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Stock dividends: long-term answer in low-interest climate

Retirement Planning

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Walking into the lobby of the building where my office is located, I passed a sign for a high-yield, two-year CD from the bank located on the ground floor. The rate being offered was for less than 1 percent, and I had to look twice to confirm this was a high-yield CD.

One-year bank CDs are averaging just over 1 percent and 10-year government bonds are paying less than 3 percent. With interest rates at these low levels, many people are reconsidering their investment strategy.

An alternative is to invest in the shares of high-quality companies that pay regular dividends.

The dividend yield on many leading companies, such as Procter & Gamble, Coca-Cola, Johnson & Johnson and Exxon, is greater than the yield on government bonds. These companies not only have attractive dividend yields, but they have a long history of raising those dividends each year.

A top financial concern of my clients is generating enough income to fund their retirement and to grow that income to keep up with inflation.

A long-term benefit of investing in a portfolio that generates dividend income is that dividends have historically grown an average of more than 5 percent each year for the past half century, which is greater than the 4 percent rate of inflation for that same period.

Rather than invest in products like bank CDs or government bonds that do not grow principal, many investors would greatly benefit long term by investing in a portfolio of stocks that generate income that grows over time and has the potential to appreciate.

New 'old' strategies

Investing in dividend-paying stocks has provided many of my clients a good source of growing income and long-term protection against inflation.

Only in seven of the past 50 years have dividends on average been decreased, and last year was the most recent year when dividends declined due to the financial crisis which began in 2008.

This year, the trend of annual dividend increases has resumed with many companies, including General Electric and Microsoft, announcing dividend increases.

And Cisco Systems, a company that never paid a dividend, has announced that it will begin paying one next year.

Stocks can also provide tax advantages to investing in dividend-paying companies.

Dividends have been taxed at a maximum rate of 15 percent since Congress passed the Jobs and Growth Tax Reconciliation Act of 2003. However, investors in the 15 percent tax bracket or lower have not had to pay taxes on qualified dividends.

This favorable tax treatment of dividends will end beginning Jan. 1, 2011, unless Congress acts to extend this benefit.

Another tax benefit to investing in dividend-paying companies is that capital gains on shares held by investors outside retirement accounts are only taxed when the shares are sold.

The capital gain is taxed at the maximum 15 percent just like for dividends as long as the shares are held for at least one year.

Many investors hold their dividend-paying companies for many years. In doing so, they defer tax on the capital gain on the shares and they enjoy a lower tax rate on the quarterly dividends they earn.

Investing in dividend-paying stocks is not as easy as looking at a newspaper's business pages and picking those with the highest dividend yield.

Dividends have grown an average of more than 5% per year for the past half-century

It is important to research how much profit the company is expected to earn and what percent of those earnings the dividend represents.

Investing in dividend-paying stocks may not be for everyone, but investors that cannot achieve their long-term goals through low interest-bearing fixed rate investments may want to learn more about investing in dividend-paying stocks. NHBR

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