

CHAPTER 1

Why Dividend Stocks?

Let me start by making a bold statement: The ideas in this book are one of the most important gifts you can give to yourself or your children. On the pages that follow is the recipe for generating 11% yields and 12% average annual returns for your portfolio. Significantly more if the stock market or your particular stocks cooperate.

I'm not trying to brag. I wasn't the one who thought up this strategy. I just repackaged it in a compelling, easy-to-read book that you will want to buy more copies of for all your friends and family. Or at least lend them yours.

If you follow the ideas in this book and teach them to your children, it's very conceivable that many of your concerns about income in the future will be over. And perhaps just as important, if your children learn this strategy at a young age, they may never have financial difficulties. They will have the tools to set themselves up for income and wealth far before they are ready to retire.

Keep in mind that I cannot teach you or your kids how to save. If you would rather buy a new car at the expense of putting money away, I can't and won't attempt to fix that. This book is for the people who already know how to save and are trying to make that money work as hard as they do.

As far as saving money is concerned, the only advice I'll offer can be found in one of my favorite finance books, *The Richest Man in Babylon*, by George S. Clason. In that book, first published in 1926, Clason writes: "For every ten coins thou placest in thy purse

take out for use but nine. Thy purse will start to fatten at once and its increasing weight will feel good in thy hand and bring satisfaction to thy soul.”

Many personal finance gurus proclaim the same advice, but with a more modern bent to it, stating “Pay yourself first.”

Even if you are not able to save 10% of your current income, saving anything is crucial. As you will see, the money you save and invest using the ideas in this book will grow significantly over the years. So if you can only save 8% or 5% or even 2%, start doing it now. And if you get a raise or an inheritance or win the football pool, do not spend a dime of it until you have put away 10% of your total income.

Here are some scary statistics. According to the Employee Benefits Research Institute, only 14% of Americans believe they will have enough money to retire comfortably. Even worse, 60% of workers reported household savings of less than \$25,000.

If you are serious about improving your family’s financial future—and I know you are because you’re investing the time to read this book—start saving today, if you haven’t already.

Imagine if you saved 10% of your money and put it into the kinds of dividend stocks discussed in this book. Over time, your wealth should grow to the point that it will have generated significant amounts of income, perhaps even replacing the need to work.

This is the last point I will make about saving. You didn’t spend your money on this book (or drive all the way to the library) just to have me beat you up about saving. Instead, I will assume you really are serious about securing your future and want to learn how to take those funds and add a few zeros to the end of the total number in your portfolio.

And if you’re already retired and need income right away, the strategies in this book can help you too. You may not have the ability to compound your wealth, but you can invest in companies that will generate more and more income for you every year. Not only can you beat inflation, but you can also give yourself and even your loved ones an extra cushion.

There are lots of ways to invest your hard-earned money. But you’ll soon see why investing in dividend stocks is a conservative way to generate significant amounts wealth and income. This isn’t theory. It’s been proven over decades of market history.

Some people believe that real estate is the only way to riches. Others say the stock market is rigged so that the only people who

make money are the professionals—therefore, you should be in the safety of bonds. Still others only trust precious metals. None of these beliefs is true at all.

Within the stock market, there are various strategies that are valid. Value investors insist you should buy stocks when they're cheap and sell when they're expensive. Growth investors believe you should own stocks whose earnings are growing at a rapid clip. Momentum investors suggest throwing valuation out the window and investing in stocks that are moving higher—and getting out when they stop climbing.

Still others only trust stock charts. They couldn't care less what a company's earnings, cash flow, or margins are. As long as it looks good on the chart, it's a buy.

Each of these methodologies works at some point. Value and growth strategies tend to switch on and off: One will be in favor while the other is out until they trade places. For one stretch of time, value stocks outperform. Then for another few years, growth will be stronger. Eventually, value will be back in fashion.

Whichever is in vogue at the moment, supporters of each will come up with all kinds of statistics that prove their method is the only way to go.

The same dynamic applies when it comes to fundamentals versus technicals. The technical analysts who read stock charts assert that everything you need to know about a company is reflected in its price and revealed in the charts. Fundamental analysts, who study the company's financial statements, maintain that technical analysis is akin to throwing chicken bones and reading tealeaves.

There are plenty of other methodologies as well. These include quantitative investing, cycle analysis, and growth at a reasonable price (GARP) to name just a few more.

Diehard supporters of all these strategies claim that their way is the only way to make money in the markets. It's almost like a religion whose most fanatical followers act as if their beliefs are the only truth—period, no debate, end of story. They're right and you're wrong if you don't believe the same thing they do.

I'm no authority when it comes to theology. But when it comes to investing I know this: Dogma does not work.

You will not consistently make money investing only in value stocks. Again, sometimes they're out of favor. If you only read stock charts, sometimes you'll be wrong. Charts are not crystal balls.

Quantitative investing tends to work until it doesn't. Just ask the investors in Long Term Capital Management, who lost everything in 1998.

Long Term Capital was a \$4.7 billion hedge fund that utilized complex mathematical models to construct trades. It made a lot of money for investors for several years. It was supposed to be fail-proof. But like the *Titanic*, which was also supposed to be unsinkable, Long Term Capital hit an iceberg in the form of the Russian financial crisis and nearly all was lost.

“Y'all Must've Forgotten”

During his prime, legendary boxer Roy Jones Jr. was one of the best fighters that many fans had ever seen. However, Jones didn't seem to get as much respect as he thought he deserved. So, in 2001, he released a rap song that listed his accomplishments and reminded fans about just how good he was. The song was titled “Y'all Must've Forgotten.” Roy was a much better fighter than he was a rapper. The song was horrendous.

Looking back, investors in the mid- to late 1990s remind me of boxing fans in 2001, when Roy released his epic tribute to himself. Both groups seemed to have forgotten how good they had it—boxing fans no longer appreciated the immense skills of Jones, while investors grew tired and impatient with the 10.9% average annual returns of the Standard & Poor's (S&P) 500 (including dividends), since 1961. After decades of investing sensibly, in companies that were good businesses that often returned money to shareholders in the form of dividends, many investors became speculators, swept up in the dot-com mania.

I'm not blaming anyone or wagging my finger. I was right there with them. During the high-flying dot-com days, I was trading in and out of Internet stocks too. My first “ten bagger” (a stock that goes up ten times the original investment) was Polycom (Nasdaq: PLCM). I bought it at \$4 and sold some at \$50 (I sold up and down along the way).

However, like many dot-com speculators, I got caught holding the bag once or twice as well. I probably still have my Quokka stock certificate somewhere in my files. Never heard of Quokka? Exactly. The company went bankrupt in 2002.

With stocks going up 10, 20, 30 points or more a day, it was hard not to get swept up in hysteria.

And who wanted to think about stocks that paid 4% dividends when you could make 4% in about five minutes in shares of Oracle (Nasdaq: ORCL) or Ariba (Nasdaq: ARBA)?

Did it really make sense to invest in Johnson & Johnson (NYSE: JNJ) at that time rather than eToys? After all, eToys was going to be the next “category killer,” according to BancBoston Robertson Stephens in 1999. Interesting to note that eToys was out of business 18 months later and BancBoston Robertson Stephens went under about a year after that.

If, in late 1998, you invested in Johnson & Johnson, a boring stock with a dividend yield of about 1.7% at that time, and reinvested the dividends, in late 2011, you’d have made about 8.6% per year on your money. A \$3,000 investment would have nearly tripled.

Johnson & Johnson is a real business, with real products and revenue. It is not as exciting as eToys or Pets.com or any of the hot business to business (B2B) dot-coms that took the market by storm.

But 13 years later, are there any investors who would complain about an 8.6% annual return per year? I doubt there are very many—especially when you consider that the S&P 500’s annual return, including reinvested dividends, was just 2% during the same period.

Now, you might have gotten lucky and bought eBay (Nasdaq: EBAY) at \$2 per share and made 16 times your money. Or maybe you bought Oracle and made 5 times your money. But for every eBay and Oracle that became big successful businesses, there were several Webvans that failed and whose stocks went to zero.

In the late 1990s, the stock market became a casino where many investors lost a ton of money and didn’t even get a free ticket for the buffet. It doesn’t seem that we’ve ever completely returned to the old way of looking at things.

My grandfather, a certified public accountant who owned a seat on the New York Stock Exchange, didn’t invest in the market looking to make a quick buck. He put money away for the long term, expecting the investment to generate a greater return than he would have been able to achieve elsewhere (and possibly some income).

He was willing to take risk, but not to the point where he was speculating on companies with such ludicrous business ideas that the only way to make money would be to find someone more foolish than he to buy his shares. This is an actual—and badly flawed theory used by some. Not surprisingly, it is called the Greater Fool Theory.

There were all kinds of companies, TheGlobe.com, Netcentives, Quokka, to name just a few, whose CEOs declared we were in a new era: This time was different. When I asked them about revenue, they told me it was all about “eyeballs.” When I pressed them about profits, they told me I “didn’t understand the new paradigm.”

Maybe I didn’t (and still don’t). But I know that a business has to eventually have revenue and profits. At least a successful one does.

I’m 100% certain that if Grandpa had been an active investor in those days, he wouldn’t have gone anywhere near TheGlobe.com.

One principle that I believe many investors have forgotten is that they are investing in a business. Whether that business is a retail store, a steel company, or a semiconductor equipment manufacturer, these are businesses run by managers, with employees, customers and equipment and, one hopes, profits. They’re not just three- or four-letter ticker symbols that you enter into Yahoo! Finance once in a while to check on the stock price.

And these real businesses can create a significant amount of wealth for shareholders, particularly if the dividend is reinvested.

According to Ed Clissold of Ned Davis Research, if you invested \$100 in the S&P 500 in at the end of 1929, it grew to \$4,989 in 2010 based on the price appreciation alone. However, if you reinvested the dividends, your \$100 grew to \$117,774. Clissold says that 95.8% of the return came from dividends.¹ (See Figure 1.1.)

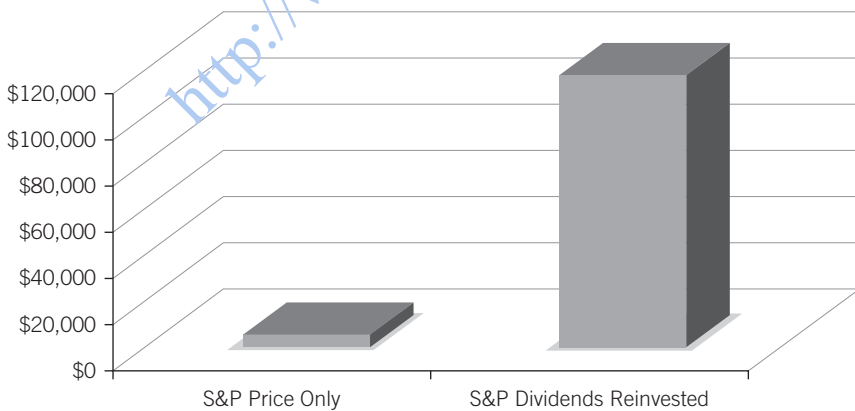


Figure 1.1 1929–2010: \$100 Original Investment

Source: Ned Davis Research

Marc Lichtenfeld's Authentic Italian Trattoria

Years ago, my wife and I were in Ashland, Oregon. We loved the town and started talking about escaping the rat race, moving to Ashland, and opening a pizza place. We've repeated that conversation on trips to Banff in the Canadian Rockies, Asheville, North Carolina, and even Tel Aviv, Israel.

Considering that I know nothing about how to run a restaurant, would be unhappy if not in close vicinity to a major American city, and am a lousy cook, the pizza joint remained a happy fantasy.

But for the purposes of this book, Marc Lichtenfeld's Authentic Italian Trattoria will serve as an example of a business with revenue and profits. We're also going to assume that I'm your brother-in-law (your sister was always a very good judge of character) and you've agreed to become my partner in the business.

One day I come to you, my favorite brother/sister-in-law, with my plans for the restaurant. I have the space lined up. It's in a popular location with a lot of foot traffic. I've been talking with a wonderful young chef who is eager to make an impression on local diners and critics. All that's missing is start-up capital.

This is where you come in. In exchange for a \$100,000 investment, you will receive a 10% ownership stake. I show you my projections: The restaurant will break even the first year, make \$100,000 in the second year and \$200,000 in the third year.

One of the questions you may have is how you'll get your money back. Do you have to wait for the restaurant to be sold, or will you receive some of the profit each year?

If I tell you that my goal is to build the business to \$1.5 million in sales and then sell it for two times sales (\$3 million), where you'll receive \$300,000, your response might be very different from what it would be if I tell you that half the profits will be invested back in the business with the other half split up among the partners in a yearly payout (dividend).

Your decision on whether to give me the money will depend in part on your goals. Are you willing to speculate that you'll receive the big payoff in several years when the business is sold, or would you rather receive an income stream from your investment but no exit strategy (plan to sell the restaurant)?

When buying stocks, investors have to make similar decisions. Do they buy a stock with the sole purpose of selling it higher down the road, or do they buy one that provides an income stream and opportunities for income growth in addition to capital gains?

I don't know about you, but if I'm investing in someone's business, I want to see some money as soon as possible rather than wait for an exit strategy.

Here is another factor that might affect your decision to invest in my trattoria: Instead of offering to pay you your cut of the profits ever year, I might offer to reinvest that money back into the restaurant and give you more equity. That way, your piece of the profits gets larger each year. Eventually, you can start receiving a significant cash payout on an annual basis or receive a bigger slice of the pie when you sell your stake in the business because your equity has increased above your original 10%.

This last scenario is the same as reinvesting dividends, a method that is the surest way I know of to create wealth.

And what I love about this strategy is that it works (and has worked) no matter who is President of the United States; what happens in Europe, Iran, or the Middle East; unemployment; inflation; and so on. Sure, those things will impact your short-term results, but over the long haul, they mean nothing and in fact could help you accumulate more wealth, as I'll explain in the section on bear markets in Chapter 3.

The Numbers

Investing in dividend stocks is the best way to make money in the stock market over the long term.

But don't just take my word for it. Harvey Rubin and Carlos Spaht, II, both of Louisiana State University in Shreveport, wrote, "For those investors who adopt ten- and fifteen-year time horizons, the dividend investment strategy will lead to financial independence for life. Regardless of the direction of the market, a constant and growing dividend is a never ending income stream."²

Just a few pages ago, I told you that dogma doesn't work, yet here I am sounding fairly dogmatic. The proof that dividend investing creates wealth is in the numbers.

First of all, investing in the stock market works. Since 1937, if you invested in the broad market index, you made money in 67 out

of 74 rolling ten-year periods, for a 91% win rate. That includes reinvesting dividends.

The seven ten-year periods that were losers ended in 1937, 1938, 1939, 1940, 1946, 2008, and 2009. The periods 1937 to 1940 and 1946 were tied to the Great Depression. The ten-year periods ending 1936 to 1940 were brutal with an average decline of 40%. The decade ending in 1946 was much tamer with a loss of 11%. The 2008 and 2009 ten-year periods each lost 9%.

So the only ten-year periods that didn't make money were associated with near financial Armageddon. And even in some decades tied to those financial collapses, such as 2000–2010, investors still came out ahead.

Paul Asquith and David W. Mullins Jr. of Harvard University concluded that stocks that initiated a dividend and increased their dividends produced excess returns for shareholders. Additionally, the larger the first dividend payment and subsequent dividend raises, the larger the outperformance.³

And research shows that dividend stocks significantly outperform during market downturns.

Michael Goldstein and Kathleen P. Fuller of Babson College concluded, "Dividend-paying stocks outperform non-dividend-paying stocks by 1 to 2% more per month in declining markets than in advancing markets."⁴

Later on in the book, I'll show you how you can achieve double-digit yields, which would nullify the effects of even the weakest historical markets, performance and enable you to make money regardless of what the overall market is doing.

Think back to other methods that I mentioned at the beginning of the chapter: value, growth, and technical analysis. They all work—sometimes. No system, strategy, or methodology that I know of has a 91% win rate that can approach 100% when the dividends have been reinvested.

Oh, I know, but it's different this time. We're in an unprecedented period of debt, unemployment, financial crises, and everything else unpleasant under the sun.

Things were pretty lousy in 2008 and 2009, with the entire financial system on the precipice of collapse. Nevertheless, the market came roaring back, doubling in two years.

Similarly, there was little to get excited about during the 1970s—with mortgages and inflation in the teens and each U.S.

President less popular than the last. Yet the ten-year return on the market was positive every year throughout the 1970s and 1980s (encompassing years from the 1970s).

Since 1937, the average cumulative rolling ten-year total return on the stock market is 129%. This includes the seven negative ten-year periods. Since 1999 (the first year the ten-year data was available), the S&P Dividend Aristocrat index's ten-year rolling return average has been 187% and was positive every year, with the lowest ten-year return of 40% in the period ending in 2008 (when the market tanked 38% that year), compared to a 9% loss for the S&P 500 in the ten years ending 2008 (and a loss of 26% when you exclude dividends). I'll explain what a Dividend Aristocrat is in the next chapter.

I recently read a government official's estimate (and we know how accurate they usually are) that, over the next ten years, stocks will lose 13% due to baby boomers taking their money out of the market.

I don't think that's likely. As I've shown you, historically, there's a 91% chance of the market giving you a positive return over ten years. Additionally, where are the baby boomers going to put their money? Bonds are paying ridiculously low interest rates right now. Is it worth it to lock up your funds for ten years to earn 2%? That won't even keep up with inflation.

For that little, I'd rather invest in a stock with a 4% or 5% yield and take the risk that in ten years, the stock will at least be where I bought it today.

But you know what? Even if the stock falls, you can still make money.

Let's assume you buy 500 shares of stock at \$20 for a total of \$10,000. It pays a dividend of \$1 per year or a yield of 5%. Now, this company has a long history of raising its dividend every year. Over the next ten years, it raises the dividend by an average of 5% per year.

Let's also assume that the government official was right and the stock tracks the market and falls 13%.

If you reinvest your dividends for the next ten years, while the dividend is increasing and the stock price is falling, you'll wind up with about \$17,000. That's a 70% increase, or a compounded annual growth rate of 5.45%—despite a *decline* in stock price of 13%!

But what if you invested in a ten-year treasury, paying 2% per year? After ten years, you get your \$10,000 back, plus you've

collected \$2,000 in interest for a total of \$12,000, or a compound annual growth rate of 1.84%.

So in this example, your stock investment lost 13% in price yet still nearly tripled the performance of a ten-year bond where your principal is guaranteed.

Think about that for a moment. Your stock lost value, but because you reinvested your dividends, you nearly tripled your return on the guaranteed principal of the ten-year bond. And that takes into account a drop in the market over a ten-year period that would be equal to the fifth largest in the last 74 years.

Oh, and if you decide after ten years to start collecting the dividend instead of reinvesting it then, you'd receive \$1.63 per share, up from \$1 per share. And because you reinvested the dividends, you're collecting that \$1.63 per share on 1,000 shares instead of your original 500. So your yield is going to be over 16% on your original investment. This alone should convince you to run out and buy dividend stocks. As they say on TV, but wait, there's more.

Keeping Up with Inflation

People don't talk much about inflation these days. Since 1914, the average inflation rate in the United States is 3.4%. In 2009 and 2010, inflation was well below the historical average. The year 2011 saw a return to more normal levels.

Inflation of 3.4% seems pretty tame, especially for any of us who remember the 1970s and 1980s when inflation hit double digits. But even at 3.4%, your buying power is cut in half after 20 years.

Because inflation is low today, people underestimate its erosive powers. Despite the fact that for the past decade inflation has averaged nearly three quarters of a point below the historical 3.4% figure, buying power has still been cut.

What would have cost \$1,000 in 2001 cost \$1,270 at the end of 2011.

And what if you're saving for something whose price rises faster than the average 3.4% rate, such as college tuition or retirement (and the associated medical costs)?

For example, in 2011, the College Board reported that tuition at public four-year universities increased 8.3%. And since 2006, it has risen at a rate 5.1% above the inflation rate.

Where are you going to find an investment that will grow 8.3%? Today, if you lock up your money for 20 years in a treasury, you'll be lucky to get 3% per year.

Let's see how cost increases could impact tuition fees in the future. Right now, tuition for in-state students at a public university averages \$8,244. Private university students are paying an average of \$28,500. If those tuitions continue to increase by 8.3% per year, in 18 years, you'll have to shell out \$34,629 per year for the public university and \$119,717 for the private school. And that doesn't include room and board (or beer). Sure hope your kid can hit a jump shot.

So if you're lucky enough to be able to buy \$100,000 worth of treasuries for your newborn child's education, and they pay 3% per year, you should be where you need to be to pay tuition for four years, but you'll still have to come up with some cash for room and board, books, and more (beer). But remember, this is just an in-state school. At the private university, forget it. You need to average a 9% compound return per year to hit your target.

This is an extreme example, but you can see that treasuries are a tough way to fund any future expense. One of the problems with fixed income is that you can't reinvest it in order to let it compound, the way you can with dividend stocks.

As you'll soon see, a 12% compounded annual return is readily achievable when you invest in stocks that pay dividends. In fact, if you reinvest those dividends, there is no reason why you shouldn't be earning 12% per year, over the long run.

12%. That was not a typo. You can earn that much per year (and even more) by investing in boring, large-cap, dividend-paying companies that simply match the overall return of the market. And at 12% per year, all you need to do is start off that college fund with \$1,000 and add \$2,000 per year and the in-state school is entirely paid for by the time your little boy or girl graduates high school.

We're not taking any extra risk here. We're not investing in speculative companies with new technologies that may or may not work. All we are doing is trying to match the market with companies that have a long track record of paying shareholders. But through the system I'm about to show you, it can help you achieve your financial goals.

You need to know which types of dividend stocks to buy in order to achieve the maximum returns. So now, let me show you.

The 10-11-12 System

When I started the process of writing *Get Rich with Dividends*, my objective, besides spreading the gospel of dividend investing, was to give readers a process for achieving their financial goals. The process had to have three simple but key components.

1. It had to be easy to understand and implement.
2. It had to work.
3. It had to be inexpensive.

I've read truckloads of financial books and products in my lifetime, many claiming to have an easy system that would make me rich. The problem was they usually didn't work. Often they weren't easy to use, nor were they cheap.

For example, one book I read recommended buying tax lien certificates and explained how I could make 16% per year on those investments.

Maybe somebody has achieved those kinds of results, but when I checked with offices of various county governments around the country that were selling those certificates, I found I'd be lucky to make a few percentage points on my money. And the process was far from easy or inexpensive.

Other strategies have recommended changing my entire portfolio every year, incurring hundreds of dollars in commission charges, even with a cheap discount broker.

So I set out to create a system for investors that would be so easy to use and so inexpensive, they'd be free to devote their energies to things that really excite them, like their families, friends, work, hobbies, rather than having to spend countless hours working on and constantly adjusting their portfolios.

If you're the kind of person who likes to check stock quotes during the day, research companies, and follow business news—that's great. You and I will have a lot to talk about if we meet.

But most people want to invest and more or less forget about it, checking in only occasionally to make sure everything is going according to plan.

The result is the 10-11-12 System. It is designed so that, in ten years, the investor will be generating 11% yields and will have averaged a 12% *annual* return on his or her portfolio. Just to be clear,

you won't achieve a total return of 12% in year 1. But by year 10, your average annual return over the entire ten-year period should be 12% and quite possibly higher.

It is so easy to use that my ten-year-old son instantly grasped the concept and was excited about its prospects for his money when I explained it to him. He took his birthday and allowance money and bought shares in the kind of stocks I talk about in the book, understanding his funds should more than double by the time he gets to college.

And other than the commission on buying the stocks when you set up the portfolio, it doesn't have to cost you *anything* after that.

Simple, easy to use, and it works.

For example, Southern Company (NYSE: SO), which has raised its dividend every year for the last ten years, returned 193% over the past ten years when dividends were reinvested. This is a real-life example, not theoretical. A \$10,000 investment was worth \$29,332 versus the S&P 500, which would have been worth \$13,931.

So let's get started so you can begin earning 12% returns right away.

Summary

- Save money—try to save 10% of your income to put to work in dividend-paying stocks. If you can't save 10%, start smaller and work your way up.
- Investing in dividend-paying stocks is the best way to create wealth in the stock market.
- Dividend stocks will help you beat the ravages of inflation, unlike treasuries.
- The 10-11-12 System is designed to generate 12% annual returns over the long term, cost next to nothing, be extremely easy to implement, and take up very little of your time over the many years you'll use it.
- Roy Jones Jr. made one of the worst songs in the history of recorded music.

Notes

1. Harvey Rubin and Carlos Spaht, II "Financial Independence Through Dollar Cost Averaging and Dividend Reinvestments," *Journal of Applied Business and Economics* 12, no. 4 (2011) pp. 11–19.

2. Ibid.
3. Paul Asquith and David W. Mullins, Jr., *Journal of Business* 56, no. 1 (1983), pp. 77–96.
4. Kathleen P. Fuller and Michael A. Goldstein, “Do Dividends Matter More in Declining Markets?” *Journal of Corporate Finance* 17, no. 3 (June 2011), pp. 457–473.

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