

Focus on Dividends

When you come right down to it, there are only two ways the value of the investments in your retirement savings plan account can increase in value. They could increase in price—meaning that they are worth more now than when you bought them. Or, your investments could generate income, which would be paid to you in the form of dividends. Dividends have become big news since the IRS reduced the income tax on dividend income.

What Are Dividends?

Dividends are shares of a company's profits that are paid out to its shareholders. Dividends typically are paid by large, well-established companies that generate profits most years, but are too mature and settled to generate much growth. Stock funds that invest in dividend-paying companies tend to pay dividends as well. Bond funds also pay dividends—even though individual bonds pay interest. The dividend tax is often referred to as a “double tax.” This is because a company may pay taxes on its profits and—if those profits are then distributed to shareholders as dividends—they may be taxed again.

Of course, not all investments pay dividends. Fast-growing companies in such relatively new industries as telecommunications and biotechnology prefer to reinvest any profits they may make to pay for future growth. Because these companies rarely pay dividends, neither do the funds that invest in them.

The Great Dividend Drop

For decades, the dividend yield on stocks in the Standard & Poor's 500 Stock Index (S&P 500) was about 4%¹, meaning that an investor would receive \$4 in dividends each year for every \$100 he or she invested in the stocks held in the S&P 500 Index. Then came the long bull market of the 1990s and dividends pretty much went out of favor because company executives, anxious to generate the growth investors wanted, kept cutting their dividends to reinvest their profits in ways they thought would help generate that growth.

Dividends Pay Off in the Long Run

There's evidence that dividend-paying stocks are more attractive to investors than those that don't pay dividends. Dividend-paying investments have always been attractive for tax-deferred retirement plan accounts because you can defer paying taxes on that dividend income until after you retire and start withdrawing money from your account. But even if dividend income becomes tax free, you would probably still want to hold dividend-paying investments in your retirement plan. That's because the rules of diversification suggest keeping income-producing investments as well as growth-oriented ones.

¹Standard & Poor's, July 24, 2008, standardandpoors.com