Why Long-Term Investors Should Consider Dividend Stocks

*Today we have a guest post from the folks over at **Sure Dividend** who will be sharing why they think long-term investors should consider dividend-paying stocks. I won't steal their thunder as to why they recommend this strategy, but you'll soon find out.*

Sure Dividend, the floor is yours…

Not all stocks are created equal. Stocks are generally grouped into three main categories: value stocks, growth stocks, and income stocks. Sometimes a stock can offer a mix of two, or even all three, categories. At Sure Dividend, we believe stocks that offer such a blend of value, growth, and income can be the best investments for long-term wealth creation.

This is why we recommend investors consider high-quality dividend growth stocks to buy and hold for the long run. Specifically, we focus on the stocks with the longest histories of *raising* their dividends each year, such as the Dividend Aristocrats. The Dividend Aristocrats are a group of 66 stocks in the S&P 500 Index that have each raised their dividends for at least 25 consecutive years.

This article will discuss Sure Dividend's investment methodology, and why we believe investors looking for the best stocks to buy and hold should take a closer look at the Dividend Aristocrats.

Dividend Aristocrats Overview

Among other criteria, the Dividend Aristocrats must be in the S&P 500 Index, have a market capitalization of at least $3 billion, have raised their dividends for at least 25 years, and have a daily value traded of at least $5 million for the three months prior to the rebalancing reference date. The index is spread across every major market sector, with varying concentrations. For example, the Dividend Aristocrats are overweight the consumer staples sector (22% of the Dividend Aristocrats) and

Industrials sector (21%) while being relatively underweight Information Technology and Communications Services (1.5% each).

Investors can purchase stock in the Dividend Aristocrats individually, or through exchange-traded funds. The major ETF that tracks the Dividend Aristocrats is the ProShares S&P 500 Dividend Aristocrats ETF, which trades under the symbol NOBL. NOBL has net assets of approximately $5.5 billion, with a Morningstar rating of four stars.

One of the big advantages of ETFs is that they provide investors with instant diversification by holding a basket of stocks. And, ETFs typically have lower expense ratios than traditional mutual funds. Indeed, NOBL has a low annual expense ratio of 0.35% and provides investors diversification by owning small portions of all the Dividend Aristocrats. For all these reasons, NOBL is our top Dividend ETF.

Why Invest In Dividend Growth Stocks?

While all investing styles have their place, dividend growth investing has proven to generate as consistent returns as the broader market index, and at the same time has exhibited lower volatility over the past decade. Consider that over the past 10-year period through April 30th, the Dividend Aristocrats generated total returns of 11% annually, matching the total returns of the S&P 500 Index in the same time period.

Meanwhile, the Dividend Aristocrats had standard deviation (a widely used measure of stock volatility and risk) of 12.8%, compared with 13.8% standard deviation for the S&P 500. This means the Dividend Aristocrats had stronger risk-adjusted returns than the S&P 500 Index in the past decade. And, this data defeats the notion that dividend growth stocks such as the Dividend Aristocrats tend to be stodgy, slow-growth investments.

Instead, quality dividend growth stocks such as the Dividend Aristocrats (and also the “Dividend Kings,” which are stocks with 50 years or more of consecutive dividend increases, but unlike the Dividend Aristocrats, not officially tracked by ratings companies) possess multiple qualities that make them ideal investments to buy and hold for the long run. First, in order to maintain such a long streak of annual dividend increases, a company must have a consistently profitable business model that generates positive cash flow, even in recessions.

Many companies that operate in cyclical industries, such as banks, automotive manufacturers, and oil companies, typically enjoy strong growth when the global economy is expanding. But in recessions, these companies are usually among the first to cut or eliminate their dividends, as they are highly exposed to economic activity. This makes it virtually impossible for companies in cyclical industries to maintain long histories of annual dividend increases, and explains why on the list of Dividend Aristocrats there are only two energy stocks (Exxon Mobil and Chevron) and only one bank stock (People's United Financial).

By contrast, the Dividend Aristocrats list is heavily skewed towards consumer staples and health care stocks. These industries typically continue to see steady cash flow even in recessions. Consumers will always need to buy staples products such as household cleaners, paper towels, laundry detergent, toothpaste and other similar items, regardless of the state of the economy. Health care stocks also benefit from recession-resistant business models, as consumers who need medicine and other healthcare products will usually need to continue buying these products, even if the economy is in a downturn.

In addition to their recession-resistant business models, companies that have shown the ability to raise their dividends each year hold leadership positions in their respective industries. Many of the Dividend Aristocrats, such as Johnson & Johnson, Procter & Gamble, Walmart and Coca-Cola, just to name a few, dominate their industries and hold top market share. This adds to their ability to raise dividends every year, as their leading market share provides pricing power and brand loyalty. For example, Procter & Gamble can successfully increase the price of some of its core products like Crest toothpaste and Tide laundry detergent without losing market share, because of their brand power.

Lastly, the sheer size of the Dividend Aristocrats is a durable competitive advantage. The largest operators in a given industry enjoy global economies of scale, which allows them to realize higher profit margins than smaller competitors. Size also allows more financial flexibility to cut costs quickly during economic downturns, which helps the Dividend Aristocrats continue to raise their shareholder payouts each year.

The end result of all the competitive advantages mentioned above is that companies with the longest histories of annual dividend raises have generated strong and consistent earnings growth. Ultimately, in order for a company to increase its dividend each year, it must have the ability to do so through rising sales and earnings-per-share over time.

The Importance Of Valuation And Dividend Yield

In the above section, we demonstrated how the Dividend Aristocrats and Dividend Kings generate long-term growth, which has allowed them to raise their dividends each year. But growth is not the only consideration for investors; valuation and dividend yields must also be assessed before investing in a stock. After all, even a high-quality dividend growth stock can be a poor investment over time, if the investor pays too high a price for the stock.

This is why we incorporate valuation and dividend yields into our models of total expected return. While we certainly appreciate dividend stocks that generate strong growth, we feel that shareholder returns can be amplified even further by purchasing high-quality dividend growth stocks when they are undervalued and have high dividend yields.

An example of this is healthcare giant AbbVie (ABBV), which is one of our top-ranked Dividend Aristocrats. AbbVie is a global pharmaceutical manufacturer with a market capitalization of $162 billion. It has traded as an independent company since its spin-off from former parent company Abbott Laboratories in 2013.

AbbVie is an industry leader in its core therapeutic categories, led by its flagship product, Humira, which alone represents approximately 60% of the company’s total revenue. This poses a challenge for AbbVie going forward, as Humira has lost patent exclusivity in Europe, and is on schedule to lose patent exclusivity in the US in 2023. Fortunately, the company has prepared for this by investing in its diversified pharmaceutical pipeline.

AbbVie has continued to report high growth rates in 2020. In the most recent quarter, AbbVie’s revenue increased 10% year-over-year, while its adjusted earnings-per-share increased 13% year-over-year. Humira continues to generate growth in the U.S., while new products lead AbbVie’s growth. For example, in the 2020 first quarter global Imbruvica revenue increased 21% while sales of Venclexta, more than doubled year-over-year.

We believe AbbVie is capable of generating earnings-per-share growth of 5% to 6% per year primarily from revenue growth and share repurchases. This will add to shareholder returns, as will dividends paid to shareholders. AbbVie has a current dividend payout of $4.72 per share (AbbVie qualifies as a Dividend Aristocrat as its former parent company qualified for the list at the time of the spin-off) which represents a high dividend yield of 5.1%.

At the same time, AbbVie stock appears to be considerably undervalued. Based on consensus analyst estimates, the company is expected to generate adjusted earnings-per-share of $10.70 for 2020. AbbVie stock has a price-to-earnings ratio of 8.6 using analyst estimates. We view AbbVie as an undervalued stock. We believe AbbVie should trade at a multiple of at least 10.5, which represents fair value for a growth company. An expanding price-to-earnings ratio would add to shareholder returns through a higher share price.

Through the combination of earnings growth, dividends, and an expanding valuation multiple, AbbVie stock could generate total shareholder returns well above 10% per year over the next five years in our estimation. This makes AbbVie another of our top-ranked Dividend Aristocrats.

Reach Financial Independence With Dividend Growth Stocks

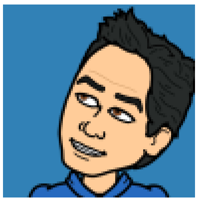
Investing in high-quality dividend growth stocks can help individuals reach financial independence sooner. Investors buying dividend growth stocks should become familiar with the concept of yield on cost, which helps show the powerful impact of dividend growth. It is rumored that Albert Einstein called compounding interest the most powerful force in the universe, and dividend growth investing can show he had a good argument.

The appeal of dividend growth stocks is that they could eventually allow an investor to retire and live off their dividend income. The goal of this strategy is to generate enough passive income to pay for all their monthly expenses. If an individual invests enough over time, this goal can be accomplished through annual dividend increases, as well as dividend reinvestment, whereby an investor uses each quarterly dividend payment to purchase additional shares of stock. These additional shares pay their own dividends, which can be used to buy even more shares, and eventually creates a snowball effect of rising dividend income.

To help explain the concept of yield on cost, assume an investor purchases $10,000 of a dividend growth stock with a current yield of 3%. In the first year of ownership, the investor will receive dividend income of $300. But further assume that the company increases its dividend by 10% per year. In year 10, the dividend growth stock will pay out dividends of approximately $778, for a “yield on cost” of 7.8%. The yield on cost figure is even higher if the dividends are reinvested.

Final Thoughts

There are a number of ways investors can decide which dividend-paying stocks to buy. There are many different kinds of stocks, from speculative tech stocks that offer the potential for rapid growth, to slow-moving utilities that offer high dividend payouts but little in terms of growth. We believe investors looking for dividend stocks with the highest return potential should look for stocks with a mix of growth, value, and income. In our estimation, these represent the most attractive investment opportunities to build long-term wealth. The Dividend Aristocrats are a great source of high-quality dividend growth stocks, and many Dividend Aristocrats such as AbbVie are also undervalued right now.



Gen Y Finance Guy

Hey, I’m Dom - the man behind the cartoon. You’ll notice that I sign off as "Gen Y Finance Guy" on all my posts, due to the fact that I write this blog anonymously (at least for now). I like to think of myself as the *Chief Freedom Officer* here of my little corner of the internet. In the real world, I’m a 30-something former C-Suite executive turned entrepreneur turned capital allocator. I am trying to humanize finance by sharing my own journey to Financial Freedom. I believe in total *honesty* and *transparency*. That is why before I ever started blogging, I decided that I would share all of my own financial stats. I do this not to brag, but instead to inspire motivate, and also to hold myself accountable. My goal is to be a beacon of hope, motivation, and inspiration for *you*, the reader, by living life by example and sharing it **all** here on the blog. My sincere hope is that you will be able to learn from me - both from my successes and my failures! Read More