How *Not* to Invest in Dividend Stocks:

*Seven Mistakes Investors Commonly Make*

By David Ruff, CFA, Portfolio Manager, Forward Dividend Signal Strategy™ Team

While investors may assume that dividend investing is relatively straightforward, they commonly make mistakes that may undercut the potential income and total return of their investments.

**Highlights**

Dividend stocks have clear appeal, but dividend investing can come with challenges.

Investors and passive strategies can become too focused on high yields, ignoring company fundamentals or growth factors.

Following the herd may create less diversified portfolios too heavily invested in large cap and U.S. stocks.

Not so many years ago, dividend stocks were often dismissed as staid and old-fashioned. Particularly in the 1980s and 1990s, many investors snubbed dividend-paying stocks in favor of stocks that were rapidly appreciating in value.

It’s different today. At a time when fixed-income yields are near historical lows—just as a whole generation of baby boomers is at or near retirement age—dividend investing is very much back in favor. Even USA Today anointed the “stodgy dividend-paying stocks that Grandpa and Grandma used to buy” as the “new rock stars on Wall Street.”

But whenever a strategy becomes the darling of financial advice columnists and bloggers, it may be time to proceed with extra caution. As straightforward as dividend investing may appear, investors commonly make mistakes that undercut both the income potential and the total return of their portfolios. Forward’s Dividend Signal Strategy team has compiled this list of seven pitfalls investors should avoid.
MISTAKE #1
Chasing Lofty Yields

While it may seem only logical for income-focused investors to pursue stocks with the highest dividend yields, those stocks may have some problems of their own. First of all, very high dividends can often be unsustainable. Indeed, dividend yields are often highest just before they are cut or eliminated.

Investors who care about total return should also know that the highest-yielding stocks often underperform by that measure. For example, the highest-yielding global dividend stocks in the MSCI ACWI have consistently underperformed the index as a whole over the last 10 years (Figure 1). One explanation for this is that companies paying too high a dividend may leave themselves short of cash to finance future growth. Research also shows that companies that steadily and incrementally grow their dividends over time tend to outperform high-yielding stocks with no dividend growth.

These are all reasons why dividend investors should consider a company’s dividend payout ratio as well as its dividend yield. Our historical analysis across a variety of global markets shows that companies with the best long-term performance were those combining attractive—but not ultrahigh—dividend yields with relatively low payout ratios. Based on our research, the “sweet spot” is a payout ratio in the 30-60% range—a percentage high enough that companies can commit to delivering regular, meaningful cash payments to shareholders, but low enough that they can reinvest capital for internal growth.

Both of These Ratios Matter

<table>
<thead>
<tr>
<th>Dividend yield</th>
<th>Dividend payout ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>The ratio of a company’s annual dividends to its share price. It is a way to measure cash flow per dollar invested in an equity position.</td>
<td>Dividend payments as a fraction of net income (company profits). The higher the percentage, the greater the portion of earnings that have been paid out.</td>
</tr>
</tbody>
</table>
Passive dividend strategies tend to rely on one or two factors—typically dividend yield or growth—without considering the fundamentals of individual stocks or critically assessing companies’ ongoing ability to generate cash flow. The failure to do such research too often leads to unfruitful investments.

For example, investors flocked to European dividend-paying telecoms based on their strong yields in 2011. A closer look, however, would have revealed that some companies produced those high yields with dividend payout ratios exceeding 100%—a clear signal that their dividends would not likely be sustainable for long.

We believe that, compared to a passive manager who invests strictly by the numbers, active managers who specialize in dividend investing are better equipped to anticipate and respond to companies’ changing dividend policies, whether that means sensing trouble before a dividend is cut or increasing their holdings in high-conviction names.

Research on the topic seems to agree. Active Share, a measure of active portfolio management, analyzes the share of portfolio holdings that differ from the benchmark index holdings. A study of equity mutual funds from 1980 to 2003 demonstrated that funds with the highest Active Share significantly outperform their benchmarks and exhibit strong performance persistence while funds with the lowest Active Share underperform their benchmarks. Other studies have found that active dividend strategies have outperformed passive ones in the small cap, international and emerging markets equities sectors, where information is harder to come by and analyst coverage is relatively thin.

In our view this outcome is predictable, given that a company’s business success, and thus its ability to pay sustainable dividends, depends on a wide range of factors—from the quality of its management to industry dynamics and local regulatory policies—that quantitative screens alone cannot fully illuminate.

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RISKS

There are risks involved with investing, including loss of principal. Past performance does not guarantee future results, share prices will fluctuate and you may have a gain or loss when you redeem shares.

Foreign securities, especially emerging or frontier markets, will involve additional risks including exchange rate fluctuations, social and political instability, less liquidity, greater volatility, and less regulation.

Diversification and asset allocation do not assure profit or protect against loss.

There is no guarantee the companies in our portfolio will continue to pay dividends.

Data and statistics presented have been obtained from sources we believe to be reliable, but we cannot guarantee their accuracy or completeness. All expressions of opinion are subject to change without notice.
**MISTAKE #3**  
**Overlooking Growth Factors**

Investors who are focused on increasing near-term yields may overlook one or both of the growth features in dividend stocks: the growth of the dividend itself and the potential for capital appreciation.

The importance of a growing dividend stream is self-evident; for retirees and others who depend on their investment income, yield pays the bills. A truly active dividend manager will research companies with an eye to their commitment and capacity to continue growing their dividend over time.

At the same time, there are good reasons why even the most income-focused investors may need some growth in their portfolios. Take the hypothetical case of an investor with a $1 million portfolio who wants to withdraw $50,000 a year for living expenses. After 20 years, an investor earning 3% annual total returns would have less than half of his or her starting balance remaining, while one earning 7% would have more than $1.8 million in assets. After 30 years, an investor earning 3% a year would be scraping the bottom of the barrel while one earning 7% annually would have a nest egg of more than $3 million.

One of the beauties of dividend investing is that it can serve both income and growth objectives. That’s especially true for stocks that qualify as “dividend growers and initiators” by virtue of their ability to raise or begin paying dividends. While dividend-paying stocks in the S&P 500 Index have generally outperformed the index in terms of total return, the dividend growers and initiators have done even better (Figure 2).

Dividend-paying stocks should also prove attractive to investors who are concerned with the bond market’s vulnerability to interest-rate and inflation risks. Unlike bonds, dividend stocks would be only indirectly affected by a rise in interest rates, and they are considerably less sensitive to inflation than fixed-income securities.

![FIGURE 2]

**“Dividend Growers and Initiators” Have Outperformed**

Total Return Comparison Based on Hypothetical Growth of $100, January 31, 1972 – April 30, 2013

<table>
<thead>
<tr>
<th>Category</th>
<th>Total Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend Growers and Initiators</td>
<td>$4,769</td>
</tr>
<tr>
<td>All Dividend-Paying Stocks</td>
<td>$3,524</td>
</tr>
<tr>
<td>S&amp;P 500 Total Return Index</td>
<td>$1,839</td>
</tr>
<tr>
<td>Non-Dividend-Paying Stocks</td>
<td>$217</td>
</tr>
<tr>
<td>Dividend Cutters or Eliminators</td>
<td>$96</td>
</tr>
</tbody>
</table>

Returns based on monthly equal-weighted geometric average of total returns of S&P 500 Index component stocks, with components reconstituted monthly.

Source: Ned Davis Research

Past performance does not guarantee future results.
In the last 20 years, emerging and frontier markets have more than doubled their share of the world economy and now account for 47% of GDP.

The argument for global investing is a compelling one in light of the importance of portfolio diversification and the pending shift in economic power from developed nations to faster-growing emerging economies. In the last 20 years, emerging and frontier markets have more than doubled their share of the world economy and now account for 47% of global gross domestic product (GDP).

Yet investors in many developed countries still tend to favor stocks of companies domiciled in their home nations. Research shows that U.S. investors have become more comfortable with foreign securities, but are still subject to home-market bias. While the U.S. represented less than half of global stock market capitalization at the end of 2010, American investors had 72% of their equity holdings allocated to stocks domiciled in the U.S.

Investors no doubt have reasons for favoring companies that are headquartered in their own nations. They may feel greater confidence in the economy they are most familiar with, or be concerned about currency fluctuations, geopolitical events or the higher costs of investing abroad.

Still, U.S. dividend investors have many good reasons to pursue more opportunities in equity markets abroad, including:

**Higher yields.** Average dividend yields are higher in many countries outside the U.S. (Figure 3). A weak-dollar environment can further boost dividend income for American investors.

**Attractive valuations.** With the rising demand for income investments, the U.S. stock market sectors known for generating attractive dividends have become more highly valued. The spread between price-to-book valuations in the U.S. versus those seen in Europe and the emerging markets has widened over the last three years. Now that there are relatively few obstacles to overseas investments, it is possible to buy quality foreign dividend streams for less than a comparable investment would command in the U.S.

Then, too, where a company is headquartered often has little to do with where it generates its earnings. Many iconic American household brands are now owned by foreign corporations, while one can also name many familiar foreign companies that have flourished in the U.S. By seeking opportunities abroad, dividend investors can pursue their diversification and income objectives at the same time.

**FIGURE 3**

**Dividend Yields Are Higher Abroad**

Average Equity Dividend Yields in G20 Economies, as of April 30, 2013

<table>
<thead>
<tr>
<th>Country</th>
<th>Average Dividend Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>South Korea</td>
<td>0.68</td>
</tr>
<tr>
<td>India</td>
<td>1.43</td>
</tr>
<tr>
<td>Mexico</td>
<td>1.54</td>
</tr>
<tr>
<td>Japan</td>
<td>1.72</td>
</tr>
<tr>
<td>Turkey</td>
<td>1.96</td>
</tr>
<tr>
<td>United States</td>
<td>2.08</td>
</tr>
<tr>
<td>Indonesia</td>
<td>2.27</td>
</tr>
<tr>
<td>China</td>
<td>2.93</td>
</tr>
<tr>
<td>Canada</td>
<td>3.02</td>
</tr>
<tr>
<td>Germany</td>
<td>3.02</td>
</tr>
<tr>
<td>South Africa</td>
<td>3.26</td>
</tr>
<tr>
<td>France</td>
<td>3.37</td>
</tr>
<tr>
<td>Italy</td>
<td>3.52</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>3.56</td>
</tr>
<tr>
<td>Brazil</td>
<td>3.64</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>3.70</td>
</tr>
<tr>
<td>France Union</td>
<td>4.01</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>4.14</td>
</tr>
<tr>
<td>Brazil</td>
<td>4.14</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>4.17</td>
</tr>
<tr>
<td>Russia</td>
<td>4.17</td>
</tr>
<tr>
<td>Australia</td>
<td>4.17</td>
</tr>
</tbody>
</table>

Source: Bloomberg and MSCI

Past performance does not guarantee future results.
MISTAKE #5

Having Blue-Chip Tunnel Vision

When it comes to dividend investing, many investors, professionals included, focus on a limited universe of blue-chip, large-cap stocks—those deemed “safer” because they are industry giants and household names. These stocks offer a liquidity advantage, to be sure, but they don’t necessarily represent the best growth or yield opportunities, especially in light of their valuations. In our view, rising investor demand has made many blue-chip dividend stocks too expensive to consider.

We also believe that blue-chip bias is an outdated mindset. In today’s domestic and international markets, many younger small- and mid-cap companies are willing and able to reward their shareholders with consistent dividend payments. They tend to be less subject to buying pressure than familiar blue-chip names, and are thus less expensive—which may translate into a better value.

While it’s true that smaller-cap stocks can be more volatile, they often exhibit greater long-term appreciation potential. Since the inception of the MSCI ACWI Small Cap Index in 2007, small- and mid-cap stocks delivered more total return than large-cap names. Our research shows that dividend opportunities abound across markets and capitalization levels. We also believe that owning a blend of large-, mid- and small-cap dividend stocks gives investors broader opportunity and greater diversification than an income portfolio dominated by blue-chip names.

Overemphasizing large, blue-chip dividend payers is an approach we can only describe as myopic.

MISTAKE #6

Following the Herd

Review the holdings of the largest dividend-focused mutual funds and exchange-traded funds and you will find a high degree of overlap—especially when it comes to large-cap domestic stocks with broad analyst coverage. In fact, since 1990 there has been a significant shift from active to passive management within the mutual fund space. Perhaps it should come as no surprise that so many funds invest in the same “usual suspects.” After all, many strategies rely on indexes to drive the composition of portfolios. But while there may be safety in numbers in some situations, the herd mentality does little or nothing to help investors. For one thing, large-cap stocks are overrepresented in indexes and, as discussed previously, being overweight in large-cap stocks can put investors at a disadvantage. The same goes for overrepresentation of countries and sectors, which can leave investors more vulnerable to macro risks. It is more than difficult to outperform the index if you are simply piggybacking it.

Hugging a benchmark may lead investors to hold the same stock in different funds, whether they know it or not, leaving them overexposed to certain companies and less diversified than they may think. At the same time, commonly held stocks are more likely to become overvalued, offering less potential for capital appreciation. And while these popular names do offer plenty of liquidity advantage, that factor can be double-edged—meaning they may be more vulnerable to downside price pressure on bad news, especially if the bulk of their shares are held by institutions and pension plans that trade in large volumes. If something goes wrong and the big institutional investors run for the exits, share prices can quickly plummet.

In other words, the comfort that comes with being part of the crowd may be illusory. We believe investors would be wise to scrutinize the holdings of the equity funds in their portfolios, and make sure they diversify beyond the dividend-paying stocks that “everybody” likes to own. Picking a fund manager that researches and invests off the beaten path can help investors diversify, manage risk and capture growth potential.

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Dividend investors should be mindful of market fundamentals, but not paint regions of the world with too broad a brush.

**MISTAKE #7**

**Giving Macro Factors Too Much Weight**

High debt levels, political turmoil, stubbornly high unemployment—there has been no shortage of macro worries to roil global markets. But as much as dividend investors need to be mindful of market fundamentals, they do themselves a disservice if they paint regions of the world with too broad a brush.

Europe is an obvious example. At this point, the words “eurozone” and “crisis” seem fused in our minds, and many investors are shunning European stocks as a matter of policy. Yet with some research it is certainly possible to uncover strong, dividend-paying European companies that derive a significant share of their revenues outside the eurozone. And, as shown in Figure 3 previously, European countries have among the highest average dividend yields available in the developed world, so avoiding those stocks altogether can lead to missed opportunities.

Attractive valuations give these opportunities added appeal. With the recent run-up in the U.S. market, the spread between U.S. and European equity valuations is getting wider.

Investors may also be justifiably wary of how macro events might impact the emerging markets. Still, we believe that with careful research, one can find companies that can grow and raise dividends despite macro factors. For example, while some stocks in Indonesia may be affected by events in China or Europe, a water company or other local population-serving enterprise could be far less affected by those occurrences, if at all. European and emerging market investments are certainly not without risk. But by being selective and diversifying exposure, investors can mitigate those risks and, indeed, potentially be well-compensated for taking them.

**Conclusion**

At a time when so many investors are looking for new sources of investment income, dividend stocks have clear appeal. But that does not mean dividend investing is without challenges, especially as the competition for high-yielding options grows. With so much focus today on dividend-payers, it’s important for investors to recognize and avoid the common pitfalls involved with investing in them.

We believe success depends on:

- Thoroughly analyzing individual companies on their own merits rather than depending on simplistic formulas or index names, or being too focused on macro factors
- Taking the long view, with an emphasis on dividend sustainability and growth rather than ultrahigh yields
- Breaking away from the crowd to include stocks from all market caps and regions

We hope the perspectives we have outlined here will help investors and advisors to explore dividend stocks as a way to pursue their income, growth and diversification objectives. We recommend that investors talk with their financial advisors about dividend strategies that avoid the common mistakes and how they can play a role in a portfolio.

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7. The Economist online, “Emerging vs. developed economies: Power shift,” 08/04/11, IMF, World Economic Outlook Database, HSBC Calculations, October 2012
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The new direction of investing

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Definition of Terms

A blue chip is a nationally recognized, well-established and financially sound company. Blue chips generally sell high-quality, widely accepted products and services.

Inflationary risk refers to the possibility that the value of assets or income will decrease as inflation shrinks the purchasing power of a currency.

Interest rate risk is the risk that an investment’s value will change due to a change in interest rates.

G20 (Group of Twenty) is a group of finance ministers and central bank governors from 19 of the world’s largest economies, and the European Union. The mandate of the G20 is to promote growth and economic development across the globe.

Liquidity is the degree to which an asset or security can be bought or sold in the market without affecting the asset’s price.

MSCI ACWI (All Country World Index) is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global developed and emerging markets.

MSCI ACWI High Dividend Yield Index is based on MSCI ACWI, its parent index, and includes large- and mid-cap stocks across 45 developed market and emerging market countries. The index is designed to reflect the performance of equities in the parent index (excluding REITs) with higher than average dividend yields that are both sustainable and persistent.

MSCI ACWI Small Cap Index captures small cap representation across 24 Developed Markets (DM) and 21 Emerging Markets (EM) countries. With 5,998 constituents, the index covers about 14% of the free float-adjusted market capitalization in each country.

S&P 500 Index is an unmanaged index of 500 common stocks chosen to reflect the industries in the U.S. economy.

Valuation is the process of determining the value of an asset or company based on earnings and the market value of assets.

Volatility is a statistical measure of the dispersion of returns for a given security or market index.

One cannot invest directly in an index.