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VF Wealth

Financial Freedom Through Dividends

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Safety + Dividends = Passive Income

The basic prerequisite for any success, especially in the stock market, is setting the right goals. That's why today I want to explain what you can expect from my dividend strategy and why this strategy is not only promising but also particularly transparent and easy for you to implement.

Acting rationally is the foundation for success

In principle, every person behaves according to economic principles. Trust your gut feeling when it tells you that this or that promise in advertising sounds too good to be true. In investment, as well, effort and results must be in optimal proportion to maximize profits and use your resources as efficiently as possible.

Distinguishing between the minimal and maximal principles

In the minimal principle, a goal is set and should be achieved with as little effort and resources as possible. In the maximal principle, the best possible result is aimed for with given and limited resources. Applied to investment, these principles can be adapted by considering risk and return. Important: Just like with any economic principle, these laws cannot be circumvented! Risk and return are always related – if you increase your target return, the risk of your investment automatically increases. Investors lose billions every year because they believe in promises to the contrary.

Alluring dividend yields

You can assemble a dividend portfolio with a current yield of eight percent without much effort. With a portfolio value of $150,000, you would receive payouts of $12,000 per year or $1,000 per month. Sounds tempting? But please don't forget the law of risk and return! You currently only achieve eight percent if you neglect the security aspect at the company level and are also hardly geographically diversified. In other words, you are almost exclusively invested in US securities and furthermore in companies whose stock prices and in some cases dividends fluctuate greatly.

Security + Dividends = Passive Income

No investment in individual stocks is completely risk-free. In the dividend portfolio, we therefore focus on the security of dividends. As genuine quality companies, the shares of most portfolio holdings also show relatively stable trends in price performance over the years. However, for passive income, we focus mainly on the reliability of the distributions, which will increase over the years, thus increasing our passive income - that's what it's all about! As a safety-oriented investor, ask yourself the following question before each purchase: Do I absolutely need this company's product, or can I do without it? Then you will have a portfolio for eternity and won't have to worry much about daily price fluctuations.

High inflation and growing uncertainty make dividend stocks more attractive

The world has become more uncertain. This concerns not only geopolitics but also the economic environment. The global economy and markets are being shaken by the shocks of the Corona pandemic and the Ukraine conflict. Added to these are the challenges of climate change. All of this together questions two important prerequisites for the stable development of the economy and markets in recent years: globalization and favorable energy supply.

Fluctuations in the stock market are increasing

This not only weighs on economic growth but also leads to significant increases in inflation rates. Such an environment has not been seen since the 1970s. It's no wonder that comparisons to "stagflation" during that time are being drawn. Like back then, fluctuations in economic growth and inflation are increasing. However, an unstable economic development also results in stronger fluctuations in the stock markets than we have been accustomed to in recent years.

Security is becoming more important again

The significant increase in inflation rates has forced policymakers to rethink. Interest rates have already risen significantly, especially in the USA. The end of the long-standing low-interest-rate policies of central banks has significant implications for the valuation of stocks. Future earnings are valued lower with higher interest rates, and higher debt on the balance sheet leads to stronger price declines. So-called growth stocks, for example, from the technology sector, are valued lower, as evidenced by the significant downturn in many stocks' prices in recent months. Conversely, stocks with currently high cash flows and proven business models promising secure returns are valued higher. This applies to dividend stocks. With the end of central banks' low-interest-rate policies, an extraordinary phase in the markets is coming to an end, which is unlikely to return soon.

Bond yields are rising

Even safe government bonds are yielding returns in this environment. However, bond yields are still significantly negative in real terms due to high inflation, and this is unlikely to change quickly, as government debts continue to grow, and countries must remain solvent. Central banks are virtually condemned to ensure low real interest rates in the long term. In recent years, bonds have not been an alternative to stocks. This could change again with the rise in yields. For decades, bonds and stocks competed for investors' favor, and whenever risk-free US Treasury bonds yielded more than four percent above the inflation rate, the days of stocks were numbered, and a massive shift occurred. But as mentioned, we are far from that scenario; high real interest rates for government bonds would destabilize the financial system.

Stocks vs. Bonds

Investors should also consider that there is a fundamental difference between bonds and stocks. Bonds are debt capital lent for a predetermined period, while stocks represent equity capital permanently retained by companies. They entail ownership in a company; the shareholder is a co-owner, not an external creditor. This difference can have significant implications. On one hand, the shareholder has a say because they usually have voting rights at the general meeting (this is not the case with preferred shares). Thus, they are in a better position than a bondholder.

Stability for Your Portfolio

Bankruptcy Risk

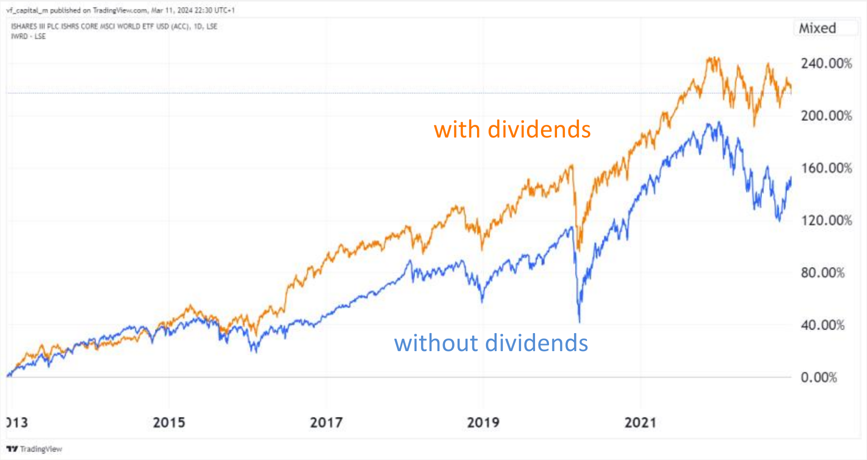
However, in the event of bankruptcy, this advantage turns negative for the shareholder. The shareholder, as a co-owner, stands at the back of the line when it comes to distributing the remains. Before them, the bondholder comes into play because they are creditors of the company. Their risk is thus lower than that of the shareholder. However, their chances are also limited, as during the bond's term, they only receive their predetermined interest and eventually get back the principal amount. The shareholder, on the other hand, does not get money back. However, as a co-owner, they benefit from the company's success, which can be reflected in rising stock prices and/or high dividend payouts. Or in losses if things don't go well.

While bondholders may not necessarily need to keep an eye on their investment's price since they will receive 100 percent at maturity, for shareholders, the price represents a significant portion of their total return. When dividends are paid, this money flows out of the company, leading to a corresponding decrease in stock price. This must be regained through operational successes and profits generated by the company. Therefore, stocks offer higher potential returns than bonds but also entail higher risks. When selecting them, investors should pay particularly close attention to avoid unpleasant surprises.

Bond yields with a turning point upwards?

Source: macrotrends.net

➢ MSCI World with and without dividends in comparison over 10 years



Dividends are an important factor for a successful investment. This profit-sharing significantly contributes to the overall return and thus to the success of an investment – providing shareholders with a welcome income stream that can enhance retirement or cover the cost of the next vacation.

Ideally, dividends are reinvested back into stock investments, thereby leveraging the compounding effect to achieve even higher returns and maximize personal income flow.

What Makes a Good Dividend Stock

Dividends are profit distributions, and for this, companies should first make profits. Of course, dividends can also be paid when companies incur losses, but this depletion of substance ultimately harms the company. This is not a promising strategy.

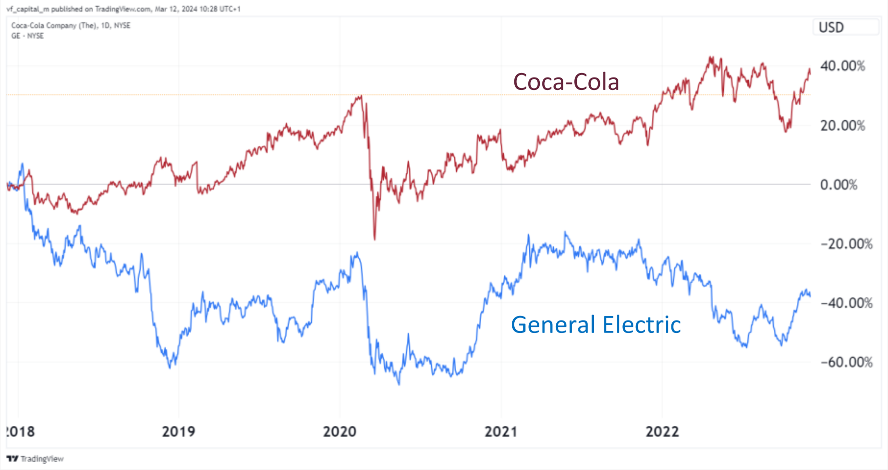
Net income vs Free Cash Flow

Now, one should not overvalue net income either, as it has lost much of its significance since the change in accounting standards (IFRS 16) a few years ago. Valuation changes, such as gains or losses on securities or subsidiaries, are now also included in the income statement, which can lead to colossal profit fluctuations. Nevertheless, the principle remains that dividends must be earned. Therefore, attention should be focused on free cash flow, as this metric represents the result after all necessary expenses for the operational business have been made. The free cash flow is then available for acquisitions or share buybacks. And also for dividends.

Coca-Cola vs General Electric

Let's take a look at two well-known US corporations, Coca-Cola and General Electric. Both were long considered among the most interesting dividend stocks in the world. This still applies to Coca-Cola, but not to General Electric anymore. At the beginning of 2005, General Electric was even the most valuable company in the world, but then began a phase of decline that continues to this day. In 2018, the last remaining founding member of the Dow Jones was ejected from this index and then had to drastically cut its dividend. With that, General Electric also lost its status as a dividend aristocrat. What a double blow for the industrial icon. Many investors continued to stick with GE. While business kept deteriorating and its stock price kept falling, the dividend yield still looked tempting. In 2018, it amounted to over six percent, if one took the payout for the previous fiscal year as a benchmark. No wonder, because falling prices with unchanged dividends increase the dividend yield.

➢ General Electric and Coca-Cola in comparison over 5 years



The industrial conglomerate General Electric has been struggling with increasing problems for years. Parts have to be sold repeatedly to service the crushing billion-dollar debts, while revenues collapse. Whether it's the power generation division or aircraft manufacturing, GE is staggering towards the abyss.

In contrast, Coca-Cola continues to thrive. The beverage company has consistently increased its dividend on an annual basis since 1988.

And so, especially dividend hunters were tempted to keep General Electric stocks in their portfolios or even collect them anew. But this should be a lesson for all investors. Dividend yield says little about a company's success. If that success fails to materialize and the stock plunges, the dividend yield shoots up until the dividend has to be cut or entirely scrapped. And then, shareholders are left facing the wreckage of their ill-fated investment. That's what happened with General Electric: The dividend for 2018 was only half as high and then was almost completely slashed.

Investment failures don't belong in the portfolio

Because investors fear losses greatly, many ignore warning signs and cling to their investment blunders. Their brains play tricks on them, believing that the loss is only real once they sell the stocks. As long as the dividends keep flowing, they console themselves with the thought that everything is going fairly well. Especially since falling prices further boost the dividend yield. However, one should approach the matter objectively and rather admit their mistakes. Even the world's best investors are wrong about nearly half of their investments. Yet, they limit their losses while letting their profits run. The average investor does exactly the opposite and thus accumulates the duds in their portfolio. The result is a significantly below-average return.

Investing in successful companies

The solution lies in investing in successful companies. In firms that generate sustainable revenues and profits. Ideally, they have a broad economic moat that others cannot easily overcome. These enduring competitive advantages fuel corporate profits. In addition, there is experienced and sound management as well as a strict focus on shareholder value. This allows Coca-Cola to consistently generate good profits thanks to its strong brand and smart corporate policies. More importantly, the cash flow is large enough to continue increasing payouts despite fluctuations in profits in individual years. Since 1988, the dividend has always been higher than the previous year. However, the dividend yield was "only" about 3.2 percent in 2018, half as much as at that time with General Electric. Those who preferred to focus on high dividend yields then look at stocks such as Daimler or General Electric. What a pity.

Payout ratio and dividend growth

Instead of now choosing stocks with the highest dividend yield, it is better to pay attention to other criteria. Firstly, the payout ratio. It indicates the percentage of profits distributed as dividends. The higher the ratio, the less potential for growth remains. With a ratio of 30 percent, the company can increase dividends despite stagnant profits, whereas this is hardly possible with a ratio of 80 percent. Secondly, dividend growth and dividend history are also interesting. If the dividend is increased by 5 or 10 percent every year, the dividend yield can keep pace with rising stock prices. Thus, even seemingly low initial yields become true dividend gems in the portfolio over time. And they further enhance the return through the compounding effect. Dividend growth stocks are therefore the most promising dividend securities in the long run.

Conclusion

Dividends significantly contribute to the performance of a portfolio, that's for sure. However, for sustainable investment success during the accumulation phase for a stock portfolio, it takes more than just dividend stocks. Some companies distribute their profits in the form of dividends, while others reinvest the profits in new growth. If this is done successfully, the stock price also rises. Those who only focus on dividend stocks miss the opportunity to participate in the success of growth companies.

However, if one is beyond the accumulation phase and wants to use their capital to generate additional income from dividends, then a portfolio consisting of stocks from companies that pay stable dividends is suitable for this purpose. For the VF-Wealth, I have compiled, to the best of my knowledge, a corresponding, balanced portfolio that focuses on safety and continuity. The emphasis is fully on dividend payments, with the stock's price movement and timing of purchase playing a subordinate role.