Avoid the growth trap when investing

Solid dividend-paying stocks the closest to a sure thing when playing the market

The burst of the technology bubble, which sent stock markets crashing, has not faded from the memories of most investors. Although things are picking up, many individual investors are wary of returning to the market and the recent spate of high profile fraud cases doesn't help matters much.

The average investor is somewhat skeptical of the value of the stock market and long-term investing. The real estate boom on both sides of the border seems to indicate that North Americans consider real estate a better bet.

However, it is important to remember that investment fads come and go. Markets of all kinds will always fluctuate. Sound investment principles, on the other hand, stand the test of time and produce solid results. One of those principles is to seek out stocks of companies that pay stable dividends.

When you buy stock in a company, you can obtain a return in two ways: through capital appreciation of the stock and through the payment of a regular dividend. While an appreciating stock price cannot be guaranteed, regular dividend payments are the closest you can get to a "sure thing" in the stock market. They aren't guaranteed, but they're predictable.

Choose solid performers

The key is to find the right dividend-paying stocks. Look for companies that are: large and mature companies; past their growth phase with no major expenditures; showing strong cash flow and earnings growth; well managed with proper corporate governance to ensure the activities of the company are in the best interests of the shareholders; and regularly increasing their per-share dividend (preferably higher than the rate of inflation).

Many companies offer automatic dividend reinvestment plans that put your quarterly dividend payments towards acquiring more stock. As your number of shares grows, so will your quarterly dividend payments.

In his book *The Future for Investors* (Crown Publishing Group, 2005), Jeremy Siegal suggests that the reason most investors don't do well is that they overpay for stocks. The enthusiasm for new fads causes many investors to pay too much to get in on the action. He calls this fallacy of investing the "growth trap."

Siegal uses the cases of IBM and Standard Oil (now Exxon Mobil) to illustrate his point. If you got in early on IBM, you would have expected to outperform a mature, old economy stock such as Standard Oil. However, his study found the opposite. Between 1950 and 2003, IBM's growth was superior to that of Standard Oil in every way. Sales and earning growth at IBM were higher, as were dividends. Yet an investment in Standard Oil during

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this period would have outperformed IBM. How is that possible? The reason is simple: overvaluation. You paid more to buy every $1 of earnings in IBM than Standard Oil. IBM's share price/earnings ratio (commonly referred to as the P/E ratio) was more than twice that of Standard Oil. Standard's dividend yield was also two-and-a-half times higher. As an investor, you were paid a higher percentage return via a dividend and, when you reinvested that dividend, you bought more stock. Since the stock has a much lower P/E ratio, you could get a much bigger bang for your buck. A Standard Oil investor in that period would have been able to accumulate five times more stock through reinvestment. An IBM investor would only have been able to increase their stock holding threefold.

According to a recent *Canadian MoneySaver* study by Derek Foster, an investment in George Weston Limited (majority owner of Loblaw) on December 31, 1995, would have cost $16.75 per share. The dividend at the time was only $0.027 per share. Fast-forward to 2005. The company has increased its dividend so many times that it now pays $1.44 per share (an 8.6% return on your initial investment of $16.75 per share). And, the share itself would be worth over $100.

Similarly, if you had bought Royal Bank of Canada shares in 1995 when they were trading at $15.56, they now pay a dividend of $2.20 per share. That's a return of over 14% per year on the original investment. Again, it doesn't hurt that the company's stock trades at more than $70 per share.

The other important consideration is taxation. For investments outside of an RRSP, dividend income is taxed more favourably than interest income from investments in products like bonds and GICs.