

## Beware of high-yielding stocks

Over the years, the *Forecasts* has been accused of not liking high-yielding stocks. After all, no stock on our Buy List or Long-Term Buy List yields more than 4.5%. And only five recommended stocks have yields higher than 2%.

“What about those stocks with juicy yields of 9% or more?” subscribers often ask. “Aren’t those good investments?”

In most cases, no.

All too often, investors — particularly those hungry for yield — forget that a stock’s *total return* is what matters. Two components make up the total return — *yield* and *capital gains*. Unfortunately, investors who buy high-yielding stocks tend to focus exclusively on yield and ignore the capital-gains part of the equation. And that can be a big mistake.

To drive home this point, we looked at the returns of high-yield stocks. At the end of April 2007, only 58 of the nearly 5,000 stocks in our Quadrix® universe yielded 8% or more. A peek at the total-return performance of those stocks over the next 12 months (through April 2008) shows that a high yield doesn’t necessarily mean a high total return.

Indeed, the average high-yielder delivered a negative total return of 9.1% — including the dividends. In contrast, the S&P 500 Index posted a negative return of 4.7% over the same period.

Consider what those numbers mean. The average yield of the stocks we considered was just over 10% at the end of April 2007, meaning the average stock in our study fell more than 18% during the 12-month period.

This trend is not new. In rolling 12-month periods since March 1995, the top quintile (one-fifth) of stocks in the S&P 1500 Index as measured by dividend yield underperformed the average stock by an average of 1%. At this time, stocks yielding 3.4% or more fall in the top quintile of the S&P 1500.

When considering high-yielding stocks, remember that yield represents a potential proxy for risk. Indeed, a stock with a yield well above the market average — currently, the S&P 500 yields 2.1% and one-half of U.S.-traded stocks yield 1.5% or lower — may be signaling that the company is in distress and the dividend in jeopardy.

In addition, high-yielding stocks generally pay out most of their profits in dividends rather than investing in the business, and as such do not offer the best opportunities for growth. This limits total-return potential over the long term. In fact, it is not unusual for high-yielding stocks to cut or eliminate their dividends when the business environment deteriorates. Nearly one-third of the high-yielders in our study reduced or omitted their payouts during the test period.

Given the *Forecasts'* focus on total return, our preference when shopping for yield is to target stocks with the combination of above-average market yields in the 2% to 3.5% range, solid dividend-growth prospects, and healthy appreciation potential.