What Dividends Tell You

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Every Fool loves dividends. What better way to juice your stocks' returns than by enjoying regular cash payments from your companies? Best of all, dividends can tell you a lot about a company -- provided you know what to look for.

Dividend basics
A dividend is a portion of a company's earnings that it pays out to its shareholders. If **Home Surgery Kits** (Ticker: OUCHH) is earning roughly $4 in profit per share each year, it might decide that it will issue $1 per share annually to shareholders. If so, it will probably pay out $0.25 per share every three months.

This may seem like a pittance, but it adds up. If you own 500 shares of a company that's paying $1 per share in dividends, you'll receive $500 per year from the company.

If you're evaluating a company's dividend, make sure you're looking at its *dividend yield* -- the current annual dividend, divided by the current share price. Suppose two companies are each paying $2.50 per share in dividends, but one company is trading at $25 per share, and the other at $50 per share. The first company has the greater yield; it pays you back 10% of your initial investment in cash, compared to the second company, which yields only 5%.

Remember that since the dividend yield is essentially a fraction, with the annual dividend on top and the share price on the bottom, it will fluctuate daily along with the share price. (Annual dividend amounts typically change only every year or so.)

Be a dividend detective
If you look closely, dividends can tell you a lot about a company's fortunes:

- Most dividend-paying companies are in fairly stable financial shape, since they need to be fairly certain they'll have enough cash on hand to keep making those payments to shareholders. Better still, companies with track records of regularly and significantly hiking their dividends tend to be extra-consistent earners. **Waste Management** (NYSE: WM) and **Colgate-Palmolive** (NYSE: CL), for example, have hiked their dividends by a compound annual average of 10% and 12%, respectively, over the past five years.
- Though companies usually strive to avoid reducing or eliminating dividends at all costs, the contracting economy forced several businesses to cut or scrap their payouts last year to conserve cash. **Citigroup** (NYSE: C), **Bank of America** (NYSE: BAC), and **Dow Chemical** (NYSE: DOW) are just a few of the offenders in this category.
- A fat yield alone is no reason to buy a stock. As a stock price rises, the yield will fall, and vice versa. Sure, a hefty dividend yield could reflect a generous company -- but it could also signal that a struggling business's stock has just tanked. If a company's dividend payouts exceed its earnings, then the company won't be able to sustain them in the long run.
- Dividends generally signal that a company is flush with cash it doesn't immediately need. That cash could otherwise go toward hiring more employees, building or refitting factories, paying down debt, buying back shares, or snapping up a rival, among other uses. That's why smaller, faster-growing companies such as **Ebix** (Nasdaq: EBIX) or **Smart Balance** (Nasdaq: SMBL) often pay little or no dividend; they want to keep that cash to help their business expand or to make acquisitions.

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