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Dividend Investing -- On Course for a Comeback?

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Over the past two years, dividend-focused investors saw hundreds of companies reducing or suspending dividend payments. The tide is turning, but as we move toward a post-stimulus economy, will there be further impacts? We asked Daniel Peris, who with Walter C. Bean is co-manager of Federated Strategic Value Fund, for his views on what to expect on the dividend front in 2010 and beyond.

Daniel Peris

Do you believe the threat of widespread dividend cuts is behind us?

I would argue that dividend cuts were widespread only within certain sectors, certainly the Financial sector, as well as Consumer Discretionary, Industrials and to some extent Materials. The threat of widespread dividend cuts did not affect sectors that offer dividend stability and growth, where we tend to invest. So this wasn't an issue for Consumer Staples, Telecommunications, Utilities, Integrated Energy or Pharma.

Where do you see favorable prospects for dividend growth today?

We are likely to see dividend opportunities among the sectors I just mentioned-Staples, Telecommunications, Utilities, among others-but the growth prospects may be more modest over the next few years. One caveat we would have for dividend seekers is that times have changed. Corporate managers are more cautious, businesses are more cautious as are consumers. For example, in the portfolio we currently anticipate a 4-5% organic dividend growth rate versus the 7% growth and higher that we often experienced pre-2008.

In a yield-challenged market that is likely to continue, we've been finding strong dividend opportunities overseas. These are primarily global businesses with well-recognized names. They typically have extensive operations in the U.S. but happen to be headquartered and listed abroad, most often in the U.K. Companies overseas typically pay out a higher percentage of their net income as dividends. It's how many of these companies allocate their cash flows, and it's what their shareholders expect. As a result they have a more balanced return pattern that is consistent with a high and growing dividend strategy.

Given the market comeback, are there still dividend stocks to be had trading at a discount?

As dividend investors, we view the discount issue a little differently. The yield communicates a good deal of information for us. The rest is our analysis of dividend growth. We're looking for stocks that pay us money. Given the nature of the rally in 2009, where small caps and highly leveraged companies surged well ahead of mature, cash distributing ones, the challenge has been to find securities that have the combined attraction of good upfront dividend yields and at least modest dividend growth.

Of course, the quality of the dividend is based on the quality of the company paying it. It's important to take a long-term focus, looking at five-year trends in sectors where companies historically have built up free cash flows. You can't build a long-term dividend strategy based on short-term considerations.

The Financial sector, for many years, had been an important part of any dividend investing strategy. Given continued uncertainty in the credit markets, do you believe that dividends on financial stocks will start to grow?

We will be looking for evidence that the banks are capable, not just of reinstituting dividends, but also of paying a proper dividend. By that I mean evidence that the components of total return are once again skewed toward the dividend as they have been for many, many decades and that is through commercial bank stocks. From our perspective regular commercial banks are the sweet spot for dividend investors within the Financial sector and until they come back in a significant way, we will wait.

It's widely believed that we're entering a slower growth, high volatility environment. What does that mean for dividend-focused investors?

I would say that we are entering a slower growth, low volatility environment. As such an environment progresses, investors are likely to shift from attempting to chase non-existing growth and running the risk of overpaying for it to getting cash payments for their ownership stakes in companies. By definition that's a shift to a more dividend-oriented, less volatile environment.

In such an environment, how do you measure risk?

Dividend investors would ask how does one measure risk in the absence of a dividend-oriented market. In the past few decades, as this country has moved away from dividends, there's been a need to create all sorts of risk measurements-Value at Risk (VaR), the Chicago Board Index Exchange Volatility Index (VIX)-among others. That's because the stock market has shifted from cash payments, a measurement that is relatively low risk and predictable, to stock market behavior, which is virtually random and related to factors that can and do change every day.

One of the benefits of a dividend-oriented strategy is that you are linking your returns to cash payments. Therefore, you measure the risk to a company's cash flows and payments that while changeable are not nearly as unpredictable as those factors affecting a stock's price.

Can you provide an example of a company that meets Federated Strategic Value Fund's criteria?

One company that represents our strategy is Kimberly Clark (3.0% of the portfolio as of 12/31/09), the maker of tissues, diapers and other paper products. It's a modestly growing, cash-distributive business that has an excellent track record of paying and increasing its dividends. Specifically, a high degree of the company's total return comes from the dividend. In all sorts of economic environments, people will continue to buy Kleenex®, Huggies® and related items, so we're reasonably confident of that continuing cash payout.

Thank you, Daniel. Any final thoughts on the market and dividend investing?

It's our view that we are coming out of 25-year period of stock-focused investing where the interest of investors was geared toward rising stock prices and away from the cash component of their investments. Twenty-five years of declining interest rates, greater participation in the markets, deregulation, and rapid growth of the investment industry all contributed to this shift. No doubt recent events are having an impact: interest rates have nowhere to go but up, reregulation is likely, economic growth is slowing and investors have lost confidence. As an increasing number of investors seek out a cash return for their investments, a dividend strategy should do well and, we believe, more companies will become dividend-oriented.

Views are as of February 16, 2010 and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security.

Past performance is no guarantee of future results.

There are no guarantees that dividend-paying stocks will continue to pay dividends. In addition, dividend-paying stocks may not experience the same capital appreciation as non-dividend-paying stocks.

Funds whose investments are concentrated in a specific industry, sector or geographic area may be subject to a higher degree of market risk than funds whose investments are diversified.

International investing involves special risks including currency risk, increased volatility of foreign securities, political risks, and differences in auditing and other financial standards.

Investors should carefully consider the fund's investment objectives, risks, charges and expenses before investing. To obtain a prospectus containing this and other information, contact us or view the prospectus provided on this website. Please carefully read the prospectus before investing.

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Federated Investors Tower
1001 Liberty Avenue
Pittsburgh, PA 15222-3779
Telephone: 412-288-1900

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