Fortune Brands' Dividends May Not Last Forever by Prince Damin

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Whether you're a beginning investor or a near-retiree, the importance of purchasing stocks that pay dividends cannot be overstated. Not only do companies that have quarterly or annual payouts provide you with a steady stream of income, they also have the potential for capital appreciation. Simply put, dividend stocks can give your portfolio what almost no other investment can both income and growth. At The Motley Fool, we're avid fans of dividends and not just because we like that steady stream of cash. Studies have shown that from 1972 to 2006, stocks in the S&P 500 that don't pay dividends have earned an average annual return of 4.1%; dividend stocks, however, have averaged a whopping 10.1% per year. That is an incredible difference one that you'd be crazy to not take advantage of!

But investing in dividends can be dangerous companies can cut, slash, or suspend dividends at any time, often without notice. Fortunately, there are several warning signs that may alert you,and these red flags could be the crucial factor in determining whether or not a company is likely to continue paying its dividend. Today, let's drill beneath the surface and check out Fortune Brands (NYSE: FO).

What's on the surface? Fortune Brands, which operates in the housewares and specialties industry, currently pays a dividend of 1.3%. That dividend yield may not seem like much, but considering that more than 100 companies in the S&P 500 don't pay anything at all, it's nothing to complain about. Plus, don't forget, dividends typically grow with time, so that 1.3% has the potential to skyrocket over time.

But what's more important than the dividend itself is Fortune Brands' ability to keep that cash rolling. The first thing to look at is the company's reported dividends versus its reported earnings. If you happen to see dividend payments that are growing faster than earnings per share, it may be an initial signal that something just isn't right. Check out the graph below for details of the past five years:

In response to declining earnings, Fortune cut its dividend a couple years ago. But given its lowered payout, can Fortune continue to keep paying its dividend?

The more secure, the better:- One of the most common metrics that investors use to judge the safety of a dividend is the payout ratio. This number tells you what percentage of net income is paid out to investors in the form of a dividend. Normally, anything above 50% is cause to look a bit further. According to the most recent data, Fortune Brands' payout ratio is 28%. It's obvious that, at least on the surface, there aren't any problems with Fortune Brands generating enough income to support that nice dividend of 1.3%.

More important than checking out the payout ratio may be simply taking a peek at Fortune Brands' cash flow. Free cash flow all the cash left over after subtracting out capital expenditures is used by firms to make acquisitions, develop new products, and of course, pay dividends! We can use a simple metric called the cash flow coverage ratio, which is cash flow per share divided by dividends per share. Normally, anything above 1.2 should make you feel comfortable; anything less, and you may have a problem on your hands. Fortune Brands' coverage ratio is 4.86, which is more than enough cash on hand to keep pumping out that 1.3% yield. Barring any unforeseen circumstances, there really shouldn't be any major problems moving forward.

The Foolish bottom line:- Only you can decide what numbers you're comfortable with in the end; sometimes a higher yield and a higher reward means additional risk. However, when we look at

Fortune Brands' payout ratio compared to its peer average, we see that it is a lower percentage, which illustrates that its dividend is probably more sustainable. The bottom line, however, is to make sure that with anything whether it be a dividend, a share repurchase, or an ordinary earnings report you do your own due diligence. Looking at all of the numbers in the best context possible is just the best place to start.

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Prince Damin - About Author:
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