Focus on Quality, Not Higher Yields

Linda Bannister, CFA  •  Senior Equity Analyst

As the number of coronavirus cases increases globally, the effects of social distancing are taking a toll on the global economy and forcing some companies to suspend or cut dividends. Times like these highlight the importance of focusing on high-quality companies and not high-yielding stocks. Quality companies with strong balance sheets are generally the ones that are most able to sustain their dividends in tough times and increase their dividends over the long term. Higher yield is usually associated with higher risk, and these stocks may fall short of expectations because of dividend cuts or lack of dividend growth.

Many investors wisely look at dividend-paying stocks as complementary income-producing vehicles to other asset classes, such as fixed-income investments. However, in their search for additional income, some investors are focusing on the highest-yielding stocks, which we believe carry additional income-reducing risks, as these companies may be forced to suspend or cut their dividends. These stocks also have tended to underperform the market despite having very high dividend yields (see chart on page 2). We recommend owning higher-quality, dividend-paying stocks that have the potential to grow their dividends over time.

High-yield Stocks Typically Carry Higher Risk

High yields can be the market’s signal that investors have concerns. If the market is pricing a stock at a level where the yield is unusually high, it may be signaling one or more of the following:

- The dividend is increasingly at risk and could be cut.
- Growth prospects or business fundamentals at the company have deteriorated, and future dividend increases are unlikely.
- The level of income isn’t quite what it appears to be. With certain types of investments (such as master limited partnerships), some of the income ends up reducing your cost basis and may potentially result in your having to pay more taxes when you sell the stock.

Economic Downturns Bring Challenges

The pullback in the market has led to lower stock prices, higher dividend yields, and increasing uncertainty. It has also led to dividend cuts or suspensions for financially strained companies as they focus on preserving cash. Industries that are being especially hard hit, such as airlines, cruise operators and hotels, could continue to struggle in the months ahead. Rather than attempting to guess at which companies might be able recover if coronavirus fears subside, we recommend focusing on companies with strong balance sheets, as we believe they are better positioned to weather the storm and sustain or grow their dividends in all market environments.
Rising Income and Total Return Matter

It’s important to focus on your total return from owning stocks and the potential for rising income, not just the current dividend income. Total return includes share price appreciation and dividend income over time. In addition, a primary reason for owning dividend-paying stocks is the opportunity for rising income, whether reinvested or used to pay for everyday living. If the dividend is not growing, an investor’s inflation-adjusted income from the stock actually declines over time.

Higher-quality companies that grow their dividends over time can provide a rising stream of current income that helps offset inflation. Historically, these stocks have delivered a higher total return for investors.

Focus on Higher-quality Dividend Growers

Companies that pay and grow their dividends over time have historically offered several benefits, including:

- **Ability to maintain and grow dividends** – High-quality companies with strong balance sheets are more likely to maintain their dividends and increase them over time.
- **Rising income potential to help offset inflation** – A potentially growing stream of dividend income can help offset rising prices over time.
- **Quarterly or monthly income** – While most companies pay dividends quarterly, you can receive monthly income by staggering the dividend payment dates of your stocks.
- **Total return potential** – Historically, dividend payments have been an important part of the total return from stocks. Since 1950, dividends (with reinvestment) have accounted for approximately 90% of the total return of stocks, according to Bloomberg, and we expect growing dividends to continue to play an important role in stock returns.
- **Track record of good performance** – Dividend-paying stocks have performed well over long periods of time and have dramatically outperformed the highest-yielding stocks and those that don’t pay a dividend. In addition, stocks in companies that have been able to grow their dividends have outperformed stocks that pay a dividend but have not been able to grow it (see chart).

Check Out the Equity Income Buy List

A good place to start when looking for dividend-paying stocks is the Edward Jones Equity Income Buy List, a list of Buy-rated stocks that on average offer dividend yields greater than 4.1% – well above the market yield near 2.5%. Most of these stocks also offer above-average dividend growth potential, good historical dividend growth and attractive prices.

Actions for Investors: Add Rising Income Today

We believe now is an especially compelling time to consider rising-income stocks for your portfolio, including those on the Edward Jones Equity Income Buy List. Take this opportunity to talk with your financial advisor about appropriate ways to include rising income as part of your overall portfolio.