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Why Compound Income?

Some investors chase story stocks and growth stocks which they hope will show them either a big and or quick profit. However, they often end up over paying as a result and getting disappointing returns when things don't turn out as they hoped. Though I'm sure many will be able to point to individual growth stocks or speculative E & P stocks they have made a fortune on in a short space of time, I prefer to take a more tried and tested value approach to get rich slowly. Now I know many a reader, if they haven't clicked away already will be thinking boring. But as Paul Samuelson said,

"Investing should be dull. It shouldn't be exciting. Investing should be more like watching paint dry or watching grass grow."

Plus as Warren Buffet said:

"Investing is simple, but not easy."

So I prefer to keep things simple and based on the history of where returns have come from (dividends) and what has worked (value). In addition I like to screen for Quality and Financial Security.

When I started my investing journey having read around the subject I learned of the value effect which, despite having been identified decades ago, still seems to be going strong to this day. Great background evidence to this was produced by Tweedy Browne.

The second thing that had a great influence on me was what was then called the Equity Gilt Study which in those days was produced BZW or Barclays De Zoete Wedd. This showed the returns to various asset classes over the years and demonstrated that the best long term returns come from shares and that most of the returns from shares in the long term come from dividends. This publication is only available to clients these days, but professors Elroy Dimson and Paul Marsh, who I studied with at the London Business School, have also produced a similar study in recent years and written a book called - Triumph of the Optimists: 101 Years of Global Investment Returns. Or better still you can download a copy of their 2013 Yearbook. This still shows a similar picture and this is where the data for the graph which features on my blog comes from.

Consequently when I first started investing on my own account in the early 1990's, when self select PEP's first became available, it made sense to me to focus on yield to maximise returns by compounding the dividends in a tax free environment. In those days you were also able to reclaim the 20% tax credit that existed at the time - oh happy days. Thus to sum up why I compound income

by buying shares with dividends and yield it is because:

1) In the long run that is where most of the returns come from (see p56 2013 yearbook above for UK data) and also with real growth in dividends it can protect your capital and income from inflation in the long run. So to my mind it therefore makes sense to focus on yield.

2) Value and yield outperform in the long run (see Tweedy Browne research in the resources tab on the web site) and since yield is a successful value factor, by focussing on it I force myself to have a natural value bias in my portfolio.

3) Yield can act as a buy and sell discipline.

Finally to conclude this part with what I have found to be true in my experience over the years, I'll finish with some extracts from the Tweedy Browne Yield paper:

"Professor Siegel also coined the terms “bear market protector” and “return accelerator” to describe how dividend reinvestment during stock market declines can dramatically lessen the time necessary to recoup portfolio losses.

The following conclusions can be drawn:
1. Over the last 100 plus years, an investment in a market-oriented portfolio that included, most importantly, reinvested dividends, would have produced 85 times the wealth generated by the same portfolio relying solely on capital gains.
2. There is substantial empirical evidence to support a direct correlation between high dividend yields and attractive total returns.
3. Three of the studies found that the best returns were not produced by the highest yielding decile or quintile, but rather by the next highest yielding one or two deciles, or the next highest yielding quintile.
4. At least one study demonstrated that the returns associated with market-beating high dividend yield stocks were also less volatile in terms of the standard deviation of returns.
5. In several of the studies, high dividend yield stocks also sold at low ratios of price-to-book value and/or price-to-earnings.
6. The return advantages of high dividend yield stocks held for equity securities in both the U.S. and throughout the world.
7. At least one study found that high dividend yield stocks outperformed other value strategies as well as the overall stock market return in declining markets.
8. The reinvestment of dividends from high-yield stocks can dramatically shorten the time necessary to recoup losses in declining markets.

It seems clear, at least from the studies contained herein, that stocks with high dividend yields have enjoyed interesting return advantages over their lower yielding counterparts."

So there you have it the background to my approach which is simple but not necessarily easy to implement or stick with in the long run. In the next part, I will pick up on some of the findings from the research above plus other papers to detail the factors I use when scoring Compound Income stocks in a ranking system.

How to Score Compound Income Stocks

1.Dividend and Earnings Yield – Value.

The most obvious place to start is with the dividend yield which is certainly one factor which I use. However, when it comes to picking value stocks more generally this is not necessarily the best way to identify value stocks. Even though yield covers this to to a certain extent, as often higher yielding shares tend to offer value as they have got onto a high yield by being beaten up or neglected. I do however, like to check other valuation and financial metrics when considering yield shares to ensure that I am buying value and not just an expensive, low quality and financially challenged high yield stock.

Research carried out in the Book - Quantitative Value by Gray & Carlisle suggested that the best measure for this was earnings yield or EBIT/EV which is calculated by taking the operating earnings (operating margin x turnover) and dividing this by the Enterprise Value of the company (Market Capitalisation + Net Debt) which better reflects what it would cost to buy the whole company based on its existing financing arrangements. In the book they also examined combining value measures and found that this could also do a good job of identifying value stocks.

Therefore I combine earnings yield and dividend yield or EYDY as a way of scoring the value offered by a stock as I am interested in buying cheap (value) stocks with a decent yield. I do then also look at other measures such as the P/E to get a feel for how expensive a stock is overall.

2. Earnings and Cash Flow Cover - Dividend Security.

In this part I will briefly look at the security of income from dividend stocks which is quite commonly measured by the extent to which dividends are covered by earnings. This is probably conventional wisdom, quite sensible and there was research by CSFB to back up why it is a good idea when selecting yield stocks.

In addition, I combine this with the level of cover by free cash flow, again fairly obvious as the more free cash flow a company has, the greater leeway or discretion they will have over maintaining or increasing the dividend and considering share buy backs or paying off debt.

Indeed share buy backs and changes in debt levels are also worth noting as Mebane Faber has found in his research and book titled: Shareholder Yield: A Better Approach to Dividend Investing. Looking at total shareholder yield, including buy backs can be more productive than just selecting yield stocks. While Jack Vogel, who works with Wesley Gray the author of Quantitative Value, has come up with similar findings in his research looking at this but including buy backs and debt pay

down in the calculation of shareholder yield. He also explored whether it was better using longer term data rather than one year data. You can read a summary of his findings at their useful site called Alpha Architect where you can also sign up for updates from them if that is of interest to you.

I don't screen for these factors (buy backs and change in debt) specifically, as I have not been able to find a way of easily tracking this for all stocks. However, using cash flow does help to identify those companies that have the flexibility to provide a greater shareholder yield overall which is why I use it in my scoring of dividend cover. Since a scoring system is just a starting point for identifying attractive stocks, one can then go onto examine if the company is undertaking buybacks and paying down debt / building up cash when you do you further due diligence research.

3. Interest Cover and Piotroski F Score – Financial Security.
In this section we are going to be looking at ways of assessing the finances of Companies. For this I use two main measures, the first one is more complicated and is called the Piotroski F score, named after the professor who devised it. The second is more simple - interest cover, the number of times interest payable is covered by operating profits.

The Piotroski F Score comes from an academic paper in which he aimed to use historic financial data to separate winners and losers in value portfolios. This looks at profitability, leverage, liquidity and sources of funds and operating efficiency as explained in brief here. Thus it seems a suitable metric to use as I am using a value based screen when trying to identify Compound Income stocks.

In addition since the research was most effective in small and medium sized firms and those with low share turnover and no analyst coverage it is helpful as my portfolio is biased in that direction generally. It may also be helpful in providing reassurance or a warning on small unknown stocks that might score well or badly on this measure. It also touches on other aspects of the business operations, apart from just the financing, which is also useful. The other way in which the Piotroski score can be used is in conjunction with valuation based models as a filter for selecting the best stocks (those scoring 8 to 9) or excluding the most vulnerable stocks (those scoring 2 or less). Others have also found that by using this measure with other valuation metrics that they can improve their performance. It is generally used to identify the stronger and weaker companies. By combining this with interest cover and scoring it accordingly I can get a quick handle on the financial strength or weakness of a company. This can then act as a green or red flag for further investigation and confirmation when doing further research.

In addition it is worth pointing out that interest cover may flatter some stocks like retailers or other companies who have lots of leased premises or equipment. Then you will need to look at fixed charge coverage to get a better feel for their financial viability going forward, but in any event it's always worth doing more research whatever a particular indicator says. It is also worth noting that interest cover is not that instructive with financial companies either, so you will need to asses them on their own merits and understand the nature of the business, although in some cases they may not have any debt.

Other than that you can of course use more traditional measures of gearing such as debt to equity where you should normally be wary of anything over 50% depending on the nature of the business. You could also consider the debt to Enterprise Value to see what proportion of the financing is coming from debt, as debt to a certain extent can be beneficial for shareholders, but it does increase the risks. Debt to EBITDA multiples are also often used in debt covenants and sometimes companies may disclose this figure as a way of showing how much headroom they have. I tend to look for, as a general rule of thumb that Interest cover >3x and or debt to EBITDA of less than 3x.

4. Return On Capital Employed and Operating Margin – Operational Quality.

Here we are going to look at how to go about assessing the operational quality of a stock or is it a good business which can generate returns for shareholders. Since we have used current profitability, cash flow and dividends in the value scoring I like to focus here on longer term measures to get a feel for stability and sustainability in these metrics.

I use five year average operating margin and five year average return on capital employed (ROCE) as indicators of the quality of a business.

Thus a Company with high and stable margins and returns will score more highly than one that sees lower figures on these measures that are volatile. For example a pharmaceutical stock would likely score well on this, as you might expect, given their high research & development spend which provides patent protected products. Whereas a house builder which might be earning good margins and ROCE today probably wasn't a few years ago, so this will have a lower score despite the current profitability to reflect the variability of it profits.

Using longer term averages therefore helps to identify, to an extent, those that have high and stable returns over those with lower and more volatile returns or cyclical companies - which should in any event be fairly obvious based on what they do. However, if we get into another extended economic cycle then some cyclical companies may appear to have high and stable margins and returns so you would then need to interpret this score with a bit of care and use your common sense.

In addition it will penalise those stocks that have seen margins and returns decline, so again you would need to do more research to see the reasons behind this, whether they are at cyclical low or if they are on a recovering trend or even moving into new areas under new management, which might lead to higher returns and can be a good thing for a value / recovery situation.

5. Another Quality Measure? - Dividend Growth and Dividend Streak.

This is a slightly controversial metric to include as many believe and some studies have shown that buying growth stocks or focussing on historic growth is not necessarily a winning strategy.

However, in income investing it can be appropriate if you are trying to secure a growing income which can protect both your income and capital in real terms. Other studies and as highlighted on this site show that compounding your income can also greatly increase your returns and speed the recovery from draw downs (declines).

So what is the evidence for looking at dividend growth? Well specifically in the UK in 2008 there was an interesting working paper titled Consistent Dividend Growth Investment Strategies by Gwilym, Clare, Seaton and Thomas from the Cass Buisness School. In the abstract from this they said:

"We investigate whether firms in the United Kingdom that have a long, uninterrupted history of dividend growth outperform the broader equity market. It is observed that firms with in excess of 10-years consistent growth have returned considerably more than the equity market as a whole, with the additional benefits of lower volatility and smaller draw downs. A size effect exists amongst these firms with lower market-capitalization firms demonstrating improved risk-adjusted returns."

They also highlighted some of the other research which suggests that looking at dividend growth history is a good idea as follows:

"There are a number of good reasons why investors should favour companies that have a consistent history of increasing dividends.

Firstly, one of the components in Gordon’s (1962) constant growth valuation model is the growth term. It takes a much greater leap of faith to assume a future growth rate when there has been no precedent set in recent years compared to a stock that has a long-term growth rate already demonstrated.

Secondly, Lintner (1956) observes that management only raise dividends when they believe that earnings have permanently increased. This implies that firms that continually increase their payments envisage a positive outlook for profitability.

Thirdly, Barth et al (1999) show that firms with a pattern of increasing earnings have been accorded higher price-earnings ratios after controlling for growth and risk. Given that in the long-run dividends and earnings are inexorably linked, this appears to bode well for the valuations of consistent dividend payers.

Finally, Arnott and Asness (2003) demonstrate that, in aggregate, higher dividend payouts are consistent with higher future earnings growth. Walker (2005) supports the case for investments in consistent payers. In the 10 years to April 2005, it is stated that a basket of US securities with at least 10-years of consistent dividend growth outperformed the S&P 500 by 3.28% per annum coupled with the advantage of two percentage points lower volatility."

Indeed S & P even produce what they call Dividend Aristocrat indices based on this concept and a number of ETF's have been launched based on these and other indices with a similar concept. See a useful site (buyupside) which details the US qualifiers and has lots of other useful free information for investors.

So it seems that there is some value in looking at dividend growth history although they found that it worked best in smaller and mid cap names, which again fits well if you are running a concentrated portfolio and not closet indexing. Indeed the authors of the above paper said:

"The conclusion is rapidly drawn that for consistent dividend portfolios to be successful they should be formed on an equally weighted basis; otherwise there is no real advantage in diverting from the benchmark. The equal versus value-weighted issue might in itself explain some of the out performance of comparable US ETFs versus the market-capitalization approach of the S&P 500 described by Walker (2005)."

Thus dividend growth history is one of the factors I take into account when scoring Compound Income stocks. It could also be argued that this is another way of measuring or assessing quality as those companies with a long history of rising dividend presumably are well managed and have a business which can generate rising returns for shareholders over time. So in a way it follows on well from the operational quality measures I looked at in part 4. Similarly here a steadily rising profile is likely to indicate a better quality / managed business, whereas weaker or more cyclical ones are more likely to have pauses in their growth or even dividend cuts which obviously you would want to avoid.

With that in mind and with an eye to the future I also factor in the one year forecast dividend growth alongside the dividend history for a combined dividend growth score as I like to know that growth is still forecast and how it compares with the past. In the next part I'll look at another indicator which helps to back this up.

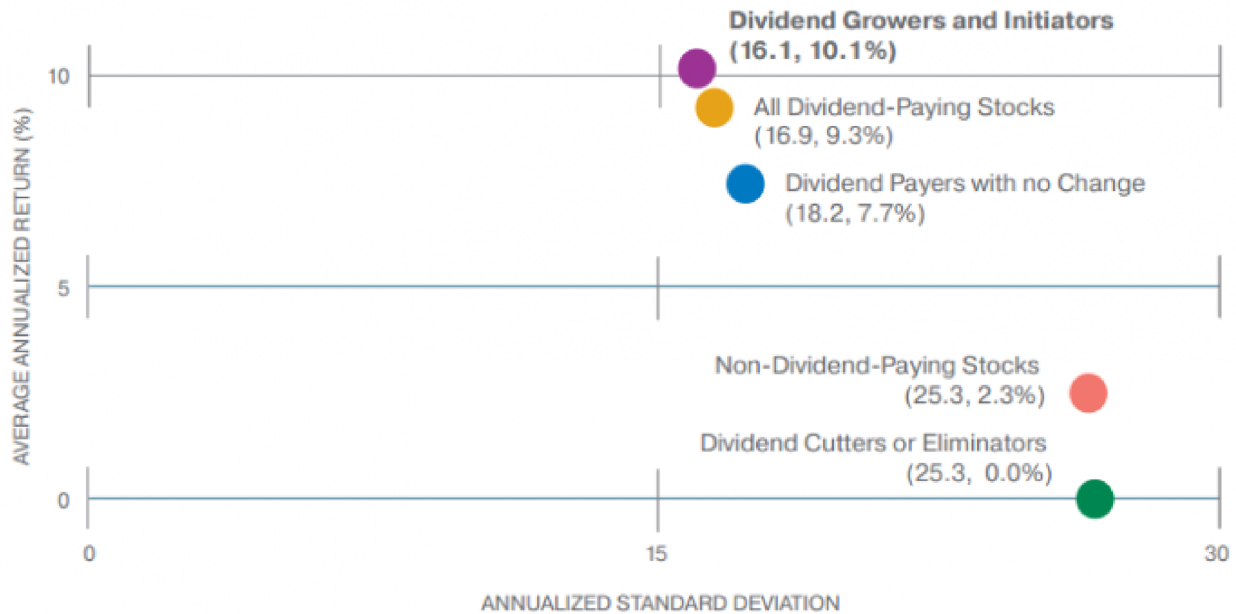
Finally, the other take away I had from this paper was the fact that they found that "a significant portion of the improvement in absolute return of the consistent dividend growth stocks can be attributed to the avoidance of non-paying firms." So when compiling a list of Compound Income stocks to compare I make a point of generally excluding zero yielding stocks as I'm not interested in them and as the authors observed:

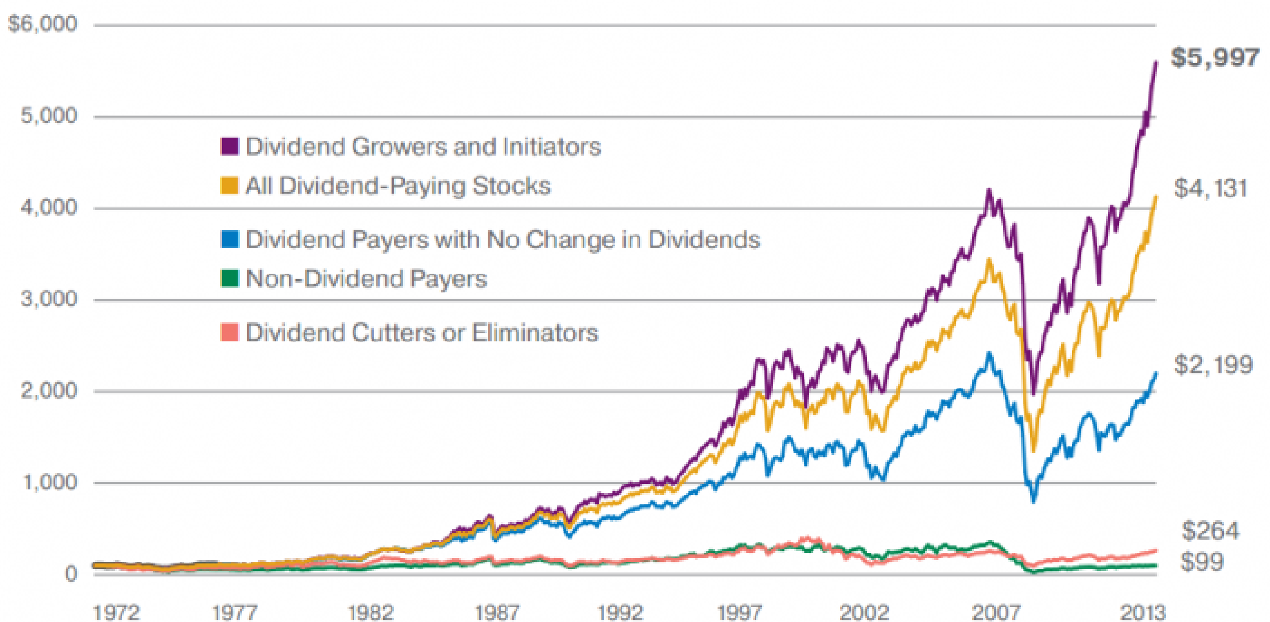
"The most immediate observation is the exceptionally poor performance of the zero-dividend firms, particularly those larger ones that were in the All-Share Index. Not only were returns comparatively low but also the volatility was much higher relative to the dividend paying firms. The maximum draw down was an eye-watering 85% for the All-Share constituents, with accompanying extreme Ulcer index levels." Ouch - buy zero yielding stocks if you like but I just say No don't do it!

Having talked about S&P Dividend Aristocrats fund above, to reinforce the point I present below a

couple of graphs for you from a fund brochure for the Oppenheimer Rising Dividends Funds, which sums up nicely some of the benefits of focussing on companies that consistently raise their dividends.

These show that by focussing on these types of stocks in an equally weighted basket of stocks that you can potentially achieve higher returns overall and at a lower risk which is in theory what every investor should want to try and achieve.





6. Earnings Revisions – Outlook and Prospects.

This is the final thing to monitor and score for Compound Income stocks. To recap from previous parts we have been trying to identified good value yield stocks, with well covered dividends, solid financial and operating statistics which have demonstrated dividend growth in the past and are forecast to in the year ahead.

Having perhaps identified a stock which looks good on those criteria and having put it on your watch list or may be even purchased it you then want to monitor its prospects. By that I mean following news announcements and reactions by brokers and other investors to the news. If these are positive then this should support the case for the dividend growth which is forecast.

I find the best way to get a quick indicator on this, as you cannot hope to follow news flow on every stock in the market, is to look at estimate revisions over the last one and three months. I then combine these into an earnings momentum indicator as a quick guide to whether prospects are improving, deteriorating or unchanged. Obviously as a support to the case for receiving the expected dividend you would prefer to see earning forecasts being either stable or upgraded overall. That will then increase the likelihood of the forecast dividend being made or even exceeded. Conversely you will probably be less sure of those companies with downgrades to their prospects which may undermine the dividend, cover and growth going forward.

You can of course track changes in dividend forecasts but I find that these are changed less frequently unless there is a dramatic change in the earnings as analysts seem to be more focussed on earnings rather than dividends. In addition I also have forecast dividend growth elsewhere in my scoring so this is already being picked up to some extent there. Thus I find using earning changes to be more effective as a guide to these changes and using one and three months captures the most information even if it is somewhat dated after three months. Obviously a ranking will be relative to other companies so you will need to look at the actual numbers to get a feel for the absolute change in the numbers.

Price Momentum is another significant outperforming factor although I don't include it in my model I do show 12 month price momentum on the Scores for reference. I find it useful together with a medium term over bought over sold indicator based on 1 month performance and % from the 200 day moving average.

Summary and Conclusion:

In this short book you have been introduced to the concept of compounding your income and why that might be a good idea. It has then looked at various indicators which can help investors to identify useful factors when selecting yield stocks such as value, dividend growth, operational quality and financial security. The final suggestion is to monitor the outlook and prospects both manually but also by using estimate revisions as an indicator of changes to these.

So if you like what you have read and would like to sign up to receive access to Compound Income Scores to help you compound your income then please visit www.compound income.org/scores to see how you can sign up.

About the Author:

I worked in the City of London for over 20 years as a Fund Manager for a number of top institutions. In my career I managed billions of £'s across a whole range of different funds from Distribution funds, Investment Trusts, OEIC's / Unit Trusts & Pension funds. I was also involved in the management of Income funds more generally. In March 2009, I quit the City and escaped the rat race to "retire" and earn my living from my own investments. Since then I have been managing my own income funds.