Dividend Growth Is The Hidden Key

Exerpt from The Single Best Investment **by Lowell Miller**

But there's one feature of the stocks we want to use we haven't discussed yet, and it is the hidden key to the Single Best Investment. A moment's reflection will confirm for you that this is an absolutely powerful secret, and yet there are very few investors actually using it. If this were not the case, if this factor were in widespread use, you would see a nation of happy investors whistling their way toward retirement. But you don't. All you see are nervous nellies, checking the price of the Dow Jones daily and intra-day, scanning the most-actives list for some key to the future, subscribing to the newsletters filled with hyperbole and sketchy research, breathlessly hanging on every word of some smug talking head on the business news channel.

This hidden key is, in a simple phrase, **dividend growth.**

As we know, mature companies pay dividends from their earnings. Every quarter the company sends a check to investors, sharing a small fraction of the profits, and many investors love those checks. The feature that few have heeded, though, is that a significant number of companies raise their dividend every year (or nearly every year). To most, this seems merely a nice amenity, but because most people don't have a long-horizon worldview, they totally underestimate the potency of this factor. It is, in fact, the electricity that will make your compounding machine run. It's the gas for your engine. Dividend growth is the critical piece in the puzzle for creating a portfolio that will serve you over the years.

Pay attention. This is a simple idea, but is also the single most important idea for long-term investors. The reason it is so important is that dividend growth drives the compounding principle for individual stocks in a way that is certain and inevitable. It is an authoritative force that compels higher returns regardless of the other factors affecting the stock market.

Let's say you have two bonds with equal credit ratings and equal time to maturity. Bond A pays you $100 per year and bond B pays you $200 per year. Which bond will have a higher price? Of course bond B will sell for twice the price as bond A, at which point they will both offer the same percent yield. The important point is that an instrument that produces income is valued based on the amount of income it produces. 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.

What makes rising income that comes from a growing dividend so attractive in a yield stock? You not only receive greater income as the years go by, you also get a rising stock price---because **the instrument producing the income (the stock) is worth more as the income it produces increases.** In effect, you get a "double dip" when you invest in high-yield stocks that have rising dividends. You get the income that increases to meet or surpass inflation, and you get the effect of that rising income on the stock price, which is to force the stock price higher.

That last paragraph has phrases in bold, and phrases in italics and some phrases are underlined. These are for emphasis. If I could get words to jump off the page and pull on your sleeves or tweak your nose, I would. But I'm stuck with words, so the least I can do is suggest that you read the last paragraph again, and remember it, and remember it well. And I can repeat, and repeat, so you don't forget: **you get rising income, and the increasing income makes the stock that's producing that income increasingly valuable.**

Dividends Tell The Truth

Dividends and dividend growth are the real-life signal that a company has the wherewithal to pay you dividends, that is has your interests at heart in the fact that it pays you dividends, and that it is experiencing real growth as proven by the real growth in its real dividends.

Bear in mind that we're not dealing here with some financial trick or some ponzi scheme run by unscrupulous corporations intent on boosting the price of their stock. On the contrary, the very attention we place on rising dividends puts us squarely in the position of "owners" of a company, of true investors who understand that a satisfying and reasonable return from a stock investment isn't a gift of the market or luck or the consequence of listening to some market maven, but it is the logical and inevitable result of investing in a company that is actually doing well enough, in the real world, to both pay dividends and to increase them on a regular basis.

Dividends are paid from earnings. When a company has reached a certain level of maturity and stability, it begins paying dividends, not unlike the way in which an individual begins saving once she's reached a level of income that satisfies her basic needs.

But many companies perceive an earnings report as an opportunity for "creative accounting." Sales can be booked early or late. Liabilities are written off right away or amortized. Contracts might be recorded as immediate income or only as and when paid. Capital asset sales are sometimes deemed ordinary income. There are a million ways for companies to "look good" at earnings time, in hopes of supporting their stock prices. Don't forget, a huge share of corporate executives' compensation, and often their very jobs, are dependent on either meeting their earnings objectives or increasing the stock price, or both. So companies have a big incentive to "put their best foot forward."

That's why dividends are a kind of acid test or litmus paper which reveals the true state of a company's finances. As Geraldine Weiss so aptly observed, "dividends don't lie." In order for a company to pay a dividend, it must have the money to pay it with. Earnings can't be some accounting sleight-of-hand. They must actually be there, in cash. Thus, while we as passive investors can never know as much about the companies we invest in as we'd like, we can know one thing: if a company pays a dividend it has the cash with which to pay that dividend.

Further, a company that raises its dividend is truly signaling the state of its business to investors. Picture a boardroom, and the classic board of directors table filled with wizened business people, people who know that there are fads and fashions and cycles, and things can go up and down, and even go bump in the night. These directors know just how well their company is doing or how poorly. They know how much will be needed to fund capital expansion or research and development, or the next takeover. They know the whole financial picture, and they also know that dividend reductions are death to stock prices. The one thing a board never wants to do is decrease the dividend, so increasing a dividend is a clear statement that the company’s fortunes are positive---or at least positive enough to keep paying and to raise the dividend.

In other words, a company can tell you about its earnings, but there is always a certain “flexibility.” There is no flexibility when it comes to paying and increasing dividends. The company must have the cash to pay to you. What you see is what you get. Through the dividend, a company can **show** you how well it’s doing.

So dividends are real, like the income from an apartment building or from a liquor store or from a bank CD. And dividend growth is real. Neither dividends nor dividend growth are some propaganda from the company, nor some hype from a brokerage firm or newsletter writer, nor some error in judgment by a finance magazine.

This is a good thing, for we wouldn’t want to build our compounding machine on a foundation of chimera and public relations ploys. We want our parts to be real, working, brand-name, durable.