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The Dividend Machine

Edited by Bill Spetrino

GENERATING A LIFETIME OF DOUBLE-DIGIT INCOME

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Three Keys to Profitable Dividend Stock Investing

My financial system, which has taken me more than 20 years to perfect, provides steady and consistent growth. During this supposed "lost decade," in which the Dow is down about 20 percent, my annual portfolio is at 17 percent compounding annually.

In my first book, *Consume, Consume, and Consume More*, written in September 2005, I selected two stocks, one of which is up more than 70 percent in that time span and the other is up almost 30 percent, despite the overall market being down about 25 percent.

If you are looking for risky, speculative stocks that may or may not work out, then watch Jim Cramer on TV or listen to the many Internet pundits, some of whom selected AIG at $900 per share or told you to buy Washington Mutual or Countrywide when they were $40 per share.

A friend of mine who also writes a newsletter was telling me about some outsized gains he has made, and I asked him point-blank: "Would you put $1 million into that one investment?"He said that is not how he invests. He plans on being right on 65 percent of them and believes that those 65 percent will outperform the other 35 percent that lose money.

I understand the math, I think, but what about the person who bought just the losers in that portfolio? Folks, no one has unlimited capital, not even Warren Buffett. Since I have perfected my system, every single one of my large equity positions has been profitable over a three-, five-, 10-, and 15-year period. That's because I follow two basic rules: No. 1 is, don't lose money. No. 2 is, don't forget rule No. 1.

Think this is too simple? Warren Buffett, the only man ever to earn more than $100 billion for himself and his investors, has these immortal words on a sign above the computer in his office. So do I, and so should you, too.

Most of my stock choices are well-known names. Trust me, the key is getting the proper entry point into the proper stock. Over the next few issues, you will see how your not-so-humble correspondent does that. Unlike most newsletters, which tell you what they buy but not why,

Inside...

CURRENT YIELD BENCHMARKS
as of Sept. 1

	YIELD	MONTH AGO	YEAR AGO
3-MO. TREASURY BILL	0.15%	0.18%	1.72%
1-YR. CD	1.38%	1.44%	3.53%
S&P DIVIDEND YIELD	2.19%	2.27%	2.34%
10-YR. TREASURY NOTE	3.40%	3.52%	3.74%
MONEY MARKET (7-DAY AVG.)	0.12%	0.16%	2.23%

at my personal "restaurant," not only do diners receive delicious gourmet meals but also the chef explains how the meals are prepared.

Remember, folks, the best idea someone gets is his or her own. My job is to help you see why a stock I recommend is right for you. These newsletters will do just that. Each person then needs to decide what stock to buy and an appropriate amount to invest for him or her personally.

My main point is that I feel confident enough in each of my conservative portfolio stocks that I would invest all of my money in each of them. If I don't feel that way about a company, I either don't recommend it, or I put it into the recently added aggressive portfolio, in which the bet size is reduced drastically but the potential for outsized gains is increased.

Powerhouse Stocks For the Future

What makes a good stock pick for me? Remember, investing is 50 percent art (instinct) and 50 percent science (numbers). Let's talk first about instinct. Take for example Wal-Mart, one of our current stock selections. How does anyone compete with it? Founded by the greatest businessman of the 20th century, the late Samuel Moore Walton, Wal-Mart started by avoiding the large retailers and developed into a worldwide powerhouse.

Those who doubt me, please read his autobiography, which can be acquired for less than $8 on the Web. Walton created a juggernaut that has outlived him and even his wildest dreams. See folks, the big fish eat the small fish, as long as the big fish stay lean and motivated and focused. The Walton Family Foundation and the employee stock fund controls more than 40 percent of outstanding Wal-Mart stock. Unlike most Fortune 500 firms, whose executives spend little money buying their own stock, the Wal-Mart executives and management "eat their own cooking."

Instead of granting options, Walton started a program that provided discounted stock to employees. For example, if the stock was $50 a share, a Wal-Mart employee was allowed to buy it for 80 percent of that price, or $40, provided that the worker held the stock for a specified period, usually three to five years. This gave the employee a tremendous incentive to work harder.

Options are like lottery tickets more than investments, with which the employee only wins or breaks even. By contrast, under Walton's plan, the employee's money is in with the investors' money, good or bad.

Simply put, selecting the highest quality of company provides the best probability for future success. My job is to try to figure out what companies not only are powerful now but also will be powerful five, 10, 20 years from now. (Who else thinks this way? Why, Buffett, of course!)

It's an inexact science, but your not-so-humble correspondent uses a three-pronged system. First, I evaluate the business from top to bottom and study the founder and the past 50 years of its financial history. Next, I personally question managers and employees on their insights. Third, I look at financial statements looking for evidence that the company's competitive moat — its ability to keep competitors at bay through brand power or other means — is increasing, not decreasing.

For example, as a Warren Buffett disciple, I analyzed The Washington Post Co., which was a fantastic investment for Buffett over a 25-year period. However, my instincts told me that the media business was undergoing a dramatic change because of the Internet.

The Washington Post, *The New York Times*, Gannett, *The Boston Globe*, CBS, and other traditional news outlets are being outmaneuvered by Web sites and upstart cable news outlets, among others. Here's an anecdote that drives home a basic, but crucial, point:

Decades ago, Henry Ford told a reporter that his personal chef made the best hamburgers in the world. When the reporter asked the chef his "secret," he smiled and said, "I get the finest cut of steak from the butcher and then put the meat through the grinder and make him his hamburgers."

Why did I recount this story? The first step in finding the right stock for your own Dividend

Machine is getting the highest quality company.

Yet, investing in the best companies often does not outperform the market because high-quality stocks seldom sell at an appropriate entry price. Knowing when the price is right is a big deal.

So, for less than the cost of bagel and coffee every week, you will get my instinct on that point, honed over the past 20 years and the 30 to 40 hours a week that I spend researching investments. This newsletter, by my calculation, brings you that work at a cost of between 5 and 6 cents per hour. As a value investor, I can tell you that that risk-to-reward ratio is definitely slanted in your favor.

Many mutual fund managers charged 1.5 percent of your total investment last year to make your net worth 20 percent to 30 percent lower! And, unlike your not-so-humble but very accurate correspondent, they do not explain why they do what they do. Each recommendation I make is backed with many reasons so that each individual investor has all the pertinent data to make an informed decision.

The Key Ingredient: Free Cash Flow

A strong economic moat is important. Buying a company with a strong free cash flow also is paramount. Companies such as General Motors always have had very high earnings per share. However, most of the profits were plowed back into the business, leaving little money to be reinvested into the business or paid out as a dividend. Many investors get enthralled by high book-value stocks, thinking they are getting a bargain.

Folks, a business is not necessarily worth the cost of its assets. Instead, you can value it correctly by estimating the total amount of free cash flow that the business will produce each year in the future. Let me give you an analogy: The economic value of a college degree is not what you paid for the degree. It is the extra income that your degree is responsible for helping you earn.

Simply put, a company's economic value is the amount of free cash flow divided by how much the company needs to invest to earn it. ExxonMobil is a great business and had the largest net profit in U.S. history. However, the oil business is capital intensive, unlike a pharmaceutical company, such as our own Abbott Labs or Johnson & Johnson.

If Exxon or any oil company gets to the right price, of course we will buy it. However, the Dividend Machine is by design skewed toward less capital-intensive businesses.

General Motors and the airlines are examples of businesses that constantly plowed their profits back into the business and took on excessive debt to pay back their creditors. During boom times this method works, but when the inevitable economic slowdown appears the rainy day fund has been decimated.

Simply put, we would rather own the fifth-best business in a profitable industry than the best business in a money-losing industry. Remember, the winner of the rat race is still a rat.

Portfolio Update

In reviewing our portfolio, our three largest positions are **Altria (MO)**, **Philip Morris (PM)** and **Johnson & Johnson (JNJ)**. Altria hit its 2009 high

Bill Spetrino is a professional investor who has earned $1 million so far solely through strategic investing. A trained accountant, he graduated from John Carroll University in Ohio and spent a decade teaching. A lifelong entrepreneur as well, Spetrino set out to understand and codify a simple dividend investing strategy for life, an idea that eventually led to the creation of the Dividend Machine. He wrote it all down in his book, *Consume, Consume, and Consume More*, about how to pick the kinds of dividend stocks Warren Buffett or the late Sir John Templeton would recommend, long-term cash generators with handsome appreciation as well. His dividend picks now generate all of his family's living expenses and more, and they keep on growing! He consults with a worldwide base of clients on investing and tax planning from his home in Ohio.

of $18.10 on Aug. 21 and closed at $18.04, which is more than 3 percent higher than many of my new subscribers grabbed it on Aug. 18.

Now, please don't expect Altria to rise 3 percent weekly, but the appreciation added to the juicy dividend (it was raised to $1.36 on Aug. 26) should more than provide double-digit annual return for the next five years and more.

Of course, those who bought the stock at $16.37 or lower in the past few months have achieved double-digit appreciation but more importantly locked in a dividend yield of more than 7.8 percent annually.

Philip Morris is another stock many of my new subscribers grabbed on Aug. 18 as low as $45.04. Those who did were able to lock in a nice dividend. Those who followed my advice saw Philip Morris close on Aug. 21 at $46.87, up more than 4 percent from three days earlier. Subscribers who bought it at $41.45 at the end of May have seen about 13 percent in appreciation. Combine that with a 5.25 percent dividend from the world's largest publicly owned tobacco company.

Johnson & Johnson was my first selection, and it has risen by about 20 percent in the past four months. Although the dividend yield is nowhere as large as the two tobacco companies, Johnson & Johnson has three advantages.

First, it has a higher chance for capital appreciation because of the higher percentage of retained earnings.

Second, it increases its dividend faster. Look for double-digit dividend increases over the next five to 10 years. Finally, Johnson & Johnson includes three major businesses — big pharma, medical devices, and consumer goods — all of which are large advertisers and the types of companies that carry much higher multiples on earnings on Wall Street. Comparatively, many major media agencies shun tobacco companies because they do not advertise much and because of the threat of litigation.

I personally have a very high percentage of my net worth in these three stocks and have followed all of them extensively for 20 years. I have interviewed hundreds of shareholders and key employees, and I have talked to many different people at corporate headquarters in that time span.

Coca-Cola (**KO**) has appreciated by more than 15 percent, and one of my regrets is that I did not make this investment a higher percentage of the portfolio. Warren Buffett's billion-dollar investment 20 years ago now is giving him a dividend yield of around 32 percent of the original cost of the shares and is one of the most powerful brand names (along with Marlboro) in the world today.

Automatic Data Processing (**ADP**), which we bought two months ago, also has appreciated more than double digits and some of you likely caught it cheaper than I originally recommended. Although the dividend itself is not large, it has increased at a much higher rate than Altria and Philip Morris.

This is the safe way to play technology and, as an accountant married to a CPA, I know this company like the back of my hand and have been enamored with it for over 20 years, ever since reading *Beating the Street* by Fidelity Funds legend Peter Lynch.

McDonald's (**MCD**), which we added in the middle of August, has moved well in the past week. McDonald's is the safe way, in my opinion, to play growth in China and is a defensive company that benefits in the event the economy sees a double-dip recession, which is not probable but is possible, given the anti-business, socialist tendencies of the present Congress, most of whom on either side of the aisle will be replaced in the 2010 election.

Abbott Labs (**ABT**) is my play on the fact that the proposed health plan will be "watered down" and will not affect the large drug companies as badly as many pseudo experts believed.

Companies that raise their dividends for more than 30 straight years, like Abbott Labs does, can be trusted. Combine this with a great entry point and a rising dividend, and you can rest easy.

Wal-Mart (**WMT**), unlike every other stock recommended here, stayed low for weeks. Wal-Mart has the lowest dividend yield and is a defensive play and a bet on future growth in China.

The combination of a $15 billion stock buyback and the low entry price and large annual increases in the dividend make the risk-reward ratio too good to pass up.

New Recommendations: Dividend Machine

Lockheed Martin Corp. (**LMT**) engages in the research, design, development, manufacture, integration, and sustainment of advanced technology systems, products, and services in the United States and internationally.

LMT has been down more than 37 percent from a year ago, and the S&P is down only about 15 percent in the same time frame. Many investors thought the liberal Barack Obama and the Nancy Pelosi-led House would cut defense and the credit crisis would cause government spending to freeze.

The government is Lockheed's best customer and provides more than 80 percent of its net sales. This perception is why most so-called "experts" believed LMT should be avoided. The integral question is the following: Is that fear real, or imagined? Let's examine this in more detail.

The perception that the Obama administration somehow can cut defense spending appears to be wishful thinking. Obama has played to his base by mentioning withdrawal from Iraq. My personal viewpoint as a student of history is that this is much easier said than done.

Recently, there has been more violence, as evidenced by the latest bombings in Baghdad. Certainly his higher-ranking military advisers have warned about the effects of premature withdrawal in Iraq. But even if the administration did decide to cut down spending in Iraq it would face a much more formidable task in Afghanistan.

During Obama's campaign, he stressed his focus on Afghanistan. Many skeptics believe this was a ruse to draw attention from his mischaracterization of the situation in Iraq. Like it or not, this administration has stressed the importance of the situation in Afghanistan and that conflict is, militarily, much more difficult than the war in Iraq.

Many "math guys" do not evaluate history and thus do not have the same edge as your not-so-humble but very accurate correspondent. I have consulted recently with three military experts, and all three agreed that challenges in Afghanistan are both enormous and crucial.

They all agreed that the campaign there will be long and arduous. Consider that both the British and the Russians tried and failed in the same mission. What concerns us as investors is that this war will be expensive in both monetary terms and in blood if these experts and my own study of history are reliable. Once investors realize the truth of what's really likely to happen in Afghanistan, earnings for LMT should exceed Wall Street's expectations.

The outlook for government spending does appear uncertain. Also, concern about healthcare, benefits for illegal immigrants, cap and trade, and Medicare and Social Security entitlements would appear to threaten future military budgets.

After assimilating the information available I have reached the conclusion that, although the rate of increase in military spending might decline, the military budget itself should nevertheless continue to rise. The U.S. government is a great customer for two major reasons. One, it has a strong military reputation and many countries count on America to defend the world. And, two, the government has proved during the past of couple years it is ready and able to print money if the situation arises.

So now that it is clear that Lockheed Martin's moat is strong, let's examine the numbers. LMT has a return on equity of 49.45 percent and 2009 earnings are projected at $7.38 per share and 2010 is projected at $8.22 per share, which is slightly over a 10 P/E ratio.

Lockheed has beaten expectations the past four quarters, so these numbers can be trusted. On July 21, the stock dropped almost 9 percent on almost nine times regular volume. During the past five weeks, despite the run-up in the S&P 500 Index, LMT has stayed level.

In the next month, I see a shift from lower-

LOCKHEED MARTIN

SYMBOL	LMT
RECOMMENDATION	BUY UP TO $76
PERCENTAGE OF PORTFOLIO	6% (DIVIDEND MACHINE)
DIVIDEND YIELD	3.04%
DIVIDEND FREQUENCY	QUARTERLY
LAST DIVIDEND PAID	$0.57 (ON AUG. 28)
EX-DIVIDEND DATE	AUG. 28

quality stocks that ran up faster than expected and a rotation into stocks and sectors that have been neglected. Add to this the fact that there are high barriers to entry in this industry because the government generally is a captive customer for upgrades, parts, and service. With a payout ratio of around 30 percent, no credit problems, and a large backlog, Lockheed Martin is a buy.

I RECOMMEND LOCKHEED MARTIN (LMT) UP TO $76. MAKE IT 6 PERCENT OF YOUR DIVIDEND MACHINE PORTFOLIO.

New Recommendations: Aggressive Portfolio

In the aggressive portfolio we first have **Stryker (SYK)**.The conventional wisdom has been that the Obama administration would punish healthcare stocks. It is logical to feel this way, given the negative comments from both the administration and the Pelosi-led House, who have taken every opportunity to demonize the insurers and the "greedy" healthcare companies. Of course, conventional wisdom is sometimes long on convention and short on wisdom.

Although few industries can claim total immunity to the ups and downs of the economy, some are more resilient than others. When in uncertain economic times, as we are today, it makes sense for the value investor to seek companies immune to the economy.

Stryker is one of the five largest players in the almost $40 billion worldwide orthopedic market. It has two advantages largely independent from the economy or business cycles. As the entire world becomes more affluent and lives longer, these favorable demographic trends worldwide offer strong tailwinds for continued strong industry growth in the longer term. Many of my close friends are well acquainted with this business and they all agree Stryker is undervalued at the present values. It is clear to me that the trend is in our favor here. Let's look at some key numbers.

STRYKER CORP.	
SYMBOL	SYK
RECOMMENDATION	BUY UP TO $41.35
PERCENTAGE OF PORTFOLIO	6% (AGGRESSIVE PORTFOLIO)
DIVIDEND YIELD	0.97%
DIVIDEND FREQUENCY	ANNUALLY
LAST DIVIDEND PAID	$0.40 (ON DEC. 29)
EX-DIVIDEND DATE	DEC. 29

Founded in 1941, Stryker develops, manufactures, and markets orthopedic products and medical surgical instruments. Stryker has grown earnings at an annual compounded rate of almost 23 percent since calendar year 1990. Split-adjusted earnings per share have risen from $0.06 per share in 1990 and are forecast to be $2.94 for 2009. What's impressive is how incredibly consistent its growth has been over this almost 20-year span. Few companies in the world can match this impeccable record of operational excellence.

So why are we getting such a bargain now? Of course, the main reason is the perception that profit margins will narrow, given the political climate. Also, many investors are chasing stocks that will double faster with much higher betas and lower quality. That method, which has seemed effective so far, is not congruent with our own method of buy and hold. The other main reason is that Stryker's forecast for the next year or so is reduced on the anticipation of lower reimbursements cutting profit margins. My estimates are that Stryker should grow at 4 percent to 9 percent, which is still growth, although slower than normal. My instincts are that this reduction in reimbursements is overstated.

Stryker has a return on equity of $18.31 and has very little long-term debt and total debt of $19.4 million, which is very little. What sealed the deal for me is that it has $2.43 billion of cash, more than $6 per share.

The dividend yield at the present time is only 1 percent, so you might wonder why this stock now? Simple. Stryker's payout ratio is only 14 percent and the buy-and-hold investor should see large annual increases in the dividend in the next 20 years or so.

I RECOMMEND STRYKER (SYK) UP TO $41.35. MAKE IT 6 PERCENT OF YOUR AGGRESSIVE PORTFOLIO.

Safeway (SWY) on the surface looks like a stock that should be avoided. There are plenty of reasons not to like the stock. The main reason is that its largest competitor is Wal-Mart, a Dividend Machine selection and a powerhouse. Safeway's employee unions have not been shy about causing conflicts in operations in years past and are a huge detriment when taking on Walmart Supercenters and their nonunion labor.

More than 150,000 of Safeway's 200,000 employees are unionized, governed by more than 400 different union contracts that are renegotiated every five years. To call that a headache is an understatement. Especially in this political climate, in which unions have been emboldened by the government's handouts to the auto industry.

This is no way a political commentary. I mention it only to show you how to make money on the underlying reality. Then there is the perception "trade-down effect," that all retailers hate. Safeway has a bit of an edge here, in my opinion. As shoppers skip the higher-end brands, they'll trade down to the Safeway brand. This shows up as lower sales but the fact is Safeway's margins are higher on its own private-label products, so the overall gross profit impact is not as negative as one would think.

SAFEWAY	
SYMBOL	SWY
RECOMMENDATION	BUY UP TO $20
PERCENTAGE OF PORTFOLIO	6% (DIVIDEND MACHINE)
DIVIDEND YIELD	2.05%
DIVIDEND FREQUENCY	QUARTERLY
LAST DIVIDEND PAID	$0.10 (ON JUNE 23)
EX-DIVIDEND DATE	SEPT. 22

This is an aggressive play and is worth a flyer for a few reasons. The dividend yield is over 2 percent but the ratio is less than 25 percent and the growth in dividend should be above average. The company's free cash flow should be more than 14 percent of the market cap at the present levels, which is a great return on your investment.

I RECOMMEND SAFEWAY (SWY) UP TO $20. MAKE IT 6 PERCENT OF YOUR AGGRESSIVE PORTFOLIO.

DIVIDEND MACHINE PORTFOLIO

Recommendation	Ticker	Portfolio Weighting	Entry Date	Entry Price	Current Price*	Dividend Paid	Total Return	Advice
[illegible]	[illegible]	8%	28-Apr-09	$50.65	$60.29	$0.49	20.00%	Buy up to $51.25
[illegible]	[illegible]	20%	1-May-09	$16.34	$18.22	$0.32	13.46%	Buy up to $17.55
[illegible]	[illegible]	4%	7-May-09	$42.75	$49.06	$0.41	15.72%	Buy up to $42.75
[illegible]	[illegible]	4%	19-May-09	$43.24	$45.92	$0.40	7.12%	Buy up to $43.60
[illegible]	[illegible]	12%	27-May-09	$41.45	$45.36	$0.54	10.74%	Buy up to $46.25
[illegible]	[illegible]	6%	16-Jun-09	$48.51	$51.13	$0.27	5.96%	Buy up to $48.75
[illegible]	[illegible]	4%	6-Jul-09	$34.07	$38.56	$0.00	13.18%	Buy up to $34.50
[illegible]	[illegible]	4%	18-Aug-09	$54.44	$56.07	$0.00	2.99%	Buy up to $56.00
[illegible]	[illegible]	6%	--	--	$74.95	$0.00	0.00%	Buy up to $76.00

** As of close August 28, 2009*

AGGRESSIVE PORTFOLIO

Recommendation	Ticker	Portfolio Weighting	Entry Date	Entry Price	Current Price*	Dividend Paid	Total Return	Advice
[illegible]	[illegible]	4%	--	--	$20.10	$0.00	0.00%	Buy up to $14.50
[illegible]	[illegible]	6%	--	--	$25.51	$0.00	0.00%	Buy up to $24.00
[illegible]	[illegible]	6%	--	--	$41.09	$0.00	0.00%	Buy up to $41.35
[illegible]	[illegible]	6%	--	--	$19.47	$0.00	0.00%	Buy up to $20.00

** As of close August 28, 2009*

The Dividend Machine

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Closing Thoughts

Each person who subscribes to The Dividend Machine is asked how I can help you achieve your financial goals. Because of securities laws I am not able to answer your e-mails directly. However, your feedback is important, and I appreciate it.

Many subscribers say the same two things: They don't want me to withhold any information and they want detailed reasons on why a particular investment is worth buying. Let me address both of these issues. First off, unlike most investors who are focused on how much money they will make you, my philosophy is much different. My main objective is safety. In Warren Buffett's office he has a large sign that says "Rule No. 1, don't lose money, and Rule No. 2, don't forget Rule No. 1."

Sounds basic right? Unfortunately, many so-called value investors, some of whom took large positions in Washington Mutual and Fannie Mae seemed to forget this — if they ever understood it at all in the first place.

My personal portfolio is down a bit short term but up more than 10 percent in the past two years and up almost 19 percent in the past three years. During the "lost decade" for stock, my portfolio went up by more than 300 percent!

Actions to Take Now:

Action 1: Decide for yourself whether an investment I recommend is suitable for you. My "secret" is that, if I think there is one good reason why a stock should not be purchased, I let it pass.

Action 2: One way to get comfortable with my recommendations is to go back and read some of my previous arguments. Hopefully, this will begin to click for you soon.

Action 3: Keep sending in your questions and concerns. I'll try to address them in upcoming issues.

Sincerely,

Bill Spetrino