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Digging For Dividends Worldwide

Steady cash flow and payout increases are possible even in a tough market.
By Bruce W. Fraser
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Among other securities currently suffering the recent global equity roller-coaster ride are dividend-paying stocks and funds. Like most value-oriented strategies, dividend-yielding investments have performed poorly during the current downturn. One need look no further than at U.S. financials, with their rich yields, or at global financials and telecoms, whose stock values have dropped precipitously this year along with those of emerging market stocks.

But even though some of these funds are off considerably this year, many value managers think this might be a great time to buy—that it might even present the best opportunity in a generation. Worldwide dividend-yielding stocks are very cheap, they note.

Investors and financial advisors can view the international dividend opportunity in two ways: as a component of a total return strategy or, separately, as an income or yield strategy, and a complement to the international side of one's portfolio. Thus a dividend strategy could effectively be paying you to wait: If an equity pays out a 6% yield, you're earning money while you wait for its stock price to go up.

Take, for example, the stock of AT&T, off nearly 39% this year through mid-October. Its dividend has risen to a juicy 6.3% with a P/E multiple of 8.7 times 2008 consensus estimates. "One could argue this is a cheap stock; the holder is being paid to just sit and wait," says Elliot Larner, an analyst at value shop Tweedy, Browne Co. LLC.

Likewise, Vincent McBride, a partner at Lord Abbett and the portfolio manager of its International Core Equity Fund (LICAX), is following the same rationale. In a report, he cites data from the S&P International Dividend Opportunities Index that suggests devoting 20% of an equity portfolio to an international dividend strategy could offer better returns and lower risk than a portfolio that is 40% invested in the MSCI EAFE Index and 40% in the S&P 500 index.

A similar line of thought is pursued in a Tweedy, Browne white paper, "The High Dividend Yield Return Advantage" (www.tweedy.com/whdyf/). Ditto for a recent Citigroup Global Markets report says dividends since 1970 have accounted for 30% of annualized returns from equities (37% in the U.K.), and "have become more important when equity markets are weak."

Though small, the universe of these funds is growing. This past September, giant mutual fund shop American Funds, which rarely trots out new portfolios, launched the International Growth and Income Fund (IGAAX), its 31st fund and the first stock portfolio it has introduced in ten years.

Neither Morningstar nor Lipper Inc. has a specific category devoted to foreign dividend-paying funds; instead, these portfolios are spread out into different classifications. "They work well as part of a total dividend strategy because those dividends give [the managers] the cash to invest. They're able to buy stocks at lower prices, so it forces you to dollar-cost average," says Bridget Hughes, an associate director of fund research at Morningstar.

While companies in the U.S. have historically tended to retain more of their earnings to fund internal growth or buy back shares, international companies have paid out a greater portion of their earnings in the form of cash dividends. According to research firm FactSet, as of October 1, 2008, 356 companies outside the U.S. with a market cap greater than $2 billion were offering dividend yields of more than 6%, versus only 90 such companies in the U.S.

Foreign Vs. U.S.

Why do foreign companies pay higher dividends? McBride explains: "For cultural reasons, many European, Australian and Asian companies pay out a large percentage of their earnings in the form of dividends. It's a function of history and culture." U.S. companies, on the other hand, despite long periods in the past when they were willing to pay out more from their earnings, have recently been "more inclined to do buybacks as opposed to paying dividends," he says. U.S. companies have also retained more earnings to plow them back into the business.

Dividend-paying stocks and funds have an added allure: Their stable income stream is especially valued by aging baby boomers and retirees (since bonds and money market funds don't pay much interest these days). "If a company has healthy operating cash flows, it has the ability to pay dividends," says Sam Sudame, CFA, CFP and chief investment officer of Shultz Financial Group Inc. in Reno, Nev. Sudame likes the Matthews Asia Pacific Equity Income Fund

(MAPIX), which, despite being down 27.15% this year through mid-October, is in the top percentile in Morningstar's Asia-Pacific fund category.

"The investment return is more dependent on stable dividends rather than unstable capital gains," Sudame says. "More to the point—the underlying fundamentals of a business tend to be more stable than the price of a stock, and those business fundamentals are what guarantees the stable dividend. For retirees, that is essential."

Wealth manager Aaron Skloff, CEO of Skloff Financial Group, Berkeley Heights, N.J., likes Thornburg Investment Income Builder Fund (TIBAX), where he's been putting clients for three years because of the "high quality of the companies the managers screen." As an added kicker, he values the fund's diversification.

At the end of the third quarter of this year, the fund paid out $1.04 in dividends on its Class A shares, which as of mid-October equaled a yield of 7.1%. Manager Brad Kinkelaar and his team look for companies that have had an earnings growth rate of 19% this year. S&P 500 companies, by contrast, are expected to see an overall 6% decline in earnings.

Lipper characterizes the $3.1 billion Thornburg fund, which was launched in 2002, as a mixed target allocation growth fund. It was a top Lipper performer up to this year, but it has suffered in 2008 after a foray into telecom stocks. The fund was down 31.4% for the year through mid-October.

"We basically invested 17% of our fund in what turned out to be the worst-performing industry so far this year," laments Cliff Remily, an associate portfolio manager on the Thornburg fund. "Although our performance has been negatively attributable to that, I'm very comfortable with the underlying businesses in these companies."

In Asia, the situation is somewhat different. "Dividends as a whole are still growing in Asia, whereas in Europe and the U.S. they're becoming increasingly hard to come by, especially in the financial area," says Jesper Madsen, the portfolio manager of the Matthews Asia Pacific fund, who scouts companies that can grow and maintain their dividend even in volatile periods.

Another fund group, Utopia Funds, allocates approximately 80% of its holdings to dividend-paying stocks. The four funds in its family, all of which launched in 2006, are the Utopia Growth Fund (UTGRX); the Utopia Core Fund (UTCRX); Utopia Core Conservative (UTCCX) and Utopia Yield Income Fund (UTYIX).

Utopia manager Paul Sutherland particularly likes Deutsche Telecom (DT), Germany's largest telecom company, which in mid-October was paying a dividend of 6.5%. The funds also contain a trio of foreign energy stocks: British Petroleum (BP), which yielded 7% as of mid-October; Royal Dutch Shell (RDS/B), yielding 6.1%; and ENI (E), yielding 7.5%.

The Tweedy, Browne Worldwide High Dividend Yield Value Fund (TBHDX), launched in September 2007, invests in U.S. and non-U.S. stocks predominantly in developed countries and typically holds between 30 to 40 stocks. A team of five partners and seven analysts manages the fund; decisions are made by consensus of the partners.

"We look worldwide for stocks with above-average yields that have demonstrated the ability to increase their dividends over time and are currently undervalued," says Bob Wyckoff, a managing director and member of Tweedy, Browne's investment committee. Even though the Tweedy Browne fund was down 26.63% for the year through mid-October, it still stands in the top 3% of Morningstar's world stock fund category.

The Lord Abbett International Core Equity Fund, which launched last June, starts with a qualitative dividend yield screen. "We look at all the companies outside the U.S. with a market cap greater than $1.5 billion," says McBride. "Within that universe, we look at the top decile companies. The lower end of the yield curve is about 5.5%. The average yield of stocks in the fund, after taxes and expenses, is about 7% currently."

Foreign Taxes

Foreign taxes can be a factor in the overall return, and such stocks or funds should be housed in one's regular taxable account. The reason: Foreign governments routinely withhold 10% to 15% in taxes from foreign dividend payments. So, for example, if you own the foreign stock or fund in an IRA or 401(k) account, you don't get any credit for those taxes withheld. If owned in a regular account, however, the first $1,500 per year of withholdings becomes a tax credit, explains John M. Smartt Jr., a CPA and RIA in Knoxville, Tenn.

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