rating companies, including material which is covered in Chapters 7-9 in this book.

A Different Look At 'Defensiveness.' Considering "defensiveness" in ways other than what sector the company is in.

Getting Started in Dividend Growth Investing: Paring the Universe of Stocks

The Technology Sector Has Become A Surprising Hotbed of Dividend Growth Stocks

Using MPT Factor Tilts in Stock Selection. Using the ideas behind Modern Portfolio Theory's "factors" in selecting DG stocks.

Chapter 7: Selecting Companies: Dividends

DGI Lesson 3: The 5-Year Rule. One of my lessons on DG investing on *Daily Trade Alert*.

DGI Lesson 17: Dividend Safety. One of my lessons on DG investing on *Daily Trade Alert*.

DGI Lesson 18: Which Is Better: High Yield or Fast Dividend Growth? One of my lessons on DG investing on *Daily Trade Alert*. This shows how yields and dividend growth rates interact to produce long-term returns.

Chapter 8: Selecting Companies: Quality

DGI Lesson 20: My 'Quality Snapshot' Grading System. How to get a quick fix on a company's quality if you don't have time for a full analysis of its business.

Chapter 10: Valuing Stocks

DGI Lesson 11: Valuation. One of my lessons on DG investing on Daily Trade Alert.

Do You Value Valuation? I think that you should.

Why Valuation Matters to Dividend Growth Investors. How buying well-valued stocks still benefits you years after you forgot what you paid.

Buffett's 50-Year-Old Principles are Still Sound. A discourse on valuation and long-term investing.

Chapter 12: Planning Your Investment Journey

DGI Lesson 12: Run Your Investing Like a Business. One of my lessons in DG investing on *Daily Trade Alert*.

DGI Lesson 13: Specific Topics to Cover in Your Dividend Growth Investing Plan. One of my lessons in DG investing on *Daily Trade Alert*.

The Business Model of The Dividend Growth Investor. You expect the companies you invest in to have a great business model. You should have one too.

What's Your Story? Dividend Growth Investing's Business Model

Pyramid of Success for Dividend Growth Investing. A look at the ingredients for investing success, from personal to technical.

Chapter 13: Getting Started – Portfolio Construction

DGI Lesson 8: How to Build a High-Yielding Dividend Growth Portfolio. One of my lessons in DG investing on *Daily Trade Alert*.

DGI Lesson 16: Diversification. One of my lessons in DG investing on *Daily Trade Alert*.

Asset Allocation 'vs.' Dividend Growth Investing: A Handy Comparator. Comparing Modern Portfolio Theory's concepts of asset allocation to dividend growth investing.

Asset Allocation for a Dividend Growth Investor. Applying asset allocation concepts to dividend growth investing.

Chapter 14: Managing Your Portfolio and Yourself

DGI Lesson 15: Portfolio Management - How to Decide When to Sell Stocks. One of my lessons in DG investing on *Daily Trade Alert*.

DGI Lesson 19: How to Increase Your Investor Returns. One of my lessons in DG investing on *Daily Trade Alert*, this discusses how your returns as an investor differ from the returns of the stocks you own. The key = reinvesting dividends.

Dividend Growth Stocks Often Provide More Growth Than 'Growth' Stocks. How reinvesting dividends enhances total returns not shown on any price chart.

Chocolate > Vanilla. Measuring total returns as price + dividends is different from price + dividends + reinvesting the dividends. Charts are often mislabeled.

Why I Don't Have Nightmares Over Disappearing Dividend Aristocrats

Risk Tolerance for The Dividend Growth Investor

Beating Back Fear for Income Investors. Controlling emotions in investing.

Yield on Cost's Role in a Selling Decision. It really does not play much of a role.

Trust the Process. Once you have a plan, stick to it.

Dividend Growth Investors: Stick to Your Process

Chapter 15: Top 30 Dividend Growth Stocks for 2021

High Quality Dividend Growth Stock of the Month for November, 2020: Amgen (AMGN)

Dividend Growth Stock of the Month for November, 2020: Lockheed Martin (LMT)

Dividend Growth Stock of the Month for September, 2020: Automatic Data Processing (ADP)

Dividend Growth Stock of the Month for July, 2020: Pinnacle West (PNW)

Dividend Growth Stock of the Month for June, 2020: General Dynamics (GD)

Chapter 16: Real-Life Investing: My Dividend Growth Portfolio

Dave Van Knapp's Dividend Growth Portfolio Monthly Update. This is where I update the DGP at the beginning of every month. You can follow the portfolio from month to month here, as each monthly update replaces the prior one.

CHAPTER 18

GLOSSARY

Note: The important terms in DG investing are inter-connected. One term may be needed to define another term.

Therefore, in this glossary, **if a term within a definition is in *italics,* that means that the italicized term is itself defined elsewhere in the glossary**.

-A-

Accumulation years: The years prior to retirement during which a person builds up their assets for use during retirement.

ADR: See *American Depositary Receipt.*

American Depositary Receipt (ADR): A negotiable (tradable) certificate issued by a U.S. bank that represents a specific number of shares of a foreign stock. ADRs are traded on American exchanges in U.S. dollars, making it easier for Americans to invest in foreign companies. Owning an ADR is just like owning a share of stock. Behind the scenes, arbitrageurs keep the prices of ADRs in line with the ordinary shares and currency exchanges rates.

Dividends are distributed in U.S. dollars in a timely fashion to the holders of ADRs. Note that currency exchange rates may alter the amount of dividend credited to the ADR-holder. Some foreign companies have lengthy

dividend-growth streaks when measured in their native currency, but not when measured in U.S. dollars.

Annual or **Annualized:** To adjust, calculate, or present a rate of return to represent a single year's worth of the return. Rates of return are usually presented in annualized form, so the term "per year" is often omitted. It is assumed that you understand that the rate of return has been annualized.

For example, the *Dividend Champions* document lists 1-year, 3-year, 5-year, and 10-year *dividend growth rates* for each stock, as in this example:

DGR 1-y	DGR 3-y	DGR 5-y	DGR 10-y
15.2	15.7	16.3	12.6
27.8	33.8	48.4	29.0
3.4	3.4	3.4	3.6

It is understood that the 3, 5, and 10-year rates are annualized, not cumulative.

Average annual growth rate: Simple average of each year's growth rate, ignoring the effects of *compounding.* The unit of measure is percent per year. See also *compound annual growth rate* and *dividend growth rate.*

-B-

Balance sheet: One of the core financial statements for corporations. The balance sheet is a snapshot of a company's assets and liabilities. It reports the company's assets (what it owns), liabilities (what it owes), and shareholders' equity (the amount invested by shareholders) at a specific point in time.

The other core financial statements are the *income statement* and *statement of cash flows.* Taken together, the three core statements provide a detailed look into a company's financial situation.

Beta: A measure of the historical variability of a stock's price in comparison to the market's overall variability. Stated another way, beta is an indicator of what the typical response of a stock's price has been to market swings. Thus, it measures exposure to the market's *systematic risk*. Some stocks' prices tend to swing more than the market itself, while others tend to swing less.

The measuring time for beta is usually three or five years, and the benchmark to which the stock's price is compared is usually the *S&P 500 Index,* which is used to represent "the market."

- A beta of 1.0 indicates that the stock's price has moved the same, overall, as the market. By definition, the S&P 500 itself has a beta of 1.0.

- A positive beta less than 1.0 means that the stock has tended to display less volatility but to move in the same direction as the S&P 500. Thus, if a stock only moves on average 50 percent as much as the S&P 500 moves, it has a beta of 0.50.

- A positive beta greater than 1.0 indicates that the security's price has been more variable than the market and tends to go in the same direction. So if a stock typically swings 30 percent more than the market, it has a beta of 1.30.

- A beta of 0 indicates that the stock's price movements have no correlation to the market's price movements.

- A beta less than 0 indicates negative correlation, meaning that the security and the market tend to move in opposite directions.

Many dividend growth stocks have betas < 1.0, meaning that they tend to be less volatile than the market itself. Thus, they tend to fall more slowly in bear markets and rise more slowly in bull markets.

Bond: A contract through which an investor makes a loan to a company, municipality, or other bond issuer. In return for the loan, the bond issuer promises to repay the amount borrowed at a specific date in the future (maturity). The bond issuer also promises to pay periodic interest on the amount borrowed, typically every six months for the term of the bond, at which time the original loan amount is returned.

Buyback: The purchase on the open market by a company of its own outstanding shares. See the complete discussion of buybacks in Chapter 5. Also known as stock repurchase.

Buyback yield: I consider this to be a misleading term. The implication is that by making a *buyback* of its own shares, a company is "returning money to shareholders," and that the amount is akin to a *yield* to shareholders.

But a buyback of shares, while it truly is a cash payout by the company, does not equate to cash income to shareholders. The cash goes to the share sellers, not to current share owners.

Therefore, the amount spent by the company on buybacks should not be added to the amount spent on dividends as if all the cash goes to existing shareholders. So-called buyback yield should not be added to real dividend yield as if to imply that the sum represents a defined return to shareholders. It does not.

-C-

CAGR: *Compound annual growth rate.* This is one of the "Big Five" definitions in dividend growth investing. See the complete discussion in Chapter 3.

Capitalization: See *market capitalization.*

Cash flow: The company's operating cash flow is important to investors, because it paints a different picture of financial viability from *GAAP earnings.* The latter are based on accrual accounting, which introduces timing noise into the flow of money into and out of the corporation and also accounts for non-cash items.

No company can survive long term unless it generates positive cash flow. To be viable, a company's long-term cash inflows must exceed its long-term cash outflows. The way *GAAP* accounting works, a company can be officially profitable but not have enough cash to pay its bills and operating expenses. And vice-versa, a company can have plenty of cash but not be officially profitable.

See also *statement of cash flow* and *free cash flow.*

Cash returned to shareholders: A loose term that can be misleading. It is most often used in this context: "The company is returning $X to shareholders through *dividends* and *buybacks."* The reason this is misleading is that dividends truly are cash distributions to shareholders, while the money spent on buybacks goes to share-sellers. The buyback program may alter the number of shares outstanding, and therefore may influence the price of shares in the market, but any benefit can only be *realized* by selling shares.

CCC: See *Dividend Champions.*

Chocolate: My term for *total return* that results when one reinvests dividends. Contrast to *total return vanilla,* which is the amount of capital gains plus dividends that one receives without accounting for dividend reinvestment.

Compound: To make money on money already earned. This is one of the "Big Five" definitions. See the complete discussion in Chapter 3.

Compound annual growth rate (CAGR): A measure of how fast a number grows when it is increased annually by a consistent percentage amount. This is one of the "Big Five" definitions in dividend growth investing. See the complete discussion in Chapter 3.

Consensus estimates: Stock analysts — employed by brokerage houses, investment banks, or financial services companies — investigate and analyze many publicly traded companies. Outside data providers poll the analysts to find out what they are forecasting for future revenue, *earnings*, and the like. The averages of analysts' expectations are called "consensus estimates" or something similar.

Consumer discretionary: Products and services that are not necessities, so they can be cut back by consumers when their financial situation is not doing well. Examples of discretionary products are automobiles, high-end clothing, certain retailers, some media, restaurants, hotels, and luxury goods. Contrast with *consumer staples.*

Consumer staples: Essential products such as food, beverages, tobacco, and certain housewares, some clothing, and drugs that are always in demand regardless of the economy. Staples are products that people "need." Note, though, that consumers can move "down-market" during hard times by purchasing generic or house-brand products rather than national brand names. See *consumer discretionary* and *cyclical.*

Credit rating: A quantified or graded estimate of the ability of a company to fulfill its financial commitments. The big three credit rating companies for corporations are Standard & Poor's (S&P), Moody's, and Fitch. See also *investment grade.*

Current yield: Yield is one of the "Big Five" definitions. In a nutshell, it means the annual dividend payout of a company, expressed as a percentage of its stock's price. See the detailed discussion of yield in Chapter 3.

Cyclical: A business, industry, or stock that tends to be affected by cycles in the overall economy. Cyclical companies typically sell discretionary items that consumers can afford to cut back during hard times, or that businesses can defer when investment capital is scarce. Examples of cyclical industries are heavy equipment manufacturers, car manufacturers, airlines, furniture retailers, fine clothing stores, high-end restaurants, and travel businesses.

-D-

Declaration date: The day that a company announces that there is going to be an upcoming dividend. The announcement will specify the *record date* and the *payment date* for the dividend. Companies make dividend declarations anywhere from a few days to several weeks before they expect to pay the dividend.

Decumulation: Spending down your assets to finance retirement. Some writers use "decumulation" to refer generally to the retirement years, but that is misleading, because not all retirement funding involves liquidating assets. Compare to *accumulation years.*

Depreciation: An amount allocated, by a corporation, during an accounting period to amortize the cost of long-lived assets over the useful life of the

assets. This is a non-cash charge to *earnings,* meaning that it is an accounting entry as distinguished from an actual cash outlay.

DGR: See *dividend growth rate.*

Diversification: A widely used technique for risk reduction. The idea is to avoid having "too many eggs in one basket." A related idea is to avoid owning assets that are too correlated with each other (meaning that they tend to move in the same direction at the same time).

In dividend growth investing, although your investments are all from a single asset class (stocks), you can mitigate risk to your dividend stream by diversifying investments among a variety of industries, companies with different dividend characteristics, different business models, and the like.

Dividend: A cash payment by a company to its shareholders. "Dividend" is one of the "Big Five" terms discussed in detail in Chapter 3.

Dividend Aristocrats: A list of companies, maintained by S&P, that have increased dividends every year for the last 25 consecutive years. To be included, companies must be members of the S&P 500 Index. This requirement causes the Aristocrat list to differ from the *Dividend Champions* list, which contains about twice as many such companies. Other variations result from different judgement calls about the length of dividend-increase streaks, how to handle spin-off companies, and the like.

Dividend Champions: Companies that have paid increasing dividends for 25 consecutive years or more. They can be found in the Dividend Champions List available each month by the Dividend Investing Resource Center. Commonly known as *CCC* (for Champions, Contenders, and Challengers), this document identifies stocks that have grown their annual dividends for at least five years (Challengers), 10 years (Contenders), or 25 years (Champions). The document also has a wealth of other research information about each stock.

Dividend growth rate (DGR): The *compound annual growth rate* of dividends. DGRs for trailing 1, 3, 5, and 10-year periods can be found in the *Dividend Champions* document.

The unit of measure of dividend growth is percent per year. The "per year" part is important: It means that *yield* (in percent) and DGR (in percent per year) cannot mathematically be compared straight across to each other. They are independent measures of different things: Yield is a measure of the magnitude of dividends, while DGR measures how fast the income stream increases.

Dividend irrelevance theory: A theory, usually taken for granted in discussions based on *Modern Portfolio Theory,* that dividends do not have any separate value to investors.

In fact, the dividend irrelevance theory includes the idea that dividends can hurt a company's performance, because the company would be better off retaining those monies and reinvesting them in the company's growth projects.

An extension of the dividend irrelevance theory is that investors do not care (or rationally should not care) about dividends – they should be indifferent to whether a company pays dividends or not.

Dividend rate: The dollar amount of the dividend. Also called *payout rate*. Contrast to *yield,* which is stated as a percentage rather than the dollar amount.

Dividend-reinvested yield on cost. See *chocolate* and *yield on cost.*

Dividend reinvestment: To reinvest dividends back into stocks. This is one of the "Big Five" definitions. For compete details, see Chapter 3.

Dividend right: The right you have, as a shareholder, to receive future dividends that a company may declare. This is not a contractual right, as dividends are paid at the discretion of the company.

Dividend safety: An estimate or projection of how safe a company's dividend is, meaning how likely it is to be cut.

In this book, dividend safety scores from *Simply Safe Dividends* are used to judge a dividend's safety.

Dollar cost average (DCA): To invest periodically, usually on a set schedule. As a strategy, DCA can reduce the impact of price volatility, producing average *valuations* on purchases by spreading them out. DCA leads to more shares being purchased when their price is low and fewer when their price is high, thus averaging the cost per share of a position rather than establishing it all at once.

On a practical level, DCA may be the only way that an investor can get started, such as by setting aside $500 per month to buy stocks. That, in effect, spreads out their purchases.

Note that an investor who *drips* dividends is dollar-cost-averaging his or her purchases made with dividend reinvestments.

Drip or Dripping: Dividend Reinvestment Plan. A program offered by corporations or brokerages through which an individual may automatically reinvest some or all cash distributions directly back into the stock of the company that issued them. See the further discussion in Chapter 3.

-E-

Earnings: Profit: Revenue minus expenses.

Earnings come in various flavors due to different accounting techniques, but when the word is used without qualification, it typically refers to *GAAP* earnings calculated under *Generally Accepted Accounting Principles* and reported quarterly and annually by publicly traded companies. Such earnings are stated after subtraction of operating expenses, taxes, interest, depreciation, and other non-cash expenses (but not dividends). GAAP earnings are also known as net income.

Sometimes "earnings" refers to *operating earnings.* See also *funds from operations*.

Earnings per share (EPS): The company's earnings divided by the number of shares outstanding.

EBITDA: An accounting term that stands for earnings before interest, taxes, depreciation, and amortization. All of those things are subtracted in the calculation of *GAAP earnings.* EBITDA adds them back in.

Thus, EBITDA, which is used as a measure of profitability, excludes from its reckoning of earnings the expenses associated with the cost of capital investments (property, plant, and equipment), interest, and taxes. The idea is that EBITDA is a better measure of corporate performance, because it shows earnings before the influence of *GAAP*-mandated accounting and financial deductions.

EPS: See *earnings per share.*

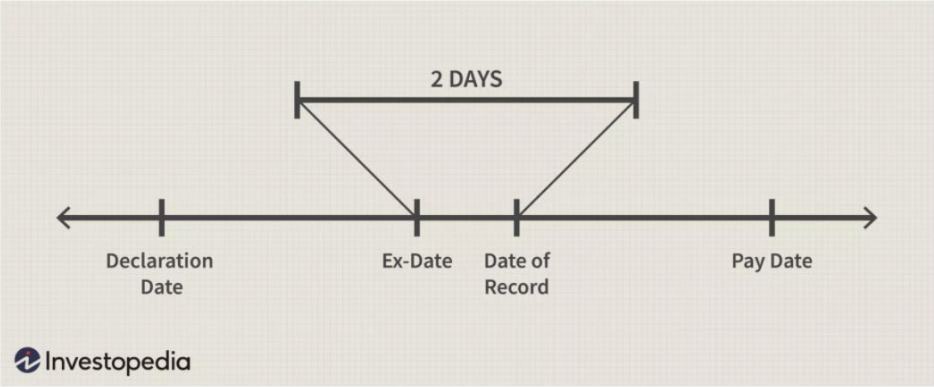
ETF: Exchange-traded fund. Thousands of ETFs have been created to follow popular indexes, aggregate stocks of particular types, implement particular investment strategies, and the like.

Ex-date: See *ex-dividend date.*

Ex-dividend date: "Without-dividend date." The first day that a newly purchased share of stock comes **without** the right to receive the next dividend. If you purchase a stock **on or after** the ex-dividend date, you will **not** receive the next dividend. In order to be entitled to the next dividend, you must buy **prior** to the ex-dividend date.

From the seller's point of view, the ex-dividend date is the first day on which they can sell the shares and nevertheless be entitled to receive the next dividend. The ex-dividend date precedes the *payment date* by a few days or weeks.

Before the market opens on the ex-dividend date, stock exchanges adjust the previous day's closing price downward by the amount of the dividend. This price adjustment reflects the fact that the cash to pay the next dividend will not be retained by the company, as it is earmarked to pay the dividend. For most stocks, that adjustment in price soon gets lost in the noise of the next day's trading.



Dividend Dates Timeline. Image by Julie Bang © Investopedia 2019

(Image source)

-F-

Fair value: See *intrinsic value.*

FAST Graphs: FAST is an acronym for Fundamentals Analyzer Software Tool, a subscription service that graphs and analyzes various fundamental and stock-price information. The service has access to 20 years of historical data on thousands of companies. Users can access a variety of charts and tables to help them think about stocks and especially about *valuation.*

In this book, FASTGraphs are used to help analyze stock valuations.

Float: The percentage of outstanding shares held by investors, excluding closely held shares (that is, those held by controlling investors or company insiders).

Forward yield: Same as *indicated yield.*

Free cash flow (FCF): Free cash flow represents the cash that is available before cash is paid out for debt payments, dividends, or share repurchases. FCF (which is not an official *GAAP* measure) is typically calculated as the company's operating *cash flow* after subtracting any capital expenditures for physical assets such as property, buildings, and equipment.

Thus, FCF is the cash available for distribution to stockholders, pay creditors, and repurchase shares.

Funds from operations (FFO): An *earnings*-like metric used by *Real Estate Investment Trusts* (REITs) to portray their cash flow performance. FFO is considered to be a better measure of a REIT's performance than *GAAP earnings*. FFO is calculated by adding *depreciation* and amortization back into GAAP earnings. In this book, FFO is used instead of GAAP earnings in valuing REITs.

FFO: See *Funds from operations.*

-G-

GAAP earnings: See *earnings.*

GICS: Global Industry Classification Standard. See *sector.*

-I-

Income statement: One of the three core financial statements for a company, the other two being the *balance sheet* and the *statement of cash flows.* The income statement shows the company's profitability during a certain period.

A simplified formula of what the income statement shows is

Net Income = (Total Revenue + Gains) – (Total Expenses + Losses)

Note that these are accounting revenues, gains, expenses, and losses, so they may not match the actual cash flowing into and out of the company, because of time shifts and other accounting rules.

Indicated yield: *Yield* is one of the Big Five definitions covered in detail in Chapter 3.

Indicated yield is one flavor of yield. It means the projected percentage yield for the next 12 months based on the most recent *dividend rate* and today's price.

In other words, it is the dividend return, expressed as a percentage of price, that you expect to receive over the coming year based on all currently known information about the company's dividend plans. It is the same as *projected yield.* Most times when you see the word "yield" used alone, it means indicated yield.

The unit of measure is percent. Thus, if you multiply indicated yield by today's price, that tells you how many dividend dollars you can expect to receive over the coming year.

Inherent value: See *intrinsic value.*

Initial yield: Your yield on the day you buy a stock. While the stock's yield (as quoted in financial news sources) will vary in the future as the stock's price fluctuates and its *payout rate* changes, your initial yield is locked in. It is the lowest *yield on cost* that you will ever experience unless the company cuts its dividend. The unit of measure is percent.

Intrinsic value: The fair, true, or inherent value of a company. While this sounds precise, and it is often calculated down to the penny as if it were exactly known, a firm's intrinsic value is not a measurable physical property. Rather it is an assessment. Investors and analysts use a variety of techniques to calculate intrinsic value, and thus they will arrive at different prices for it.

The intrinsic value is usually different from current market price, because the market price reflects assessments by all investors, news of the day, the dynamics of supply and demand, and investor sentiment.

Investment grade: Credit ratings issued by an agency such as S&P are forward-looking opinions about the ability of a corporation to meet its financial obligations in full and on time. The opinion focuses on the obligor's capacity and willingness to meet its financial commitments as they come due.

On S&P's scale, "investment grade" refers to the highest credit ratings:

Investment Grade Credit Ratings on S&P Scale
AAA
AA+ AA AA-
A+ A A-
BBB+ BBB BBB-

Companies rated below BBB- are regarded as having significant speculative characteristics, and therefore they are not investment grade.

-M-

Margin of safety: The difference between purchase price and *intrinsic value*. The basic idea is that an investor can reduce *risk* by purchasing stock when its market price is below its intrinsic value. Legendary investor Benjamin Graham called margin of safety "the central concept of investment" in his famous book, *The Intelligent Investor*.

Margin of safety provides a cushion to absorb the ill effects of bad luck, errors in judgment, and incorrect evaluation of intrinsic value. Graham stated:

> "It is a basic rule of prudent investment that all estimates…must err at least slightly on the side of understatement…. The margin of safety is always dependent on the price paid. It will be large at one price, small at some higher price, [and] nonexistent at some still higher price."

The concept can also be applied to *dividend safety*. Some dividends and dividend growth rates are more reliable and predictable than others. One is usually better off making decisions based on conservative projections. It is better to be surprised to the upside than to the downside.

Market capitalization: The aggregate market value of a company's stock. Market cap is calculated as (total number of outstanding shares) x (market price per share).

Sizes are categorized as follows:

- Mega-cap: $200 billion or higher
- Large cap: $10 billion to $200 billion
- Mid-cap: $2 billion to $10 billion
- Small-cap: $300 million to $2 billion

Market risk: See *systematic risk.*

Market timing: See *timing.*

Master Limited Partnership (MLP): A special business form used in the natural resources industries, particularly oil and gas. MLPs are explained more fully in Chapter 5.

MLP: *Master Limited Partnership.*

Moat: Sustainable competitive advantage. The highest-quality companies enjoy significant moats that help keep competitors at bay.

Some common moats are:

- economies and efficiencies of scale
- superior processes and cost controls
- established distribution systems that are difficult to replicate
- patents, copyrights, and other protections of intellectual property
- governmental approvals and licenses (which can create legal monopolies)
- unique corporate culture
- products that, once embedded, force high costs on customers who want to switch (switching costs).

Modern Portfolio Theory (MPT): An investing thesis that the expected return of a portfolio can be maximized for a given amount of *risk,* or alternatively that the risk can be minimized for a given level of expected return, by carefully choosing the proportions of various assets. See *risk* and *risk/reward.*

MPT: See *Modern Portfolio Theory.*

Mr. Market: An imaginary investor representing "the market." Mr. Market is driven by panic, euphoria, and apathy. He approaches investing in reaction to his mood rather than through rational analysis.

In the allegory, Mr. Market appears every day at the investor's door offering to buy or sell shares at a different price. Sometimes the price offered by Mr. Market seems plausible, but often it is ridiculous. The investor is free to either trade with Mr. Market or to ignore him. Mr. Market doesn't care, and he will be back the next day to quote another price.

The point is that the investor should not allow the market to determine the *intrinsic value* of shares. This famous allegory has become shorthand for the market's often irrational behavior.

Multiple: See *P/E ratio.*

-N-

Net debt: Debt obligations minus cash on hand.

Nominal value: Unadjusted for inflation. The nominal value of one dollar is one dollar. But over time, because inflation erodes the purchasing power of that dollar, its *real value* will go down. Compare to *real value*.

-O-

Operating earnings: Profits after subtracting operating expenses but not taxes, interest, and non-cash accounting items such as depreciation.

Operating earnings reflect profit from ongoing operations and exclude the effect of special items, such as discontinued operations, extraordinary or special events, and one-time income tax expenses or benefits.

-P-

Payment date: The day on which the dividend payment is actually made by being electronically deposited in your brokerage account or mailed to you. The payment date may be several weeks after the *ex-dividend* date, which itself may be several weeks or even months after the *declaration date.*

Payout rate: See *dividend rate.*

Payout ratio: Most commonly, the percent of the company's *earnings* that it pays out in dividends. For example, if in a given year a company earns $4 per share and pays $2 per share in dividends, its payout ratio is 50%.

The payout ratio is sometimes computed as a percentage of *cash flow* or *free cash flow* instead of earnings. As a rule of thumb, a lower payout ratio is safer than a higher one, because the company has more cushion to maintain or increase the dividend. Some investors will avoid a company if its payout ratio is higher than, say, 70%.

In this book, the overall safety of a dividend is based on dividend safety scores from *Simply Safe Dividends (SSD)*. Thus, payout ratios are not separately considered, because they are part of the analysis performed by SSD.

P/E ratio: The ratio of a stock's price per share (P) to its *earnings per share* (E). This is a classic *valuation* metric*,* meaning that is an indicator of

whether a stock is fairly priced, overvalued, or undervalued. The historical average P/E ratio of the broad stock market is commonly accepted as 15. This is a pure ratio, and the unit of measure is percent, although "percent" is not usually stated. Same as *multiple.*

Probabilistic belief: A belief based on your estimate of the probabilities of future events.

Stock analysis deals with the past, present, and future. The past and present are known (if the corresponding *data* exists), but the future is unknowable. Nevertheless, one can make informed judgments about what is likely to happen, or create a reasonable range of likely outcomes.

Those judgments would be probabilistic beliefs. They can become the foundation for making investing decisions.

Some such beliefs will turn out to be wrong. The idea in investing is to try to tilt the odds in your favor. Thinking in terms of probabilities is usually more realistic than creating all-or-nothing scenarios or models.

Projected yield: Same as *indicated yield.*

-Q-

Qualified dividend: A dividend that meets certain criteria under the Internal Revenue Code to be taxed at long-term capital gains tax rates rather than as ordinary income. The dividends paid by most U.S. corporations are qualified, but not all. Distributions paid by *Master Limited Partnerships* (MLPs) or *Real Estate Investment Trusts* (REITs), for example, are subject to ordinary income tax rates.

-R-

Real Estate Investment Trust (REIT): A special form of business used in some large real estate operations. This special business form is fully explained in Chapter 5.

Realize: To convert a “paper” value into cash via a transaction. If you hold a share of stock whose market value has gone up since you bought it, the gain is not realized until you sell it: It is “on paper” only, meaning that it has not been converted into cash. If you sell the share, the gain is realized.

Real value: A value that has been adjusted for inflation. Real value adjusts *nominal value* to reflect changes in purchasing power due to inflation. Throughout this book, I use nominal values, as I prefer to consider the effects of inflation separately. Each individual has his or her own personal inflation rate depending on what they buy.

Rebalance: To adjust portfolio holdings so that position size guidelines are maintained. For example, if you have a guideline that no position will account for more than 3% of your portfolio, a price run-up in a single stock may take it beyond that maximum. You would redress this by selling some of that stock and placing the proceeds elsewhere, to restore the balance that you want.

Record date: The day when you must be registered on the company's books as a shareholder to receive the dividend. The *ex-dividend date* is usually set at two business days before the record date, so that means that you must buy shares three days before the record date (i.e., the day before the ex-dividend date) in order to be entitled to receive the next dividend payment.

Regular dividend: The dividend paid out, often four times per year, based on a company’s established or typical dividend schedule. Distinguish from *special dividend.*

Also note that while most American companies pay regular dividends four times per year, many foreign companies pay just once or twice per year, and the amounts of the payments often vary.

In the US, the regular dividends are typically equal in amount, with one dividend increase per year. Some companies pay dividends monthly and/or increase them more than once per year.

Reinvest: The act of recycling dividends back into stocks rather than extracting them or letting them sit in cash in your portfolio. *Dividend reinvestment* is one of the "Big Five" definitions, fully explained in Chapter 3.

REIT: *Real Estate Investment Trust*.

Repurchase: See *buyback.*

Risk: In everyday usage, risk refers to the probability that one will be exposed to danger, harm, loss, or to things not turning out as expected. In investing, that could be the chance that an investment's return will be less than expected, and/or that some or all of the original money invested will be lost.

In *Modern Portfolio Theory (MPT)*, risk is usually defined as the *standard deviation* of the investment, which measures price volatility. For dividend investors, this measure is incomplete and may be off point, because it is confined to price variations.

Nevertheless, most of the times that you see the word "risk" in connection with stock investing, the MPT definition is what is being used, even though that usually is not spelled out. Most journalists and academics simply presume or define risk as being the same as price volatility.

The dividend growth investor is often more concerned about risk to the *dividend*, or to a company's dividend growth, than about price fluctuations. That means that many conventional discussions of risk are inapplicable to dividend growth investing, or that they can be misleading.

Risk to the dividend, or to its possibility of being raised, is usually ignored in discussions based on *Modern Portfolio Theory*. This is largely due to the *dividend irrelevance theory*.

Risk/reward: A common assumption in *Modern Portfolio Theory* that in order to gain more reward, an investor must assume more risk. And since *risk* is equated to price volatility, MPT would say that in order to gain more reward, the investor must be willing to live with more price volatility.

I believe that this correlation of risk with reward is inaccurate, as it ignores (1) the well-established tenet of *value investing* that rewards are more likely if you **reduce** risk by employing a *margin of safety* in your investment decisions; (2) the different risk characteristics of dividends (as distinguished from stock prices); and (3) the risk to purchasing power over time that is inherent in inflation.

In *The Intelligent Investor*, Benjamin Graham wrote:

> "[T]he idea of risk is often extended to apply to a possible decline in the price of a security, even though the decline may be of a cyclical and temporary nature and even though the holder is unlikely to be forced to sell at such times….The bona-fide investor does not lose money merely because the market price of his holdings declines…In current mathematical approaches to investment decisions, it has become standard practice to define 'risk' in terms of average price variations or 'volatility.' …We find this…more harmful than useful for sound investment decisions, because it places too much emphasis on market fluctuations."

Rule of 72: A handy approximation of the time it takes an increasing *payout rate* to double. Just divide the annual percentage increase into 72. For example, if a company increases its payout rate 7% per year, its dividend will double in a little over 10 years (72 / 7 = 10.3).

-S-

S&P 500: The S&P 500 index is widely regarded as the best single gauge of the price performance of large-capitalization U.S. equities. While there were predecessor indexes dating back to 1923, the 500-stock index was launched in 1957. The S&P 500 is a common benchmark for the U.S. stock market, and it is probably the most popular equity index in the world. Many investors use it as a performance benchmark.

Scrip dividend: See *stock dividend*.

Sector: A segment of the economy used for classification purposes. In this book, I use the Global Industry Classification Standard (GICS) system developed by S&P Global Market Intelligence and MSCI Inc. The GICS structure consists of 11 sectors, which are further subdivided into industry groups, industries, and sub-industries.

Code	GICS Sector
10	Energy
15	Materials
20	Industrials
25	Consumer Discretionary
30	Consumer Staples
35	Healthcare
40	Financials
45	Information Technology
50	Communication Services
55	Utilities
60	Real estate

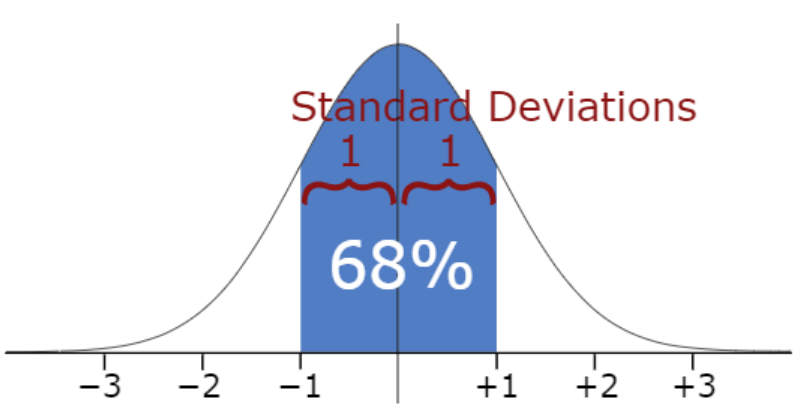
Selective reinvestment: A tactic under which you collect dividends in cash, then reinvest them periodically in a stock (or stocks) of your own choosing. Contrast to *dripping,* where you set it up so that dividends are automatically reinvested back into the same stocks that issue them. Dividend reinvestment is fully discussed in Chapter 3.

Simply Safe Dividends: Simply Safe Dividends is a dividend-oriented research and analysis suite of tools and ratings. Its central feature is its dividend safety scores. These scores, which result from exhaustive analysis, have become shorthand not only for the ongoing safety of a corporation's dividends, but also as a reckoning of company quality itself.

SSD is used in this book not only to rate dividend safety, but also as a source of stock and company analyses as well as financial graphs with benchmarks for each type of company.

Special dividend: A one-time dividend paid for some unusual reason. Perhaps the company sold a large asset and wants to share proceeds with shareholders. These are usually designated as "special" dividends to distinguish them from the *regular dividends* of the company. Some companies pay special dividends so often that some investors count on them as if they were regular dividends, but dividend statistics are usually compiled from regular dividend payments only.

Standard deviation: In mathematics, standard deviation is a measure of how spread out numbers are. As this diagram shows, in a standard curve, 68% of the results fall within +/- one standard deviation from the mean.



([Image source])

In investing, standard deviation is a statistical measure of the volatility of returns. Technically, it is a measure of the dispersion of returns from their mean over some measurement period. The more the data is spread apart, the higher the deviation from the mean.

Standard deviation is calculated from the annual rates of return of an investment to measure the investment's historical volatility, which is then used by investors as a gauge for the amount of expected volatility in the future. A historically volatile stock will display a higher standard deviation than a more stable stock. Unit of measure is percent. Compare to *beta*.

Statement of cash flows: One of the three principal financial statements used by companies (along with the *income statement* and *balance sheet*). The statement of cash flows (or "cash flow statement") reports the sources of cash, and its usage, in the company's operations, investing activities, and financing activities, along with certain supplemental information (such as interest or taxes paid).

The cash flow statement records the major reasons for the change in a company's cash (and cash equivalents) reported on the balance sheet at the beginning and the end of the accounting period.

The cash flow statement is needed because the income statement reports revenues and expenses based on "accrual" accounting, but those amounts may be different from actual cash flows in real time.

Dividends are paid out of actual cash, so many dividend growth investors pay as much (or more) attention to cash flows as they do to reported revenues and earnings.

Stock dividend: A dividend payment made with stock instead of cash. Also known as "scrip dividend."

Systematic (or systemic) risk: Price vulnerability inherent because a security is traded in the market. The idea is that market dynamics impact all stocks traded there. Systemic risk is also therefore referred to as market risk.

Systemic risk is that portion of overall risk (price volatility) that cannot be reduced by *diversification,* since all stocks in the market are affected by it.

By extension, interest rates, recessions, weather catastrophes, and wars are all sources of systematic risk, because they affect the entire market and cannot be reduced through diversification.

Of course, not every stock is affected exactly the same by macro events, and not every stock goes up and down in lockstep with the market. See *beta* regarding the tendency of a stock's price to move in concert with volatility in the market.

-T-

Timing: There are two kinds of timing: Market timing, and timing related to individual stocks. Market timing is fraught with difficulties, and there are few investors who have a great batting average at timing the market.

On the other hand, many investors routinely search for good entry (and exit) points for individual stocks, often by employing *margin of safety* and *valuation* principles. Since prices vary over time, this could be referred to as "timing" individual stock investments. It is the basis for *value investing.*

Total return: Total return taking dividends into account instead of price returns only.

In my personal nomenclature, total return comes in two flavors: *Chocolate* (total return with dividends *reinvested*) and *vanilla* (total return with dividends not reinvested). Because of *compounding,* these two flavors can be widely different, even though you are referring to the same stock.

Trailing (TTM) yield: Yield based on dividends paid in the preceding 12 months. Thus if a stock paid $1.00 in dividends over the past 12 months, and its current price is $10 per share, its trailing yield would be $1/$10, or 10 percent.

That use of TTM yield is not used much anymore, because *indicated yield* (based on the dividends that a stock is expected to pay over the coming 12 months) is far more useful.

Another use of TTM yield would be to calculate what yield a stock actually paid to you over the preceding 12 months. That would be calculated by dividing the dividends received by the stock's price **at the beginning** of the period. I do this to see what yield I **got** (past tense) on a stock or on an entire portfolio over the preceding year.

TTM: Trailing twelve months. See *trailing yield.*

-U-

Unrealized gain or loss: A gain or loss that exists on paper only, since it has not been converted to cash by selling the shares involved. See *realize.*

-V-

Valuation: To appraise the *intrinsic value* of a stock and compare it to the actual price at which it is selling. The result is an assessment of whether the stock is (1) fairly valued, or selling at about its intrinsic value; (2) undervalued, or selling at a bargain price; or (3) overvalued, or selling for more than it is worth.

Valuation ratio: The ratio of an actual valuation metric (such as P/E) to the *intrinsic value* measure of the same metric. For example, the valuation ratio for a stock with a P/E of 15 and an intrinsic value of 15 would be 15 / 15 = 1.0. That would indicate that the stock is fairly valued. Valuation ratios under 1.0 would suggest undervaluation, and valuation ratios over 1.0 would suggest overvaluation.

Valuation ratios can also be computed by comparing actual price to fair price.

Most investors, recognizing that intrinsic value is not actually measurable (and indeed won't be known until the future), use ranges for valuation rather than exact P/E ratios or prices. For example, I consider any stock with a valuation ratio within +/- 10% of 1.0 to be "fairly valued."

Value investing: A strategy of paying no more than *intrinsic value* when purchasing a stock, thus creating a *margin of safety* in your favor as regards future price changes. The value investor attempts to buy stocks for less than they are intrinsically worth, thus improving the chances that their prices will go up and that they won't lose money over the long term.

Vanilla: Total return (price change + dividends) calculated without regard to dividend reinvestment. Compare to *chocolate.*

-Y-

Yield: One of the "Big Five" definitions for dividend growth investing. See the complete discussion of yield in Chapter 3.

Yield on cost (YOC): Your *yield* based on the price you paid for the shares: Yield on cost = Annual dividends / Price you paid.

Your yield on cost is personal to you, because it depends on when you purchased your shares and the price you paid. It will increase every time the company increases its dividend. Say that on January 1, you spend $100 for a share in a company with a current *payout rate* of $5.00 per year. Your *initial yield* is $5 / $100, or 5%. During the year, if the company increases its dividend to $1.10 per share, your yield on cost rises to $5.50 / $100, or 5.5%.

Notice that yield on cost is independent of the stock's fluctuating price: The original cost remains the "Price you paid" in this metric for as long as you hold the shares. In the example above, "price you paid" stays at $100.

Yield on cost is an alternative way to state a quantity of dividend dollars. The following two formulas are identical:

(a) Dollars of dividends received = Yield on cost x Original cost
(b) Dollars of dividends received = Current yield x Current price

Yield on cost can be applied to a whole portfolio as well as to a single stock. This can be especially meaningful if a portfolio is established with only a single investment at the beginning of a portfolio's life, and no further injections of new outside money are ever made after that original investment.

Yield on cost for a whole portfolio becomes messy to calculate and probably not meaningful if new money is continually added to the portfolio.

CHAPTER 19

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At the time of publication, the author and/or his wife holds positions in these stocks discussed in this book:

Aflac (AFL)
Amgen (AMGN)
AT&T (T)
Cisco (CSCO)
General Dynamics (GD)
Johnson & Johnson (JNJ)

Kimberly-Clark (KMB)
Lockheed Martin (LMT)
Lowe's (LOW)
McDonald's (MCD)
PepsiCo (PEP)
Philip Morris (PM)
Pinnacle West Capital (PNW)
Realty Income (O)
Verizon (VZ)
3M (MMM)

Acknowledgements

I wish to thank several friends that I have met (virtually) through my work with *Daily Trade Alert* and *Seeking Alpha* and from whom I have received so much knowledge, support, and encouragement.

David Fish was the creator and author of the *Dividend Champions* spreadsheets and documents that I regard with awe. Any search for dividend growth stocks begins with his work. How he updated all of the tables, lists, and appendices on time at the end of each month was always beyond my comprehension. We all stand on his shoulders.

Since David's passing, his work has been taken up by Justin Law, and now we stand on his shoulders.

Mike Nadel, a former sportswriter-turned-financial-guru, has become a friend with whom I frequently correspond, and to whom I sometimes turn for advice about our mutual interest in DG investing. He is also a colleague at *Daily Trade Alert* (and its sister publication *Dividends & Income*), so it is fun to swap ideas and stories about our professional lives that have converged at those publications. We also yak about other stuff, especially sports. I hope to meet Mike in person one day and buy him a beer.

DTA has become the hub of my professional writing. Greg Patrick is the co-founder of DTA. The interesting story here is that, after corresponding for several months about my writing for DTA back in 2012-13, we were startled to discover that we both live in the same small, rural, western New York city. The subject had never come up before, because online it doesn't matter where people actually are. Greg has become a friend, supporter, and working colleague who brings me a welcome, younger, tech-savvy point of view about both investing and publishing. His help and support in producing this e-book (and its associated website) have been invaluable.

Also, at DTA, I would like to thank Phil Lamanna, who usually processes my articles for publication; Michael Wheeler, who sometimes does that; Greg's brother David, who writes the checks; Eunice Escamillas, a graphic designer who designed this book's cover, badges, and many of the features on the website; and Jason Fieber, whose weekly articles on undervalued DG stocks are a staple of my own reading.

Chuck Carnevale, who I call "Mr. Valuation," is the creator of the FAST Graphs that I use in the valuation process. The graphs help an investor to visualize valuation in a unique, intuitive way by plotting price and valuations on the same graph. Chuck has been totally generous in allowing me to use his creations in my writings.

I have also become friends and writing colleagues at DTA with Brian Bollinger, the founder of Simply Safe Dividends. Brian has been more than generous in allowing me to use SSD's stock research, dividend safety grades, and beautiful financial charts in this book. SSD has rapidly become a standard tool in the DG community. His dividend safety grades are used almost as shorthand for how good a stock is as a DG investment.

Another person to thank I only know as FerdiS through his work on *Seeking Alpha.* I met Ferdi online when we corresponded about Quality Snapshots, my shorthand way of assessing a company's quality. Ferdi maintains an up-to-date record of many of these snapshots, and he generously shared them

with me, which in turn helped me winnow out companies in selecting the Top 30 for this book.

Seeking Alpha is where I did some of my earliest writing about DG investing. SA was founded by David Jackson. I first met David online years ago when I wrote him a message that I was going to submit an article that disagreed with an article of his concerning dividends. He was nice about it, and over the years he gave me plenty of support as a virtual community of DG investors – now numbering several hundred thousand – grew at SA through many contributors, articles, and (most important) comments on the articles.

The community now also hangs around at a couple of blogs devoted not only to DG investing, but to investing generally and every other subject under the sun. We challenge, support, cajole, suggest, correct, and educate each other, having great fun in the process. I will unfortunately leave some names out, but among my strongest SA influencers have been the aforementioned Mike Nadel, David Crosetti, Robert Alan Schwartz, the late Bob Wells, and many others.

Finally, as always, without my wife's support, patience, love, and encouragement, this book would never have become reality. Thanks to my Sweetie, Sue!