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SPECIAL REPORT

DIVIDEND INVESTING - A GREAT CHOICE FOR APPRECIATION, INCOME, LOWER TAXES, & LOW PORTFOLIO RISK

ABOUT THE AUTHOR:

John P. Weinstein is a Certified Financial Planner CFP® and earned his Master of Business Administration from George Washington University. John has been a Financial Advisor for over 20 years after a successful career in the apparel industry. John's investment career began at Smith Barney (now Morgan Stanley) in 1998. In 2012, John joined Decision Investments as the Managing Partner & Portfolio Manager. Decision Investment's operates under the Registered Investment Advisor (RIA) model as fiduciary, fee only (no commissions) advisors. We are ethically and legally required to act in what we feel is our clients' best interest to eliminate as much as possible any conflicts of interest in a client-focused environment.

John P. Weinstein

After growing up in Purchase and Rye (Westchester County), New York, John went to college & graduate school in Washington D.C. and resided in Boston, MA - Altamonte Springs, FL – Cincinnati, OH – South Norwalk, CT & Walnut Creek, CA before making his permanent home in San Diego, CA in 1998.

John has actively participated in volunteering with under privileged and foster children for over 30 years through Big Brothers/Big Sisters, Voices for Children (Court Appointed Special Advocates), It's All About the Kids, and Promises2Kids as a mentor, friend, advisor and advocate.

John enjoys educating investors. If you have any dividend or investment questions, feel free to e-mail him at John@DecisionInvestments.com.

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ADVANTAGES OF DIVIDEND INVESTING

- Dividends **often pay higher yields** than money markets, bank CDs, or other bond (fixed income) investments. See chapter 3: "Greater Income Potential vs. Interest Payments".
- Qualified dividends are **taxed at a considerably lower rate** than ordinary income, bond (not including lower interest tax-free municipal bonds). See chapter 4: "Tax Advantages of Dividend Stocks" for greater detail.
- **Dividend payments once paid out, cannot be taken away** and become part of your net worth. Other investments, no matter how much they have risen in value, can drop at any time diminishing your on paper gains, or even become losses.
- Dividends **often rise each year**. If you buy a 10 year U.S. Treasury note with a 4% yield, that rate is fixed until maturity even if interest rates are rising. So you have to wait until maturity to re-invest at higher rates in a rising rate environment. If a stock's dividend is rising by 7.2% per year, your 3% original annual dividend yield would double to 6% at the end of 10 years ("Rule of 72s"). See chapter 6: "Growth of Income vs. Fixed Bond Interest.
- Dividend stocks **tend to have earnings** and are **value oriented investments**. See Chapter 7: "Value Oriented – Lower Risk than Speculative Stocks.
- We have the **ability to buy more stock shares on price dips and to sell higher cost lots on price spikes to constantly improve our gains and our yield to cost**. See Chapter 8: "Take Advantage of Market Volatility to Buy Low and Sell High with Active Management".
- **Closed-end Funds** can be incorporated in the portfolios by using conservative covered call strategies to **greatly enhance portfolio yield**. See Chapter 10 "Unique Closed-end Funds with Conservative Covered Calls to Maximize Income".

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GREATER INCOME POTENTIAL VS. INTEREST PAYMENTS

Since the Great Recession of 2008, many dividend stocks began paying higher dividend yields than prevailing fixed income interest rates on money market accounts, bank CDs, or bonds. As the Federal Reserve dramatically cut interest rates to near zero as well to use the quantitative easing strategy - buying bonds on the open market to increase demand and decrease supply, bonds became increasingly less attractive. The goal which was gradually, successfully achieved was to encourage more risk or equity investing to create more economic activity and ultimately increase job creation to fight the double digit (over 10%) unemployment rate. With the Fall 2018 unemployment rate below 4%... mission accomplished with the additional aid of lower corporate tax rates and other pro-business stimulus.

While post-pandemic “risk-free” interest rates went up substantially in 2022 and 2023 to fight inflation, the Federal Reserve has indicated that they plan to begin lowering interest rates moving forward. Longer maturity bonds are still unattractively low with benchmark 10 Year Treasury Notes only yielding around 4%, and the 30 Year Treasury Bond only paying slightly more at about 4½% as of 2024. With this said, it is still possible to get a higher payment from stock dividend yields with several other advantages including a lower tax rate, yield growth, ability to continually buy low and sell high as opportunities allow, and underlying stock appreciation potential which is especially attractive vs. longer maturity fixed income investments that will lose a lot of their principal value as interest rates rise. While bond investors have the option to wait until maturity, so as not to lose principal, they would have to go several years accepting below market interest rates in a rising rate environment... an unattractive option. The 10 Year Treasury Note interest rate peaked in 1981 at over 15%. With interest rates likely to decline from here, growing stock dividends will look more attractive vs bond and CD interest rates.

TAX ADVANTAGES OF DIVIDEND INVESTING

Both qualified stock dividends and the capital gains (when you sell a stock held over 1 year) federal tax rates are considerably lower than the income tax rates which are used for interest payments with the exception of tax-free municipal bonds. Tax-free municipal bonds typically pay lower interest rates, but can be relatively attractive vs. most taxable bonds especially for higher tax bracket investors. Additionally some dividend yields from certain stocks, closed-end funds, and master limited partnerships (MLPs) may be classified as tax-free return of capital. Another advantage is that losses can be strategically “harvested” to off-set capital gains taxes on current year and future year (carry-forward indefinitely) realized gains on other stock sales as well as real estate or business sale gains. But wait, there’s more... we also get to deduct losses beyond gains against ordinary income up to $3,000 annually, which can save tax payers about $1,000 per year depending on your tax bracket.

But wait... there’s even more. In addition to the tax advantaged treatment of the qualified dividends as well as on realized long-term capital gains (held just 12 months or longer before selling), stocks in general share another very worthwhile, seldom discussed attribute.

Stock appreciation prior to selling (also referred to as unrealized gains) is tax deferred. As stocks rise in price on average year-after-year, those gains have zero tax until they are sold. It’s almost as if we hold them in a retirement account since we not only receive non-taxed appreciation, but earn the enhanced magic of compound growth on that tax-deferred appreciation!

Furthermore, after years or decades of non-taxed appreciation, we can use smart, totally legal strategies to lower or eliminate the capital gains taxes all together.

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TAX ADVANTAGES OF DIVIDEND INVESTING Continued

1) We can wait to sell stocks until we have a very low tax year (perhaps retirement, a sabbatical, or a partial work transition year), where our capital gains rate may have dropped from the highest 20% bracket, down to the 15 or zero % level.

2) We can "harvest losses" to off-set capital gains taxes. For instance, if a stock is down in value from our purchase price, we sell it or "realize the loss". We can use the "wash sale strategy" (repurchase the same stock over 30 days before or after the loss sale) or replace the sale with a similar holding without having to wait 30 days. Then we own exactly or substantially the same portfolio but offset taxes on other realized stock gains, or even on other property sales (real estate or a business), plus take a $3,000 annual deduction against ordinary income to save about an additional $1,000 in taxes.

3) Your heirs get to inherit your highly appreciated stocks or other assets, at the "stepped-up" basis with no immediate taxes due up to the date of death value, no matter how great that untaxed growth has been. So again like the tax loss harvesting strategy, zero tax is owed on all that growth. Of course, any growth after the date of death date would potentially end up having a tax liability for the inheriting person, yet those same strategies can be used again to lower or eliminate those capital gains taxes.

4) If you are making a charitable gift to a qualified non-profit organization, there are two often over-looked great tax-saving opportunities. Instead of donating cash, we can donate highly appreciated stocks. Most large charities are set-up for this and are happy to receive a contribution in this manner. We get to take the full eligible tax deduction on the current appreciated market value of the stock(s). Yet we completely avoid the capital gains tax on the growth, so it is never taxed. Another strategy is to donate up to $100,000 per year from an IRA retirement account directly to the eligible charity after age 72-75 (depending on date of birth) and avoid the highest marginal tax rate on that amount contributed which would be all or part of your Required Minimum Distribution (RMD).

Again, please confirm any tax strategies with your accountant or tax professional to see how they relate to your particular situation.

NOT ALL DIVIDENDS ARE TAXED ALIKE – REAL ESTATE INVESTMENTS TRUSTS (REITS)

Not all dividends are taxed alike. While most common stocks (including many international company stocks) are federally taxed at the lower Qualified Dividend Income (QDI) rate, there are some exceptions.

Real Estate Investment Trusts (REITs) dividends are not considered "Qualified" and are taxed as ordinary income at our highest marginal rate. There's a good reason for this. Investments that qualify as REITs or the less common Business Development Company (BDC) are not "double-taxed" like most common stocks. This refers to the fact that companies must pay their corporate income tax, and then the dividend payments to the shareholders are taxed again to investors at that lower Qualified Dividend Income rate. Stocks that qualify as REITs or BDC's with a number of qualifying restrictions - for our purposes the most important being the requirement to pay out at least 90% of their realized income in the form of non-qualified dividends to their shareholders. Since as stock shareholders, we are the owners of the publicly traded companies we benefit by the REITs and BDCs not having to pay corporate taxes. While the income that passes through to us as shareholders is taxed at our higher ordinary tax rate, there's an easy strategy to maximize this for most investors.

Higher taxed, non-qualified dividends should be held in our retirement accounts, not in our taxable accounts. Part of tax-efficient, active management is to purchase investments in the accounts that will minimize our overall taxes and maximize our after-tax net worth.

Also, some distributions are taxed as "Return of Capital". In this case the income we receive is currently tax-free and becomes tax-deferred. It's better to hold these investments in our non-retirement accounts. The only catch is this can lower our cost basis and potentially lead to higher capital gains taxes when we sell the position. As discussed in chapter 4, those taxes can be minimized or eliminated by using tax-smart strategies.

The most common securities that have a portion of their distributions classified as non-taxable return of capital are closed-end funds (see chapter 11) or Master Limited Partnerships (MLPs) that have the extra tax-preparation burden of K-1s, but we can avoid in Closed-end funds and Exchange Traded Funds (ETFs).

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Real Estate Investments Trusts (REITs) can be a great addition to dividend oriented stock portfolios:

- REITs usually pay higher dividend yields than the market average.
- Real Estate is a great diversifier in that it is less correlated than other stocks.
- REITs allow a real estate investment without the day-to-day management headaches of individual real estate investments.
- Unlike small investments in a residential rental, a commercial building, or a group investment in a single project, REITs allow for participation in large real estate companies with multiple holdings and professional management.
- Also REITs allow for diversification by industry, geography, and market capitalization.
- These publicly traded REITs are daily liquid – you can sell them without lock-up periods or surrender penalties.
- Most REITS are industry specific allowing us to focus on or ignore areas as we choose such as the currently struggling office buildings. Specific areas include: apartments, casino properties, cell phone towers, cloud data storage, college housing, distribution centers, entertainment (amusement parks, family fun centers, theatre chains), farmland, fulfillment centers (for Amazon and other on-line sellers), hotels, industrial parks, medical facilities, outdoor advertising (billboards), prisons, retail strip centers or malls, senior living, trailer parks, or warehouse buildings as well as mortgage REITS, diversified real estate companies, or diversified baskets through exchange traded funds, or closed-end funds.

I STRONGLY RECOMMEND AVOIDING NON-PUBLICLY TRADED REITS unless you are a very sophisticated real estate investor:

- They often charge excessive commissions and management fees.
- They may have long lock-up periods and surrender penalties making it difficult to get your money back when you want it.
- They often have long contracts with plenty of small print and confusing “legalese”.
- Sales techniques are often non-transparent and aggressive. If you search “non-publicly traded REITs”, you’ll see that these are frequently involved with fraud, senior abuse, and other investor related lawsuits.

GROWTH OF INCOME VS. FIXED BOND INTEREST

Dividend stocks typically increase their payouts on a regular basis. This is a big advantage to bonds that have a static or fixed dividend through their maturity date.

After a long period of near zero interest rates through 2021 to help the economy and employment recover from the pandemic, the pendulum swung too far causing very high inflation. Much higher interest rates through 2022 and 2024 have now come to an end, and that high 5%+ “risk-free” interest will likely no longer be available by 2025.

A diversified portfolio of dividend stocks on the other hand will fluctuate with company news, interest rates, and market conditions. Yet, after every downturn in history, the major stocks markets have always recovered and gone higher. With dividends, if a downturn occurs, at least we’re being paid handsomely while we wait. As the chapter 2 “advantages of dividend investing” discusses, many dividend paying stocks regularly increase their payouts. If a stock dividend averages an annual payout increase of 7.2% per year, that yield would double over 10 years. A 2024 benchmark 10 Year U.S. Treasury Note paying about 4%, and will have the same 4% yield until 2034, though dividend payouts usually increase over time, giving us a “raise” can offset or outperform inflation. Since stocks have price appreciation in the majority of years, our investment growth can be much higher than through interest paying bonds.

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VALUE ORIENTED – LOWER RISK THAN SPECULATIVE STOCKS

Generally, "Dividend Stocks" are "Value Stocks", while "Growth Stocks" usually pay much lower or no dividends. While over most long periods value and growth stocks had averaged similar returns, value stocks typically have less volatility. "Growth Stocks" tend to go up more and down more in quicker periods meaning they have greater risk or are more speculative, and in some cases offer greater rewards. In recent years, growth, momentum stocks have outperformed value stocks. Our Enhanced Dividend Portfolio participates in those Growth at a Reasonable Price (GARP) stocks with high paid we wait covered call income in the 6-12% range through ETFs and Closed-end funds.

Actually, much of the market upside has been in those growth stocks since the March 2009 recession low. Historically there is a return to the mean, suggesting that value stocks may outperform growth stocks over the next few or several years. The fact that baby-boomers are now in or close to retirement, makes this more conservative investment strategy more likely to outperform.

Dividend stocks have that income/appreciation buffer. If all other factors are equal, a 10% across the board stock market decline might only equate to a real 4% total decline if your portfolio is earning a 6% annual dividend yield.

In other words, dividend stocks are likely to outperform in flat or down markets, hold their own in moderately up markets, but are likely to underperform in high momentum growth periods.

In addition to individual stocks, dividend investment vehicles include, Real Estate Investment Trusts (REITs) and Business Development Corporations discussed in chapter 5, Exchange Traded Funds (ETFs) which are baskets of stocks, owned as a single holding allowing for diversification, an inexpensive index structure, intraday trading (vs. the disadvantage of an open-ended mutual which only prices once per day at the market close), as well as preferred tax treatment, and closed-end funds discussed in chapter 9 are a unique investment with substantial advantages for dividend investors, over the more common traditional or open-ended mutual fund.

I rarely use those traditional mutual funds because they tend to have substantial disadvantages vs. individual stocks, ETFs, or closed-end funds due largely to their money pooled together structure. Those disadvantages can include, higher fees, less buy and sell flexibility (you cannot use a limit order to buy or sell at your target price and they are only priced once per day at the market close), poor tax treatment in all but retirement accounts (you can actually have a loss in your mutual fund, but owe capital gains based on a lower cost basis before you owned the fund), and the curse of negative market mob psychology. It's commonly believed that most markets (whether stock, real estate, tulips, or bitcoins) are driven by the emotions of fear and greed. This causes investors to buy high – GREED – after seeing or hearing how much something has already gone up in price and buying near the top. This is also called the Fear of Missing Out (FOMO). On the reverse side, investors often sell at a market low because of FEAR, that low prices will continue going down.

While the old cliché, "Buy low and sell high" seems obvious, those fear and greed emotions often cause investors to do the opposite. This phenomenon is seen at its worst in mutual funds since your pooled holdings are often bought high and sold low for you, without your permission or knowledge even if not by you. One of the most famous and successful fund managers of all-time, in his often quoted first book, "One Up on Wall Street" Peter Lynch wrote about this. On infamous "Black Monday", October 19, 1987 when the Dow Jones had its biggest 23% one day crash in history, he wanted to buy great company stocks on sale since he knew it was a temporary drop. Unfortunately for him and his investors, against his better judgment, he was forced to sell at those very low prices to meet fund holder redemptions. Again, since all the fund holders assets are pooled together, everyone's stocks were sold at those low prices to pay those redeeming, and there was not money available to buy at those attractively low prices. Only traditional open-ended funds are plagued with this issue.

TAKE ADVANTAGE OF MARKET VOLATILITY TO BUY LOW AND SELL HIGH WITH ACTIVE MANAGEMENT

Stocks tend to be more liquid than bonds. It is very difficult to successfully buy and sell your existing portfolio of bonds to capture greater interest rates. More typically investors time bond purchases to buy more or increase bond allocations, by adding more as interest rates rise (bond prices lower or get cheaper). It is not practical to sell currently held bonds to capture rate movements.

On the other hand, stock investments do lend themselves to incrementally buying more on dips, and selling on price spikes. For instance if a stock was originally bought at $10 per share with a 10 cent quarterly dividend, the annual 40 cent payments would yield 4%. With the greater short-term movements in stock prices, it is very likely that same stock could dip to $8 per share. If the company fundamentals still look good for the long-term, we can take advantage of this 20% decline to buy more. Now that same 40 cent annual dividend income equates to a 5% yield on the new low cost lot. The average yield on both lots would be 4½%. Then whenever the stock price rebounds, I often would sell the original high cost lot at the $10 break-even price. The advantage of this is we now have a total 5% yield, we owe no capital gains tax since we sold at break-even, and we have a 25% unrealized and tax-deferred gain from $8 to $10 per share. This also takes appreciation risk off the table, because if the stock later dropped 10% to $9 per share, we would still be up $1 or 12½%. More importantly, be selling off the high cost lot, we have freed up cash to take advantage of buying other dividend paying stocks at better values when they dip.

With this goal of maximizing yield to cost and unrealized (untaxed) capital gains, this strategy is maximized by owning a large diversified portfolio to have more opportunities to take advantage of incremental buys and sells.

If a stock was originally bought at $10 per share with a 10 cent quarterly dividend, the annual 40 cent payments would yield 4%. With the greater short-term movements in stock prices, it is very likely that same stock could dip to $8 per share.

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UNIQUE CLOSED-END FUNDS INCREASE INCOME WITH CONSERVATIVE COVERED CALLS

Closed-end funds are a special niche investment tool that can greatly increase the income yield of a dividend focused portfolio. While closed-end funds have been around as long as traditional open-end mutual funds, they can offer great advantages:

- Closed-end funds start with an Initial Public Offering (IPO) and a set starting market capitalization, usually in the $500 million to $1 billion range which is much lower than large mutual funds. With this structure, after the IPO, one invests through the secondary exchanges, just like any common stock.
- New purchases or sales come from other current shareholders, unlike an open-end fund that buys additional stock, or sells current holdings to accept new investments or to meet redemptions. This reduces the negative impact of pooled money buying high and selling low.
- Since the investor buys and sells are from other investors the fund value can be above or below the Net Asset Value (NAV). This allows the opportunity to buy holdings at a discount below the current market value. By following these premiums and discounts on a daily basis, it creates the chance to take advantage of short-term volatility and inaccurate pricing values.
- Closed-end funds can be comprised of stocks, bonds, Master Limited Partnerships (MLPs), or Real Estate Investment Trusts (REITs) in either an actively managed or passive index format. The holdings can be very broad or sector specific (technology stocks, state specific municipal bonds, country specific stocks, etc.
- Unlike an open-fund, closed-end funds trade through-out market hours as do individual stocks or Exchange Traded Funds (ETFs). This allows open limit orders to buy or sell at our predetermined price if reached. We also know exactly our cost per share. Another disadvantage of open-end funds is regardless of the intraday market moves, they only price once per day at the market close. This creates a lack of flexibility as well not knowing the price that we buy or sell at until after the decision was made after the market close.

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UNIQUE CLOSED-END FUNDS INCREASE INCOME WITH CONSERVATIVE COVERED CALLS Continued

- Closed-end funds are allowed to use leverage, so if their can borrow money at a low rate below their earnings rate, they can increase performance. This can also add risk in a rising rate or down market period, so we are cautious in this area.
- Closed-end funds are often tax advantaged as their distributions can include lower taxed qualified dividends or long-term capital gains, non-taxed return of capital that lowers cost-basis, as well as short-term gains and ordinary income. Many closed-end funds are specifically managed to maximize tax efficiency.
- Closed-end funds often use conservative covered call options to increase their annual yield on equity portfolios, often in the 6-12% range (The S&P 500 pays only about a 1.5% average dividend yield). An example of a covered call is selling a covered call on an owned stock giving an investor the opportunity to buy a stock that the fund paid $10 per share for at $12 per share for a $1 premium for a pre-determined time period. The fund receives that $1 premium regardless of whether the stock goes up, down, or remains flat. The beauty of this is that the covered call itself cannot create a loss, only limit the upside. So, if the sock drops from $10 to $8 a share, since we earned the $1 premium we would lose $1 or 10% vs. the stock's $2, 20% decline (we're ahead). If the stock remains unchanged at $10 per share, rather than earning nothing, we would have earned the $1 or 10% (again we're ahead). If the stock goes to $13, we break even since the buyer pays us $12 plus the original $1 premium. The downside is the loss of upside potential. If the stock goes up 60% to $16, we are limited to the $12 agreed upon sale price plus the $1 premium giving us only 30% vs. the potential 60% gain. In other words, if the stock price is down, equal, or moderately up, this covered call example was a benefit. If the stock was dramatically up, it would be a negative to the total upside having sold the covered call. Generally speaking, covered calls are most attractive when stock market prices are relatively high like they are now with stocks potentially having less upside probability.

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CONCLUSION

In conclusion, an actively managed, diversified, dividend stock portfolio is the best strategy for many investors. It can combine much greater appreciation and income than bonds or fixed income, significant tax advantages, the ability to take advantage of market volatility, lower risk than high-flying growth (momentum) stocks and very low long-term principal risk.

While all stocks have risk, a diversified portfolio of quality stocks actually has very low long-term risk. In the short-run the risk is much higher. In a previous chapter, I mentioned the stock market dropped 23% in one day on Monday, October 19th, 1987. In the recession crash, the Dow dropped by 55% in the 18 months from September 2007 through March 2009.

There are a few easy rules of thumb to avoid the pain of a market decline:

1) Don't have short-term money in the stock market! If you are likely to need a big chunk of money in the next year or two, that money should not be in stocks. The market could be down right when you need it. People should have enough liquid cash to cover living expenses (at least six months) as well as short-term needs such as an amount for tuition, a home purchase, a business investment, or a planned non-income event. With that said the market has **ALWAYS** recovered and gone higher after **EVERY** decline. The worst 1 year decline was 43% through February 2009. Yet, the worst 15 year period for the U.S. Stock Market (S&P 500) that included the "tech wreck" of 2000 and the Great Recession crash actually averaged a 2.74% annual gain or a total 15 year gain of 49.92% due to the big up years that surround the big decline years. If you include re-invested dividends, the worst 15 years jumps up to a positive 4.67% per year or a 98.36% total gain.

2) Be diversified! Having too few stocks can be dangerous since any company no matter how safe and attractive it looks can go out of business. In a diversified portfolio, the balance of companies that do well will make up for the surprise losers to boost the portfolio average.

3) Be in a position to sell stocks based on market conditions and company fundamentals. Avoid having to sell stocks because you need last minute cash.

Stock market risks are a realistic concern, especially since we've had two major declines in the last 25 years as well as the day-to-day volatility that is widely reported. A big not frequently discussed risk is the potential principal crash in bonds. While bond price (inverse to interest rates) move more gradually, their direction can last for decades. Long maturity bonds have the greatest risk. We had significant double digit percentage losses in both stocks and bonds in 2022. Conservative investors that are over-allocated to bonds, received a rude awakening in 2022 that perceived bonds as being risk-free of a long-term loss in value just as cost of living (inflation is often highly correlated to interest rates) was increasing. While it may seem counter-intuitive, most conservative bond holders should consider diversifying their portfolios with dividend stocks. Happy dividend investing!

While we believe any figures quoted are from reliable sources, we make no guarantee as to their accuracy. We do not give tax advice. Please consult with your tax preparer on any related issues.

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