FUND INSIGHT

High-Dividend-Yield Funds

By Rob Wherry |Rob Wherry Archive |Published: June 14, 2007

THERE IS NO mistaking how **Double Hull Tankers** (DHT: 15.13, 0.00, 0.0%) makes its money, given the company's straightforward name. It has seven huge ships that sail the world's oceans, their holds filled with thousands of barrels of crude oil. Each of the vessels is locked into long-term contracts with various energy companies. But if the demand for oil surges — and it has in parts of the world like China over the last three years — DHT also gets a small cut of the profits its customers reap on those shipments. The additional payments can easily spike its earnings.

Because the company's prospects depend so heavily on a commodity it's considered a highly speculative stock. Indeed, although DHT's revenues have grown by a third since 2003 to $87 million last year, the company's take has fluctuated greatly during that time, soaring as high as $136 million in 2004. Nevertheless, that up and down ride doesn't scare off a certain group of investors who are still attracted to this stock for one very specific reason: its dividend yield. DHT kicks off much of its profits in the form of dividends, leading to an eye-popping 11% yield, a level more than six times that of the Standard & Poor's 500 index.

In past columns we have written about the virtues of investing a portion of your portfolio in dividend-paying stocks or mutual funds and ETFs that focus on them. A Morgan Stanley report says stocks that paid dividends returned an average annual 10.2% between 1970 and 2005, almost a half dozen percentage points ahead of the ones that didn't. Studies have also shown that dividends provide a cushion when the market is in the doldrums. So not only do you get capital appreciation, but the cash these shares kick off also provide your portfolio with a potential market-beating boost. (To read a different opinion on the merits of yield, click here.)

However, investors can take that idea to an extreme by greedily chasing fat dividend yields. We've warned you in the past about doing the same thing with performance. Chasing yield is an even more dangerous prospect: Investors are just focusing on one particular trait of a given stock compared with the many that should go into judging performance. But a stock market that has shown little volatility over the last two years — February being the exception — has made many investors comfortable with taking on this risk. As you'll see, there are plenty of ways to play high-dividend yields, from individual stocks like DHT to the mutual funds that sprinkle them throughout their portfolios. Know going in though that the (hopefully) small portion of your portfolio you gamble should be an amount you can stomach seeing disappear — quickly. You would be better off investing with total return in mind. And if you are in a taxable account you need to keep in mind the potential tax hit that comes with receiving dividends.

To understand the pitfalls of chasing yield you must first understand how it is calculated. Dividend yield is a function of the dollar amount a company pays out over the trailing 12-month period divided by its share price. So if a company pays a $1 annual dividend and its shares are trading hands at $10, the yield is 10%. While a yield above that of the S&P 500 — currently at 1.76% — is usually considered high, some investors prefer to make that cutoff with the yield on a low-risk 10-year Treasury, which sits at around 5%. "Each additional point you take on means more risk," says Anthony LaGiglia, director of financial planning at J.J. Burns, an investment advisory firm in Melville, N.Y. "My clients aren't going down because they own a 10-Year Treasury."

Yield, obviously, can fluctuate if a share price moves up or down or if a firm's board of directors decides to increase or decrease dividend payments to its shareholders. And that's where the tricky part comes in. In order to make an educated bet on a high-dividend-yielding stock, you need to find out why the yield is so enormous in the first place. Is the share price imploding because the company is too? Is the firm's cash flow ample enough to continue paying these rich dividends? If the answers to those questions are "yes" and "no" it should be a huge red flag. "You can't buy a stock like this and call it an heirloom," says Mark Brown,

founder of investment shop Brown & Tedstrom in Denver. "Ultimately that yield will probably come back down."

With that 5% cut in mind, we used the SmartMoney.com stock screener to search for shares yielding above that mark. Three-hundred-and-two were spit out; 39 of them had yields above 10%. The 5% stocks run the gamut, from **Vodafone** (VOD: 32.17, 0.00, 0.0%) to utilities like **Progress Energy** (PGN: 47.10, 0.00, 0.0%). The 10%-ers include tanker companies, energy trusts and mortgage companies. **Provident Energy Trust** (PVX: 11.89, 0.00, 0.0%), a company that produces and sells oil and natural gas in the U.S. and Canada, has a yield of 11%. Its profits and revenues have been increasing as it has swallowed up additional assets, a sign that it could sustain its dividends. But just like DHT, the company's future depends, in large part, on the prices of commodities. That said, a $1,000 bet on the stock in 2004 would have doubled by now.

If you don't have the wherewithal to sift through all 302 companies you could look for a mutual fund that has a track record of investing in these dividend-paying stocks. The best move is to find a fund that weaves small positions of these stocks into a well-diversified portfolio. However, be suspicious of a fund that all of a sudden lists these shares in its portfolio. It could be a sign that a manager is trying to cover up bad performance by juicing returns with these potential highfliers. "If it doesn't fit in with the philosophy of the fund you need to ask why [it's there]," says Russell Lundeberg, the chief investment officer of Barrett Capital in Midlothian, Va.

Alpine Dynamic Dividend fund (ADVDX: 13.50, +0.09, +0.7%) uses a complex strategy that involves one part of the portfolio being rotated as companies announce distributions. It also favors turnaround firms along with strong earners that have the potential to consistently pay out dividends. This eclectic method has the fund's dividend yield at 13%, according to Lipper, one of the highest in the industry. **Westwood Income AAA** (WESRX: 10.52, +0.01, +0.1%) is a concentrated portfolio of 19 common stocks. It has a 9% stake in high-yielding transportation firms, including Double Hull, which could have an impact on performance depending on how those positions do. **ICON Energy** (ICENX: 39.61, +0.85, +2.2%) is another concentrated portfolio with a few high-yielding stocks that could influence its returns.

Another option — and one that may be safer — is to invest in a more diversified portfolio that features a few of these risky stocks. John Buckingham, manager of the Al Frank family of funds, who favors undervalued stocks that he can hold on to, has long been complementing those positions by sprinkling high-dividend-yielding stocks into his portfolios and separate accounts. For example, according to recent filings he owns 2,500 shares of **Frontline** (FRO: 45.21, 0.00, 0.0%), a company that has a modern fleet of tankers that transports crude oil, in the **Al Frank Dividend Value fund** (VALDX: 14.73, +0.10, +0.7%). Frontline has a 13.5% dividend yield. He also owns 4300 shares of **Fording Canadian Coal Trust** (FDG: 30.35, 0.00, 0.0%), a mine operator that has a 9% yield. They each come with their own set of headaches. Frontline, says Buckingham, has been slow in explaining to investors how the income it kicks off will be treated by Uncle Sam. Fording could be impacted by new tax treatments in Canada. Still, he's standing by his picks. "I look for plenty of cash on the books at these companies that will allow them to continue making distributions," he says. Al Frank Dividend Value fund has returned 26% over the last year.

The average investor, though, should be satisfied with a yield at or slightly above the S&P 500. The easiest way to get that kind of exposure to is purchase the **Vanguard High Dividend Yield ETF** (VYM: 54.92, 0.00, 0.0%) or its index fund counterpart. For an ultra low 0.25% annual expense ratio investors will get a portfolio of 528 stocks that kicks off a 2.8% yield. "If someone is giving me a big yield there has to be a reason," says LaGiglia. "You have to ask yourself why the rest of the market hasn't searched it out, too."