

Thought for the Week: Monday, February 14th, 2011

The Secrets of Dividend Hunting

Why Dividends?

Over the last thirty years, **Dividends have accounted for more than 40% of the total return from U.S. equities**. Yes, that means that capital appreciation has accounted for less than 60% of returns.

More importantly, for anyone who bought and held stocks for the last 12 years, the **dividend checks you received through the mail may have been the only financial reward accruing**.

If the dramatic equity bull market we have experienced for nearly two years has run its course with smaller, growth-type companies, more 'boring' larger companies may become increasingly attractive. In such a scenario, those **companies paying an attractive dividend yield, in addition to offering the additional opportunity for reasonable capital appreciation will be worth considering**.

But here's the secret...

...by buying a quarterly dividend payer a few weeks before ex-dividend date and selling soon after ex-dividend date (something we call Dividend Capture) then rotating the same capital into a similar dividend payer and repeating three or four times a year (something we call Dividend Rotation), a 2.6% dividend payer like G.E. can become a 8%-plus yielder.

Unless you think G.E. will be out of business anytime soon, this is **a very attractive risk-adjusted income story**.

How do we Identify Dividend Capture Candidates?

We require a number of things for a quarterly dividend stock to qualify as a Capture Target:

- **Exceptional business model and balance sheet**. The company must be generating high levels of free cash flow and have ample coverage for the forecast dividend payments.
- A track record of **consistent and ideally increasing dividend payments** without negative surprises.
- A **stock sector we feel is attractive or represents good value** (priced at a temporary discount to our view of fair value). We seek to avoid sectors with the potential for capital loss.
- A dividend payment date that doesn't coincide with a **significant company event or announcement** - we don't need surprises.

How to Successfully Capture a Lone Dividend

Having identified a capture target, **we analyze historical patterns and use our experience to determine an entry point prior to ex-dividend date**, the date after which an owner will not receive the next dividend.



GLOBAL FINANCIAL

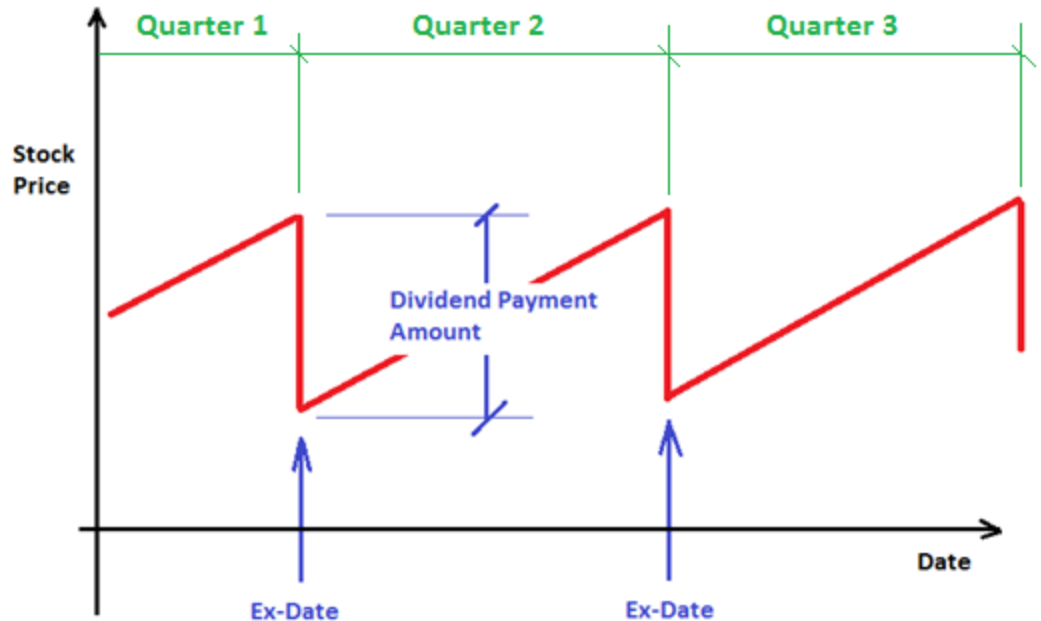
Private Capital

COMPREHENSIVE WEALTH MANAGEMENT

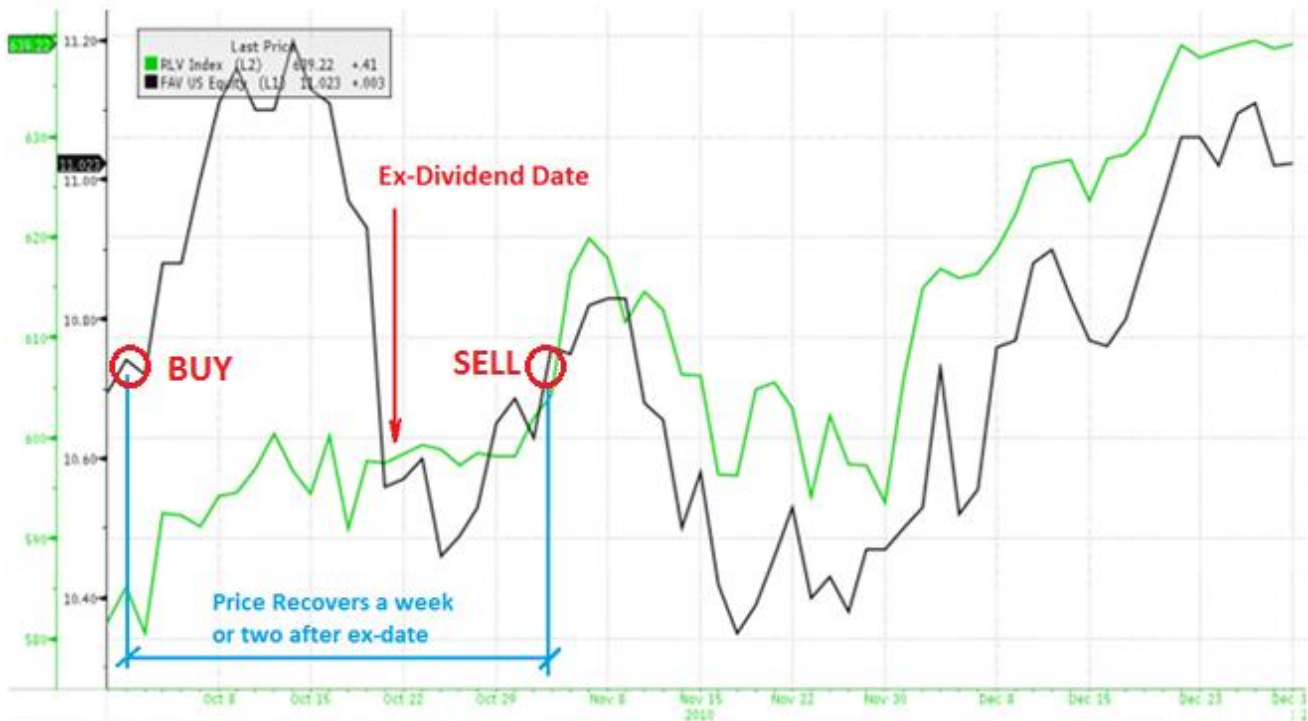
Our goal is to buy the stock, own it on ex-date so we can pocket the dividend then sell without a price loss to the market, while **keeping the dividend as profitable income**.

Many textbooks show a dividend payer steadily rising in price during the quarter by the amount of the dividend then falling by this amount on ex-date, as shown to the right. The theory is the dividend controls a great deal of the stock's price movement throughout the quarter.

This textbook saw tooth behavior is clearly not how real stocks work.



In the vast majority of cases, **the price of a stock depends on the media 'Noise' surrounding it**; the company, the sector or the overall macro-economic news and data. Only when a significant dividend approaches, does the stock market 'price-in' the impending bonus. This, more typical, practical behavior is shown below:



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The green line in the chart above is the Russell 1000 Value Index, the aggregate behavior of the large and mid-capitalization U.S. stocks. The black line is a dividend capture fund called FAV.

This example clearly shows that the price of FAV (black line) spikes just prior to ex-date, falls when the dividend has been paid then recovers to its pre-dividend price within a couple of weeks.

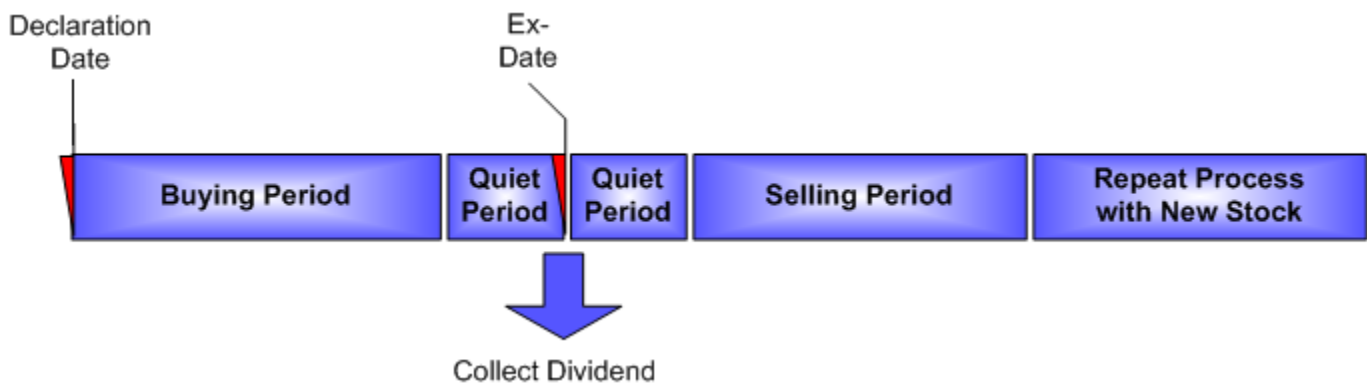
Our conclusion: the payment of the dividend has an effect on price for approximately one month every quarter. The rest of the time, the market noise and action control the price.

Dividend Capture works by buying and selling this type of stock where indicated in the chart above with the **net result of capturing the dividend by holding the stock for about one month and suffering no capital loss.**

Remember, **this process can be repeated every quarter**, therefore, the stocks we use for Dividend Capture leave tracks that are easy for our research team to follow. We continually monitor company fundamentals and sectors to ensure each target remains 'attractive'.

Efficiently Rotating through Dividend Seasons

So, if we can often Capture one quarter's worth of dividend in one month, what do we do with the cash for the other two months? We try **to rotate the capital into two similar sector quarterly dividend payers, thereby multiplying the yield.** If **we can capture three dividends** in a similarly behaving sector over one quarter, **we can triple the dividend yield** for little or no extra risk.



Once the dividend is declared, not all stocks are priced efficiently, especially if the price is discounted for temporary reasons. Therefore **an opportunity exists to buy and sell the stock, capture the dividend and exit in a short period.**

The table below shows **how this same sector rotation might work**:

Same Sector Rotation (Industrial Sector)					
Action	Date	Price \$	Stock	Ex-Date	Divi. Yield
Buy Sell	2/12/09 3/17/09	24.92 20.80	Cummins Inc	2/18/09	0.80%
Buy Sell	3/17/09 4/08/09	39.40 41.76	Raytheon	4/03/09	0.80%
Buy Sell	4/08/09 4/27/09	29.57 33.39	Caterpillar	4/16/09	1.30%
3 month Yield = 2.90% Hypothetical Annualized Yield = 11.60%					

Turnover

Although the concept of Dividend Capture has been around for as long as dividends have been paid by companies, the ability to **rotate capital efficiently between dividends has been made possible by the reduction in trading costs.**

Whereas many investors still pay \$10 or \$20 every time they trade, **modern institutional trading costs in the region of \$0.01 (1 cent) per share.** Therefore, the additional turnover associated with Dividend Hunting can now be cost effective.

Once declared, no S&P 500-listed U.S. company has failed to pay a dividend.

Dividend Checks don't Bounce!

Note: Aviance Capital Management, LLC is the sub-advisor to the First Trust Active Dividend Fund which may utilize the techniques described above.