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**Lawrence Carrel**

*Author, ETFs for the Long Run*



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**by Lawrence Carrel**



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# About the Author

**Lawrence Carrel** is a seasoned financial journalist and author of *ETFs for the Long Run: What They Are, How They Work, and Simple Strategies for Successful Long-Term Investing* (Wiley). He currently writes a blog of the same name at [www.ETFsForTheLongRun.com](http://www.ETFsForTheLongRun.com).

After working as a newspaper reporter and editor, Carrel got in on the ground floor of the online publishing business when financial news entered the Internet age. As a founding staff member of The Wall Street Journal.com, he was one of the original writers of its *Cyber Investing* column and among the first to write about small stocks for the Web. Later at SmartMoney.com, his daily market commentary tracked the dot-com bubble and the crash of 2000. A year later, he created SmartMoney's daily online hot stocks column, *The One-Day Wonder*. Over five years, he reported on nearly 1,200 different companies in almost every industry.

In 2006, Carrel originated SmartMoney.com's *Under the Radar* column, which looked for investments among small stocks, and the *ETF Focus* column just as the exchange-traded fund (ETF) industry began its era of explosive growth. In 2007, he took over the weekly ETF and mutual funds columns at TheStreet.com. While there, Carrel predicted the 2008 stock market decline in August 2007 and told readers to start shorting the market with ETFs. He was also the first to report on the connection between the subprime mortgage crisis and the plunge in municipal bonds. And a year before it happened, he was the first to focus on the possibility of money market funds "breaking the buck."

For three years, Carrel served as a daily contributor to *The Wall Street Journal This Morning* radio show and has been a guest commentator on MSNBC, CNN, and numerous other news networks. He has addressed the NASDAQ Stock Market as an ETF expert, and served as a founding featured journalist on The Investor Network, a social network for investors. In addition, his work has appeared in *The Wall Street Journal*, *Barron's Online*, Bankrate.com, *The Big Money*, *ETF Report*, *Financial Planning*, *Hard Assets Investor*, IndexUniverse.com, and *Structured Products*. In a break from financial journalism, Carrel worked as a contributing editor on the college humor compilation, *Lunacy: The Best of the Cornell Lunatic* (Lunatic Press). A native of Buffalo, New York, and a graduate of Cornell University, he lives in New York City with his two sons.

# *Dedication*

To Judy Hayes, who believed in me when no one else did.

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# Introduction

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**T**he purpose of the stock market is to enable companies to raise the capital they need to start or grow their businesses. Instead of borrowing money from a bank and paying interest on it, a company can sell shares of itself to investors. Over the years, the stock market has gone from being a respectable venue for investors to purchase partial ownership in companies to something more akin to a casino. Seduced by reports of individuals earning millions nearly overnight by investing in high-growth stocks, speculative investors poured money into many companies that offered nothing more than a promise of sales and profits, further inflating share prices. When the needle point of reality finally popped the bubble, the poor unfortunates who failed to cash out their chips early enough were blown away like dust.

Fortunately, the deflated bubble (along with some dividend-friendly tax legislation) brought many investors down to earth and back to the basics — investing in companies with a proven track record of earning profits and paying dividends. As they return to the fold, investors are beginning to realize what their parents, grandparents, and great-grandparents already knew — dividend investing offers a host of benefits that provide a safer and often more profitable way to invest in the stock market.

Dividend investing is nothing new. In fact, since 1602, when the Dutch East India Company became the first corporation to issue stock, dividends have been the primary way for investors to receive profits from their investments without dissolving the company or selling the investment. However, following a dividend-investment strategy is new to many modern investors who've been focused solely on growth investing. If you count yourself among this crowd or are just starting out and plan on investing in dividend stocks, you've come to the right place. *Dividend Stocks For Dummies* contains all you need to know to develop your strategy, find and evaluate potentially good dividend stocks, manage your portfolio, and avoid the most common and critical mistakes.

## *About This Book*

I'd love to be able to hand you a list of stocks and send you off with instructions to buy each one, but investing doesn't work that way. Every investor is different. You have a unique personality, specific goals, and a tolerance for risk that's different from your neighbors next door or across the street. Every company is different, too, operating in a specific industry, offering unique products and services, and being managed to varying levels of success. As an

investor, your goal is to pair yourself up with investment opportunities that are a suitable match. That's what this book is all about.

In *Dividend Stocks For Dummies*, I present the idea of dividend investing and lead you through a process of self-examination to determine the type of investor you are, identify your goals, and develop an overall strategy that can move you most efficiently (and safely) from point A to point B. I show you how to find promising candidates and how to then evaluate them by using time-tested criteria so that you choose the best stocks to meet your needs. I mention some historically well-performing stocks you may want to check out, show you various ways to buy and sell shares, and offer guidance on managing your portfolio after you've purchased some shares.

The best part about this reference book is that *you* decide where to start and what to read. I've written every chapter to stand on its own, so you can start at the beginning of the book or pick any chapter from the table of contents and dig in.

As you read, keep one important point in mind: Past performance of a stock is no guarantee of future returns. I know, I know — you've heard that one before. But it's worth repeating. What it boils down to is this: If I mention a company in this book that I think is a potentially good dividend stock, don't assume I'm telling you to buy it. You may want to look into it, but I'm not necessarily recommending it. After all, by the time you read this book, that stallion of a stock may be a bust. Whatever you invest your money in or spend your money on is entirely your choice. I provide some guidance in picking stocks that may be likely to outperform other stocks, but I provide no specific recommendations. Take all the credit for your good investment decisions, but take all the blame for bad ones, too.

## *Conventions Used in This Book*

I use several conventions in this book to call your attention to certain items. For example:

- ✓ *Italics* highlight new, somewhat technical terms that I follow up with straightforward, easy-to-understand definitions.
- ✓ **Boldface** text indicates key words in bulleted and instructive steps numbered lists.
- ✓ `Monofont` highlights Web and e-mail addresses.
- ✓ When this book was printed, some Web addresses may have needed to break across two lines of text. If that happened, rest assured that we haven't put in any extra characters (such as hyphens) to indicate the break. So, when using one of these Web addresses, just type in exactly what you see in this book, pretending as though the line break doesn't exist.

## What You're Not to Read

You can safely skip anything you see in a gray shaded box. We stuck this material in a box (actually called a *sidebar*) for the same reason that most people stick stuff in boxes — to get it out of the way, so you wouldn't trip over it. However, you may find the case studies and brief asides in the sidebars engaging, entertaining, and perhaps even mildly informative. You can also pass over text tagged with a Technical Stuff icon; it's technical or historical information that isn't vital to understanding the topic at hand.

## Foolish Assumptions

While writing this book, I made a few foolish assumptions, mainly about you and how much you know about investing:

- ✔ You have a general understanding of investing and your investment options, including CDs (certificates of deposit), money market funds, stocks, bonds, mutual funds, real estate, and so on. If you don't, check out *Investing For Dummies*, 5th Edition, by Eric Tyson (Wiley).
- ✔ You grasp the basics of stock market investing. I provide a brief refresher in Chapter 2, but to develop a deeper understanding, check out *Stock Investing For Dummies*, 3rd Edition, by Paul Mladjenovic (Wiley).
- ✔ You realize that investing always carries some risk, that some risks are greater than others, and that *not* investing can also be risky.
- ✔ You have some money (capital) to invest. It doesn't need to be stuffed in your pocket or sitting in a bank account. It can be money you already have invested, perhaps sitting in an IRA or 401(k).
- ✔ You want a safer way to invest your hard-earned dollars, so you're interested in introducing or adding more dividend stocks to your portfolio.

## How This Book Is Organized

Although I encourage you to read this book from cover to cover to maximize the return on your investment, *Dividend Stocks For Dummies* presents the information in easily digestible chunks so that you can skip to the chapter or section that grabs your attention or meets your current needs, master it, and then skip to another section or simply set the book aside for later reference.

To help you navigate, I divvy the 22 chapters that make up the book into six parts. The following sections provide a quick overview of what's covered in each part.

## ***Part I: Introducing Dividend Investing Basics***

Share prices grab headlines. Dividends don't. As a result, investors are often in the dark about dividend investing, even if they're well-schooled in picking stocks based on share price alone.

In this part, I bring you up to speed with a brief primer on dividend investing, explore dividend stocks in a little more detail, and then reveal over a half-dozen advantages that dividend stocks offer.

## ***Part II: Selecting an Investment Approach and Picking Stocks***

Picking stocks is like playing matchmaker for yourself. When you're looking for a date, you need to know who you are and what you're looking for before you start skimming the personal ads. In the same way, you need to know what type of investor you are and your overall investment strategy so that you can find a suitable match.

The first couple of chapters in this part show you how to perform an investor self-assessment, which includes gauging your tolerance for risk, so that you can determine what kind of investor you are and what situation you're in. Based on the results of this assessment, you can choose the investment approach that's likely to be best for you. Finally, in the last two chapters of the part, I show you how to identify stocks that pay dividends and then how to evaluate them to pick the best dividend-paying stocks of the bunch.

## ***Part III: Exploring Income-Generating Industries***

The stock market groups businesses by market sector, which can be a single industry or a combination of connected industries, including consumer staples, energy, transportation, technology, utilities, and health care. Companies in certain sectors are more likely to pay dividends than companies in other sectors. In addition, some companies within a sector are generally better income-generating (dividend-paying) companies than others.

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The chapters in this part introduce you to the sectors that are better known for paying dividends. For each sector, I explain the types of companies included in the sector, why companies in the sector are more likely than companies in other sectors to pay dividends, and what to look for when considering companies in this sector. For each sector, I also provide a list of companies that have had a pretty good track record for paying dividends.

## ***Part IV: Checking Out Dividend Investment Vehicles***

Not so long ago in a land not very far away, the only way to invest in the stock market was to buy shares directly from the company or from other investors. Since then, some inventive souls have developed all sorts of ways to buy and sell shares. This part introduces you to the most common and effective methods as they relate specifically to dividend investing.

Here, you discover how to reinvest your dividends one drop at a time with dividend reinvestment plans (DRIPs), eliminate the middleman (or woman) with direct purchase programs (DPPs), diversify through mutual funds and exchange-traded funds (ETFs), and invest in foreign companies that pay dividends without having to exchange your dollars for euros or yen.

## ***Part V: Managing Your Portfolio***

Although other parts of this book address the intricacies of dividend investing, including analyzing specific companies, this part takes a step back to reveal big-picture tasks, including coming up with a solid strategy, examining various ways to buy and sell shares, and monitoring tax legislation so that you can keep more of your earnings.

## ***Part VI: The Part of Tens***

Every *For Dummies* book includes a Part of Tens, and I didn't want to be the first author to break rank, so I included one in this book, too. In this part, I cover the ten most prevalent myths and misconceptions about dividends and ten common dividend investing mistakes (along with suggestions on how to avoid them). As a bonus, the end of the book also includes an appendix of Dividend Achievers.

## Icons Used in This Book

Throughout this book, you can spot icons in the margins that call your attention to different types of information. Here are the icons I use and a brief description of each:



Everything in this book is important, but some of it's more important. When you see this icon, read the text next to it not once but two or three times to brand it on your brain cells.



Tips provide insider insight from behind the scenes. When you're looking for a better, faster, safer, and/or cheaper way to do something, check out these tips.



This icon appears when you need to be extra vigilant or seek professional help before moving forward.



Investing has its fair share of highly specialized language and concepts that typically flies above the heads of mere mortals. Whenever I explain something highly technical, I flag it with this icon so that you know what's coming.

## Where to Go From Here

*Dividend Stocks For Dummies* is designed to appeal to a universal audience of intermediate and experienced investors at all stages of developing and managing their investment portfolios.

For the new dividend stock investor, I recommend you read the book from cover to cover starting with Chapter 1. More experienced dividend stock investors who already know themselves and their goals and have an effective strategy in place to reach those goals may want to skip to Chapter 7, where I show you how to track down income-generating, dividend paying stocks, or Chapter 8, where I show you how to evaluate them.

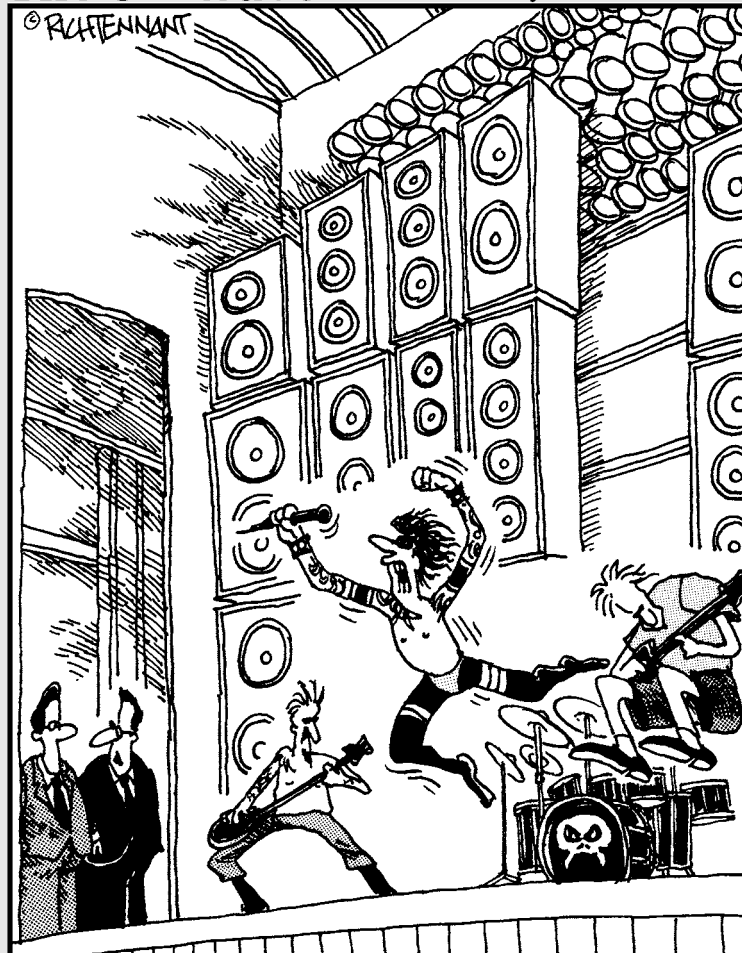
Regardless of your experience, however, feel free to skip around and read whatever catches your interest. Each and every tidbit of knowledge and insight you acquire can only serve to make you a more astute investor.

# Part I

# Introducing Dividend Investing Basics

The 5<sup>th</sup> Wave

By Rich Tennant



"It's surprising considering his portfolio is so conservative."

## *In this part . . .*

**I**f you can't tell the difference between dividend stock and livestock, you've come to the right place. In this part, I lead you on the nickel tour of what dividend investing is all about, reveal the bare essentials of dividend stocks and how they differ from their non-dividend paying counterparts, and showcase the numerous advantages you can reap by investing in dividend stocks.

## Chapter 1

# Wrapping Your Brain Around Dividend Investing

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### *In This Chapter*

- ▶ Understanding dividend stocks and their benefits and risks
  - ▶ Preparing to become a savvy dividend stock investor
  - ▶ Knowing what to look for as you shop for dividend stocks
  - ▶ Monitoring and adjusting the holdings in your portfolio
- 

**I**nvesting is a lot like car shopping on a budget. When you're shopping for a car, you usually have at least a vague notion of how much car you can afford, and you want to get the most car for your money without getting stuck with a lemon. When you're shopping for investments, you want the biggest bang for your buck without exposing yourself to more risk than your strategy calls for. And you have plenty of choices of where to put your money — stocks, bonds, mutual funds, money market accounts, real estate, or even socking it away in the bank.

For many investors, dividend stocks offer the best of both worlds — a healthy balance of risk and return. Investors receive the benefits of both share price appreciation and the ability to realize profits through *dividends* (cash payments) without having to sell shares. (Later in this chapter, I list more of the many benefits of dividend stocks, and in Chapter 3, I explain them in greater detail.)

In this chapter, I pack the essentials of dividend investing into a nutshell, starting with the bare basics, such as defining what a dividend is, and taking you to the very end — managing your portfolio after you populate it with promising dividend stocks. Along the way, I reference other chapters in this book where you can find additional information and guidance on each topic.

## Coming to Terms with Dividend Stocks

*Dividend stocks* are stocks that pay dividends — payments in cash (usually) or shares (sometimes) to stockholders. Through dividend payments, a company distributes a portion of its profits to its shareholders every quarter and pumps the remaining profits back into the company to fuel its continued growth.



The percentage of total profits a company pays in dividends to shareholders is called the *payout ratio*. For more about payout ratios and how to use the number in evaluating dividend stocks, check out Chapter 8.

In the following sections, I explain the purpose of dividends, reveal several potential advantages of investing in dividend stocks, and remind you that investing in anything always carries some risk.

### Understanding why companies pay dividends

Successful companies are profitable companies. They earn money, and they can use that money in several ways:

- ✓ **Reinvest it:** Companies usually invest a good chunk of their profits, if not all of them, into growing the business.
- ✓ **Pay down debt:** If, in addition to selling shares, companies borrowed money to raise capital, they may use profits to pay down the debt, thereby reducing the expense of their interest payments.
- ✓ **Buy back shares:** Companies may use profits to buy back shares that they feel are undervalued, or for other reasons. In some cases, they initiate buybacks to artificially inflate the share price and improve investor confidence in the company.
- ✓ **Pay dividends:** Paying dividends is a form of *profit sharing* — spreading the wealth among the company's owners, the shareholders.

A company's dividend policy generally reflects the board of directors' and shareholders' preferences in how to use profits. Two schools of thought govern their decision:

- ✓ **Pro growth:** This school believes a company is better off reinvesting its profits or using profits to pay down debt or buy back shares. This strategy makes the company more valuable, and the share price rises accordingly. Shareholders benefit when they sell their shares for more than they paid for them.