YIELD HOG
Five reasons why dividend stocks are here to stay

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You've probably heard the argument before: Dividend stocks are living on borrowed time. As soon as interest rates rise, investors will pull their money out of dividend-paying companies and plow it into bonds, causing stock prices to plunge.

Kinda scary, isn't it?

Well, relax. It's not going to happen. Here's why.

1. Rising bond yields might actually help stocks

Ten-year Government of Canada bonds are currently yielding just 1.80 per cent. In the United States, 10-year Treasuries are yielding about 1.65 per cent. Investors are so afraid of an economic collapse that they're willing to accept negative after-inflation returns as long as their money is perceived to be safe.

This won't last forever. Assuming an inflation rate of 2 per cent, government yields will eventually climb back to about 4 per cent once the U.S. Federal Reserve unwinds interventions aimed at keeping yields depressed, said Lyle Stein, chief executive officer at Leon Frazer & Associates in Toronto.

But while bond investors will feel the pain – bond prices and yields move in opposite directions – stocks could well benefit from rising bond yields. "The runup in yields from 2 per cent to 4 per cent will reflect either that the economy is growing – a very good thing for stocks – or that investors are losing their appetites for government fixed income, implying an asset-mix switch out of bonds and into stocks," he said.

2. Dividends will keep rising

Cash-rich U.S. companies boosted dividends by a net $24.2-billion (U.S.) in the first quarter, up from a net increase of $19-billion in the first quarter of 2011. The number of companies hiking dividends rose to 677, up from 510.

Yet, the average payout ratio – dividends as a percentage of profits – is at a historic low of about 30 per cent. That's less than the long-term average payout ratio of about 52 per cent, indicating that dividends have plenty of room to rise.

"Given underlying fundamentals, low payouts and [high] cash reserves, we expect 2012 to set a record high for cash dividend payments," says Howard Silverblatt, senior index analyst at Standard & Poor's Indices.

Scores of Canadian companies are also hiking dividends, which will provide support to stock prices.

3. Stocks are attractively valued

Stocks in general aren't overpriced. The price-to-earnings multiple on the S&P/TSX composite index is about 13.3, which is significantly lower than the average Price to Earnings ratio (P/E) of 18 over the past 10 years.

In the United States, the S&P 500 trades at a P/E of 13.4, less than the 10-year average P/E of about 17 and the 50-year average of 16.3. Such low P/Es suggest that investors who get in now will be rewarded.

"We continue to believe that equities remain a very attractive investment for the long haul, with current levels of valuation and sentiment suggesting healthy long-term returns," Bank of America Merrill Lynch strategists said in a recent report.

True, some individual dividend stocks are commanding higher multiples. Dollarama, for instance, trades at a P/E of 21.3 based on current year estimates, and Enbridge has a P/E of 23.5, but both are growing companies that deserve a premium valuation. There are plenty of solid dividend stocks trading at much lower P/Es. Many of the banks, for instance, have P/Es of less than 10.

4. Boomers need income

As baby boomers retire, they need income to supplement their government and private pensions. The demand for income will support dividend stock prices for years to come.

"All of my clients are 55 and older, and all of them are income seekers," said Tony Demarin, president of BCV Asset Management in Winnipeg. Many dividend stocks yield significantly more than bonds or guaranteed investment certificates. What's more, the income stream from dividend stocks grows over time, which isn't the case with bonds.

"So, I'm not in a hurry to sell my TransCanada or BCE or Emera or my other higher-yielding stocks," he said.

5. Dividend investing works

Dividends contribute anywhere from 50 per cent to 90 per cent (depending on which source you read) of the market's total return over long periods. Stocks with rising dividends have also outperformed those with flat dividends or no dividends at all. In fact, before people became obsessed with reaping short-term gains in the stock market, they invested primarily for dividends. It's a proven strategy – and it's not going away.

So chill out and, if watching the market gives you fits, try counting up your dividends instead.