Not All Dividend Investments are Created Equal!

Tim Plaehn
Editor
Automatic Income Machine, The Dividend Hunter

Investors Alley

www.TheDividendHunter.com

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Tim Plaehn

- Lead investment research analyst for income and dividend investing at Investors Alley.
- Air Force Academy Graduate –1979– with a degree in mathematics.
- Nine years as an Air Force pilot and instructor pilot.
- Post Air Force a stint as a registered securities rep, and Certified Financial Planner.
- Launched Dividend Hunter service in June 2014.

The Challenge

- Income focused investors have the privilege and challenge from having thousands of income paying investments from which to build an income portfolio.
- Most of these investment choices trade on the stock exchanges. This makes them easy to buy and sell.
- Just because they trade on a stock exchange does not mean these securities are all common stock shares.
- I receive a lot of communication from investors who have purchased for the yield and don't know what they really own.

Income Investment Types

I am going to give an overview of each of these categories. Since this a Master "Class" don't be afraid to raise your hand and ask a question.

- Shares of dividend paying corporations – **Common Stock**
- **Preferred Stock Shares**
- Companies organized as pass-through business entities – **REITs, BDCs, MLPs**
- Packaged Products: **ETFs and CEFs**

I will close out with some thoughts on how to integrate all of these types of securities into an income focused investment portfolio.

Common Shares

- Common stock is ownership or equity investment in publicly traded U.S. corporations.
- These are the name brand companies that the public thinks of when the topic of the stock market comes up.
- GAAP metrics such as net income and EPS are usually adequate to use when evaluating common shares.
- Dividends on common shares are at the discretion and policy of the Board of Directors.

Common Shares – continued

- Income focused investors gravitate to select groups of common stocks. Dividend Achievers, Dividend Aristocrats, and shares of regulated utility companies.
- Dividend yields will be moderate – typically 2% to 5%.
- Investment focus is on dividend growth. You want to own companies that will grow the dividend rate for years, or decades.
- I view a common stock DGI (dividend growth investing) strategy as more of a wealth preservation approach.

Preferred Stock

- Preferred stock shares are another type of share class issued by corporations.
- Preferred shares sit in the capital stack between corporate debt and common stock.
- Preferred shares get their name because they have preference for dividend payments over common shares. In a BK, preferred shareholders stand behind bond owners in line for company assets.
- Preferred stock are issued with a par value, usually $25 and no maturity date. Most are callable at par after 5 years.
- Cumulative preferred shares give an extra level of income guarantee.

Preferred Stock – continued

- Preferred stock dividends are fixed. View these as a type of fixed income investment.
- Invest in preferreds for the dividend yield.
- Attractive because yields on preferred shares from investment grade companies can be significantly higher than other fixed income investment types.
- Risk is that preferreds trading above par are subject to being called by the issuer.
- This can happen when you have a nice high yield preferred and rates in the current market are lower. A bummer when yours get called in!

Pass-Through Business Entities

- There are several types of business entities that do not pay corporate income taxes. The trade-off for a zero tax bill is the requirement to pay out the majority of net income (nominally 90%) as dividends to investors.
- **REITs – Real Estate Investment Trusts**. Own commercial property or real estate related finance securities.
- **BDCs – Business Development Companies**. Provide debt and equity capital to small to midsized corporations.
- **MLPs – Master Limited Partnerships**. Publicly traded partnerships that own energy infrastructure assets.

REITs – Quick and Dirty

- Generally dividend themselves into two types – equity or finance.
- Equity REITs own properties across the commercial spectrum.
- These REITs are an income focused way to invest in sectors such as retail, ecommerce, housing, healthcare and general business.
- Finance REITs can be sub-divided into those who focus on residential mortgages and those in the commercial mortgage space.

REITs – Continued

- The GAAP metric EPS does not give a good picture of an equity REIT's cash flow to pay dividends. This is due to high, non-cash amortization expense.
- REIT's report funds from operation – FFO or AFFO, to state free cash flow.
- REIT dividends will often show high payout ratios on stock screens, which use EPS.
- Finance REITs EPS are more useful and companies in the group may also report cash available for distribution – CAD or core earnings.

Business Development Companies

- BDC’s are a pass-through hybrid, with features of finance companies and closed-end funds.
- BDC’s required to provide debt or equity capital to small to medium sized corporations. Most BDCs focus on building loan portfolios, with small equity positions in their client companies.
- BDC rules limit debt financing to two times equity. For example, a BDC with $1 billion of equity could have an investment portfolio worth up to $3 billion.
- Must pay at least 90% of net investment income out as dividends.

BDCs – continued

- BDC rules are quite restrictive. The biggest issue is that they cannot set aside loan loss reserves.

- This is a sector where having share prices at a discount to NAV is not a good deal.

- Most BDCs are externally managed. Management fees can be a serious drag on investment results.

- I currently recommend just two stocks from the sector:
  - **Main Street Capital (MAIN)**
  - **Hercules Capital (HTGC)**
- Both are internally managed.

Master Limited Partnerships – MLPs

- MLPs are partnerships –not corporations– that have units which trade on the stocks exchanges. Investors own limited partner –LP– investments in the companies.

- MLPs primarily focus on owning energy infrastructure assets. Pipelines, storage facilities, processing plants, loading/unloading terminals.

- Another term is midstream energy assets and services.

- There are also specialty MLPs in areas such as propane retail and fuels retail.

- General partner interests are often controlled by another company. The Sponsor company.

MLPs – continued

- Prior to 2014-2016 energy sector crash, MLP sector was focused on growing cash flow and paying out almost 100% as distributions to LP & GP unit holders.

- Growth in those days required low cost access to debt and equity markets. That plan blew up in in 2015.

- Over the last 4 years, MLPs have restructured balance sheets, distribution plans, and business structures.

- Today's midstream businesses are more sustainable, with lower debt, elimination of IDRs, and higher cash flow coverage of distributions.

MLPs – investment considerations

- MLP distributions are classified as non-taxable ROC. Taxes are reported via Schedules K-1.
- The restructuring period has led to a larger number of 1099 reporting midstream companies, giving investors more options.
- I believe there is tremendous value in the midstream sector. Yields are high, distributions are much better covered by free cash flow, balance sheets are improved, and growth projects are now at least partially funded by internal cash generation.
- It has been tough to be Patient, but the outlook is Great!

Pass-Through Investment Considerations

- Companies organized using pass-through tax structures are unique businesses. Each requires its own analysis.
- Investment potential ranges from low yield + high dividend growth to high double digit dividend yields.
- Even with the three types of pass-through's, you can diversify across a large portion of the range of business sectors. Venture capital to renewable energy to housing.
- Biggest danger is that these companies need access to growth capital –debt and equity– and costs that allow accretive or at least sustained cash flow per share.

Packaged Investment Products -- Funds

- Two basic types of exchange traded products: Exchange traded funds –ETFs– and closed-end funds –CEFs.
- Funds allow you to get diversified exposure with a single or small number of investments.
- There are thousands of funds that cover every type of security. Stocks, bonds, muni bonds, non-traded debt, commodities.
- Sometimes investors don’t realize the differences between owning a packaged product and an individual security.

Exchange Trade Funds

- ETFs are designed to own the components and match the returns of a specific index.
- ETF shares are created and redeemed between fund sponsors and large financial institutions.
- ETF management fees are very low compared to other packaged investment options.
- This means an ETF’s market share price will stay very close to the net asset value –NAV.
- With an ETF you get the good, the bad and the ugly of the underlying index.

Closed-End Funds

- CEF shares are sold via an IPO type process. After the IPO the fund sponsor does not issue or redeem shares.

- Market share prices can be at significant discounts or premiums to NAV.

- CEFs can be information black holes where it is difficult to see what a fund manager is owning in the portfolio.

- Many CEFs elect to employ a “managed distribution policy”. This often leads to dividends that have not been earned by a fund. Destructive return of capital.

Portfolio Plan is Most Important Part

- When I was a fighter pilot, 80% time was spent on the mission plan. 20% on flying the plan.
- Developing a portfolio management plan to fit your risk tolerance and goals is the primary determinant of your stock market success.
- Like flying a combat mission, your plan has to be flexible. But it still must force you to get back on path to get to your target.
- Crash and burn investors don’t have a plan.

Risks of High Yield

- Individual stocks have high yields to price in market expectations of a dividend reduction.

- Two potential outcomes: The market is right and the dividend will be reduced, or the market is wrong and investors will reap an above average yield.

- Most of these companies most or choose to pay out a high (90% or more) percentage of free cash flow as dividends.

- If cash flow per share is not sustained, dividends won’t be either.

Risks of High Yield - continued

- Many of these companies need to access the capital markets – equity and/or debt – to raise capital for growth or even to sustain revenue and cash flow

- Dividend yield is the cost of equity capital, so a share price crash can put the brakes on a business model.

- A couple of examples:
  - Uniti Group (UNIT)
  - Most of the MLP sector.

Balance Dividend Growth Income Stocks with High-Yield

- Higher yield stock typically don’t have much dividend growth.
- You can manufacture dividend income growth using dividend reinvestment.
- Compound growth becomes a powerful force as dividend yields increase.
- Different income focused strategies diversify risk in your portfolio.
- You have control over your dividend income. You don’t over stock prices.

An Example of Risk Categories

I divide the recommended stocks for my Dividend Hunter services into three categories.

- Conservative Dividend Stocks: Average yield: 6.5%
- Aggressive, High-yield Stocks: Average yield: 12.5%
- Fixed-Income Investment: Average yield: 4.5%

Portfolio Maintenance

- Take partial profits when you get above guidance share gains.
- Reinvest dividends and sale proceeds to generate a higher portfolio yield.
- Track your results by quarterly dividend income. This is my primary measurement of strategy success.
- Don’t be afraid to buy when the market corrects.
- Place more focus on portfolio management vs. individual stock price movement.

I have two services for dividend focused investors:

- **Dividend Hunter** provides a recommendations list of high yield stocks, ranked by risk factors. I include a lot of educational material to subscribers. Dividend Hunter has something for beginner stock market investors through the most experienced. More at www.thedividendhunter.com

- **Automatic Income Machine** uses a dividend growth on steroids strategy to help subscribers build wealth. Complete portfolio tools including number of shares to own and buy/sell trades. More at www.incomewithtim.com

Compound Growth Illustrated (Dividend Hunter)

- The low interest rate environment of the past decade has pushed compounding income for growth out of the investing publics mindset.

- My Dividend Hunter recommended stocks list has a average yield of over 8%.

- A $100,000 portfolio of high yield stocks will grow to $147k in five years and $216k in 10 years at 8% compounded.

- More importantly and predictably, portfolio income would grow from $8k to 17k in ten years.

Total Return Potential (Automatic Income Machine)

- High yield should be balanced by dividend growth holdings.

- Sustained dividend growth of 8% to 10% is attainable. Add in 4% to 6% yields, and you have long-term mid-teens compounding total returns.

- That will give a double in roughly five-years. Reinvestment and taking partial profits will enhance return potential.

- This approach can build total portfolio value towards a retirement 5 to 10 years in the future.

Change Your Mindset About Share Prices!

- Falling share values are an opportunity not a curse.
- Buy low to earn a higher yield and larger dividends.
- Your stock selections are based on portfolio plan to diversify and control risk.
- Take a profit if one of your shares moves rapidly higher, and the yield no longer make sense.
- As an individual investor you have no control, and very little foresight concerning dividend prices.
- You have a lot of control and future visibility of the dividend income from your stocks.

Thank You!

Some Income Stock Recommendations

- **Aircastle Ltd (AYR).** Just re-added it to Dividend Hunter recommendations list. 6% yield. Great cash flow coverage. Annual dividend increases. 6.7% or 10% increase later this year.
- **Antero Midstream Corp. (AM).** Merger of AMGP and MLP including corporate conversion will produce great dividend growth over next few years. 10% yield. 20% annual total return potential.
- **NextEra Energy Partners LP (NEP).** High dividend growth. Yieldco. Stealthy and steady. 4% yield plus mid-teens dividend CAGR.
- **Virtus InfraCap Preferred Stock ETF (PFFA).** Actively managed to weed out the ugly of PFF. Monthly dividends with an 8.8% yield.

Thank You!

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- Diversified portfolio of 20+ high-yield stocks
- Mix of monthly and quarterly paying stocks
- Average yield over 8% across the portfolio
- Tools to get you on track:
  - Monthly Dividend Paycheck Calendar
  - 36 Month Accelerated Income Plan
- Dedicated Start Out portfolio for new members
- Stock of the Week emails with new research and recommendations
- Low intro rate of just $49
- 1 year full money-back refund policy
- See me after this presentation for more information.

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