

Income Investing

Feb 2022



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Disclaimer

- Opinions that may be expressed in this presentation are not necessarily those of AAll or the Portland Chapter.
- My intent is to provide a background for the understanding of income investing and share my own personal experiences
- Viewers should not consider my views as recommendations
- I do believe in the AAll mission: A grassroots organization led by volunteer members, and extend the mission of "person to person" to individual investors in our community
- I hope what's provided herein is unbiased investment education in a social context.

Agenda

- Income Goals
- Income vehicles
- Dividend investing guidelines
- Sources and tools
- Taxes
- Mitigating risk in today's market
- ERP and Debt to EBITDA ratio
- Closing remarks
- References



Income Investing Goals

- Steady stream of income... year in year out
 - Income pays bills, so the cash has be available
- Grow income faster than inflation
- Preservation of capital
- Optimizing after-tax income
- 10% yield on original cost in 10 years



Common Income Investing Choices

If your over 40 you should be developing an income portfolio!

➤ Dividend Investing

➤ Preferred Stocks

➤ Convertible Preferreds

➤ MLPs (Master Limited Partnerships)

➤ REITs (Real Estate Investment Trusts)

➤ Option-Income (covered calls etc.)

➤ Income-oriented mutual funds

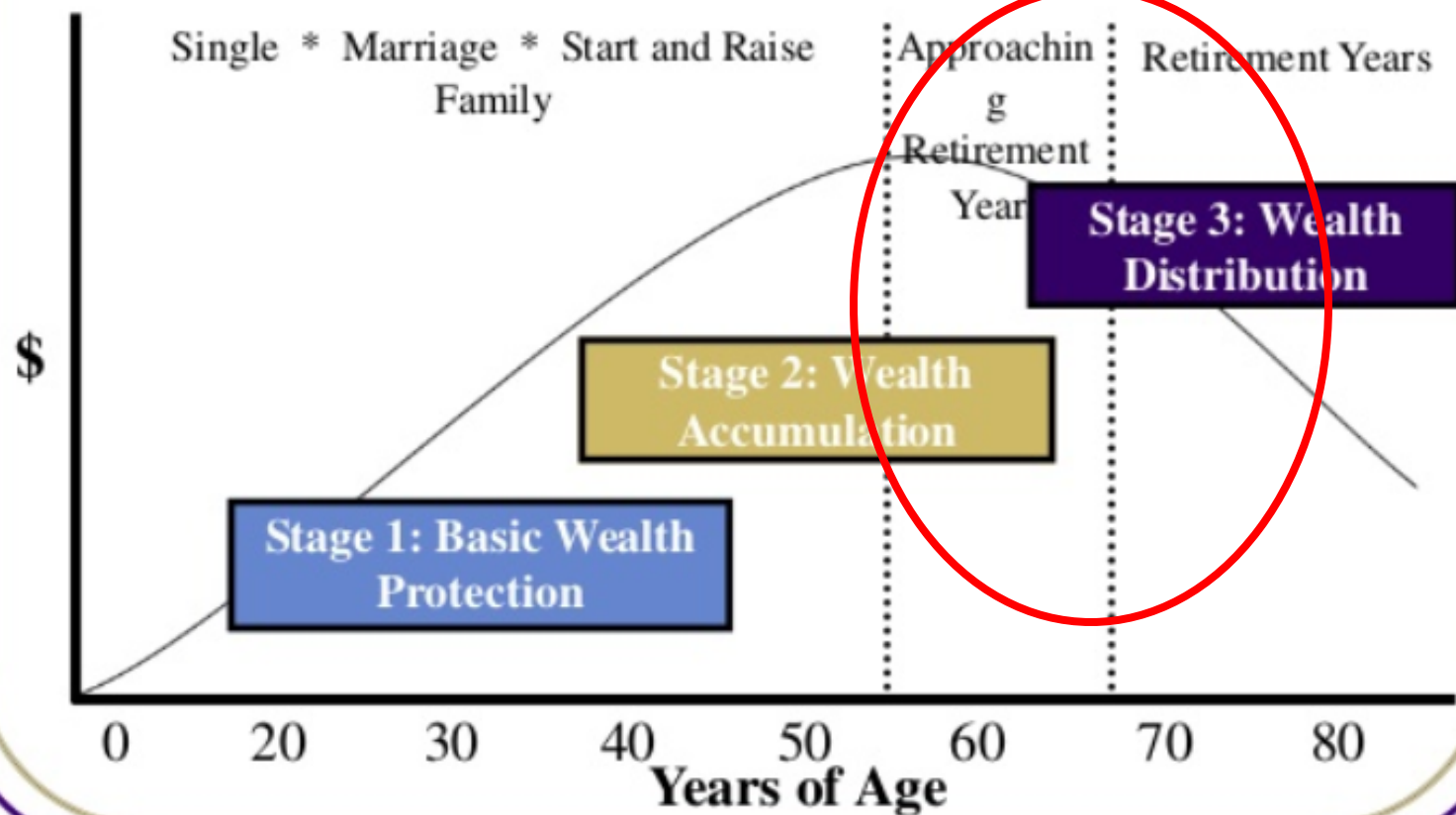
➤ Income ETFs

➤ Bonds and bond ETFs

➤ Cash equivalent securities



An Individual's Financial Life Cycle (ages are averages)



Trading Off Performance for Stability

- Dividend Stocks have yield and share price appreciation can deliver decent returns, but...
- Most are not high-growth companies. For example, the last 5 years:
 - Johnson & Johnson 7.7%
 - Procter & Gamble 10.7%
 - Amazon 28.4%
 - Alphabet 32.2%

No dividends
No steady income stream

Share Prices Do React to Dividend Policy

- Income investors don't like dividend cutbacks. If a company makes a dividend announcement that investors find disappointing, the share price will reflect the negative sentiment.
 - GE slashed its dividend in 2018, the share price fell 34%



Reliable, But No Guarantees

- Dividend stocks may not be a great fit if you have a long investment timeline and an appetite for risk.
- Dividend-payers promise more reliability and steady income but at modest growth,
- So capital gains investors prefer more risk in exchange for higher growth potential. If you have the time to ride out some volatility,
- Growth-oriented stocks have a brighter future than many dividend payers.



Good Income but...

- Dividends are not guaranteed. While some companies have established decades-long dividend track records, shareholder payments can be reduced or disappear.
 - In 2018, General Electric cut its dividend from \$0.12 to \$0.01 per share. The company had been paying its dividend for 119 years
 - General Motors' dividend suspension in 2008
 - Citigroup's suspension in 2009.
- But... with careful analysis and diversification, dividend cuts can be minimalized



Average Return on Invested Capital

- Typical business profiles:
 - ROIC < 5% considered low margin or highly competitive industries
 - Examples... airlines, automobiles
 - Unless its trying to develop a competitive advantage
 - ROIC 10 to 20%
 - Examples... hotels, package foods, grocery stores, drug stores, book publishers
 - ROIC > 20% consider high margin and better price elasticity
 - Examples... software, soft drinks, pharmaceuticals, distilled spirits, luxury products, medical instruments

Tax on Qualified Dividends

Tax-filing status	Single	Married, filing jointly	Married, filing separately	Head of household
0%	\$0 to \$41,675	\$0 to \$83,350	\$0 to \$41,675	\$0 to \$55,800
15%	\$41,676 to \$459,750	\$83,351 to \$517,200	\$41,676 to \$258,600	\$55,801 to \$488,500
20%	\$459,751 or more	\$517,201 or more	\$258,601 or more	\$488,501 or more

My Dividend Guidelines

- Current yield-on-cost: 12% on original investment
- Goal: 9% - 10% yield-on-cost (nearly there after 14 years)
- Dividend portfolio selection criteria
 - 2.5 - 3% yield and 6.5 – 7% yearly growth in dividends
 - Yield + growth = 9 to 10%
- Allocation: Each equity on cost basis is about 2.5% to 3.0% of the entire portfolio.
 - Diversify across major industries and sectors.
 - 25 – 30 equities, mostly dividend stocks, a few MLPs, REITs, and preferreds



My Dividend Guidelines

- Dividend payments are received in cash
 - Past dividend growth often suggests future performance.
 - Portfolio growth can be accelerated by re-investing dividends
- Optimize after tax income
 - Best done in tax-differed accounts
 - Qualified dividends in non-differed accounts are taxed at:
 - 0% in 12% bracket or below (MFJ)
 - 15% in 22% - 24% brackets (MFJ)
 - 20% in 32% and above brackets (MFJ)**



My Dividend Guidelines

- Selling Criteria
 - Cuts, freezes or suspension of dividend
 - Bubbles: the stock becomes grossly overvalued
 - Major fundamental changes impacting the company
 - Announcements such as: splits into separate entities or spin-offs
 - Current value exceeds about 6% of portfolio
 - Warning light: Senior management changes
 - Over valuation
- No, margin, no shorting, no options, no futures etc.
- Review portfolio 4 times a year.



Where Do I Find Dividend Equities?

- Newsletters

- Morningstar Dividend Investor



- AAI Dividend Investing



- Utility Forecaster



- Kiplinger's Investing for Income



- Intelligent Dividend Investor



- Value Line



- Simply Wall Street



Info on Overall Economy and Valuation Tools?

- Gilbert Ho's slide deck on the economy (AAll SV Computerized Investing SIG)
- [Econ-pi](#)
- St. Louis Fed
- Aswath Damodaran: Valuation tutorials
 - Musings on Markets
- Value Academy (YouTube tutorials on valuation see: Fast Graphs Channel)



Portfolio Admin Tools

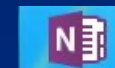
Software, software and more software ad nauseam...

- Quicken Premier... my choice, but others like



- Investment Account Manager (Gets good reviews on the AAI Computerized Investing site)

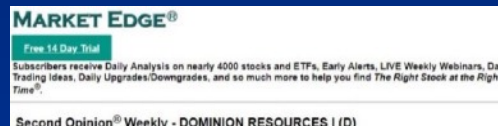
- OneNote (Journal keeping and follow-up notes)



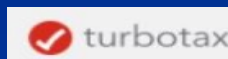
- Fundamentals Analyzer Software Tool and screener



- Schwab Market Edge



- TurboTax (used at tax-time and throughout the year to model sell scenarios)



Quality Score System

(Dividends Growth Investing)

Points	Value Line Safety Rank	Value Line Financial Strength	Morningstar Economic Moat	S&P Credit Rating	Simply Safe Dividends Dividend Safety Scores
5	1	A++	Wide	AAA AA+ • AA • AA-	81-100 (Very Safe)
4	2	A+	Narrow	A+ • A • A-	61-80 (Safe)
3	3	A	—	BBB+ • BBB • BBB- No debt*	41-60 (Borderline Safe)
2	4	B++ • B+	—	—	21-40 (Unsafe)
1	—	B	—	—	—
0	5	< B	None	< BBB levels	0-20 (Very Unsafe)

Source: David van Knapp

Quality Score Ranking

		S&P Rating	Points	VL Safety Rank	Points	VL Financial strength	Points	MS Economic Moat	Points	Quality Score
MMM	3M CO	AA-	5	1	5	A++	5	W	5	20
CL	COLGATE PALMOLIVE CO	AA-	5	1	5	A+	4	W	5	19
CSCO	CISCO SYSTEMS INC	AA-	5	1	5	A++	5	N	4	19
EMR	EMERSON ELECTRIC CO	A	4	1	5	A++	5	W	5	19
HD	HOME DEPOT INC	A	4	1	5	A++	5	W	5	19
LMT	LOCKHEED MARTIN CORP	A-	4	1	5	A++	5	W	5	19
TXN	TEXAS INSTRUMENTS INC	A+	4	1	5	A++	5	W	5	19
UNP	UNION PACIFIC CORP	A-	4	1	5	A++	5	W	5	19
BLK	BLACKROCK INC	AA-	5	2	4	A+	4	W	5	18
ITW	ILLINOIS TOOL WORKS INC	A+	4	1	5	A++	5	N	4	18
MCD	MCDONALDS CORP	BBB+	3	1	5	A++	5	W	5	18
IBM	IBM	A	4	1	5	A++	5	N	4	18
T	AT&T INC	BBB	3	1	5	A++	5	N	4	17
CMI	CUMMINS INC	A+	4	2	4	A++	4	N	4	16
WBA	WALGREENS BOOTS ALLIANCE	BBB	3	2	4	A+	4	N	4	15

Safety Factor (SF): Key Elements

(Simple way to identify systematic risk)

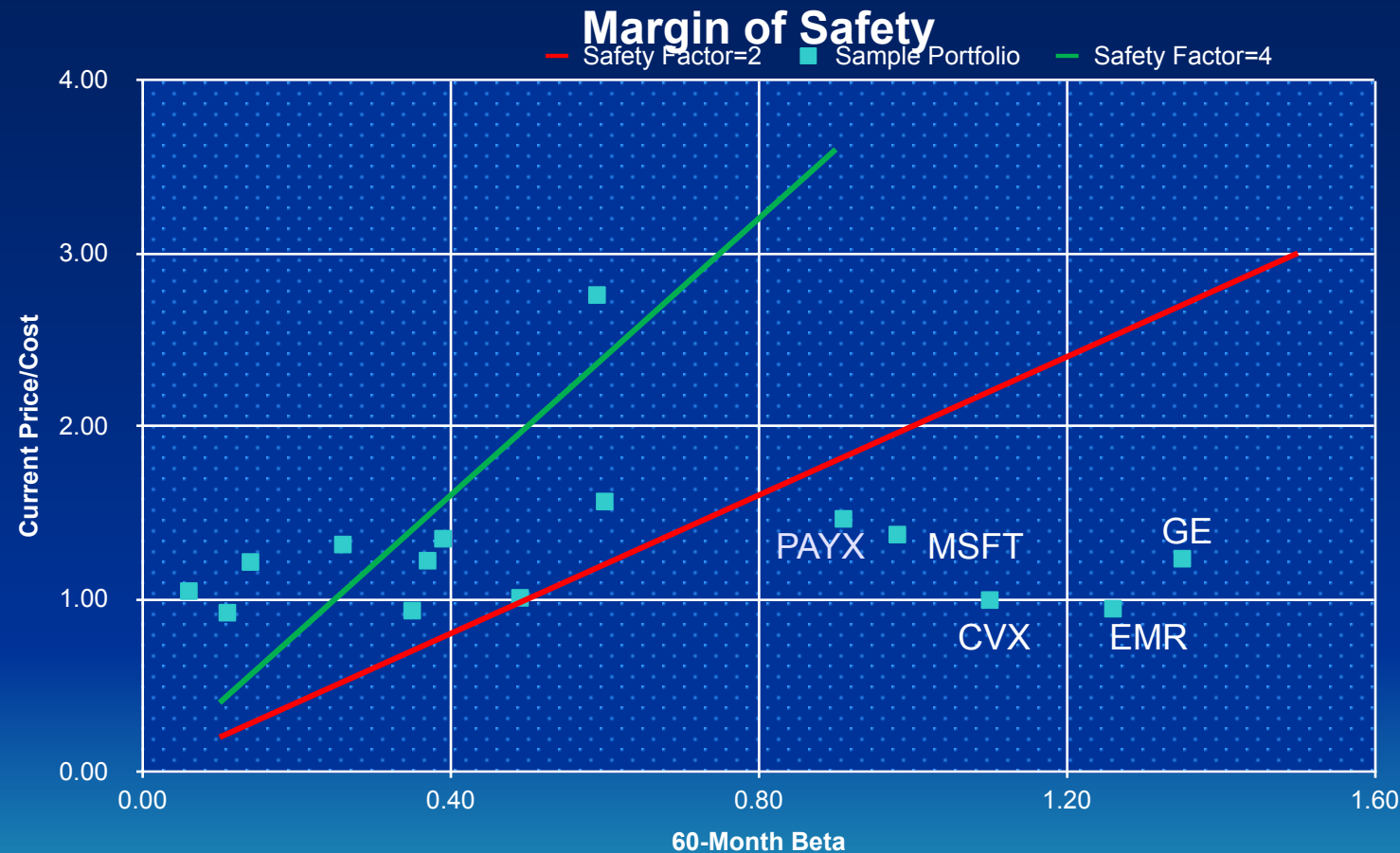
- Stock appreciation/depreciation
 - Lowering cost basis by using market volatility to select multiple entry points (dollar cost averaging)
 - Initial stock purchases should have a beta < 1.0
- Low beta: Leads to less risk in volatile markets
- Another way to manage portfolio/stock risk... the higher SF the less risk.
- SF: 2.0 to 4.0 is optimal... provides protection against major market downturns.

Safety Factor = Market Value/cost
divided by Beta.

Sample Portfolio

31-Aug-15		Cost Basis	Market Value		Beta	Market Value/Cost	Safety Factor = (Price/Cost) Beta
Name	Ticker	(Price)	(Price)	Gain/Loss	(60 m)	Value/Cost	Beta
CHEVRON CORP	CVX	81.01	80.50	-0.63%	1.10	0.99	0.90
DUKE ENERGY CORP	DUK	76.88	70.78	-7.93%	0.11	0.92	8.37
EMERSON ELECTRIC	EMR	49.30	46.52	-5.63%	1.26	0.94	0.75
GENERAL ELECTRIC	GE	20.08	24.75	23.28%	1.35	1.23	0.91
GENERAL MILLS INC	GIS	43.26	56.88	31.48%	0.26	1.31	5.06
JOHNSON & JOHNSON	JNJ	60.26	94.21	56.34%	0.60	1.56	2.61
MAGELLAN MIDSTREAM	MMP	26.09	71.95	175.78%	0.59	2.76	4.67
MICROSOFT CORP	MSFT	29.80	43.61	46.33%	0.91	1.46	1.61
PAYCHEX INC	PAYX	32.73	44.92	37.23%	0.98	1.37	1.40
PEPSICO	PEP	68.91	92.92	34.84%	0.39	1.35	3.46
PROCTER & GAMBLE	PG	70.07	70.53	0.65%	0.49	1.01	2.05
REALTY INCOME	O	36.88	45.04	22.13%	0.37	1.22	3.30
SOUTHERN CO	SO	41.39	43.27	4.54%	0.06	1.05	17.42
VERIZON	VZ	49.12	45.81	-6.75%	0.35	0.93	2.66
WEC ENERGY GROUP	WEC	39.27	47.66	21.38%	0.14	1.21	8.67
				Totals:	0.60	1.29	4.26

How Safe is the Portfolio?



Risk Premium

- Market risk premium reflects the additional return required by investors in excess of the risk-free rate.
- Equity Risk Premium (ERP) is the calculation of discount rates and derived from the CAPM.
 - It stems from the IRR which equalizes the discounted present value of forecasted cash flow and the current share price.

Equity Risk Premium (ERP)

- ERP is the excess return over a risk-free rate.
- It compensates an income investor for taking on the higher risk of equity investing.
- ERP is theoretical because there's no way to tell how well equities or the equity market will perform in the future.
- Calculating an equity risk premium requires using historical rates of return.
 - Not an exact science nor completely accurate, but... It can be used to avoid over-valued dividend stocks

So Much for the Theory

- Visit Financial Fairness site:
 - <https://www.fairness-finance.com/fairness-finance/finance/sample/sp500/product/equityriskpremium.dhtml>



Equity Risk Premium S&P 500



The market risk premium reflects the additional return required by investors in excess of the risk-free rate. The ERP is essential for the calculation of discount rates and derived from the CAPM. It stems from the IRR which equalizes the discounted present value of forecast cash flow and the current share price.

Details on the concepts and methodology, along with some examples and a glossary, are provided in the site's [methodology](#) section, particularly methodological notes 1, 2, 3 and 5.

Focus on... Spot as of 29 September 2021

7.70

Market IRR

1.49

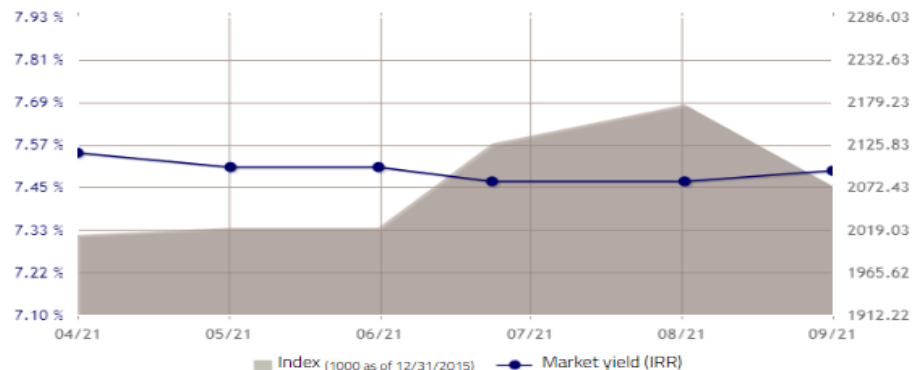
Risk free rate

6.21

Equity Risk Premium

CAPM Risk Premium

Market IRR



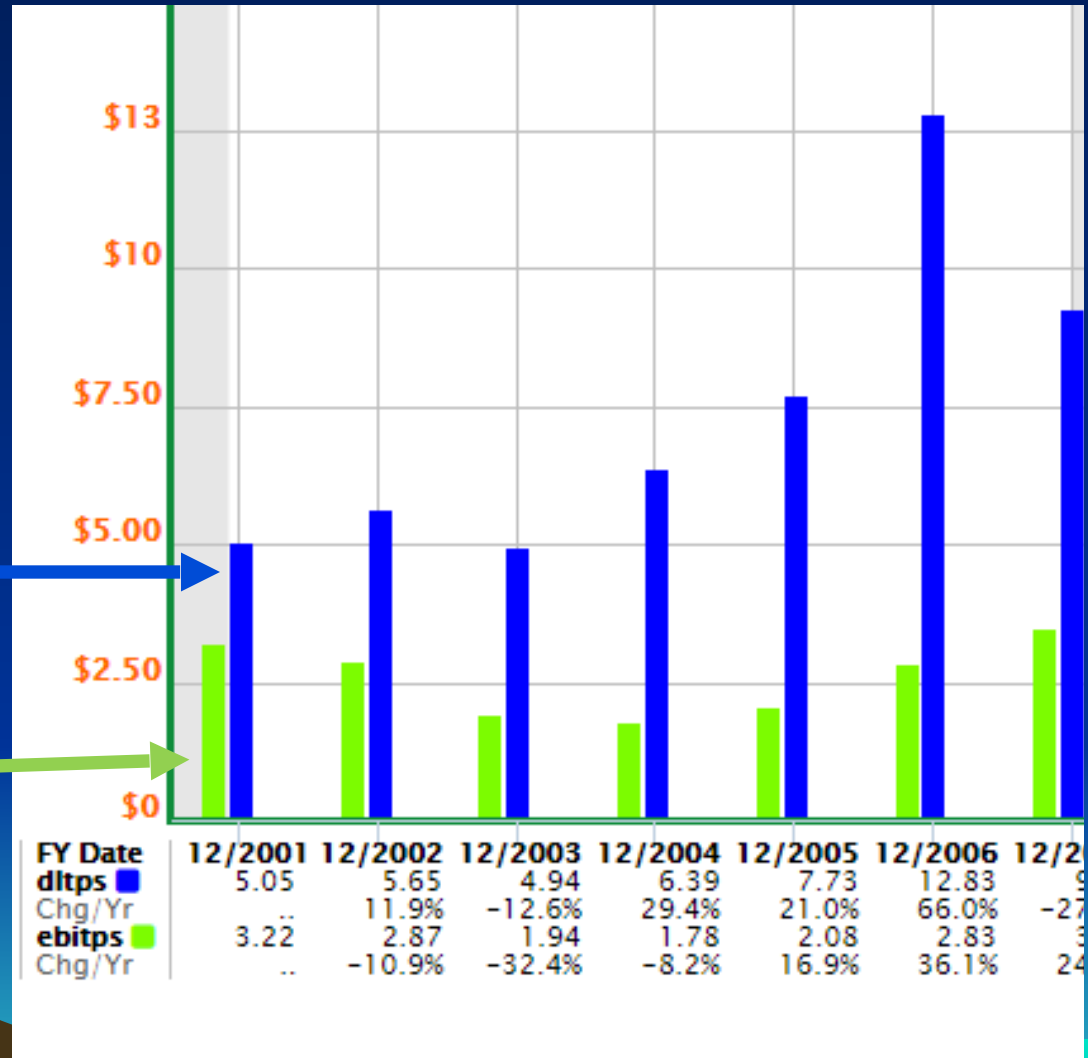
Debt to EBITDA Ratio

- Debt to EBITDA ratio measures a company's ability to pay off debt with EBITDA.
- Commonly used by credit rating agencies.
- Low ratio is preferred... indicates a company is not excessively indebted.
- High ratio may result in a lower credit rating... higher borrowing costs
- Ideal debt to EBITDA ratio depends on the industry. A ratio of greater than 5 is usually a cause for concern.
- To ensure a company is able to repay debt obligations, loan agreements typically specify covenants that dictate the range debt/EBITDA ratio.

Ratio of Debt to EBITA

Debt long-term per share
(dltps)

Earnings before interest,
taxes, depreciation, and
amortization (ebitdaps)

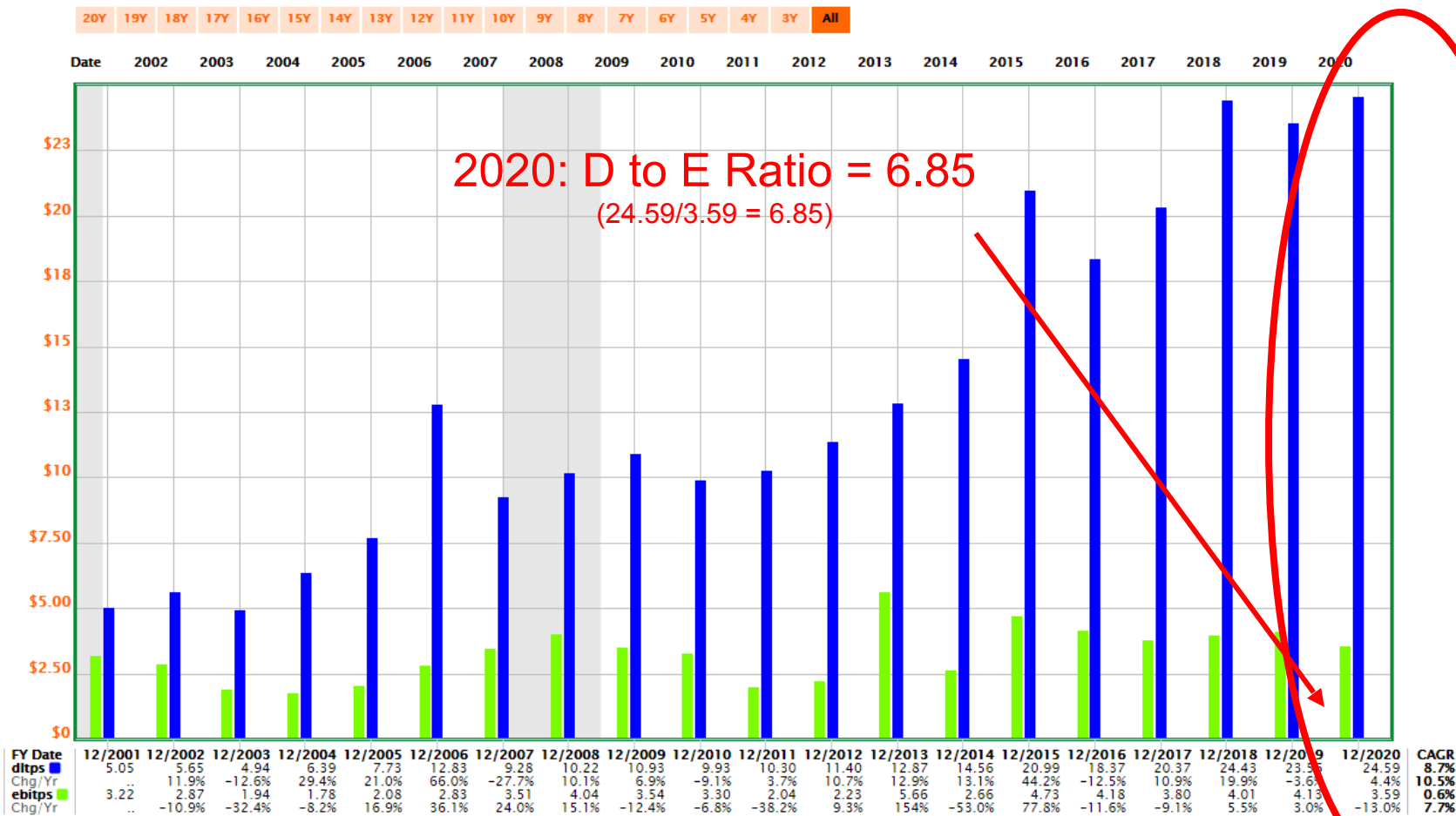


Warning Light Debt to EBITA Ratio (D-to-E Ratio)

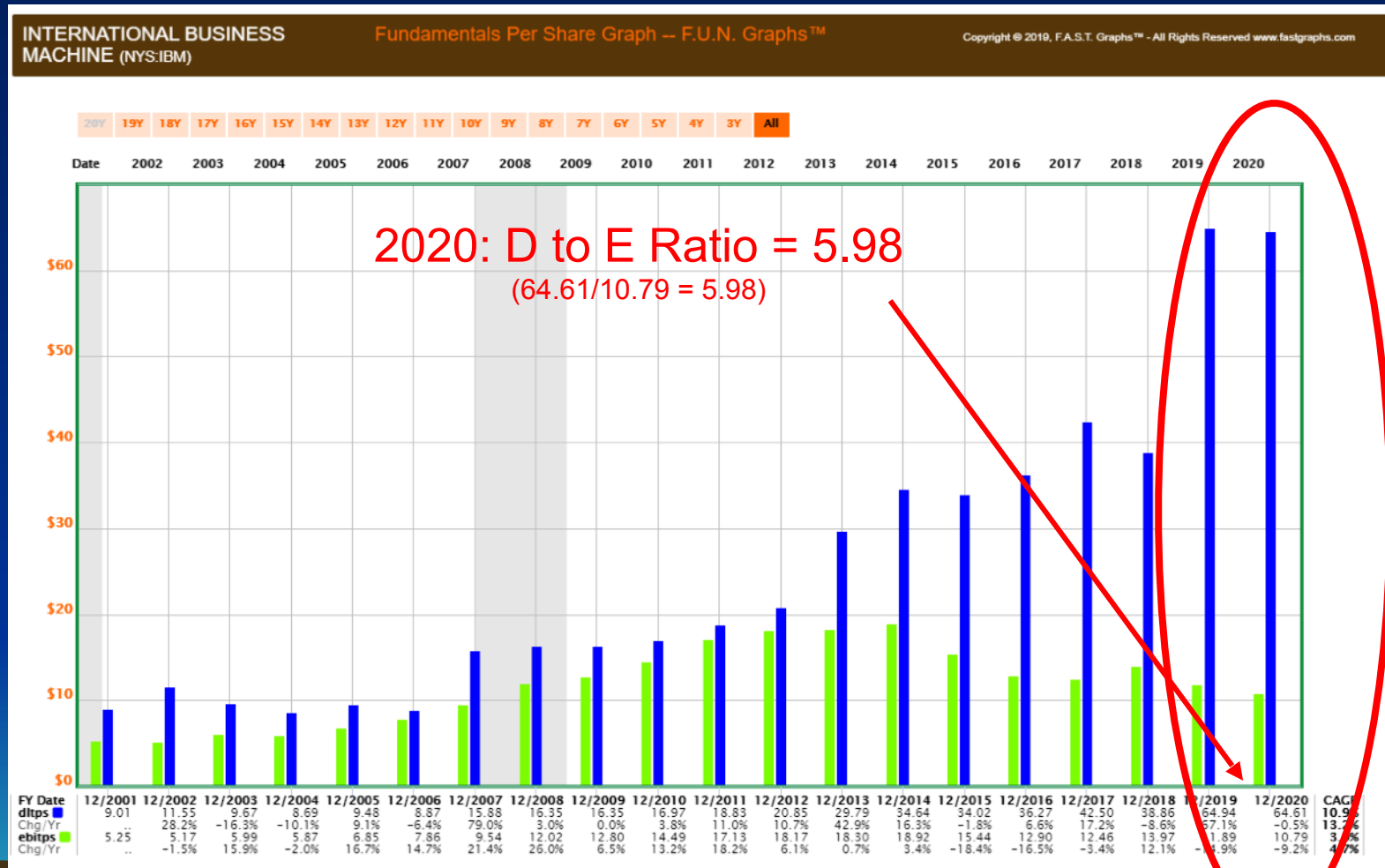
AT&T INC (NYS:T)

Fundamentals Per Share Graph – F.U.N. Graphs™

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Warning Light Debt to EBITA Ratio (D-to-E Ratio)

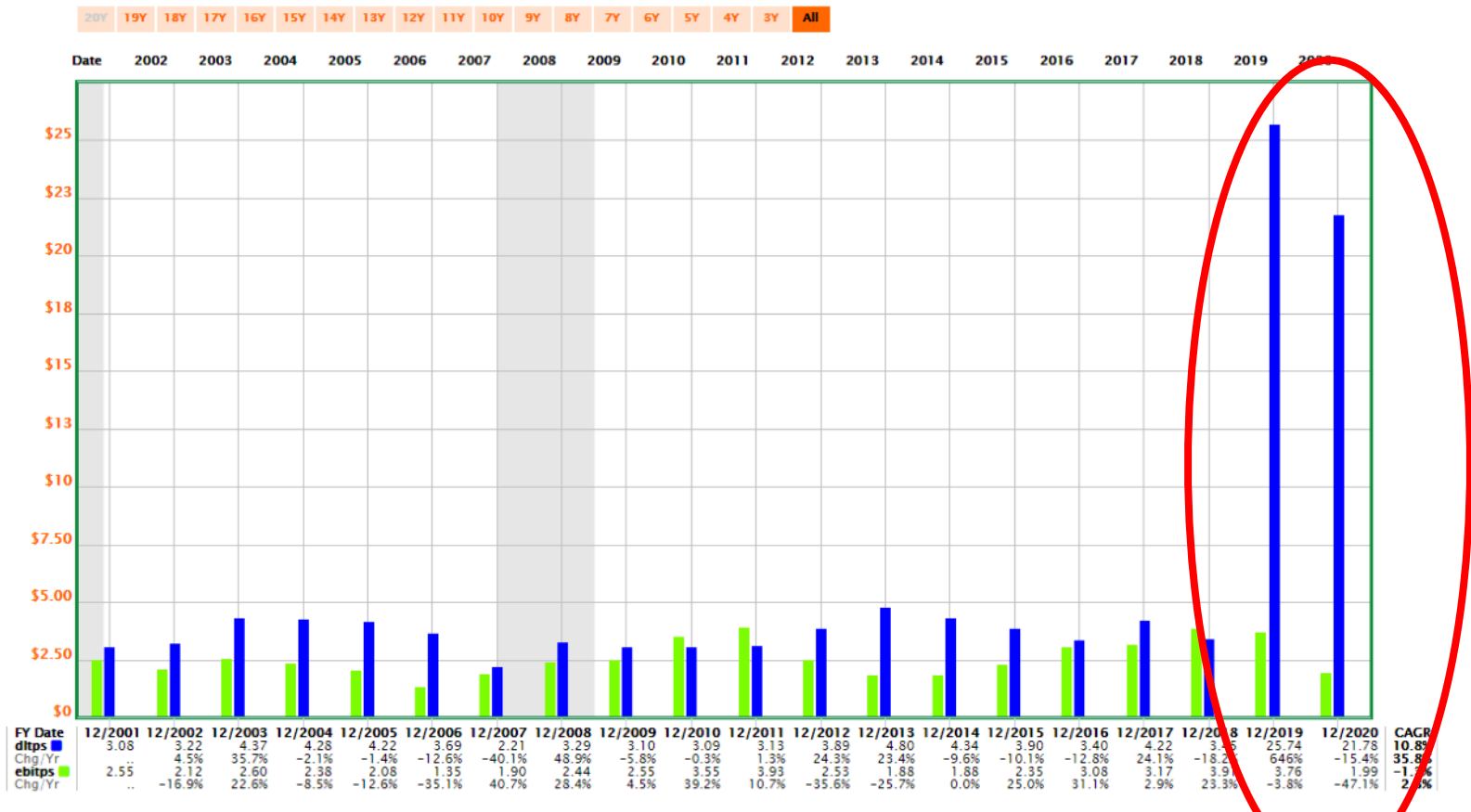


Warning Light Debt to EBITA Ratio (D-to-E Ratio)

BRISTOL MYERS SQUIBB CO
(NYS:BMJ)

Fundamentals Per Share Graph – F.U.N. Graphs™

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Closing Remarks

Investing for Income is Effective But...

- Be patient: It takes 8 -10 years to achieve a sustainable yield on cost.
- Be realistic: Your income needs may not always match what the market offers
- Higher the yield the great the risk
- Be sure to have plan for income investing if you or your partner become cognitively impaired.
- Getting older means more medical expenses
- Taxes won't disappear once you retire
 - Always calculate your after-tax return
 - Check out April 2018 Journal: “[Social Security and Medicare Can Raise Retirees' Tax Rates](#),” by William Reichenstein and William Meyer

More on Portland AAI Meetings

– Future Portland Chapter AAI Meetings:

- aaiipdx.com
- Todd Blickenstaff – President, AAI Portland



AAI Portland, OR Chapter

Welcome to the Portland, Oregon Chapter of the [American Association of Individual Investors](http://www.aaiinvestors.org). We generally hold six-seven main chapter events per year for the purpose of providing unbiased investment education and tools that can help improve the investment decision making process for individual investors. All individual investors are welcome to attend our meetings. It is not necessary to be a member of AAI to attend our meetings.

Subscribe to learn about upcoming meetings. Your email address is private, and not shared; and you may unsubscribe at any time:

AAll Portland Income SIG

- ***Self-directed investors***
- ***Learning (everyone contributes!)***
- Become prudent knowledgeable investors
- Sustainable stream of income
- Growing income faster than inflation
- Preservation of capital
- Long holding periods (Buy and hold or better yet... buy and monitor). Income investors are in it for the long run.



AAll Portland Webinars

Oct. 10, 2021 Income Investing SIG: Open Discussion of Dividend Stocks and CEFs.

Oct. 9, 2021 General Chapter Meeting: Timothy Bock – *Six Essential Steps to Becoming a Better Investor*.

Sept. 12, 2021 Income Investing SIG: Philip Mause – *High Dividend Opportunities: Current interest rate environment and its impact on equity valuations*

July 11, 2021 Income Investing SIG: Peter Lingane – *Tactical Strategies to Reduce Volatility and Drawdown*

June 6, 2021 Income Investing SIG: Don Maurer – *What Can Computerized Investing Offer Dividend Investors?*

May 2, 2021 Income Investing SIG: Nicholas Ward – *Intelligent Income Investor*

Apr. 11, 2021 Income Investing SIG: Steven Shaw – *Bond Savvy*, and Gilbert Ho, Silicone Valley CI SIG – *Economic Indicators*.

Feb. 7, 2021 Income Investing SIG: John Griffith – *Selling Cash-Secured Puts for Monthly Income*.

Jan. 9, 2021 General Chapter Meeting: Dr. Marvin Appel – *2021 Investment Outlook and Recommendations*.

Jan. 3, 2021 Income Investing SIG: Todd Blickenstaff – *Equity Income Investing with ETFs Video* (supporting PDF file [click here](#))

Questions, Comments or Mud Slinging



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Dividend Investing With ETFs

(Commonly Mentioned... not a recommendation)

- Power Shares S&P 500 High Dividend Low Volatility (SPHD)
- Schwab U.S. Dividend Equity ETF (SCHD)
- SPDR Portfolio S&P 500 High Dividend ETF (SPYD)
- AAM S&P 500 High Dividend Value ETF (SPDV) (A recent ETF)
- Vanguard Dividend Appreciation ETF (VIG)
- ALPS Sector Dividend Dogs (SDOG)
- Cboe Vest S&P 500 Dividend Aristocrat Target Income ETF (KNG)
- ProShares S&P 500 Dividend Aristocrats ETF (NOBL)



Reference URLs



- My favorite authors on income:
 - David Van Knapp: Sensible Stock Investing
 - Bruce C. Miller: Retirement Investing for Income Only
 - Chuck Carnevale: See his YouTube Channel
 - Warren Buffett: Warren Buffett and the Interpretation of Financial Statements
- Quicken Premier 2018: <http://quicken.intuit.com/personal-finance-software/premier-investment-management.jsp> (love-hate relationship)

Reference URLs

(Continued)

- Damodaran Online: <http://www.damodaran.com>
- Drip Investing: <http://dripinvesting.org/Tools/Tools.htm>
- F.A.S.T. Graphs; <http://www.fastgraphs.com/>



Musings on Markets

Aswath Damodaran : Stern School of Business at New York University

Risk Measures	Cost of Funding	Pricing Multiples
1. Beta	1. Cost of Equity	1. PE & PEG
2. Standard deviation in stock price	2. Cost of Debt	2. Price to Book & EV to Inv Capital
3. Regression statistics (R squared, Jensen's alpha)	3. Cost of Capital	3. EV/EBIT and EV/EBITDA
4. High-Low Price Risk Measure		4. EV/Sales and Price/Sales
Profitability	Financial Leverage	Cash Flow Add-ons
1. Net Profit Margin	1. D/E ratio & Debt/Capital	1. Cap Ex & Net Cap Ex (including acquisitions & R&D)
2. Operating Margin	2. Debt/EBITDA	2. Non-cash Working Capital as % of Revenue
3. Gross Margins	3. Interest Coverage Ratios	3. Sales/Invested Capital
4. EBITDA, EBIT and EBITDA&D Margins	4. Accounting lease debt vs my estimates	4. COVID effects on market cap and earnings
5. Tax rates (cash, effective)	5. Debt breakdown (term, type)	
Returns	Dividend Policy	5. R&D and Goodwill statistics
1. Return on Equity	1. Dividend Payout & Yield	6. Financing flows from debt/equity
2. Return on Invested Capital	2. Dividends/FCFE & (Dividends + Buybacks)/ FCFE	Growth
3. ROE – Cost of Equity	Corporate Governance	1. Historical growth in earnings & revenues
4. ROIC – Cost of Capital	1. CEO, Insider and Institutional Holdings	2. Sustainable growth in earnings per share and operating income