WIDE MOAT
RESEARCH

SPECIAL REPORT

Sucker Yields – and How to Avoid Them

By BRAD THOMAS

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By BRAD THOMAS
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If you think high-yield stocks are necessary to achieve higher total returns, I don't blame you. But I will do my best to show you otherwise in this special report.

At face value, it seems like more automatically means better. And it seems sensible to want more of something.

What kind of idiot would go for the smaller option if given the opportunity to take the bigger one?

Well, that question depends on what those numbers represent.

Are we talking about two years of bad luck versus 10? Because, in that case, I'm opting for the smaller amount, thank you very much.

I imagine you would, too.

For that matter, if we're talking about two large all-meat pizzas from your favorite pizza joint versus 10 where it's just you at the feast… Unless you have much more self-control than I do, the healthy option would be to go with the two.

Otherwise, everything inside of you is going to be very unhappy very quickly… and for a while after that, too.

In the same way, higher yields can often lead to major regrets. Not always, mind you. But often enough to *always* do more investigation beyond that instant feeling of falling for the big, shiny yield.

I know it's awfully tempting to swing for the fences when you see a double-digit yield in your face flashing "BUY ME! BUY ME!!!!!" But making yield your one and only focus means you're putting dividend quantity over dividend quality.

That "strategy" – which isn't a viable strategy at all – is what I call yield-chasing. And it leads to buying up a whole lot of **sucker yields**. That is, companies with unpredictable and unreliable earnings histories and ultimately unsafe dividend payouts.

Let me be clear: If that sounds bad, that's because it is.

Here's another way of stating it: Companies with sucker yields offer dividends that don't match their fundamentals. Their payout proportions look really good while the market sun is shining bright…

But once the temperature shifts, the wind begins to blow, and the clouds start rolling in, you'd better seek some other shelter. Fast.

Sucker yields aren't sustainable. They're too good to be true, preying on investors' emotions instead of their intellects. If you've ever been victim to something like that, again, I won't judge you for it. I've fallen for it once or twice in the past as well.

And I suffered the consequences just like you did – or like you will if you don't learn from my mistake.

So in this report, I'll show you how to spot a sucker yield and give you a list of some of the most dangerous ones in the market today.

Suckers Line Right Up!

I think it's safe to say none of us wake up in the morning determined to be suckers. Yet, it happens over and over and over again anyway.

CNN Money published an article in 2016 titled "The Science of Why We Fall for Scams That Are So Obviously Scams." And it often doesn't matter how much we should know better.

The article cites Peter, a retired lawyer, who lost $2,000 on a literal get-out-of-jail scam. It was supposedly to keep his step-grandson out of jail: something he admits he's "much too smart" to fall for.

Or at least he should have been.

Unfortunately, mere brains aren't enough to avoid such traps. It also takes mastery over our emotions, which can fall fast and hard when something near and dear to us in on the line, whether that's a loved one, our own pride, or our dreams.

All of us have a weak spot. Probably many of them. As legendary investor Warren Buffett once said, "Look around the poker table. If you can't see the sucker, you're it."

To be fair, most sucker-yield companies aren't going out of their way to damage your finances. They're offering what they're offering because of poor management, really bad luck, or a combination of both.

Moreover, they're going to have to deal with the consequences themselves… From plummeting stock prices after the consequences of their bad decisions catch up… to desperately trying to figure out how to get back into investors' good graces.

But as bad as we might feel for them being in that position, we don't want to be in it with them.

That's why, as a true measure of safety, investors should always analyze at least these three aspects beyond just yield:

1. The dividend's underlying safety.

2. The dividend's ability to grow from current figures.

3. The stock's overall merit.

Real dividend power can't be calculated by yield, but by overall quality – the kind you can see by studying a real estate investment trust's (REIT's) history of dividend payments.

Here are some of the questions you want to ask: Has it increased over time? How has it funded those payouts? Are those methods sustainable enough to continue funding them in the near future?

Looking in the rear-view mirror almost always gives clear snapshots of corporate performance and tendencies. And if you see any dividend cuts, it could suggest management isn't effectively controlling risk.

Again, it's not always the company's fault. Sometimes, stuff happens...

Like the COVID-19 pandemic, which forced many REITs into places management couldn't have foreseen. Those with high leverage and unreliable rental streams were, of course, the hardest hit… particularly lodging and malls.

All REITs in both sectors either cut or suspended their dividends, with **CBL Properties (CBL)** and **Pennsylvania REIT (PEI)** – both mall owners – filing bankruptcy.

Knowing that, we've screened our universe of dividend-paying stocks to identify two REITs with dividend yields that look way "too good to be true." Based on what we can see, they're headed toward dividend cuts, which could lead to portfolio-plummeting principal losses.

If that's the last thing you're looking for, I advise you steer clear from these high-yielding picks.

Sucker Yield No. 1: Global Net Lease

GNL is a net lease REIT that owns 311 properties (39.5 million square feet) covering 50 different industries. As of Q2 2022 the portfolio occupancy was 98.9% with a weighted average lease term of 8.3 years.

Sounds good, right?

But upon closer inspection, we find the company has around 42% invested in the office sector.

Why is that a problem?

Well, just remember the average office REIT is now trading at an adjusted funds from operation (AFFO) multiple around 13x.

[AFFO is an important metric used to measure REIT value. It measures a REIT's funds from operations, adjusted for recurring expenses to maintain the properties' quality.]

This may help explain the reason GNL is trading below that multiple at 7.4x.

Most net lease REITs, however, are trading at around 17x, so clearly GNL does not have the cost advantage compared with its actual peer set.

Speaking of cost of capital, GNL's equity yield is an eye-popping 13.5% which makes it virtually impossible for the company to acquire properties with any investment spread whatsoever.

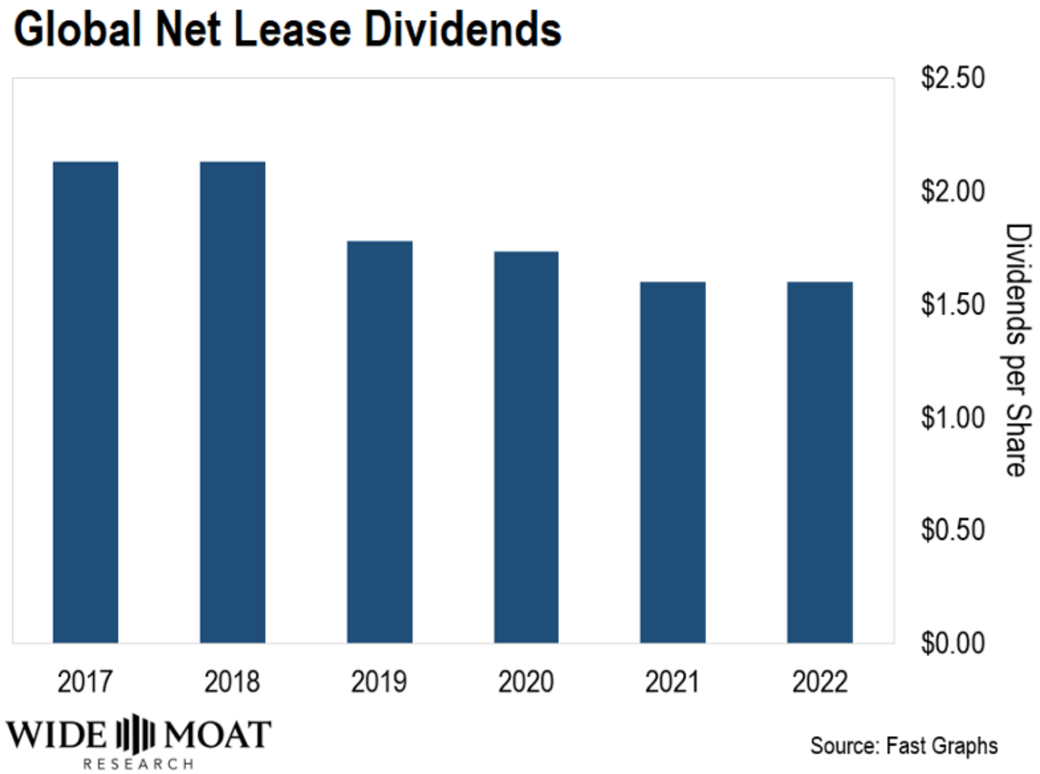
What about the dividend?

GNL is a high-yielder – with a dividend yield of 12.8% – and of course the 7.4x multiple explains much of the risk. However, you must also remember the elevated payout ratio of 93% (AFFO in Q2 2022) suggests the yield may not be sustainable. (See chart on next page.)

It's true its AFFO is growing – up 5% in Q2 – yet the office exposure adds an elevated element of risk, because there's a much higher cap-ex requirement for office buildouts.

In other words, when an office tenant vacates, the landlord must fork out additional capital to replace the carpet, paint, and payout other inducements to release the space.

One other risk worth mentioning is GNL's external management contract, in which it must pay its manager, AR Global, to run the platform. Given GNL's size (over $1.3 billion market cap), we believe the company should internalize and break ties with its manager.



Finally, analysts are modeling modest growth of just 2% in 2023 (based on AFFO), and the office exposure, high payout ratio, and external management will continue to provide an overhang.

This 12% yielder is just too dangerous… And there are much better income opportunities out there for us with far less risk.

Sucker Yield #2: Annaly Capital Management (NLY)

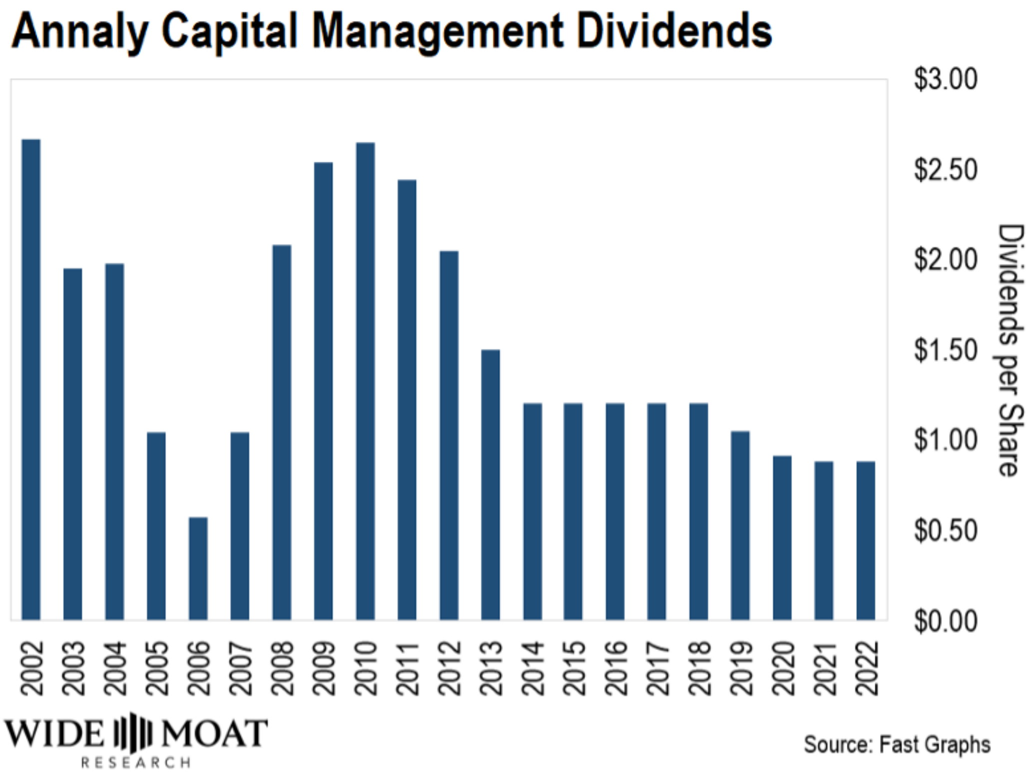
Mr. Market is telling us loud and clear that Annaly Capital Management has an even greater chance of a dividend cut.

And our research estimates there's a better than 75% chance this mortgage REIT whacks its dividend *again*.

NLY has been a chronic dividend cutter and has reset its dividend 10 out of the last 20 years. (See chart on next page.)

To be honest, I don't have much interest in residential mortgage REITs, simply because these "trading" vehicles are too complex for the average investor. Even if you had the skill set to trade mREITs, the returns simply do not compare to those of equity REITs.

Add in rising inflation and headwinds to net-interest margins, and the dividends for mREITs are becoming riskier by the day. They are extremely sensitive to interest rate fluctuations and rarely perform well in rising-rate environments.



That's because most of the mortgages already on their books are fixed-rate assets. So they don't benefit from those changes.

Also, they then must pay higher interest rates to borrow money to fund their current operations. The result is shrinking profit margins, which in turn can easily impact the stock price, not to mention the dividend.

While NLY's 14.6% dividend yield may be tempting, our team doesn't believe the thrill of victory is worth the agony of defeat.

Buy Dividend Growth Stocks

Here's the bottom line: REITs create value by investing cash that promises to generate more money in the future. The amount of value they create is the difference between the cost of their investments and the money they're taking in.

The sucker yield REITs referenced above aren't just generating unsafe dividends… they're not growing anything else, either. At least not anything worthwhile.

Growth creates value only when a REIT generates returns on invested capital above and beyond its cost of capital.

That's why my team and I often focus on growth REITs: entities that increase their funds from operations (FFO) much faster than their peers.

This means we stay on top of trends in property cycles, rental rates, and geographic-specific occupancies, as well as specific management strategies… or the lack thereof.

Both short-term and long-term, knowing the difference between a sustainable dividend and a sucker yield can make all the difference.

Our List of Sucker Yields to Avoid

Now that you know the various metrics we look at to identify sucker yields when it comes to REITs, here's a list of our top 10 sucker yields to avoid in other sectors of the market today:

AGNC Investment Corp (AGNC)	15.62%
Apollo Commercial Real Estate Finance (ARI)	14.80%
B&G Foods (BGS)	10.40%
Broadmark Realty Capital (BRMK)	15.08%
Lumen Technologies (LUMN)	12.79%
National CineMedia (NCMI)	15.54%
Office Properties Income Trust (OPI)	15.43%
Orchid Island Capital (ORC)	20.32%
Ready Capital Corporation (RC)	15.34%
Telefónica (TEF)	9.67%

Happy SWAN (sleep well at night) investing,

Brad Thomas
Editor, *Intelligent Income Investor*