NICO Asset Managers

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INVESTOR'S GUIDE

A guide to the financial markets, investments and the economy
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Topic 291: Dividend paying stocks

While the basic investment strategy of "buying low and selling high" tends to provide a simple and practical formula to profit in a market with rising prices, it may be difficult to sustain when prices are falling.

For investors looking to preserve wealth when stock prices are falling it is better to follow a strategy called defensive investment which involves purchasing "dividend paying" stocks rather than "growth" stocks. Although dividend paying stocks may not offer as high a payout as the return on growth stocks, an investor is more likely to weather downturns in the market if they can identify qualities that make a good dividend stock.

Different indicators can be used to determine if a stock is a good dividend paying stock including the following ratios which can be calculated from the company's financial statements:

1.Current ratio -Investors can track the ratio between the company's current assets and current liabilities. This ratio measures a company's ability to meet its short-term liabilities**.** Generally, companies with a current ratio above 1.5 may be more flexible to make a dividend payment. A high current ratio may still need to be considered with some caution though as a large portion of liquid assets may not necessarily imply a company will channel all the cash to dividend payments.

2. Payout Ratio -Many companies may choose to reinvest capital to promote growth or pay down long-term debt. Therefore, a company's payout ratio, which is a ratio that represents the percentage of its earnings that it channels to dividends would be a good indicator to watch.

Too high payout ratios may bring into question the company's ability to sustain such dividend payments. There are exceptions however as companies with generally stable earnings, such as utilities and health care, may post higher payout ratios without indicating risk.

3. Dividend Growth -Any given company can pay an occasional dividend or make steady payments to its investors on a regular basis. Companies that are likely to pay future dividends are those which have a history of dividends that consistently increase.

These companies are thus not only maintaining their profitability but improving it and passing those increases on to shareholders. Companies that display a history of dividend growth for five or more years are the most solid dividend-stock purchases.

4. Price to earnings ratio -The ratio of the company's current price to its earnings can also be considered. Ideally, companies with low price/ earnings ratios would be considered attractive for an investor who wants to buy a dividend paying stock.

5. Dividend yield ratio -A high dividend yield may be a good indicator although it is important to factor in that in real terms this indicator does not represent the future return on investment as the dividend is based on the current performance. In general, dividends are not paid out by growth stage companies as the companies reinvest profits in the business to generate higher growth.

Risks of Dividend Stocks

Historical dividends and current earnings may be strong indicators of a good dividend stock purchase, but they're no guarantee that the company will continue to pay dividends. Downturns in the economy or a shift in priorities to reinvest earnings can lead once-profitable companies to cancel dividend payment. Lastly finding a great dividend stocks is thus more than just finding the stock with the biggest yield. Even though a stock may pay a great dividend today if the company is not generating the free cash flow it needs to fund its dividend, it might be forced to cut its dividend in the future and probably the stock price may plummet as other investors flee the falling dividend.

Head Office
19 Glyn Jones Road
Chibisa House
P.O. Box 3173
Blantyre
Tel No: 01 832 085/086 Fax: 01 821 617

Lilongwe Branch
Corner Kenyatta Drive
NICO Centre
P. O Box 30729
Lilongwe 3
Tel no: 01 757 086 Fax: 01 751 617

invest@nicoassetmanagers.com | www.nicoassetmanagers.com

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