INVESTING FOR INCOME IN THE STOCK MARKET

Retirement Income Source®

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 a 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 drop in value, and because dividends can be cut or reduced. 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 don't work forever, and eventually, they fail to protect the investor.

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

The Real Estate Analogy

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 decide to invest in a rental property instead. Each month this couple can 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 values. If they had no intention of selling their property anytime soon, it might not even impact their ability to fund their retirement.

In essence, the second couple's approach is like using a dividend-based stock strategy. If you're retired when the market experiences a downturn, but the dividends you're receiving every month help satisfy your income needs, you can hold the stock and wait for the market 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 your way to more growth. I call this growing your money the old-fashioned way.

Additionally, stock dividends have preferential tax treatment, and since the dividends these types of stocks pay can increase, they can also offer a potential hedge against inflation. All of this is why many believe that a dividend-paying value stock strategy can be ideal for retirees and those nearing retirement who can still tolerate a bit more 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 doing so. In it, I note that one of the main reasons many retirees today fall short of their financial goals is that their advisor is still "stuck in the 90s" mentally, meaning he's addicted to chasing stock market growth, often using 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 another of our reports, Why Investing in Mutual Funds Could Jeopardize Your Retirement.

Growth Stocks vs. Value Stocks

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

By contrast, value companies 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 out a higher percentage of their profits in the form of dividends. They also 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 their perch. For example, companies like Woolworths, 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 trying to determine which stock represents a good value, he must ride a knife's edge between dividend-paying companies that are at the beginning of their mature stage versus those that are at the tail end and on their way out. This is one of the trickiest challenges for a value-based stock analyst.

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

Many factors go into determining if a dividend-paying stock represents a true value. Typically, though, an analyst 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 in—meaning those potential drivers are not reflected in the current share price. One of the most common drivers is takeover potential, especially when the company can be taken over at a premium.

It's Not Easy to Be a Dividend-Oriented 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 fact is, investing for income in the equity markets can be much more difficult than buying a stock on the upswing and capitalizing on its momentum.

It can 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, the investor 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 once it hits a certain price. That way, if the stock loses momentum and experiences a couple of bad days in a row, you will have sold before those bad days kicked in, thus ensuring your profit.

In short, you don't need to have an advanced understanding of things like P/E ratios and market analytics to trade on momentum. But you do need that knowledge to be a successful dividend investor because — as noted — it is essential to helping you recognize a true value from a value trap.

True Value vs. Value Trap: An Analogy

Here is an analogy I like to use to explain the difference between a true value and a value trap. Years ago, I was visiting Italy with a friend. My friend decided to buy a fake Rolex. He haggled with the vendor to get the price down from $50 to $20. It was a very nice-looking watch, so that seemed like a great deal—a true value, in other words. But the next day, my friend went to set the watch and the knob snapped off in his fingers. Turns out the watch was cheap for a reason. It was obvious now the initial $50 price tag was ridiculously high, and that the vendor's whole strategy was to let customers talk him down to think they were getting a bargain. This would be considered a value trap.

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

On the flip side, I have another friend who always wanted a certain collector's edition of a real Rolex. For years, he wouldn't buy one because he thought the prices were too high. But during the Financial Crisis in 2008, he was able to get a great deal on the exact watch that he always wanted. Because he was able to buy the watch at a good price during the Financial Crisis, today that watch is worth a lot more than the price he paid for it. It was a true value. Similarly, that's the goal of a true value stock — to enjoy all the dividends it pays for years, and eventually be able to sell it at a higher price.

Experienced Dividend Investors Dig Deeper

Again, being a good dividend-oriented value investor takes having the right knowledge and doing the right research. It starts with gathering and analyzing all the quantitative information that's publicly available about a company—as would be expected. For growth-based investors, that's often where the process stops. But for a good dividend-oriented value investor, that's where the research only begins. From there, they go on to speak with different analysts to get a variety of opinions about that company and its industry. Next, they might create a list of questions about the way that company does business, its competition, its competitive advantages, and so forth. Then, they might contact investor relations to get answers to those questions. Only after taking all these steps and analyzing all this data will they decide about purchasing this particular stock.

Most everyday investors don't have the time to do all this. And even if they did, most don't have the resources or relationships with professional analysts or know the right data to look for. The same thing goes with many of today's financial advisors. Many simply don't have the proper knowledge to be good dividend-oriented value investors. In the end, it is why many financial advisors continue to 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 — which is the cornerstone of successfully investing for income in the stock market.

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