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Why Dividend Stocks Aren't The New Bonds

You can get generous yields... but also considerable risk

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For many investors who crave steady income, bonds don't look as good as they used to.

With U.S. Treasury yields languishing near historic lows, some people believe they've found a great alternative: dividend-paying stocks or dividend-focused mutual funds.

Many investment pros say it can be a reasonable move for at least part of an income-oriented portfolio. But they caution that investors need to understand the risks. The most basic concern: Equities don't behave the way bonds do, and investors face a much greater chance of capital losses with stocks and stock funds.

"People may not appreciate that moving from bonds to stocks is a major change in asset allocation," says Joseph Davis, chief economist and principal at Vanguard Group.

Investors should also remember that dividend-paying stocks don't always behave like other stocks, either. Dividend payers are often larger, established companies—which means they often aren't perceived to have the same potential for earnings and revenue growth as smaller firms. When the rest of the market is booming, dividend payers are often lagging behind the crowd.

To be sure, they often deliver better results than other stocks during market selloffs, since the income they provide makes up for some of the lost return. But investors can get the same kind of downside protection from bonds—with substantially lower capital risk.

For instance, last August, when the European debt crisis flared, U.S. stocks lost about 6% while the Barclays Capital U.S. Aggregate Bond index gained about 1.5%. And equity-income funds, which focus on dividend payers? They posted a negative 4.6% total return on average that month, according to Thomson Reuters Corp.'s Lipper unit.

For all the caveats in this category, investors have been plowing money into these dividend-focused funds.

Last year, nearly $17 billion flowed into equity-income funds, even as U.S.-stock funds overall saw about $80 billion in outflows, according to Morningstar Inc. Equity-income funds were the top-performing group among nonsector U.S.-stock funds in 2011, according to Lipper, with an average total return of 3.1%.

Behind those returns are strong dividend yields. Familiar names including Bristol-Myers Squibb Co. and Merck & Co. currently offer yields around 4% to 5%. (Calculate the yield by dividing the annual dividend by a company's share price.)

In contrast, the 10-year Treasury note now yields about 1.9%, below the 2% or so average yield of the stocks in the Standard & Poor's 500-stock index. That's unusual; for most of the past 50 years, the average S&P 500 yield usually was less than half that of long-term Treasurys.

If you're thinking of using dividend-paying funds as a source of income, here are some pointers that will help you make the most of your investment.

DIVERSIFY YOUR INCOME SOURCES. To limit stock-related risk and boost income, plan to get income from a mix of bonds, as well as dividend-paying stocks.

Lewis Altfest, principal adviser at New York-based Altfest Personal Wealth Management, offers an example of what this might look like. He suggests a 70% to 30% stock-to-bond portfolio now, if clients can tolerate the volatility in the stock portion. If they can't, he suggests 60% to 40%.

Then he would put a maximum of about half of the stock allocation into large-cap stocks that pay dividends (some yielding about 4% to 5%). The remainder of the stock portion would comprise small and midcap U.S. stocks, additional non-U.S. stocks and possibly another equity position.

The 30% stake in bonds, meanwhile, would be divided among various maturities of Treasurys, convertible bonds, high-yield U.S. corporate bonds (those with below-investment-grade credit ratings) and emerging-markets bonds.

OWN SOME STOCKS JUST FOR GROWTH. Most investors—even those who already have entered retirement—need the capital appreciation that stocks can generate to reduce the risk of outliving their assets.

A study by Milwaukee-based Heartland Advisors found that historically investors who reinvested dividends could have realized total returns averaging around 11% a year. The study looked at the performance of dividend-paying stocks since 1928 and compared their returns against those of non-dividend-paying stocks, as well as comparing the returns of stocks that paid higher and lower dividend yields. The 11% figure covers the higher payers.

But dividend-paying stocks aren't always an ideal source of capital growth. The stocks are often mature, and when investors tap them for income they aren't reinvesting dividends to maximize their returns.

Keith Singer, a certified financial planner in Boca Raton, Fla., encourages clients to combine dividend-paying stocks with other, more growth-oriented stocks. Among those are companies that continually buy back some of their outstanding shares, a practice that Mr. Singer says can boost returns well above those of the broad equities market.

BE MINDFUL OF FUND COSTS. For many investors, mutual funds are the most practical way to get exposure to stocks that pay dividends. Unless you have several hundred thousand dollars to invest, you probably can't buy enough individual stocks to get reasonable diversification in your portfolio.

But you should be mindful of the costs involved. Actively managed mutual funds typically charge around 1% of assets annually to cover management fees and other expenses. And those expenses reduce the income that funds distribute. In simplified terms, if a fund holds stocks yielding an average of 3% and the fund has a 1% expense ratio, the yield to fund investors will be around 2%.

Are the fees worth it? It depends on whom you ask.

Many investing pros argue that you're getting a lot for your money. Christopher Davis, an analyst at Morningstar, says

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that the biggest advantage of actively managed funds is the expertise behind them: A professional manager can judge when a company is financially solid enough to maintain, or even raise, its current dividend, and it might be tough for casual investors to make that call.

Among actively managed funds, the Morningstar analyst likes Vanguard Dividend Growth, T. Rowe Price Equity Income and Allianz NFJ Dividend Value. The funds have expense ratios, respectively, of 0.34%, 0.70% and 1.06%. Their yields, meanwhile, are in the range of 2% to 2.5%.

On the other hand, many financial advisers argue that actively managed funds rarely generate strong enough returns to justify the fees that the fund companies charge. As a general rule, Bill Palmer, a certified financial planner at Win Wealth Management in Denver, prefers index funds or exchange-traded funds for their lower fees.

Dividend-focused ETFs include Vanguard Dividend Appreciation, with an expense ratio of 0.18%; SPDR S&P Dividend, at 0.35%; and iShares Dow Jones Select Dividend Index, at 0.40%.

BE SURE YOU'RE COMFORTABLE WITH OVERSEAS EXPOSURE. One classic strategy for income-oriented investors—and the funds that cater to them—has been to blend U.S. stocks with European stocks, since the latter historically have had higher yields.

But as Europe's economy weakens because of the sovereign-debt crisis there, more companies are likely to slash dividends, says David Ruff, who heads dividend investing at San Francisco-based Forward Management LLC.

Forward International Dividend, which has about half of its portfolio in Asian stocks and about 40% in Europe, currently yields around 3.7%. That yield is attractive in part because international shares generally fell last year; yields rise when a company's share price, which is the denominator in the yield equation, declines. The fund's total return for the 12 months through January was a negative 6.2%. (Total return reflects both price change and distributions; the negative number indicates that the dividend income wasn't enough to offset the price drops.)

On the bright side, though, Mr. Ruff says there are opportunities now to buy shares at attractive valuations. And, eventually, that may lead to much better total returns for fund investors.

BRACE FOR STOCK-MARKET TURMOIL. While you are collecting periodic income distributions from a dividend-oriented stock fund, the share price of that fund will be moving up and down, sometimes resulting in periods when the overall return is negative. Look at a fund's total return over several years, rather than just its yield, to gauge its overall performance and compare it with peers. (With individual stocks, remember that a struggling company may cut or eliminate its dividend.)

It is important to hang in there, despite the market's ups and downs.

You can't fully benefit from owning equities unless you hold them for a multiyear period, says Quintin Price, chief investment officer for fundamental equity at BlackRock Inc. That means "you've got to have patience to withstand the volatility," he says.

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