Alley Company Commentary
Managing Dividend Portfolios – More Art than Science

"The prime purpose of a business corporation is to pay dividends regularly and, presumably, to increase the rate as time goes on."
-Benjamin Graham

Dividends have long been an attractive feature of investing. They represent a positive cash return on an investor's capital irrespective of the ebb and flow of stock prices. The dividend yield for an investor is the expected annual income divided by the current stock price:

$$Dividend\ Yield = \frac{Dividends\ per\ Share}{Current\ Stock\ Price}$$

Constructing a portfolio of dividend-paying stocks can appear to the layperson to be an elementary process. Simply compile a list of the highest-yielding companies, sprinkle some weighting into each of these "bargains", and presto, you have a dividend portfolio!

This "reach for the highest yield" approach, however, can be shortsighted. Within the past decade it would have led the average investor into ill-timed investments in banking and insurance companies in 2008, energy master limited partnerships (MLPs) in 2015, and the former blue-chip General Electric (GE) in 2017. Despite enticing dividend yields, these stocks turned out to be anything but bargains, as investors, in many cases, stomached poor performance and ultimately harsh dividend cuts as the underlying fundamentals of the businesses could not support the dividend payments.

Managing a portfolio that can tap the true long-term power of dividend income requires a more thoughtful approach. In this commentary, we examine the importance of:

1. **"Quality" dividend income**
2. **Balance within the portfolio management process**
3. **Dividend growers as a complement to higher yielding companies**

Alley Company LLC
585 Bank Lane, Suite 2400
Lake Forest, IL 60045
Phone 847-482-0938
Fax 847-482-1237
www.alleycompanyllc.com

QUALITY

Not all dividends are created equally. Sustainable dividends come from businesses that have strong recurring revenues, stable cash flows, conservative balance sheets, and moderate payout ratios.

Businesses that are highly cyclical or have too much debt on their balance sheets are inherently lower quality in nature. The reason is that the risk profile of these companies is generally higher given the peaks and valleys of profitability; and, a heavy debt load can weigh on a business should the company enter into a tough operating environment.

To illustrate the point, consider the U.S. auto industry. These companies have historically struggled to produce consistent profits, at times sought bankruptcy protection, and have overseen haphazard dividend programs. The lack of consistency in profitability within this particular industry has translated into inconsistent dividend payments for shareholders.

Ultimately, it is the *quality* of the business that dictates the *quality* of the dividend income!

BALANCE

Striking an appropriate balance of sectors is an important element of managing dividend-oriented portfolios. Just as boats that have too much weight loaded to one side of the vessel can make for a volatile and rocky ride for passengers, so too can portfolios that lean too heavily into certain areas of the market.

Today, the sectors with the highest average dividend yields are Telecom, Utilities, Real Estate, and Consumer Staples. For the investor that is singularly focused on yield, a portfolio with a narrow group of sectors can invite unintended risks. Notwithstanding some positive attributes of these sectors, they are by no means immune from changing business conditions, including shifts in interest rates and new competitive threats.

An income-focused approach that lacks sector diversification can also lead to missing out on opportunities elsewhere within the business landscape. Attractive investments can be found in many sectors of the market and casting a wider net can add “balance” and enhance a portfolio’s overall level of diversification.

DIVIDEND GROWTH

Mature industries, where the re-investment opportunities are limited, often contain companies with moderate overall growth prospects and high dividend yields. While the upfront yield from these companies is attractive, the annual dividend growth rate can be muted due to slower cash flow growth. Dividend growers are an excellent complement to higher yielding companies as they augment the future income stream of a portfolio.

In a previous commentary, The Power of Dividend Growth, we noted how consistent dividend growth can produce remarkable results. For example, if a company with a current dividend yield of 2.5% were able to grow its dividend at a pace of 10.0% annually, the dividend yield ten years hence would be 6.5% (assuming no change in the stock price). Interestingly, a company with a *higher* current dividend yield of say 4.0% that exhibits only 3% annual growth would actually have a lower dividend yield after ten years by comparison (see chart below).

Impact of Dividend Growth over Time

Starting Dividend Yield and Annualized Dividend Growth Rate	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
2.5% @ 10% Dividend Growth	2.75%	3.03%	3.33%	3.66%	4.03%	4.43%	4.87%	5.36%	5.89%	6.48%
4.0% @ 3% Dividend Growth	4.12%	4.24%	4.37%	4.50%	4.64%	4.78%	4.92%	5.07%	5.22%	5.38%

High dividend yield companies and dividend growers both bring positive characteristics to a portfolio — blending them together allows for an investor to benefit from an *attractive upfront yield* and a *growing income stream*.

Conclusion

Constructing and managing dividend portfolios is more of an art than a science. Rigidly focusing on just one attribute, such as the level of the current dividend yield, can have unintended consequences. Expanding the process to contemplate the ***quality*** of a company (and its dividend payment), striking the right overall ***balance*** among sectors, and including companies that provide attractive dividend ***growth*** can go a long way towards achieving the desired goal of generating attractive risk-adjusted total returns for investors.

Alley Company, LLC

Alley Company, LLC is a private money management firm based in Lake Forest, Illinois. The firm was founded in 1998 by Steven J. Alley to operate a disciplined investment philosophy for clients in a separate account format.

The **Alley Company Dividend Portfolio** seeks to achieve a balance between attractive absolute dividend yield and strong dividend growth underpinned by quality company fundamentals. Our results are achieved by maintaining portfolio holdings in companies with strong financial condition, strong relative earnings power, astute management, and a culture of returning capital to shareholders through dividends. For more information, please visit our website at www.alleycompanyllc.com or contact us at 847-482-0938.

October 2018