Triple-treat investing

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A late-summer rally in stocks is providing one more reason for investors to look to stocks, not bonds, to increase their returns and to provide some stability to their portfolios.

What? Stocks as a stabilizer? Stocks for income? Yes, if they're well-chosen companies that pay good dividends with prospects for growth in share price and dividend. Toss in the cut to taxes on dividends that Congress passed in May, and there's a trio of good reasons to like dividend-paying stocks and stock funds.

The new tax law drops the tax on most dividends to 15 percent from as high as 35 percent. Investors in the lowest tax brackets will pay just 5 percent tax on their dividends. But the tax on bond interest remains at ordinary income rates, ranging from 10 percent to 35 percent.

The difference "should result in higher long-term returns from dividend-paying stocks for both growth and income investors," says Dan Sharp, a Beaverton investment adviser. Investors who can put up with the ups and downs of stock prices "can now have their cake and eat it, too."

Bonds provide good ballast to a portfolio, as many an investor learned during the recent unpleasantness for stocks. We aren't suggesting that investors should ditch their core bond holdings or drastically alter their allocation of bond assets.

However, bonds are probably at the end of their run now. Most of the major bond indexes show declines so far this year, while the Dow Jones average is up 15 percent, the Standard & Poor's 500 is up 17 percent, and the Nasdaq is up 40 percent.

Now is not the time to make large new commitments to bonds or bond funds because they'll lose value if interest rates rise -- and if the economy continues to pick up steam, that is a likely prospect. Bonds you own or a fund owns that were purchased before rates rose are worth less because they earn less interest than newer ones.

If you hold an individual bond until maturity, you don't have to worry about the decline in price because you'll get back your principal and earn interest along the way.

But the manager of a bond fund buys and sells bonds every day and incurs losses when bond prices go down. Newer, higher-interest bonds can't replace the bulk of the portfolio at a rate fast enough to make up for the loss in value of the older bonds. So although the fund's yield may increase slightly, its share price and total return decline.

Long-term bond investors can ride out the down times because just the opposite happens when interest rates drop: Older bonds become worth more and sell at a premium instead of a discount.

A good time for a checkup - To reduce your exposure to bond interest-rate whiplash, review how much of your portfolio is allocated to bonds and cash to see whether there's room for stocks that pay good dividends. We talked to several money managers who agreed on that course and who suggested some possibilities.

To mitigate the generally higher risk and volatility of stocks compared with bonds, be choosy about the dividend-paying stocks you put in your portfolio, Sharp says.

"Invest in large, stable companies with growing significant dividends," he says. "Prudent investors are now doing this, which is the reason many companies are now considering adding a dividend payout."

Among the companies and dividend yields he likes are General Motors (4.69 percent), Albertsons (3.63 percent), Bristol-Myers Squibb (4.36 percent) and Washington Mutual (3.55 percent). Washington Mutual has raised its dividend every quarter for the past 32 quarters, he notes, in addition to doubling its share price during the past three years. Albertsons shares jumped just last week when the company's earnings beat analysts' estimates.

"Dividends matter again," Sharp says, "and the trend of rising dividends should continue through at least 2008." That's when the current dividend tax law expires.

High-paying dividends Carol Clark, an investment principal at Lowry Hill, a Minneapolis-based firm with $5 billion under management for wealthy families, says investors shouldn't be tempted by stocks paying the highest dividends. High dividend yields can mean the stock price is depressed for a reason, such as inferior earnings, poor growth prospects or litigation troubles.

Instead, Clark likes companies with strong management, good competitive position and lots of cash on the balance sheet. Those companies may not pay the highest dividend now, but they have better long-term growth prospects and are in a better position to increase dividends in the future.

Another bonus, she says, is that companies that pay dividends are likely to have real earnings -- no WorldComs here -- and research shows they have lower stock price volatility than companies that don't pay dividends.

Lowry Hill doesn't publicly recommend individual stocks, but Clark named several companies that qualify and are in her clients' portfolios, including Microsoft, Johnson & Johnson, General Electric, Washington Mutual and Merck.

Clark noted that the 20-year decline in dividend yield among stocks in the Standard & Poor's 500 has reversed and is beginning to edge upward again.

"That is good news for a lot of people, especially elderly people who rely on dividend income," she says.

Now she is able to build them portfolios of solid stocks and get price appreciation, dividend income and tax advantages, too.

"They're seeing the light at the end of the tunnel," she said.

Prospects in growth stocks Louis Navellier, a Reno-based investment advisory service publisher and stock picker, predicts a period of smooth, steady growth ahead. As a result, he likes the prospects for growth stocks such as Microsoft and thinks more of them will start paying dividends or increase the small dividends they already pay.

"The dividend tax relief is already changing corporate behavior," Navellier says. "Many high-profile growth stocks have already boosted their dividends."

Qualcomm announced its first-ever dividend payment in February and has already boosted it once, he says. The stock's dividend yield is 0.42 percent.

Paccar, the Bellevue, Wash.-based truck manufacturer, pays a 1.79 percent dividend. With the big share-price pop it's had this year, the company has a total return of 88 percent through August.

Investors who aren't comfortable picking and owning individual stocks can get the new tax benefit and buy diversity and professional management through mutual funds that specialize in dividend-paying stocks.

But be sure you know what investments the fund contains.

If it contains preferred stocks, find out whether the payouts qualify as dividends or interest. Many preferred stocks are really trusts, and the IRS treats their payouts as interest, so you won't get the tax benefit. To check further on preferred stocks and to see a list of preferreds that probably do qualify for the lower tax, visit www.QuantumOnline.com .

Mutual funds an option - Carl Marker, a Portland investment manager, estimates about 65 percent of the income from his IMS Strategic Income Fund qualifies for the lower tax treatment. Marker's fund is relatively new -- he started it in November -- but it's succeeded in mixing common and preferred stocks, income funds and bonds to produce a current yield of 6.6 percent and a total return through August of 10.03 percent.

Among dividend-paying stocks he has in the fund (and their current yields) are Alliance Capital Management (5.21 percent), Great Plains Energy (5.62 percent) and R.J. Reynolds (10.68 percent).

The Reynolds tobacco company pays a high dividend because its shares are out of favor, and the company relies heavily on sales in the United States, where smoking is declining, reports Morningstar, a Chicago mutual fund and stock research company. The shares aren't recommended for long-term investment but might fill a gap in the short term.

For a prospectus or further details about Marker's fund, call IMS Capital Management at 503-788-4200 or visit www.imscapital.com .

To find other dividend-paying stock funds, check out T. Rowe Price, Fidelity or Vanguard's equity income funds or the Dodge & Cox Stock Fund. All are up 12 percent to 20 percent through August and pay dividend yields of 1.5 percent to 2.4 percent.

Julie Tripp does not give financial advice. For questions, call her at 503-221-8208 or e-mail julietripp@news.oregonian.com. For reprints of this or a previous column, call 503-221-8242.