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High-Quality Stocks Reward Wise Investors

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The past few years have been difficult for investors of all stripes. With the financial crisis and the global recession, the Standard & Poor's 500 dropped 50 percent in late 2007 and then recovered strongly in 2009. But in recent weeks, stocks retreated again as investors became nervous about the economy.

For investors in bonds and short-term fixed income securities such as CDs, opportunities are limited because interest rates are extraordinarily low.

As investment counselors, we advise clients to maintain a portion of assets in cash or liquid, short-term vehicles to pay living or other upcoming expenses. For clients seeking income and preservation of principal, we recommend an allocation of fixed income in their portfolio.

But most importantly, we see the greatest opportunity for income and growth through owning a group of carefully selected high-quality stocks.

Many of the companies we have recommended recently are financially strong, with healthy cash flows and relatively high dividends. And as a result of the recent decline in the stock market, they are at historically attractive valuations.

Stock investing is never easy. Economic and market conditions can be difficult, unpredictable events can occur and there can be abrupt shifts in investor psychology.

Our company's founder, David Wendell, once noted: "One of the biggest obstacles to good investment results is the tendency to place too much emphasis on the short-range outlook. At times, the majority of investors seem to believe that the whole future is wrapped up in the headlines of the day."

This year these headlines have included the oil spill in the Gulf of Mexico, the disruptive volcano in Iceland, a still unexplained "flash crash" in the stock markets, a sovereign debt crisis in Europe and increasing concerns about our nation's fiscal policies.

Focusing on short-term developments, many investors lose sight of the fundamental progress achieved by well-managed, financially sound companies. Over the long haul, it is our belief that this progress in earnings and dividend growth is ultimately reflected in a company's share price.

Since 1926, dividends have contributed nearly 50 percent of total return from stock ownership, while capital appreciation has accounted for the remainder. Our analytical work focuses on companies with long records of consistently increasing earnings and dividends, with low levels of debt and high cash balances and with attractive valuations for current purchase.

Today, it is not difficult to create a basket of a dozen or more high-quality companies consisting of such household names as Johnson & Johnson, Colgate-Palmolive, McDonald's, IBM and Microsoft, as well as Automatic Data Processing, Abbott Labs, United Technologies and Exxon Mobil.

As a group, these companies have a dividend yield greater than 3 percent, exceeding the current yield on a 10-year U.S. Treasury bond.

Importantly, unlike a bond whose annual interest payment is fixed, this group of companies has a distinguished record of increasing their dividends each year. In fact, this group has more than tripled their dividends over just the past 10 years, a decade that includes two recessions. Given their market leadership, financial strength, management talent and the prospect for continued global economic growth, we expect significant dividend increases to continue in the future.

High dividend yields are not necessarily attractive if there is a strong possibility that the dividend could be reduced or eliminated.

Many investors became painfully aware of this as dozens of companies cut or eliminated their dividends in 2008 and in 2009 during the financial crisis. Some of these included Citigroup, Bank of America and Pfizer.

Overall, 78 companies in the S&P 500 cut or suspended their dividends in 2009, reducing payments to shareholders by a record $37 billion.

We continue to make the bullish case for high-quality stocks.

The combination of strong earnings, dividend growth and little change in stock prices over the past decade has resulted in very attractive valuations for many fine companies. Not only are these stocks currently appraised at their lowest absolute valuations in over 20 years, the premium these companies have typically commanded over the broader market has nearly disappeared.

Accordingly, the list of companies attractive for current purchase is large and growing.

While no one knows what the stock market will do in the short term, over the long haul companies with high-quality fundamental characteristics will continue their progress of higher earnings and dividend growth and will ultimately reward their owners with greater income and higher share prices.