Get a Rise Out of Your Dividends: The Changing Metrics of Successful Investment

23 October 2014
By **Michael Fraiman**
Contributor

There are any number of metrics by which we can judge sound investments. Typically, investors flock to low volatility with high returns—established corporate bonds, treasury bills, or secure banks. But there's another lens through which we can distinguish successful investments: dividend growth.

Arguably the most shocking part of this concept is how few investors actually utilize it. While fully grown companies pay out dividends to every investor in quarterly earnings, not many of those same investors look at the percentage by which those dividends have risen each year. This is a significant oversight, as dividend growth is one of the most telling metrics in investment.

Dividends, of course, are more than just a given sum. To understand their full potential as market indicators—as well as their long-term market value—dividend growth must be looked at through a critical lens in order to ensure a diverse and thriving portfolio for years to come. It can eliminate a great amount of perceived risk, and clarifies much of the status of a given company.

Putting it into practice

One of the most prominent proponents of this dividend growth-

first mindset is Lowell G. Miller, president and founder of Miller/Howard Investments, Inc. and author of "The Single Best Investment: Creating Wealth with Dividend Growth." Miller/Howard portfolios are heavily weighted against conventional cap-weighted indexes, instead favouring companies across all markets that consistently raise dividends and have proven histories of distributing secure payouts.

Its keynote index, the largely midstream Miller/Howard MLP Fundamental Index, is comprised of 25 MLPs, mimicked by C-Tracks ETN, which routinely outperform both the Alerian MLP Index and S&P 500 Index based on a strategy including energy commercial values, infrastructure, utilities and income-equity broad market stocks. This index is based primarily on Miller's dividend growth-driven mentality, and its success is proof of the methodology.

Dividend growth can capture the reason stocks succeed or fail with almost scientific accuracy. Regardless of outside forces which might affect stock market results, dividend growth is consistent, Miller argues, and leads to higher returns than any other available metric.

In his book, Miller cites a basic example: he creates a comparison between two bonds, each with equal credit ratings and time to maturity. One pays $100 annually; the other, $200. The $200 bond will sell for twice as much as the $100 bond, and after that, their yield percentage will remain roughly the same. "The important point is that an instrument that produces income is valued based on the amount of income it produces," Miller writes. "And if it produces more income, it is worth more. The same would be true for, say, an apartment building—the more income it produces, the higher the market value. Or a hardware store—again, the more income, the more an owner could get for the store if he wanted to sell the business."

> "Dividend growth can capture the reason stocks succeed or fail with almost scientific accuracy."

The reason this methodology works is that, this way, investors receive not only a greater income year-over-year, but also a rising stock price. This is because the stock itself becomes worth more while the income it produces increases. In this lens, investors are doubling up on high-yield stocks with rising dividends, garnering both income to meet (or surpass) inflation, as well as the effect of rising income on the base stock price, which, in turn, forces the stock to price higher. Value leads to value: rising income doesn't just increase the yields themselves, but also the stock that produces them.

> In his book, Miller cites a basic example: he creates a comparison between two bonds, each with equal credit ratings and time to maturity.

Results that matter

Energy MLPs are perfectly poised for this sort of analysis. Together they moderate $28 billion, and have been the source of a steady flow of stable income compared with other sectors. Plus, they pay higher dividends due to the comparatively low level of competition in the industry—the opposite being true of, say, tech stocks, which fluctuate wildly with little predictability, passing fads and increased obsolescence.

But even still, dividend growth isn't the only metric Miller/Howard focuses on. Distribution coverage, EBITDA and projected capital investment all play a role as well—the common theme among them is that they don't focus on a market cap-weighted index. The focus on EBITDA, for instance, grows from the certainty of safe distribution and the company's financial security.

This shifts the index's market focus towards quieter players in the energy sector, drawing attention away from the top 10 industry names (typically oil companies) and towards promising, secure, developing MLPs outside that specific sector, diversifying the entire portfolio and encouraging untapped market growth. In this light, too, a shift towards dividend growth makes sense—by breaking free of the previously conceived-of shackles and embracing a new, modern investment methodology.