Choosing Quality Dividend Stocks

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My investment specialty is building a portfolio of quality dividend stocks. Good dividend stocks tend to be boring investments making a steady stream of small income that accumulates over time to significant income – that is good for excitement often means big losses. Over the years I have made considerable money in dividends and also in long term capital gains on quality dividend stocks. In this piece I am going to document my method so you can apply it. It is remarkably simple to implement although it took a lot of study and research to develop it. It is not absolute – you still have to do complete research but the number of stocks to research is significantly reduced.

I buy stocks for the long term as that is the only sane way to own stocks – particularly dividend stocks. You do not buy a dividend stock because you expect the stock price to increase significantly in the short term – with rare exception that is not going to happen. You buy a dividend stock for steady income for the long term and also for long term capital gains as the stock price grows with dividend increases over the years. You also buy a portfolio of at least a dozen and perhaps several dozen quality dividend stocks to diversify the risk of a given stock going bad – that will happen – often unexpectedly. With good diversification that will hardly make a dent in your portfolio value and income.

A quality dividend stock to consider buying has all of the following attributes:

- ✓ The company has real and stable earnings and has had these in recent years and prospects for that continuing in future years looks good.

- ✓ The company has a history of paying regular dividends and preferably the dividends have been increasing steadily in recent years.

- ✓ The market sector the company is in looks to be expanding.

- ✓ The company has a low debt to equity ratio. What is low depends on the sector the company is in. Public utilities tend to have relatively high debt but have stable cash flow to cover that so their ratios will often be much greater than 1.0. For industrial companies the ideal ratio is zero but values in the 0.5 range are not bad. Because I am conservative I get concerned when the ratio is approaching 1.0 and particularly if it is higher. However, keep in mind that special situations exist and as long as the company has stable cash flow to cover the debt then a relatively high debt may be alright. But I have a bias towards low debt and will forgo possible good returns with high debt companies – I am also forgoing possible losses.

- ✓ The dividend yield is at least 2% but not more than about 8%. Be wary of unusually high dividend rates. It is not unusual in doing computer screens for dividends for companies to show up that are apparently paying a dividend rate of 80%. That is fantastic! – too good to be true. Keep in mind that the reported dividend rate in the various newspapers and websites is derived by dividing the previous twelve months of dividend payments by the current stock price and expressing the result as a percentage – so there is a time distortion in the reported value. So a company that had been paying a quarterly dividend of twenty-five cents per share and who stock price has fallen in recent months to $1.20 per share will appear to have a fantastic dividend when the truth is that because of a grave financial problem the company no longer pays a dividend and may even go out of business.

- ✓ The dividend payout factor is not higher than about 0.5 although in special cases it can approach 1.0. It should never be greater than 1.0. If it is greater than 1.0 then the company is borrowing money to pay the dividend – generally a very foolish move to satisfy certain special stockholders at the ultimate expense of others.

I generally do not like bank or financial stocks anymore. In the past those made for good investments but that ended in 2007. The financial situation post 2008 is perpetual uncertainty coupled with government sanctioned and even mandated fraudulent accounting. The government is too embedded in financial institutions (or is it the other way around?) to consider many of them as part of a free capitalistic market worthy of making an investment. Do not trust what you are told. The government has ordered that lies be told to the public. If you want an example then check out the government manipulated Bank of America acquisition of a (secretly) bankrupt Merrill Lynch.

I do like utility stocks, energy stocks, and consumer staple stocks as those are generally insensitive to ups and downs in the economy – you can sleep well and enjoy steady income in good and bad times. I also diversify into good industrial and other stocks as a good portfolio covers most of the major market sectors.

There are many thousands of stocks and it would take an incredible amount of time to sift through them manually to choose good buy candidates. It is much better to use computer screening coupled with human intelligence. My brokerage account is with Schwab and I have access to a free stock screening system (years ago I had the privilege of meeting Mr. Charles Schwab and discussing investing with him. In short he is very much my kind of person – but that is a story for another day.). I will tell you how I set up my screening system and you can adapt that to whichever computer system you have access to.

My screen is very simple:

- ✓ I look for companies with a dividend yield between 2 and 8 percent. I use 8% as a ceiling to exclude stocks where the dividend yield is artificially inflated by the method of calculation. I adjust those numbers based on current market conditions.

- ✓ I reject companies with a debt/equity ratio greater than 2.5. I only use a number that high so that normally high debt companies such as utilities are not arbitrarily excluded and even then I tend to avoid stocks with a ratio above around 1.7 – however note that in a down market the ratio will be artificially elevated if the stock price is down – so a high ratio might not be as bad as it seems – further research is needed before making a decision. For most other stocks I am concerned in the ratio is not significantly less than 1.0.

- ✓ I generally reject companies with a dividend payout ratio greater than 0.8 as that is rarely sustainable except in special cases.

- ✓ I often ignore microcap companies (although there can be some fantastic deals there if you are willing to do more detailed analysis.).

I run the screen and see how many stocks show up. If there are more than about 200 I tighten the criteria so that the total is not more than 200. Sometimes I target as few as 100. This is just a starting point. Most of these stocks will be rejected by manual screening.

I print the list with the columns of screened data and manually strike companies that are poor fits to my goals and star companies that look like good fits to my goals. I also strike companies that I either do not like or are some foreign company that I am not familiar with. Yes, I pass over some possible good deals but I would rather focus on good deals that I am familiar with rather than possible good deals I am clueless about. As the great fund manager, Peter Lynch, once said, “Only buy what you know.” I make a number of passes through this list paring it down to around a dozen stocks that I really like the basic appearance of. I then do individual research on these selected stocks to better understand the big picture of each. Perhaps the big picture is good and I will buy the stock or perhaps I see a problem that leads me to drop the stock from consideration. My goal is to obtain a list of at least a half dozen stocks to purchase with the money I have available. I understand that not every stock I pick will be a long term winner – that is true for every stock picker. The important thing is that I do have some winners that more than make up for what will turn out to be losers. There is no clairvoyance. That is what investing is about. If you can’t accept that then you have no business making investments for you will be biased towards making bad moves.

I have no way of explaining my process of manually scanning this list. I am looking at the data and making conscious and subconscious judgment calls. It is much easier to explain if I discuss it in objective terms that can be entered into a computer. In recent years I tend to use the computer approach instead of manual in the interest of time as it takes a lot of time to manually go through a list of 200 stocks multiple times. So I export the data to a .csv file which enables me to use the spreadsheet program, Excel, to automate further refinement. A brief sample spreadsheet is shown later to illustrate the points. The following is my best effort at translating my conscious and subconscious judgment calls into something objective. It is not exactly everything I do but it is close – there is some subjective intuition based on years of experience that I have not found words to explain. I will revise this piece if I do find the words.

There is a plethora of data such as cash flow, price/earnings ratio, return on equity, etc. that as a whole paints a very complicated picture that can overwhelm any rational decision process. Some of these parameters may be very volatile quarter to quarter which makes them poor indicators in the short run. After some years of study trying to make sense of it all I realized that I could make good decisions based only on three parameters: dividend yield, debt/equity, and dividend payout ratio. If all of these are good then the plethora of other values just about have to be good.

The objective method described here is only an aid in selecting candidate stocks to perform more detailed research on. Never let any algorithm tell you absolutely what stocks to buy. The only sane way to make a final buy decision is your individual research of the whole picture rather than the reduced view of the algorithm.

The data columns I import into a spreadsheet are:
Stock symbol, Stock name, Market capitalization, Dividend yield, Debt/equity, Payout ratio.
The last three columns are processed to rank the stock as a buy candidate. For the spreadsheet to perform any calculations I must tell it three parameters as follows:

- ✓ I enter a dividend yield that is at the upper end of what I consider reasonable considering the current market (for 2012 I often use 5%). I then compute a dividend score for each stock by dividing its dividend yield by the value I entered and multiplying by 100. Stocks with a higher yield will score higher than 100 but that is OK.

- ✓ I enter an absolute maximum debt/equity ratio that I will tolerate (often I use 2.5 as discussed previously). I then compute a debt/equity score for each stock by subtracting the debt/equity divided by the maximum I entered from 1.0 and multiplying the result by 100. A stock with zero debt will score 100 and a stock with high debt may score zero or even negative.

- ✓ I enter a maximum allowable payout ratio (often I use 1.0) and perform the same calculation as with debt/equity. A stock with an undesirable payout ratio of 1.0 will score zero. No stock will score a 100 and even a good stock with a payout ratio in the 0.5 range will only score around 50.

To combine the three scores into a single value I use a simple average. Do not view this average as an academic grading scale – A, B, C, D, etc. The absolute score is meaningless. It is the relative score that is important. One could consider a weighted average but it becomes complicated as to what to weight more. If I did anything at all I would probably weight the payout ratio score a little bit less – say 25%. In the big scheme of things it is really going to make little, if any, difference. However, there is an inherent weighting built into the three parameters entered above so further weighting is really unnecessary.

The next step is to pick the highest final averages such that only about a dozen stocks show up. I enter a minimum score – say 80 and have the spreadsheet produce a 1 if the score is equal or higher or a 0 otherwise. I then show the sum of the number of stocks passing this test. I manually tweak the minimum score until the number of stocks passing the test is about my target – typically around 12. That does not mean that stocks that fail this test are bad – don't immediately rule marginal cases out as the threshold you enter is rather arbitrary. Keep in mind that this is just a selection guide. Next I will discuss the individual research you must do on the selected stocks.

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A sample spreadsheet is shown in Figure 1 that illustrates the above concepts.

	A	B	C	D	E	F	G	H	I	J	K	L
1	**Spreadsheet to illustrate dividend screening concept**							*Bold italic red cells are user input*				
2	dividend_screen_sample.xlsx							Green cells are computed values				
3	written by Kenneth A. Kuhn										**Total Selected:**	7
4				Max.	Max.	Max.					Min.	
5	**Imported data**			***5***	***2.5***	***1***		**Computed scores**			***73***	
6	Symbol	Name	Capitalization	% Yield	Debt/Eq.	Payout		Yield	Debt/Eq.	Payout	Average	Select
7	ABC	ABC Thingies	Small	7.20	1.72	0.95		144	31	5	60.1	0
8	DEF	DEF Stuff	Mid	2.30	0.25	0.42		46	90	58	64.7	0
9	GHI	GHI Industries	Large	3.30	0.00	0.35		66	100	65	77.0	1
10	JKL	JKL Corp	Large	4.90	0.85	0.44		98	66	56	73.3	1
11	MNO	MNO Enterprise	Small	3.50	0.12	0.28		70	95	72	79.1	1
12	PQR	PQR Bank	Large	3.60	0.90	0.70		72	64	30	55.3	0
13	STU	STU Utilities	Mid	6.30	1.30	0.40		126	48	60	78.0	1
14	VWX	VWX Products	Mid	2.50	0.20	0.27		50	92	73	71.7	0
15	YZM	YZ Manufact.	Small	3.70	2.80	0.50		74	-12	50	37.3	0
16	ZYX	ZYX Automotive	Large	4.70	1.50	0.73		94	40	27	53.7	0
17	WVU	WVU Foods	Mid	2.40	0.30	0.13		48	88	87	74.3	1
18	TSR	TSR Drugs	Small	5.10	0.72	0.55		102	71	45	72.7	0
19	QPO	QPO Toys	Small	3.30	0.27	0.60		66	89	40	65.1	0
20	NML	NML Shoes	Mid	6.40	2.21	1.10		128	12	-10	43.2	0
21	KJI	KJI Furniture	Mid	2.10	0.82	0.53		42	67	47	52.1	0
22	HGF	HGF Planes	Large	4.30	0.32	0.21		86	87	79	84.1	1
23	EDC	EDC Financial	Mid	2.90	1.10	0.72		58	56	28	47.3	0
24	BAC	BA Chemicals	Large	2.25	0.15	0.20		45	94	80	73.0	1

Figure 1: Screen capture of Excel sample dividend screener

Notes:
A copy of this spreadsheet is on the author's website (http://www.kennethkuhn.com) next to this article. I encourage the reader to download or build this spreadsheet and experiment.

The black cells on the left would be imported data in csv format. Manually enter values are used for this example. Only 18 stocks are shown for brevity. Typically there would be 100 to 200.

The bold italic red cells are user input as described previously.

The equation for cell H7 and below is =100*D7/D$5

The equation for cell I7 and below is =100*(1-E7/E$5)

The equation for cell J7 and below is =100*(1-F7/F$5)

The equation for cell K7 and below is =AVERAGE(H7:J7)

The equation for cell L7 and below is =IF(K7>=K$5,1,0)

The equation for cell L3 is =SUM(L7:L24)
Discussion of the example spreadsheet

For the purposes of illustration I created a list of 18 imaginary companies with numbers rigged to bring out some important points as discussed below. The minimum average score (73) was tweaked to produce seven candidates.

Observe that the first stock (ABC) has a great yield but has high debt and almost all of earnings are paid out in dividends. This is not a good situation. The apparent yield is probably more a function of past performance than representative of future performance as discussed previously. The high payout ratio is not sustainable and will have to drop if it hasn't already. Avoid this stock. The particular user choice of 5 percent yield as a reasonably high level and the simplistic method of calculation conspire to give this stock a higher average score than it should have although its average score did fall below the user threshold of 73 – but that might not always be the case. That is the reason why in the initial screen I cull stocks with an apparent dividend yield higher than 8% as there is just no point in looking at those. This is a classic example of why I previously stated not to blindly select a stock based on this algorithm. Further research into this stock would likely result in very clear reasons to avoid this stock. ZYX is a not as bad example but still is a stock I would avoid for the same reasons.

Observed that GHI has a nice dividend, no debt, and a low payout ratio. This is a good stock to do further research on because the company appears to be in great financial shape and the low payout ratio means that there is easy room for the dividend to be increased over time. Although you can't be clairvoyant, you like to pick stocks whose dividends will grow with time thus enhancing your income. Stocks with payout ratios less than about 0.5 are good candidates. If further research indicates that this stock fits the complete criteria then this is a stock I would buy. Observe that there are some other similar stocks – WVU and BAC. VWX almost scored a select with my method – be sure to read the subsequent section concerning stocks that almost made the cut – you may want to consider them.

STU is a utility stock with a great dividend although the debt is high. However, high debt in utilities is common and is not as troublesome as it might be for a stock in other industries because the utility is generally able to charge customers a sufficient amount to cover the debt. I don't like high debt but is the way things are. I do own a number of utility stocks and would likely buy this one because I like its low payout ratio – the dividend is probably secure. My screening algorithm picked this stock but I would still do further research before deciding to buy.

YZM is an example of a company that appears to have a great dividend and even a reasonable payout ratio but has high debt – note its negative score on Debt/Eq. That concerns me for high debt can quickly lead to bankruptcy if the economy sours. Yes, the yield of 4.7% if solid for now is nice but is very vulnerable to be cut drastically if little things go wrong. I would avoid this stock. Note that my scoring method gave it a low relative rating.

NML shoes appears to have a fantastic dividend (remember my previous cautions) but has high debt and a payout ratio exceeding 1.0. That means that the company is borrowing money to pay the dividend. Believe it or not that really happens. It is incompetent management to the maximum. Management sometimes feels forced to do this to maintain a certain relationship with major stockholders such as some large mutual funds. That situation is one of the corruptions on Wall Street that needs to be corrected – the practice of certain large fund shareholders who only have an interest in bleeding the company and manipulating the stock price (analysts paid to give good ratings) so that their personal results look good. I will address this topic in more detail in another piece. But for now the important thing is to recognize that this is a stock to avoid – no matter what “professionals” may say about it. Note that my scoring method gave it a low relative rating which it should have.

HGF has the highest score on the list and would be a strong buy candidate if further research is confirming. It has a great dividend, low debt, and low payout. That combination is a rarity. You will find few of these. It is even a large cap stock which is a further plus.

Some stocks, VWX and TSR, had average scores just below my arbitrary threshold of 73 and BAC was right on the edge. Always look at stocks that are just below your arbitrary threshold for there may be some very good deals there. VWX looks to be a very safe stock and TSR has a nice dividend and not too bad debt and payout. I would likely consider buying TSR and maybe a little bit of VWX particularly if I thought from further research that its dividend might grow significantly over time. You are always investing for the future, not the present.

Market capitalization

The above discussion did not get into whether the stock was small, mid, or large cap as that does not figure into the calculation. Unless I know them or have a good reason to own them I generally avoid microcap stocks because they are illiquid (very few shares trade daily and even a small transaction can significantly affect the price) and good research is often barely available if at all. Having said that, I once worked for a microcap company and accumulated a large amount of stock (about 5% of my total portfolio) because I knew the place well and truly believed in its future. That turned out well as they ended up being acquired for a substantial premium by a large cap stock and I made an obscene amount of money. Above microcap I give a low weight to market capitalization. If it is an equal contest between two stocks one large and one mid then I will favor the large. If it is an equal contest between two stocks one mid and one small I will favor the mid. The vast majority of the stocks I own are in the mid to large cap range as I have a bias towards big. But I own small cap stocks and have made good money on them in the past.

Detailed research

It would be foolish to blindly purchase a stock just because it passed my algorithm. The next step is to do more detailed research on the small number of stocks passing this test and then select the best ones and discard any bad ones that slipped through (it is rare but that can happen). When I do a stock buy I like to purchase the six or so best overall (passed the screen plus individual research). There is no guarantee that all of these stocks will perform well over time. A few will probably become “mangy mutts with fleas.” But others will probably become eagles. I have a saying, “The eagles eat the mutts.” The worst you can do is having a stock go to zero. There is no limit on how well you can do. If one stock goes to zero and another goes to twenty times what you paid for it then you are ahead. In my twenty plus years of investing that has been very true. Don’t lose sleep over the mutts – one hundred percent of stock pickers will have some mangy mutts in their portfolios. Accept it and go on with life. Savor the eagles that make you a lot of money and erase the effect of the mutts. Focus on the big picture.

Once you have a list of candidate stocks from this algorithm then the next step is to do some detailed research on each of those to see if that results in confirming information or you discover a potential big negative that would change your mind about the stock. Keep in mind that no company is perfect. All companies, even the best ones, have some negatives. What you are looking for is a significant negative beyond the ordinary. There is such a variety of things that might be a big negative that I cannot begin to list them. However, any significant negative should be obvious. A key thing you want to watch for is anything that might result in the dividend being cut in the foreseeable future – the stock price falls well in advance of that thus making the current apparent dividend look high. Your purpose in research is to compare the stock to the criteria I outlined for a quality dividend stock. If it meets that then buy it – but be sure to diversify into a variety of other stocks also meeting the criteria. Diversification is your friend. I like to do buying on down days when prices are lower – although dividend stocks do not fluctuate that much. I follow the advice of the great investor, Sir John Templeton, “You find your best bargains where you find maximum pessimism.”

Analysts’ opinions

In research you will come across analysts’ opinions and ratings. It is fine to read those particularly when you are new to investing as there are many things you can learn in general. However, do not base your decision on their opinions. Just because they rate the stock a superb buy does not mean you should buy it. Just because they give the stock a D- rating does not mean that you should avoid it. You would want to examine the stock to understand why it might have a low rating as maybe that is truly justified. Understand that in A, B, C, D letter ratings that the universe (typically only major stocks) of stocks covered is broken into percentile groups and the upper 25% get an ‘A’ and the lower 25% get a ‘D’. The ratings will likely be based on some short term criteria such as probability of making a quick, albeit not large profit. If the rating criteria were altered to favor long term then some ‘A’ stocks might receive a ‘D’ and some ‘D’ stocks might receive an ‘A’. The short of this is, don’t blindly allow an analyst’s opinion or rating to influence your buy decision. I made that mistake early in my investment career. There was a stock that looked like a gold mine to me but had very low ratings. I compromised and only bought half the number of shares I had intended. Those ratings might have been true for the short term but I am a long term investor and time proved me right – I have owned the stock for over twenty years and have made a ton of money in dividends from it – and if I ever sell it I will also have a huge capital gain. There was another example of a stock that had very low ratings (they were literally laughing at the stock) but I knew the company well and knew that the issue was a fixable short term problem. I bought the stock and when it was about five times what I paid for it those analysts then rated it a buy – my observation over the years is that analysts rate a stock a buy after it has substantially gone up in price – pretty much useless, duh. That was also over twenty years ago and now that stock is dozens of times what I paid for it and now pays me an annual dividend greater than my initial purchase price. My only regret is not having bought more – but I was sane – I bought what I felt comfortable owning at the time. I diversified into other stocks that have also performed about as well. The key is diversification. In conclusion, I ignore the analysts' ratings as their criteria and my criteria are very different. My criterion is what counts for me.

Not everyone is meant to be an investor

Some years ago someone who had recently come into a substantial sum of money and wanted to get involved with investing handed me a list of around twenty stocks he had researched and asked me which one he should buy. I looked over the list and was familiar with and even owned many of the stocks and my response was all of them. He said, "No. I want to know which stock is going to perform the best." I responded, "There is no way to know. However, a portfolio of all of these should do well." He said, "I do not want to lose return by buying a stock that does not do as well as the best one." I said, "Putting all of your money in one stock is the riskiest thing you can do and the surest way to lose a lot of money. Yes, if you happened to be lucky enough to pick what turned out to be a great performer then you can make a lot of money. But the probability of that is low. It is much better to own a portfolio because that reduces your risk and although there are no guarantees it enhances the likelihood that you will make money." He said, "All stocks are risky so I don't see how twenty stocks is less risky than one stock." I forget what was discussed next but the conversation was going nowhere. He ended up buying nothing and hired some money manager who then proceeded to buy stocks. This chap later told me that he was dismayed at how fast the money manager was buying stocks and complained to the manager. I heard later that he fired the money manager and transferred the money to a different type of investment where they guaranty a certain income flow and what they do with the money is invisible. For him that was probably the best thing to do. Not everybody can handle investment concepts. They feel better making a certain small amount of money rather than risking making a significant amount of money. That is OK.

Conclusion

I wish you well in building a profitable dividend stock portfolio. I make no claim that my method is the ultimate. It has worked very well for me over many years of investing and I will continue using it. Feel free to experiment with varied approaches. The market as a whole works best when all of the investors use different methods as that provides stability. Wild market swings are often caused by the large crowd acting in a generally unified fashion. That seemingly bad situation can be good as it provides opportunity for intelligent investors to buy good stocks at low prices – I seek and have profited from these opportunities. So as crazy as it sounds, some degree of idiocy is good for the market. The worst case scenario is that all the market players follow exactly the same approach even if it is a good method. Keep this in mind – you do not have to win every contest. In fact that is impossible to achieve. All you have to do is to win enough to make money over time. That is readily possible as long as the global market is expanding. It is not a crap shoot as some say. It is mostly skill although good luck is not to be rejected. Do not invest if a volatile market is going to worry you. The market always has been and always will be volatile. There will be periods of time when the market is down for years. But the long term trend is up as the global economy keeps expanding. Dividends, even if some companies cut their dividends, provide nice income even in a down market. Ignore the fact that the paper value of your portfolio is down when the market is depressed – savor your dividend checks. That will correct soon enough when market conditions improve – and they will. If the market was never to improve then it would make no difference where you put your money – you would either lose here or lose there. Keep that in mind.