Dividend Growth Investing

The Chowder Rule Explained

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The Chowder Rule *has nothing to do with soup*… The name is a bit misleading. The Chowder Rule is *not* a commonly used financial metric. With that said, The Chowder Rule is an excellent tool to have in your dividend growth investing tool kit.

A brief definition of The Chowder Rule is below:

The Chowder Rule is a rule-based system used to identify dividend growth stocks with strong total return potential by combining dividend yield and dividend growth.

The Chowder Rule was invented and popularized by Seeking Alpha contributor Chowder. The rule gets its name from the Seeking Alpha contributor.

The Chowder Rule is applied differently to different stocks. The criteria and rule are below:

Rule 1: If stock has a dividend yield greater than 3%, its 5-year dividend growth rate plus its dividend yield must be greater than 12%.
Rule 2: If a stock has a dividend yield less than 3%, its 5-year dividend growth rate plus its dividend yield must be greater than 15%.
Rule 3: If a stock is a utility, its 5-year dividend growth rate plus its dividend yield must be greater than 8%.

This article examines the methodology of the Chowder Rule. The article also lists all stocks with 25+ years of steady or rising dividends that pass the Chowder Rule.

Intelligent Rules

The Chowder Rule combines 2 intelligent financial ideas:

- Total Return Investing
- Having a Margin of Safety

Total return investing is a strategy where investors look for businesses with the highest expected compound annual growth rate. The expected compound annual growth rate is dividend yield + expected earnings-per-share growth.
Total return investing combines growth and dividends. It is a close proxy fordividend growth investing.
The 'Margin of Safety' concept was popularized by Warren Buffett's mentor (and value investing pioneer) Benjamin Graham.

Benjamin Graham required a margin of safety in his investments. If he thought the fair value of a stock was $100, he wasn't willing to pay $100 for it. Graham typically required a 33% margin of safety. In the $100 example, Graham would only pay ~$67 for the stock.
Combining the margin of safety principle with business trading below liquidation value allowed Graham to compound his wealth at around 20% a year for decades.

The Goal of The Chowder Rule

The goal of the Chowder Rule is to create a long-term compound annual growth rate of over 8%.

The Chowder Rule applies both 'Margin of Safety' and 'Total Return' thinking to accomplish this goal.

For stocks with a dividend yield over 3%, a 50% 'margin of safety' is used. Instead of hoping everything goes smoothly with a stock with a projected CAGR of 8%, invest in stocks with a projected CAGR of 12% and give yourself a 50% margin of safety.
The margin of safety is *expanded* for fast-growing low-yield dividend stocks. If a stock has a dividend yield *below* 3%, the required projected CAGR is expanded from 12% to 15%. This gives you an 87.5% 'margin of safety'. The intuition behind this is that fast-growing stocks will likely have their growth slow at some point, so a higher margin of safety is required.

Utility stocks typically have high yields and slow growth rates. They are highly regulated and typically enjoy regional competitive advantages from strong barriers to entry. As a result, the margin of safety on utility stocks is removed using the Chowder Rule. Utility stocks need only have an expected total return of 8% to pass the Chowder Rule

The Chowder Rule Is Just the First Step

Passing the Chowder Rule does not *automatically* qualify a stock for investment. Passing the Chowder Rule means that the stock is a *candidate* for investment.

Investors should make sure they are comfortable with the underlying businesses' long-term competitive advantage. The valuation of a stock should be considered as well after it passes the Chowder Rule.

Adjusting The Chowder Rule

The Chowder Rule makes intuitive sense.

The only issue that I have with the Chowder Rule is how unreliable using the 5 year dividend growth rate is for projecting growth.

The dividend growth rate subject to changes in the payout ratio. Take the following example:

- Stock sees EPS fall from $10.00 to $5.00 in 5 years
- Stock raises dividend from $1.00 per share to $3.00 per share in 5 years

Does the stock really have a fantastic 30%+ growth rate? No; the underlying business is likely in decline. The dividend growth rate shows tremendous growth – but this is not sustainable. This is because the payout ratio has increased from 10% to 60% in 5 years. That is where the illusory growth comes from.
Earnings-per-share growth is *usually* a better indicator of underlying business growth than dividend growth.

Earnings-per-share numbers are far from foolproof. They are reliant on profit margins. Profit margins are typically mean reverting over long periods of time and can unfairly skew (either up or down) a company's real underlying business growth.

I prefer to use a reasonable estimate of future growth that is based on:

- Historical earnings-per-share growth
- Historical dividend growth
- Future growth expectations

Estimating future growth *does* put human bias into the investment decision. It also eliminates errors from accounting irregularities or one time earnings (or dividend) spikes or declines. The goal in estimating future growth is to be reasonable and cautious, not to be rigid.

Sure Dividend Stocks & The Chowder Rule

There are currently 182 stocks in the Sure Dividend database. Each stock has 25 or more years of dividend payments without a reduction.

Only 22 Sure Dividend Stocks pass the Chowder Rule test at this time. Interestingly, only 2 Dividend Aristocrats pass the test at this time. Archer-Daniels-Midland (ADM) and Emerson Electric (EMR) are the two Dividend Aristocrats that pass the Chowder Rule.

All 22 Sure Dividend stocks that pass the Chowder Rule are shown below:

Helmerich & Payne (HP)
Dividend Yield: 4.5%
Growth Rate: 10.3%
Chowder Rule Minimum: 12% because dividend yield is greater than 3%
Chowder Rule Score: 14.8%

Cummins (CMI)
Dividend Yield: 3.5%
Growth Rate: 14.0%
Chowder Rule Minimum: 12% because dividend yield is greater than 3%
Chowder Rule Score: 17.5%

Waddell & Reed (WDR)
Dividend Yield: 7.6%
Growth Rate: 10.2%
Chowder Rule Minimum: 12% because dividend yield is greater than 3%
Chowder Rule Score: 17.8%

Weir Group Plc
Dividend Yield: 4.2%
Growth Rate: 12.5%
Chowder Rule Minimum: 12% because dividend yield is greater than 3%
Chowder Rule Score: 16.7%

Phillips 66 Partners (PSXP)
Dividend Yield: 3.0%
Growth Rate: 15.0%
Chowder Rule Minimum: 12% because dividend yield is greater than 3%
Chowder Rule Score: 18.0%

Johnson Controls (JCI)
Dividend Yield: 3.0%
Growth Rate: 10.3%
Chowder Rule Minimum: 12% because dividend yield is greater than 3%
Chowder Rule Score: 13.3%

Archer-Daniels-Midland (ADM)
Dividend Yield: 3.1%
Growth Rate: 10.0%
Chowder Rule Minimum: 12% because dividend yield is greater than 3%
Chowder Rule Score: 13.1%

Caterpillar (CAT)
Dividend Yield: 4.1%
Growth Rate: 9.0%
Chowder Rule Minimum: 12% because dividend yield is greater than 3%
Chowder Rule Score: 13.1%

Emerson Electric (EMR)
Dividend Yield: 3.5%
Growth Rate: 9.0%
Chowder Rule Minimum: 12% because dividend yield is greater than 3%
Chowder Rule Score: 12.5%

Flowers Foods (FLO)
Dividend Yield: 3.1%
Growth Rate: 13.3%
Chowder Rule Minimum: 12% because dividend yield is greater than 3%
Chowder Rule Score: 16.4%

Enbridge (ENB)
Dividend Yield: 4.2%
Growth Rate: 10.0%
Chowder Rule Minimum: 12% because dividend yield is greater than 3%
Chowder Rule Score: 14.2%

Nike (NKE)
Dividend Yield: 1.0%
Growth Rate: 17.0%
Chowder Rule Minimum: 15% because dividend yield is less than 3%
Chowder Rule Score: 18.0%

Novo Nordisk (NVO)
Dividend Yield: 1.8%
Growth Rate: 18.3%
Chowder Rule Minimum: 15% because dividend yield is less than 3%
Chowder Rule Score: 20.1%

Spectris Plc
Dividend Yield: 2.7%
Growth Rate: 13.0%
Chowder Rule Minimum: 15% because dividend yield is less than 3%
Chowder Rule Score: 15.7%

Rotork Plc
Dividend Yield: 2.7%
Growth Rate: 13.7%
Chowder Rule Minimum: 15% because dividend yield is less than 3%
Chowder Rule Score: 16.4%

Deere & Company (DE)
Dividend Yield: 2.9%
Growth Rate: 13.3%
Chowder Rule Minimum: 15% because dividend yield is less than 3%
Chowder Rule Score: 16.2%

Tennant Company (TNC)
Dividend Yield: 1.6%
Growth Rate: 13.5%
Chowder Rule Minimum: 15% because dividend yield is less than 3%
Chowder Rule Score: 15.1%

Fortis
Dividend Yield: 3.8%
Growth Rate: 8.8%
Chowder Rule Minimum: 8% because it is a utility
Chowder Rule Score: 12.6%

Canadian Utilities
Dividend Yield: 3.7%
Growth Rate: 7.3%
Chowder Rule Minimum: 8% because it is a utility
Chowder Rule Score: 11.0%

California Water Service (CWT)
Dividend Yield: 2.7%
Growth Rate: 10.8%
Chowder Rule Minimum: 8% because it is a utility
Chowder Rule Score: 13.5%

American States Water (AWR)
Dividend Yield: 2.3%
Growth Rate: 8.5%
Chowder Rule Minimum: 8% because it is a utility
Chowder Rule Score: 10.8%

Questar Corporation (STR)
Dividend Yield: 3.6%
Growth Rate: 5.0%
Chowder Rule Minimum: 8% because it is a utility
Chowder Rule Score: 8.6%

Final Thoughts

The Chowder Rule is a well-thought out method to find attractive dividend growth stock investments.

One of the biggest drawbacks of the Chowder Rule is the inaccuracy of using 5 year dividend growth numbers. A longer growth look-back period combined with selecting better growth metrics will provide a better picture of Chowder Rule stocks.