4 fundamentals of dividend investing

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Looking for reliable income? Consider a strategy that focuses on rising dividends from companies with growing free cash flow.

Investing for income is a perennial challenge. For many investors, the goal is not only to generate a sufficient stream of income but also to grow their assets to maintain future purchasing power. We believe a disciplined strategy that focuses on rising dividends from companies with growing free cash flow is a vital component to accomplishing this goal.

1. **Dividend growth.** When investing for dividends, it's important to consider a disciplined strategy that focuses on dividend growth rather than yield alone. A high-yield strategy doesn't necessarily translate into a reliable stream of income because the highest yields may not be sustainable. We believe the best opportunity for success in a dividend strategy is with the stocks of companies that can sustain and grow their dividend over time. And it's important to consider that returns from these stocks generally have less variability.
2. **Sustainable free cash flow.** Companies need cash, not only to pay dividends but also to grow their business. If a corporation generates cash returns that exceed what it needs to grow its asset base (i.e., the company is left with free cash flow), then it will have the firepower for dividend growth. Dividends that aren't supported by free cash flow may not be sustainable.
3. **Payout ratio.** Investors often look to the payout ratio based on a company's earnings, but this can be misleading — earnings are based on accrual accounting, and that can be manipulated. To assess a company's true potential to grow dividends and avoid dividend cuts, we prefer to focus on the percentage of annual operating free cash flow consumed by the dividend.
4. **Active management.** Assessing a company's ability to raise its dividend is critical. A history of paying dividends doesn't necessarily mean a company can increase or even maintain a dividend in the future. For example, many banks had a long history of paying and even growing dividends prior to the great financial crisis, but excess leverage forced most of them to cut or eliminate them. Active management, supported by fundamental sector research, can help identify and avoid these types of situations.

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The bottom line

When you're building an income portfolio, it's important to consider both income and growth to maintain purchasing power over time. Fundamentally, we believe that dividend growth matters a lot more than current yield.

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