
I really enjoy the articles written on Seeking Alpha. If I had a subscription I would probably read one every day. Occasionally they let everyone read an article and this one by Samuel Smith is fantastic. You can read if for free at: Seeking Alpha

Here is a copy of it. Most of the links work to the other good articles. Many of his points are excellent. Most of the ETFs he mentions are in my portfolio. I particularly agree with using QYLD and XLYD to take advantage of using options to improve returns.

**What I Wish I Knew Before Investing In Dividend Stocks**

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**Samuel Smith**

**Summary**

- Dividend investing has been extremely rewarding for me.
- However, I have learned several very expensive lessons along the way.

- I share four very important - yet seldom discussed - lessons in this article.
- Looking for a portfolio of ideas like this one? Members of High Yield Investor get exclusive access to our subscriber-only portfolios. Learn More »

**Magical_Light**

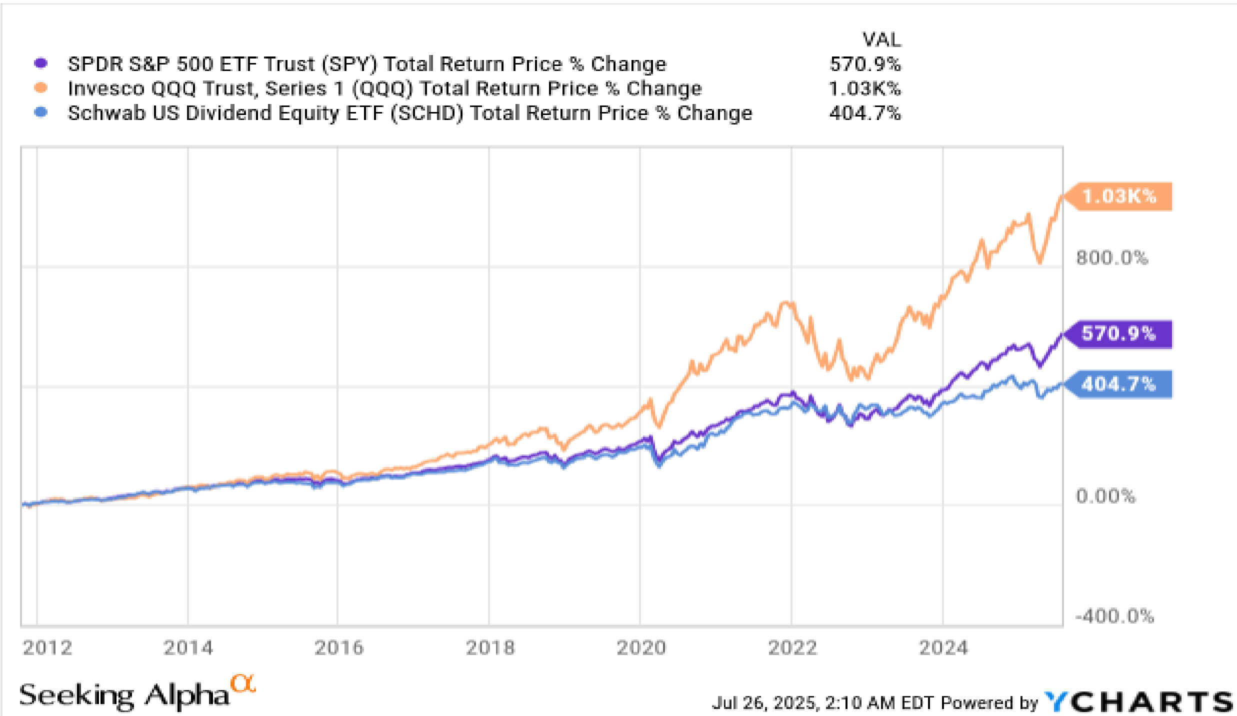
Dividend investing has been a wonderful experience overall for me, in addition to learning a lot about the world and its major corporations, as well as learning a lot about myself, I have managed to enjoy significant total return outperformance of the S&P 500 (SPY), thanks to implementing a valuation and fundamentals-focused opportunistic capital recycling strategy. That being said, I have also learned quite a few costly lessons along the way. With that in mind, in this article I am going to share four lessons that I wish I knew before investing in dividend stocks.

**Lesson #1**

The first major lesson is that dividend stocks tend to be relatively poor long-term compounders, though of course there are some exceptions. The reason for this is that stocks that pay dividends, especially high yields, do so in large part because they have limited opportunities to reinvest and retain cash flows at high returns. Therefore, while they may present attractive current income and may even grow at a rate that meets or beats inflation over time, they are unlikely to be highly dynamic growers due to their limited retained capital. These are the sorts of stocks you see in a lot of high yield sectors like REITs (VNQ) such as Realty Income (O), business development companies (BIZD) such as Ares Capital (ARCC), MLPs (AMLP) like Energy Transfer (ET), and even some consumer goods companies like Altria (MO).

Of course, some of these do have very impressive long-term total return track records; however, most of their peers lack such impressive long-term compounding performance, and in the case of companies like O and ARCC, it is largely due to the fact that they have at times traded at premiums to their underlying NAVs, which enable them to issue additional shares on an accretive basis to accelerate the compounding process. Meanwhile, stocks like MO were able to grow their earnings per share at a strong clip for years with a powerful moat, but their moat is now rapidly eroding as their core smokeables business is experiencing huge volume declines and they are struggling to grow out of it.

All that to say, when you are investing in a portfolio of higher-yielding stocks like this, capital recycling needs to be a part of your strategy if you truly value long-term total return performance. The inability to reinvest a lot of capital at high rates of return makes these companies limited from a long-term compounding perspective, especially compared to dynamic growth and innovation stocks like Microsoft (MSFT), Meta (META), and Tesla (TSLA) that are constantly developing new technologies and retaining the vast majority of their cash flows to pursue growth opportunities. This is evidenced by the fact that the S&P 500 and the NASDAQ (QQQ) have significantly outperformed dividend stocks, as evidenced by comparing their performance relative to the Schwab U.S. Dividend Equity ETF (SCHD) over the long term:




Data by YCharts

**Lesson #2**

Another important lesson that I wish I had learned before investing in dividend stocks is that certain types of dividend stocks can be either extremely tax inefficient or extremely tax efficient investment vehicles, depending on which accounts you hold them in. For example, REITs, BDCs, and MLPs are all pass-through entities, and so they are largely exempted from corporate income taxes, which can make them extremely tax-efficient investment vehicles.

However, BDCs primarily invest in loans, so the vast majority of their dividends are classified as ordinary income. Given that the vast majority of the total returns they generate tend to come from the dividends themselves, since they have to pay out at least 90% of their taxable income as dividends to maintain their status as BDCs, they are very tax-inefficient to hold in taxable accounts. However, these investment vehicles are excellent to hold in a retirement account, since the dividend tax classification is meaningless, while the underlying business itself is largely tax-exempt.

REITs are a bit more complicated, as some of their payouts do count as return of capital, and they also qualify for a 20% QBI deduction in many cases. So, depending on the REIT's dividend yield and the classification of its dividend, it could be a good fit for a taxable account, or in other cases where much of the dividend is classified as ordinary income and has a high yield, it is likely much better suited to holding in a retirement account.

Finally, MLPs that issue K-1 tax forms are much better suited to taxable accounts, since the distributions are largely classified as return of capital, making them very tax-efficient income instruments for a taxable account, whereas if they are held in a retirement account, they can generate UBTI, which could force you to pay a tax bill in an account that is supposed to be tax-sheltered.

Beyond that, dividend stocks, as previously mentioned, are not the best wealth compounders, so capital recycling is often a useful strategy to overlay on top of them. This is particularly true since they tend to be easier to value than high growth stocks, because you simply look at the yield for a large portion of the return and then add to that some relatively modest yet highly predictable growth rates to determine what kind of total return you are going to get from the investments. Therefore, if you do plan on implementing a capital recycling program with stocks, it is best to hold as many of them as possible in a retirement account in order to mitigate the tax headache that can come from frequent selling positions at short-term capital gains rates. Note that none of this is tax advice, rather simply my opinion based on my years of experience dealing with tax-related issues from investing in dividend stocks. Be sure to do your own diligence and speak to your own tax advisor before making any of these decisions.

**Lesson #3**

Another lesson I wish I had learned before investing in dividend stocks is that it is very important to understand what type of dividend stock you are investing in. For example, if it is a cyclical stock, you need to be extra careful because they can often experience sharp declines in earnings as you head into down cycles and, with it, a deep decline in the stock price. If the balance sheet is not particularly strong, this can lead to steep dividend cuts or even dividend eliminations, as I learned the hard way with Hanesbrands (HBI) and some investors who are currently in Dow (DOW) are currently learning the hard way as well.

Meanwhile, if it is a stalwart, steady stock like Enbridge (ENB), IBM (IBM), or NNN REIT (NNN), you can count on very dependable dividends, but you are not going to get much in the way of growth. As a result, these are the sorts of stocks you need to make sure you buy on a value basis and will likely want to implement a capital recycling program on to accelerate the compounding process if total returns are important to you. Meanwhile, stocks that have lower yields but high dividend growth rates are ones that can generate a lot of wealth, but you need to be careful because once the dividend growth rate slows meaningfully, the stock is likely going to pull back sharply as well. Just look at what happened to the late NextEra Energy Partners (XIFR) as an example of this.

BDCs, MLPs, and REITs generally tend to belong in the stalwart category, yet their underlying mechanics are quite different in terms of how they relate to macro factors. BDCs tend to benefit from rising short-term interest rates, whereas REITs tend to suffer when interest rates rise. MLPs, meanwhile, are much more commodity price sensitive in terms of unit price performance, even if their underlying cash flows are quite stable. Therefore, you need to make sure you realize these factors when buying these securities instead of just looking at the yield that they offer and ignoring all the other considerations that go into those investments.

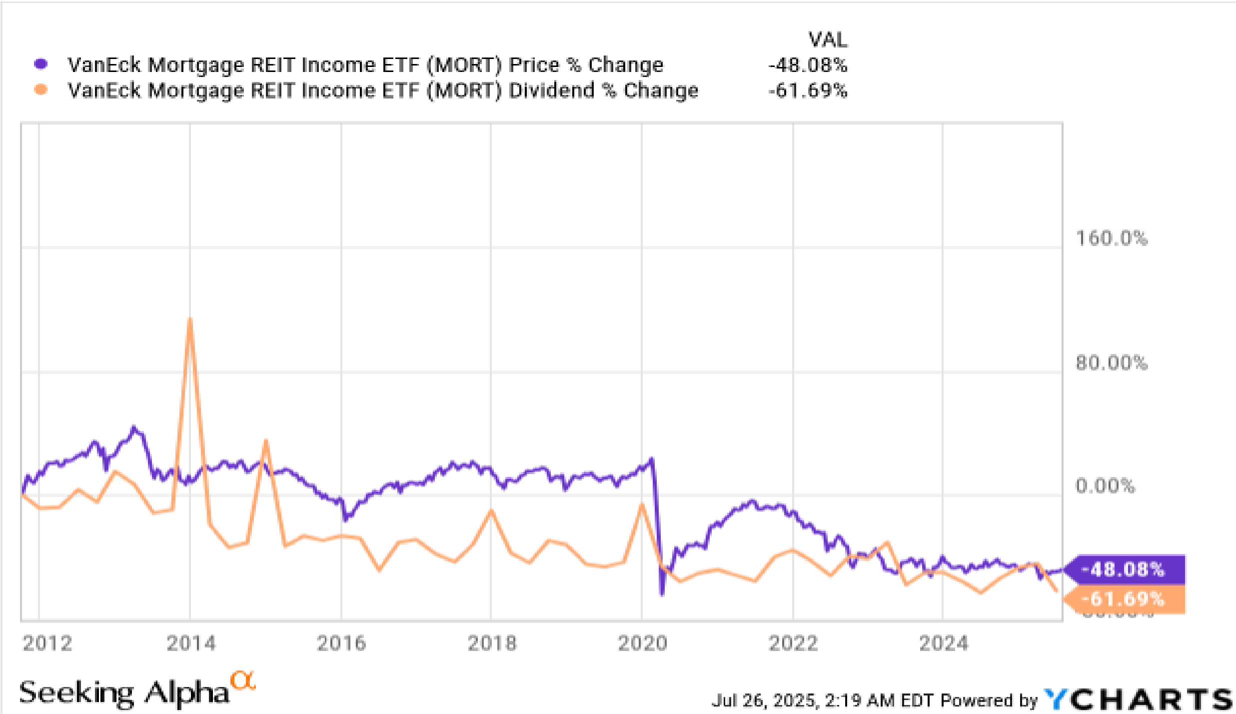
**Lesson #4**

Finally, I wish I had known that high-yield funds are often fundamentally flawed. This is because it is very rare for a large portfolio of stocks to offer a sustainably high yield such as these high-yield funds offer. Yes, you can find perhaps one or two dozen high-yield stocks at any given time that have genuinely sustainable high yields and compelling valuations. This is what I do, in fact, in my portfolio.

However, many of these other funds are very broadly diversified, and so they generate their yields from less sustainable sources. One way they do this is by selling covered calls as the JPMorgan Equity Premium Income ETF (JEPI) does, which often leads them to long-term NAV erosion risk as evidenced by the abysmal long-term performance of the Global X Nasdaq 100 Covered Call ETF (QYLD).

Data by YCharts

Another way they can do this is by filling their portfolio with very low-quality underlying holdings, which get exposed whenever the markets experience a downturn. An example of this is the VanEck Mortgage REIT Income ETF (MORT), which has seen its dividend payout decline meaningfully over time.

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Another option is that they may employ significant leverage risk, which can juice returns in the short term and enable them to pay out a higher yield, but also puts them at significant risk during a market crash. This is especially common in the closed-end fund space, where piling on significant amounts of leverage is quite common, as seen with funds like the PIMCO Dynamic Income Fund (PDI), the Cohen and Steers Quality Income Realty Fund (RQI), and the Cohen and Steers Infrastructure Fund (UTF). Note that some funds can navigate carrying significant leverage quite well, but the risks are still elevated when this route is taken.

Finally, there are other funds such as the Liberty All-Star Equity Fund (USA) that pay out a high yield yet generate that yield entirely from the proceeds of selling underlying positions rather than actually generating it from dividends from underlying holdings. This exposes them to significant sequence-of-return risk and/or dividend cut risk because if the market were to ever enter a prolonged bear market, they would either significantly erode their NAV and lock in permanent losses on their underlying holdings or they would have to cut their dividend. Either of these outcomes should be a major no-go for investors looking for long-term, sustainable, and growing passive income.

**Investor Takeaway**

Realizing that many dividend stocks are actually pretty poor long-term compounders, that they can be potentially extremely tax-inefficient investments if you do not understand what you are doing, that they can also lead to dramatic downside risk both in terms of share price performance and dividend payouts if you do not understand what type of dividend stock you are investing in, and that high-yield funds are often yield traps due to some fundamental flaw are some very important lessons that I have learned the hard way as a dividend investor over the years. However, it is important to keep in mind that each of these challenges can be mitigated or avoided altogether while still reaping the long-term wealth and passive income compounding that comes from dividend investing. Hopefully these lessons are useful for you as you craft your own dividend portfolio, as they are invaluable to me as I build my portfolios of high-yielding, high-performing stocks at High Yield Investor.

I hope you gained some insights from that Seeking Alpha article. You can read it in its entirety as originally published using the link in the start of the article.

Another good article on 7 Best Monthly Dividend Stocks appeared this week on U S News and Reports. Click on link above to read it.

As always, these are ideas to consider. Never take information we publish as fact, but just ideas that might work for you. Discuss all decisions with your broker or financial advisor.


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