Look to Dividend Changes for a Stock's Direction

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7600A Leesburg Pike
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Look to Dividend Changes for a Stock's Direction

By Jim Fink (bio at end)
August 24, 2018

A high-yielding stock is not any good if the yield is unsustainable. There is nothing worse than investing in a stock expecting a certain level of dividend income to meet living expenses, only to see that income cut from under you. There are several financial warning signs investors should look out for to avoid such dividend time bombs.

One of the warning signs is a recent dividend cut. If a dividend cut signals financial distress, it makes sense that this financial distress could cause a second round of dividend cutting.

The corollary of dividend cuts acting as a ***negative*** signal of future financial distress (and additional dividend cuts) is the idea that dividend raises act as a ***positive*** signal of future financial success, which will result in stocks that have recently raised their dividends raising them again, or at least not cutting their dividends anytime soon.

Dividend Research Does Not Lie

Does the academic research support the theory of current dividend changes signaling future corporate performance? For dividend raisers, the answer is yes. One study found:

Firms that increase dividends are less likely than non-changing firms to experience a drop in future earnings. Thus, their increase in concurrent earnings can be said to be somewhat "permanent." Firms that increase dividends have significant (though modest) positive excess returns for the following three years.

Another study concluded:

We find that increases in payout ratios predict significantly higher future earnings over all time periods. This provides support that higher payout ratios signal higher future earnings.

For dividend cutters, the evidence is inconclusive. On average, earnings in the year after a dividend cut actually rise, but this rise may be from such a low level that further dividend cuts are still needed.

Whatever the case, I took a look at some companies that raised and cut their dividends in the 2016-2017 time frame to see how their 12-month stock performances subsequent to the dividend change announcements played out relative to the S&P 500. The results are below:

Dividend Raisers

Company	Old Quarterly Dividend Per Share	New Quarterly Dividend Per Share	Announcement Date of Dividend Change	Total-Return Performance Relative to S&P 500 From Announcement Through 12 Months Later
Lear Corp. (NYSE: LEA)	$0.30	$0.50	February 13, 2017	+15.10%
SunTrust Banks (NYSE: STI)	$0.26	$0.40	June 28, 2017	+6.68%
Farmer Mac (NYSE: AGM)	$0.26	$0.36	March 9, 2017	+22.87%
Home Depot (NYSE: HD)	$0.69	$0.89	February 21, 2017	+12.66%
Boeing (NYSE: BA)	$1.09	$1.42	December 12, 2016	+69.25%
Best Buy (NYSE: BBY)	$0.28	$0.34	March 1, 2017	+69.20%

Source: Bloomberg

Dividend Cutters

Company	Old Quarterly Dividend Per Share	New Quarterly Dividend Per Share	Announcement Date of Dividend Change	Performance Relative to S&P 500 From Announcement Through 12 Months Later
Mattel (NYSE: MAT)	$0.38	$0.15	June 14, 2017	-34.74%
Viacom (NSDQ: VIAB)	$0.40	$0.20	September 21, 2016	-39.78%
Teva Pharmaceutical Industries (NSDQ: TEVA)	$0.34	$0.085	August 3, 2017	-22.74%
CoreCivic (NYSE: CXW)	$0.54	$0.42	December 8, 2016	-24.64%
Frontier Communications (NYSE: FTR)	$0.105	$0.04	May 2, 2017	-71.09%
Diebold Nixdorf (NYSE: DBD)	$0.287	$0.10	August 15, 2016	-41.00%

Source:*Bloomberg*

Anomalies to the Pattern

I wouldn't say that I cherry-picked the stocks that fit my thesis on dividend changes, as the majority of stocks behave as expected, but one must also keep in mind that some stocks do not behave as expected, especially those of commodity producers that face fluctuating macroeconomic conditions that quickly alter the supply/demand situation for their commodity products.

For example, over the last couple of years, natural resource stocks such as **BHP Billiton** (NYSE: BHP), **ConocoPhillips** (NYSE: COP), **National Oilwell Varco** (NYSE: NOV), and **Mosaic** (NYSE: MOS) all outperformed the S&P 500 after dividend cuts. Some retail apparel stocks also acted counter-intuitively, with **TJX Companies** (NYSE: TJX) under-performing after a dividend hike and **Stage Stores** (NYSE: SSI) outperforming after a dividend cut.

But these exceptions prove the rule. If you want to put the probabilities in your favor (and who doesn't?), focus your purchases among the stocks of companies that are raising dividends and be wary of companies in industries outside of the commodity space that are cutting dividends.

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About the Analyst

Jim Fink is chief investment strategist for *Jim Fink's Options for Income* and *Velocity Trader*. He has traded options for more than 20 years and generated personal profits of more than $5 million. Jim also serves as an investment analyst at Investing Daily's flagship investing publication, *Personal Finance*.

Hopelessly overeducated, Jim holds a bachelor's degree from Yale University, a master's degree from Harvard's Kennedy School of Government, a law degree from Columbia University, and an MBA from the University of Virginia's Darden School of Business. For good measure, he has been a member of the Illinois and D.C. bars and is a CFA charterholder.

Prior to joining Investing Daily, and when not incurring student loans hiding out in academe, Jim practiced telecommunications regulatory law for nine years until he realized that he made more money trading stock options than writing briefs. After attending business school, Jim switched gears to the investment realm full-time, working for a university endowment, a private wealth management firm, an insurance and financial planning company, and as a Senior Analyst for an online investment newsletter service that encourages the wearing of funny hats.

A possible but unlikely descendant of legendary brawler and boatman Mike Fink, Jim defies his heritage, believing that investing success requires patience and analysis, not swashbuckling bravado. Besides his passion for analyzing and writing about stocks, Jim likes to hike in the desert Southwest, vacation in Las Vegas, play tennis, and feed his toddler son Cheerios.