INVESTING FOR INCOME IN THE STOCK MARKET

Learn about:

- How a dividend-paying value strategy can help to mitigate stock market risk
- Why identifying a true value can be a difficult thing to do
- Why many advisors don't have the understanding required to help you avoid value traps

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Investing for Income in the Stock Market

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When people think of Investing for Income, the first thing that might come to mind is investing in non-stock market investments, like bonds. Yes, bonds and bond-like instruments are an important part of investing for income, but there is also a way for those with the willingness and ability to endure some level of stock market risk to enjoy the benefits of earning steady income through dividends. That's exactly what we are going to talk about in this report—investing for income in the stock market.

Keep in mind that stocks are generally considered to be riskier than bonds, because they can cut dividends and/or drop in value. Some financial firms might tell you that they have some proprietary formula or advanced algorithm to manage stocks and help protect your investments from downside risk. Well, these algorithms do not work forever. Eventually they fail to protect the investor.

However, a dividend-paying value strategy can help to mitigate stock market risk. One reason is because buying "undervalued" stocks means that they should have somewhat less downside risk than an "overvalued" stock. The other reason is that the dividend is a "bird in the hand".

To illustrate the benefits of a "bird in the hand" strategy, let's consider two different couples who decide to invest in real estate. The first couple decides to invest in a plot of land—hoping that the value of their land will appreciate by the time they retire so they can sell it for a profit. Then, just as they're about to retire, the real estate market experiences a downturn and the value of their land drops significantly. This couple would most likely feel the pain of this drop in value.

Now, consider the second couple who decides to invest in a rental property instead. Each month this couple is able to collect rent from their tenant. Because of the steady income coming in, this couple wouldn't be so concerned about a potential drop in value. The steady income they receive would help to soften the blow of a drop in property value. If they had no intention of selling their property anytime soon, it might not even impact their ability to fund their retirement.

It's similar when investing in dividend-paying value stocks. If you're retired when the market experiences a downturn, but the dividends satisfy your income needs, you can hold the stock and wait for it to come back, essentially giving yourself staying power. Alternatively, if you don't need the income at the time, you can reinvest those dividends and essentially dollar-cost average. We call it growing your money the old-fashioned way.

Additionally, stock dividends have preferential tax treatment. Since the dividends these types of stocks pay can increase, they can also offer a potential hedge against inflation. This is why many believe that a dividend-paying value strategy can be ideal for retirees and those within 10 years of retirement who can still tolerate some investment risk.

Hopefully, if you're reading this report, that means you've read our other report: The Fundamentals of Retirement Income. If so, then you understand the difference between investing for growth and investing for income. You also understand why it is so important to make the shift from investing for growth to investing for income ahead of retirement.

If you haven't read that report, I recommend you take a moment to do so, because in it we talk about how the reason many Baby Boomers fall short of achieving their financial goals is because their advisors have become addicted to chasing stock market growth, often through the use of mutual funds.

If you are interested in learning about why your advisor's reliance on stock mutual funds could place your hard-earned savings at risk, check out our report: Why Investing in Mutual Funds Could Jeopardize Your Retirement.

Growth Stocks vs Value Stocks

In order to understand value stocks, you must also understand their counterpart, which are growth (momentum) stocks. When companies have high growth potential, they have the ability to increase market share in some way. As a result, they might not pay dividends because it would be better use of their earnings to reinvest them back into the company. These stocks tend to have higher price-to-earnings (P/E) ratios.

Value companies typically pay higher dividends and tend to be mature organizations. They tend to be highly profitable but with fewer internal growth opportunities than their counterparts. Therefore, they typically prefer to pay a higher percentage of their profits out in the form of dividends. They tend to have lower P/E ratios, thus the name "value stocks."

However, remember that no company can stay on top forever. Eventually a competitor will come along and knock them off of their perch. For example, companies like Woolworth's, Bradlees, and Caldor, which were all once market leaders, were eventually replaced by companies like Sears, Kmart, and J.C. Penney. Those companies were eventually replaced by the likes of Target, Marshall's, and Walmart—who now run the risk of being replaced by Amazon.

So, when a true value investor is going through their criteria of trying to decide which stock represents a good value, they have to ride that knife's edge between dividend-paying companies that are at the beginning of the mature stage vs those that are on the tail end and on their way out. This is one of the most challenging dichotomies for a value-based stock analyst.

Companies declare dividends in dollars paid per quarter, not a percentage. So, sometimes a stock will appear to be "cheap" and boast a high dividend percentage, but it's only because the price of its shares has dropped. It could be at the tail end of its mature stage where it may eventually have to cut dividends as the price per share continues to drop. Analysts refer to this as a value trap.

There are many criteria that go into determining if a dividend-paying stock represents a true value, but typically, one is looking for a company in the early part of its mature stage with hidden drivers for potential business growth that other analysts are not factoring into the price. Therefore, these potential drivers are not reflected in the current price of their shares. One of the most common drivers is to have takeover potential, especially when they can be taken over at a premium, and particularly if they are bite-sized and cheap.

It's Not Easy to Be A Dividend-Oriented Value Investor

Many do-it-yourself investors have the misconception that investing for income in the stock market is easier than investing for growth. They believe it's as easy as buying a well-known, dividend paying blue-chip stock and collecting the dividend. The opposite is true. Investing for income in the equity markets can be more difficult than buying a stock on the upswing and capitalizing on its momentum.

It can actually be pretty easy, for someone with a basic understanding of the markets, to buy a stock on momentum. That's because when stocks build momentum and break through a certain glass ceiling known as a resistance level, it allows investors to jump in and ride that momentum upward.

For example, an investor can follow a high-flying stock, like Amazon or Apple, and if the stock goes up a few days in a row, they can buy it, continue to ride it up, and not sell it

until it reverses its trend. If you want to use a bit of automation, you can use something known as a stop-loss order, whereby you place a standing order to sell the stock that is triggered once it hits a certain price. That way, if the stock loses momentum and experiences a couple bad days in row, the stock will be sold automatically, allowing that investor to take their profit. It can be easy to do because these investors are riding market momentum, and you don't need to be a rocket scientist to do that.

It is kind of like sailing a boat. Let's say that you aren't that great at sailing. However, you decide to try to sail your boat from point A to point B. Fortunately, the current is going with you. So, even though you aren't a skilled sailor and might not have your sails trimmed perfectly, it doesn't really matter. Your boat is still going to make some good headway toward your destination because the current is going with you.

Now, imagine that all of a sudden, the current changes, as it does every six hours or so, and now it is going against you. Well, instead of letting the current drag you back to where you started, you can drop your anchor and preserve the progress you've made.

Trading stocks on momentum is similar. You can ride that stock's momentum up, just like a sailboat would ride the current, and when the momentum slows down or turns against you, you can use your stop-loss order as your anchor—allowing you to get out and take your profits. Now, when you compare investing for growth (momentum) to investing for dividends through value stocks, the latter is often more difficult to do because of the dichotomy between a good value and a value trap.

Value Trap

Many years ago, I travelled to Italy for a conference. We were in Pisa and my good friend Ray was there. Ray decided he would buy a fake Rolex watch. He haggled with the vendor and was able to get the price of the watch down from $50 to $20. It was a pretty nice-looking watch and Ray thought he got a great deal. Well, the next day, when Ray went to set the time on the watch, he pulled the knob and it snapped right off the watch. It turned out that the watch was cheap for a reason. It was cheap because it was poorly made. This is what you would call a value trap.

The same thing can happen when it comes to buying certain value stocks. They might be paying a high dividend because the price of that stock is low since it is a contracting company and/or in a dying industry, where the price of their stock could do a slow bleed down to zero. Just like Ray's fake Rolex, the stock could be paying a high dividend because it is a value trap.

True Value

On the other hand, I have a friend who always wanted a certain type of a collector's watch that happened to be a Rolex. For years, he wouldn't buy himself one because he thought the prices were too expensive. During the Financial Crisis in 2008 he was able to get a really good deal on the exact, slightly used watch that he always wanted. Because he was able to buy the watch at a good price during the Financial Crisis, he's enjoyed the watch for the last 12 years, and today it is worth a lot more than what he paid for it. Similarly, that's the goal of a value stock—to enjoy all the dividends it pays for years, and eventually be able to sell it at a higher price.

Identifying a True Value Can Be A Difficult Thing to Do

In order to be a good dividend-oriented value investor, there's a lot of research and discussion that goes into it. Of course, it starts with spending the time to gather and analyze all the quantitative information that's publicly available about that company—as would be expected. That's where most analysts stop.

However, for a good dividend-oriented value investor, that's where the real research begins. Next, you should speak with different

analysts to get different opinions about that company and its industry. Next, you might create a list of questions about the way that company does business, its competition, its competitive advantages, etc. Then, you would need to contact investor relations to get answers to your list of questions. Only after you've taken all these steps would you be able to proceed with deciding whether you should make this stock part of your portfolio.

Most investors don't have the time to do this. Even if they did, most do not have the resources or relationships with professional analysts that have Wall Street experience to find out the right questions to ask investor relations. The same thing goes with many of today's financial advisors. Even advisors with a staff of assistants would have a hard time finding the time and resources to do so. Most don't have the relationships with top Wall Street analysts and, frankly, most wouldn't even know the right questions to ask investor relations.

This is why many financial advisors will just take the easy way out and invest their clients' money in mutual funds where they might earn a 2% or 2.5% yield, if they're lucky. The bottom line is that when it comes to investing for dividends and value, few financial advisors have the specialized knowledge required to find the true values and avoid the value traps.

Financial Advisors Who Specialize in Investing for Income Can Help to Ensure Their Clients' Smooth Transition into Retirement

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