Are Dividend-Focused Sectors Safe? - Transcript

Tom Mullooly: Do you own stocks just for the dividend? Are you looking just for income from your investments? In episode 198, we're going to talk about some of the problems you might run into. Stick around.

Welcome to the Mullooly Asset show. I'm your host, Tom Mullooly, and this is episode number 198. Thanks for tuning in. We bump into folks who say that they just want to own dividend stocks because of the safety that comes with dividend stocks. That's a corner of the market where people aren't going to get hurt. We know when we see folks who tell us they really, really like dividend stocks, we know what we're going to find. They'll bring in their statements and we're going to find bank stocks. We're going to find REITs, real estate investment trusts. We're going to find utilities. We're going to find master limited partnerships, MLPs. We're going to find closed end funds. There's problems with each of these groups and we'll take them one at a time.

If you own bank stocks, and people don't say, "Hey. I want to own the banks because they're sexy." No. They own the banks because they paid dividends. But understand that when the economy starts to struggle, banks start to struggle. Banks pump all the money into the economy. So when the economy starts to slow down, it's not a big surprise to see dividends get cut at banks, and sometimes dividends even get eliminated. What happens to the stock when dividends get eliminated? With real estate investment trusts, understand you're not actually getting a dividend. What you get from a REIT, which is real estate investment trust, these are distribution. It's called funds from operations. And in order for a REIT to maintain its special tax status, it has to distribute more than 90% of its funds from operation.

Question, what if a REIT doesn't have funds from operations? What happens to your distribution or what happens to your dividend? And then if that goes away, what happens to the stock? Let's talk about utilities. The biggest risk today with electric utility stocks is that they're tied to the bond market. A lot of times you'll hear people say, "Utilities are a proxy for the bond market." So when you see rates going up, utilities are going to go down. They're almost tied at the hip like that. It's not a surprise and even in the last five or six years, when rates have ticked up a little bit, you're going to see utilities drop between 15 and 20%. So it's not uncommon to see that. That's the real risk with utilities now.

Now with master limited partnerships, this is a lot of stuff that they just couldn't package and sell as a common stock. So now they have this master limited partnership. It's a partnership. So understand partnerships come with a K-1. You're not getting a 1099 for this. So people complain every year about getting K-1s from their master limited partnerships. You know you're getting them, just wait for them. But typically, the things that couldn't get packaged into a common stock would wind up in an MLP. So you're going to find gas pipelines. You're going to find oil fields. You're going to find these things, these MLPs, that trade on an exchange with not a whole lot of volume. And so when their dividends get caught, watch out, because these things are going down the drain.

Closed end funds. Closed end funds have been around for almost a hundred years since the 1930s and I'm going to use my air quotes, "They almost always trade at a discount to their net asset value." So they're going to behave a lot like bond mutual funds. You're not going to get any growth out of these things unless you're really savvy buying it cheap and selling it. Understand that all of these sources for income that investors have flocked to over the last 30, 40 years, they all come with a built-in bomb and you need to know that these bombs can go off. And sometimes they go off all at the same time. So investing in stocks, merely for the income, not as safe as you might think.

In the next couple of videos, we're going to talk about some different ways that you can look at stocks. We want to take a look at stocks that actually increase their dividend over time. And we're also going to cover what banks ought to be doing the next time that there's an economic slowdown. We'll cover that one in episode 199. But thanks for tuning in today.