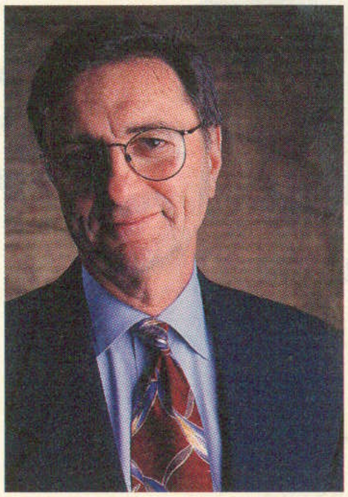
VIEWPOINT

ECONOMICS

Defensive-Dividend Stocks Neutralize Equities Volatility

The tricky part is finding them

Most investors understand that no single investment approach will produce above-average returns in both up and down markets. Such a feat would require bouncing back and forth between aggressive and defensive strategies with unerringly precise timing—a virtually impossible task that no competent investment adviser would propose.



By Allan Rudnick

Allan Rudnick is chief investment officer at Kayne Anderson Investment Management, a registered investment adviser in Los Angeles.

THE BEST OF THESE COMPANIES MAINTAIN A LOW PAYOUT RATIO

While perfection in investment timing and strategy is unattainable, it's not really necessary for maintaining clients. Most investors are satisfied with average returns during rising markets. True, the highest returns might go to those willing to take the most risk, but elevated risk also makes investors susceptible to big losses. Mounting losses might prompt investors to sell at inopportune times, preventing the opportunity to compound their money over the long term. Such miscalculations turn price fluctuation into permanent loss.

A strategy utilizing "defensive dividend" stocks can deliver favorable returns in up markets and above-average performance in bad times. It can also help avoid big losses for clients.

The historic real return from equities has far exceeded that of high-grade fixed-income vehicles, but the price for participation has been increased volatility. Almost half the returns in the equity market since 1935 have been the result of stock dividends and their reinvestment. In addition, companies that have been able to consistently raise their dividends have demonstrated their ability to withstand economic downturns. These companies typically have a matching record of consistent growth. The best of these companies maintain a relatively low payout ratio—the difference between what's paid out and what's reinvested—which contributes to advancing earnings, as well as to rising book value and the fundamental, underlying value of these corporations.

A portfolio consisting of rising-dividend stocks can provide the basis for a "hazard resistant" strategy and satisfy clients who seek reasonable returns with lower risk than the overall market. The screens Kayne Anderson Investment Management uses to identify stocks of defensive-dividend companies are: increased dividends in at least seven of the past 10 years; doubled dividends during at least eight of 10 previous years with no dividend cuts; at least 35% earnings reinvested; and long-term debt below 35% of capitalization.

Applying these screens reduces the universe of stocks to about 350 issues. Of course, not all companies with a history of growth and growing dividends are appropriate choices. Additional analysis of their financials, management, and relevant competitive factors is also vital. The companies can then be individually ranked for upside potential, risk/reward ratio, and desirability within a particular industry. Projections for anticipated growth in dividends, earnings, cash flow, and book value are then calculated to arrive at a value range and an estimated trading range for each stock over the next one to three years.

Further concentration is achieved by isolating leaders in their respective industries who enjoy dominant marketshare and are positioned to outperform the market. Of those, the best companies are typically in industries that hold promise in the coming economy but are currently out of favor with Wall Street and that sell at temporarily depressed prices. An ideal portfolio would contain 25 to 35 issues with a maximum of 5% invested in any single stock (at cost) and 15% in any single industry to ensure adequate diversification.

Cat Gwynn for TICKER