5 Reasons To Avoid Focusing On Dividend Stocks

[Editor’s Note: The following article originally ran as one of my regular columns over at Forbes and looks at the problems investors face when they place too much emphasis on investing in dividend stocks over using low-cost, broadly diverse index funds. Enjoy!]

Through my work at The White Coat Investor where I help high-income professionals to get a “fair shake” on Wall Street, I have run into many investors who inappropriately focus their investments on dividend-paying stocks. While there are far worse ways to invest, a focus on dividend-paying stocks has an almost cult-like following. There are five reasons why overly focusing on investing in dividend stocks is generally an investing error.

1 Uncompensated Risk

The main problem with focusing on dividend-paying stocks is that it often leads to individual stock investing. An investor choosing her own stocks is taking on uncompensated risk. Uncompensated risk is risk that can be diversified away. Said another way, if you can diversify a risk away, you will not be paid for it. Holding a portfolio of five or ten stocks involves taking a lot of single stock risk. Since this risk can be diversified away by simply purchasing a low-cost, broadly-diversified index fund, the investor is not compensated for it. Investing is all about risk control; there is no reason to run risks you are not paid for.

Choosing your own stocks also brings manager risk into the equation. Studies are very clear that even professionals with millions of dollars of resources at their fingertips cannot pick stocks well enough to reliably best index funds over the long run after paying the expenses of doing so, especially on an after-tax basis. If the professionals are unlikely to do it, an individual investor should have serious reservations about trying, especially after considering the value of her time.

2 Failure To Focus On Total Return

Another major issue with a dividend-focused investor is they often become so focused on the dividend, yield, or income of an investment that they fail to pay attention to the most important metric—the total return. One need only take the situation to the extreme to see the problem with this focus. Imagine two stocks. The first has a yield of 10% and the other has a yield of 0%. Which one should you invest in? While a 10% yield sounds more attractive than a 0% yield, the correct answer is "I don't know" because the yield, by itself, does not provide enough information. Broker-sold Real Estate Investment Trusts (REITs) are notorious for this. They promised an "8% yield" which seemed really great until the investors realized their shares were only worth $3 each instead of the $10 per share the investors originally paid. In reality, a significant chunk of the "yield" was more like a return of their principal. Total return is the return that matters.

3 Mistake Dividend Stocks For Bonds

An even larger error dividend-focused investors make is somehow assuming that because dividend stocks provide periodic income, that they are bond-like instruments. While dividends do have less volatility than share prices, they do still have plenty of volatility. Companies, even solid dividend-paying companies, do go bankrupt from time to time. WorldCom, Enron, Lehman Brothers, and Sears all paid a dividend at one time. Even venerable GE just cut their dividend to 1 cent per share. Stocks are still stocks, even if they pay a dividend. In 2008, not only did the price of shares drop dramatically but so did the dividends paid. Of the 500 stocks in the S&P 500, over 100 cut their dividends within the first six months of the crisis. Meanwhile, bonds maintained their yields and went UP in value. For example, the Vanguard Intermediate Treasury Fund was up 13.49% in 2008 while the Vanguard High Yield Dividend ETF was down 32.37%. Those two returns are obviously not even close to being equivalent.

4 Dividend Stocks Are Tax-Inefficient

While qualified dividends are taxed at a lower tax rate than ordinary income, distributing dividends at all isn't necessarily good for investors. This is the reason that Warren Buffett's Berkshire-Hathaway has never paid a dividend. If no dividends are distributed, the investor gets to decide when to pay the taxes on their share of the company's earnings. The investor can "declare her own dividend" any time she likes, simply by selling some shares. But in a year when no income is needed, none must be taken and no taxes need be paid. Deferring those taxes has real value given the time value of money, and thanks to the step-up in basis at death (or similar tax treatment through charitable donation of appreciated shares), might even eliminate the taxes completely.

5 Inefficient Method To Get A Value Tilt

British Columbia is a crazy place. Not as crazy as mistaking a dividend paying stock for a bond, but crazy nonetheless.

Dividend investors argue that paying out a regular dividend focuses company management on actually earning a profit for the investors. They feel dividends are more "real" than share price increases. They can even point to historical data that shows dividend-paying stocks have outperformed the overall stock market over time. However, what they may not realize is why this has occurred. The reason is that dividend-paying stocks are generally value stocks, and at least in the past, value stocks have had higher returns than the overall market.

Whether this outperformance is due to investor behavior or increased risk is not clear (probably a combination of both), but many investors "tilt" their portfolio toward value stocks in order to try to take advantage of it. When studied, it turns out that using a dividend focus is not the best way to achieve this tilt. Investors, at least in the past, have been better off tilting based on a Price to Book ratio. So even if an investor avoids uncompensated risk and manager risk by using a low-cost dividend stock index fund or ETF, she would likely be better off using a simple value index fund or ETF instead.

Dividend stocks need not be avoided completely. In fact, I essentially own all of the dividend-paying stocks in the world via total market index funds. However, these five arguments demonstrate well why building a portfolio composed entirely of a handful or two of high-yield stocks is a mistake that will be regretted by many investors.

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What do you think? Are you a dividend investor? What do you think the role of investing in dividend stocks should be in a portfolio? Why or why not? Comment below!