5 Dividend Investing Mistakes You Don't Know You're Making

Description

Do you make these five dividend investing mistakes?

Usually here at The Motley Fool Canada, we talk about the benefits of owning dividend paying stocks, how to identify wonderful businesses, and even offer ideas to get started.

But sometimes it's more helpful to know what *not* to do. There're plenty of little known mistakes that can trip up the hapless investor and result in devastating losses. If you want to build a long lasting stream of dividend income, watch out for these capital destroying blunders.

1. Chasing high-yield stocks: You can't pick stocks by dividend yield alone. Smart investors know high payouts are a red flag and often signal that a company is in distress. If you're tempted by a high yield, it always requires extra due diligence to ensure that the payout is actually sustainable.

Reitmans Canada (TSX: RET.A) is a recent example of a high yield stock that burned shareholders. Last summer many investors were sucked in by the stock's juicy 10% dividend yield. Unbeknownst to them, deteriorating sales made the payout unsustainable and the company was forced to cut its dividend by 75%. The resulting panic left shareholders with hefty capital losses.

2. Having a short-term focus: Many investment houses make recommendations based on a short-term view of the market, often no longer than six to 12 months. But such frequent trading does little to boost returns and often only lines the pockets of your broker.

Consider a study by RBC Global Asset Management that shows that between December 1986 and December 2013, a basket of Canadian dividend-paying stocks generated a 10.3% compounded annual return, outperforming the **TSX Composite Index** (TSX: ^OSPTX) by 3.8% per year. With returns like that there's no need to worry about individual fluctuations in the stock market. Simple buy a collection of great businesses and leave the rest to time.

3. Overpaying for stocks: The secret to dividend investing is to find wonderful businesses and hold for the long haul. However, no matter how great a company is, you will never be able to earn a satisfactory return if you overpay for the stock.

Consider **Coca Cola** (NYSE: KO) for example. There's little doubt that this Warren Buffett favourite is a wonderful business. However, during the stock market heydays of 2000, investors were paying over 50 times earnings for the stock. Over a decade later, those shareholders are just starting to break-even on their investment.

4. Focusing on income without growth: Many investors want to lock in a tall dividend-yielding stock today. However, in doing so they skip over their lower yielding, but faster growing peers. That could be a mistake over the long haul.

Take **Enbridge** (TSX: ENB)(NYSE: ENB). This is a stock many income hungry investors skip over because of its 2.3% yield. However, over the past 10 years the company has increased its payout at a 12% annual rate. Had you bought and held the stock over that time, the yield on your original investment would be 11.5% today. If the company can sustain that growth rate over the next decade, by 2023 our yield on cost will be almost 30%!

5. Skipping over the balance sheet: Cash is king. In the worse of times, companies sitting on a big cash pile and little debt have options: they can buy back shares, increase their dividends, buy high-quality assets on the cheap, or pay back debt. Companies with overstretched balance sheets are often forced to suspend their dividends and dilute their shareholders at exactly the wrong time.

This logic applies to the cash balance in your portfolio as well. In the minds of many investors cash is trash. It just sits in your brokerage account earning nothing. But it's far better to think of cash like an option on every asset class with no expiration date. By keeping a hefty amount on the side, you will have the resources to strike at the most opportune time.

Foolish bottom line

Dividend investing is a time-tested strategy for building wealth over the long haul. However, even this relatively safe strategy is fraught with risks if carried out poorly. Be sure to avoid these capital destroying mistakes.

CATEGORY

1. Investing

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1. NYSE:ENB (Enbridge Inc.)
2. NYSE:KO (The Coca-Cola Company)
3. TSX:ENB (Enbridge Inc.)

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