



# FINANCIAL PREPAREDNESS

*"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen*

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## Dividend Safety

Investing is about buying assets that generate an income stream (anything else is speculation). If we lived in a world of honest money, bonds and fixed annuities would certainly be viable investment options, but alas, we live in a world of fiat currency. Other than cash equivalents (such as money market mutual funds), that leaves dividends from common stocks.

All other things being equal, a high dividend yield is preferable to a low dividend yield, because it's usually a sign that a company (1) is very profitable and (2) has management that treats shareholders well (perhaps because management owns a lot of shares itself). The vast majority of non-professional investors thus tend to favor stocks that have a high current yield. The problem is that all other things are not equal. Assuming that as new managers start to work for the company, they continue to treat shareholders at least as well as the company treated them in the past (i.e., *willingness to pay*), a company also has to be financially able to pay a dividend (i.e., *ability to pay*).

Eventually, every company will go bankrupt and so every company will reduce or eliminate its dividend at some point. Although a high dividend yield is attractive to uninformed investors, an unusually high yield is actually a warning sign that the company may reduce or eliminate its dividend soon. That's because investors who know what they're doing will

use fundamental analysis to determine that the company is experiencing financial distress and therefore may be forced to reduce or eliminate its dividend soon, and will thus sell their shares. This reduces the market price of the shares, which increases the dividend yield.

Historically, stocks that increase their dividend every year have had the highest total return, followed by stocks that pay a flat dividend, and then stocks that don't pay a dividend. The worst-performing stocks are those that reduce or eliminate their dividend. This is why dividend safety is a crucial consideration, because you want to avoid owning stocks that are in the worst-performing category.

Ironically, the metric that the vast majority of investors pay attention to the most (reported earnings) have little to do with a company's ability to pay a dividend. Earnings are an accounting measure that can be (and are) manipulated in many ways by management to make the company's financial position appear better than it actually is (so they can keep their job and exercise their stock options at an elevated price). As an investor, you should focus instead on *free cash flow*, which is basically the amount of cash left over after a company pays all of its expenses. Dividends have to be paid from free cash flow (which unlike earnings, is not easy to manipulate). As the saying goes, earnings are for accountants, free cash flow is for investors.

Dividend safety is a complex question that is affected by many different factors. I rely on two different reporting services that distill various factors into a single number or grade that I can use quantitatively in my massive stock-tracking spreadsheet. The first service considers ten different factors, while the second service considers 27. But it's even more complicated than that since many stocks either aren't covered by the service or don't have enough available data (especially newer and foreign stocks) to assign a score. Investing is easy, right? Anyone can do it.

Interestingly, generally speaking and with all other things being equal, the lower a company's dividend, the safer it is (and vice versa), because financial distress probably won't jeopardize a low dividend. Real estate investment trusts (REITs) are required by law to pay out at least 90% of their taxable income as dividends, so their dividend yields tend to be among the highest. Yet they are also quick to slash their dividends when their profits decline, which generally results in fairly low dividend safety scores. Of course, just like any other stock that pays a high dividend, when these companies cut their dividend, income-hungry investors flee, and the stock price plummets.

Besides the dividend safety scores above, I also track the following metrics on my spreadsheet for each stock I follow. First, the number of consecutive years a stock has paid a dividend. This is a basic measure of how long a company has been around paying dividends (and thus how likely it will remain around paying dividends in the future, based on the [Lindy Effect](#)). In other words, how much is paying dividends part of the company's culture, or how developed are its dividend-paying muscles?

Second, the number of consecutive years a company has increased its dividend (including in foreign currency for foreign companies). Because the stock of these companies

collectively have had the highest total returns in the past, these are prized shares that you want to accumulate (ideally at attractive prices) and own for the long haul. When a company increases its dividend, it's a signal that (1) the company is probably increasingly profitable, likely because it has a strong and durable moat, (2) those profits are probably real (unlike the "profits" from reported earnings, which may be fraudulent), (3) management takes its responsibility to shareholders (the owners of the company) seriously, and (4) the company is probably not experiencing any financial distress, and management is confident about the company's prospects.

Third, the number of years in the last decade that the company had positive free cash flow (if this number isn't sufficient to cover the dividend, the company would probably have to borrow money to maintain its dividend). A company that gushes plenty of cash each year is not at risk of having to reduce its dividend.

In conclusion, there's a lot more to investing for income than comparing dividend yields. You also have to consider how likely it is that you'll actually receive that income and not a large capital loss instead.

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