HOW TO PICK DIVIDEND STOCKS
How to Pick Dividend Stocks

by David Peltier

Not all dividends are created equal. It is not always easy to decide which ones are good investments simply by looking at their stock offerings. This primer will give readers an idea of what I look for in good dividend stocks; and also what red flags cause me to avoid unsustainably high yields.

Being an investor is a little like having a crystal ball. You need to be able to look at the past, present and the future. In general when you’re evaluating a dividend-paying stock, the primary thought should be the viability and sustainability of the dividend itself. How is this determined? We look at past performance.

One way is to take a look at a company’s dividend history. While it’s never possible to predict the future from the past, some companies have exhibited a tendency to raise their payouts annually. It’s also wise to seek out yields that are trending toward the higher end of the industry and the company’s historical range.

However, earnings power alone is not the ultimate gauge for dividend stocks. A lot of the same fundamental homework that goes into picking growth stocks will still apply here, but you need to add a layer of fixed-income-like analysis.

In other words, it’s also important to look at the present, which a company’s current balance sheet. While a quick glance at the ratings from the major agencies help, we’re generally looking for a manageable level of debt and a solid cash position. The clearest danger to a dividend is a lack of cash flow.

ABOUT THE AUTHOR

Meet David Peltier, Portfolio Manager Dividend Stock Advisor

David Peltier joined TheStreet, the leading financial information and investment resource firm, as a research associate in August 2001. In addition to Dividend Stock Advisor, he also writes and manages the very popular Stocks Under $10. David has managed products that covered deep-discount value investing and used dividend stocks as part of a retirement savings portfolio. Today, thousands of investors—from individual to institutional—rely on him for his expertise and insights into high potential, long-term investing strategies and stock picks.

David graduated from New York University’s Stern School of Business with a degree in Finance. Prior to TheStreet, he was an analyst for Individual Investor magazine and its website. In addition to his regular video appearances for TheStreet, he has been a guest on NPR, Nightly Business Report, CNNfn, WNYW-TV and presented at The Money Show. David also hosts a live monthly chat on Twitter (@davidspeltier).

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A dividend stock that stops paying its dividend is of little value to anyone’s portfolio. Remember that while more than 75% of the companies in the S&P 500 offer a dividend, the payout remains a luxury, not a necessity. Other bills, namely interest on debt, must be paid before investors can be rewarded with a dividend. When a company has weak cash flow, the dividend is among the first costs to be cut.

How do you find a “safe” dividend? I look for companies whose operating earnings and cash flow can cover their annual payments at least two times over. This gives management some leeway if business slows down and earnings decline in the future.

It is possible, in the near term, to cover the dividend with cash on hand or to raise capital through debt or equity offerings to prop up dividends. However, most companies will struggle to sustain this practice for more than a quarter or two.

On a final note, the highest yields rarely offer the best dividend investments. Rather, the premium to the 10-year Treasury note or the average stock in the S&P 500 reflects a higher risk to the sustainability of the dividend.

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