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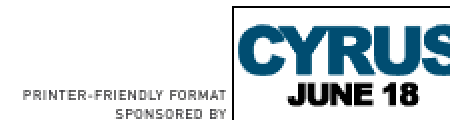

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Dividends Look Safe, Until They're Not

By RON LIEBER

If you own BP shares and rely on the dividends for your retirement income, you now matter less than shrimp boat owners and tourism workers in the Gulf of Mexico.

That's the net result of the announcement on Wednesday that BP will suspend its dividend for the rest of the year and set aside money for cleanup costs and compensating workers who have lost income as a result of the oil spill.

Whether the federal government was right to pressure BP to make this move (and whether BP should have buckled) is a question for the ages. But if you're an investor in BP and rely on dividend income to pay your daily expenses, this should serve as another reminder that relying on one stock or even a handful of stocks is incredibly risky.

We've seen this movie before. Wachovia and its dividend disappeared, hobbling many investors. Other big banks reduced their payouts drastically in the depths of the financial crisis. General Electric slashed its dividend as well.

This should have been a warning for anyone making big retirement bets on a single stock or a handful of stocks. Things that seem stable can wobble and unravel before our very eyes. And now it's happening again.

It's not supposed to work this way, at least in the minds of the many investors of the old school. To them, a stock that pays a dividend is a stock that is safe. "It told them that a company was still around and operating, it was in good health," said Milo M. Benningfield, a San Francisco financial planner.

Just because a company pays a dividend now is no guarantee that it will forever, or that the company will even continue to exist. Nor is it any guarantee that the underlying stock is stable. Steven Podnos, a financial planner in Merritt Island, Fla., notes that the iShares Dow Jones Select Dividend Index exchange-traded fund, which contains stocks that offer high annual yields through dividends,

underperformed the broader Standard & Poor's 500-stock index over the last five years.

Still, plenty of people strap on the blinders and maintain their faith in the stocks they think they know well. A frightening article in the trade newspaper Pensions & Investments on Monday estimated that BP employees and others in the company's 401(k) plan have lost more than $1 billion from the stock's decline in the wake of the spill. How can the loss be so high? Well, 29 percent of the plan's assets were invested in BP stock as of last September. This, sadly, is yet another violation of the too-many-eggs-in-one-basket rule that company plan sponsors should have had inscribed in stone for employees — even before the Enron collapse and the resulting devastation in employee retirement accounts there.

Employees or retired employees are not alone. Devotees of white-hot companies (Apple comes to mind) simply refuse to believe that anything bad could befall the stock. Retirees reliant on dividend income may be averse to change if a stock has paid out regularly for decades. Others may have inherited a big slug of stock and may simply not know any better. Then there are those who are so tax-adverse that they won't diversify their holdings because they don't want to give up some of their winnings to capital gains taxes.

If you know people who might fall into these categories, please do them a favor and send them to a financial planner post-haste if you can't talk some sense into them yourself.

Or you could simply try to scare them. Very few people saw a spill of this magnitude coming, just as only a small number could have predicted a few years back that financial stocks would go from contributing 29 percent of the dividend payments of S.& P. 500 payments in 2007 to just 9 percent in 2009.

Today, consumer staples stocks contribute more than any other sector, according to Howard Silverblatt of S.& P. How might that sector or parts of it unravel? A prolonged terrorist campaign against large American retailers could begin, or a blight could emerge that wipes out a large percentage of the nation's crops. These things are unlikely but entirely possible, and they wouldn't be a total surprise. Tempted by utilities? Mr. Benningfield suggested contemplating the remote possibility of solar flares frying the power grid.

As of Wednesday, there is now political risk to consider, too. Now that there is a recent precedent, legislators could again attempt to bully a company into suspending its dividends.

And if that isn't worry enough for dividend fans, we must also rely on those same legislators to sort out our tax policy. Currently, no one pays more than a 15 percent federal tax on dividend income. If Congress does not act before the end of the year, however, investors will start paying much higher ordinary income tax rates on dividends come 2011. "Where it will wind up, no one knows,"

said Kenneth L. Powell, a tax partner at the accounting firm Berdon LLP in New York. Wealthier investors, meanwhile, may pay even more once a 3.8 percent Medicare tax on unearned income goes into effect in 2013.

Everyone needs income in retirement, and dividends aren't a bad way to get it as long as they don't come from a single company. Again and again, we've seen out-of-nowhere scandals and crises and accidents bring big companies to their knees. Why, given the overwhelming evidence that these things do happen once in a while, would you not extract your dividend income from a low-cost, broadly diversified mutual fund that specializes in dividends?

The moral of the story, as always, is to diversify within each asset class you own, whether it's dividend-paying stocks or municipal bonds or the emerging-market countries where you're rolling the dice in search of big gains. Then, diversify your retirement income strategy, too. The more sources the better, whether it's dividend income, interest income, annuity income, rental income or periodic (and tax-savvy) outright sales of stocks or other assets.

Even this sort of diversification might not have protected you from the pain in 2008. But it can shield you from the ruin of betting too heavily on a single security like BP.