2 Dividend-Growth Stocks for your TFSA

Description

The Government of Canada's news release last Friday confirms that Canadians can immediately take advantage of the newly proposed $10,000 contribution limit for the TFSA. This boost gives an additional $4,500 of room from the previous limit of $5,500.

If you were at least 18 years old in 2009 and you have never contributed to a TFSA, you now have a capacity of $41,000. Essentially, you can invest these after-tax dollars tax free forever.

Because interest is fully taxed, Canadians might be inclined to place their interest-producing vehicles, such as savings accounts, GICs, and bonds in their TFSAs. However, with interest rates at historical lows, perhaps there are better ways to invest in a TFSA.

Traditional finance uses beta as a risk indicator. Essentially, it measures volatility compared with the market. The market's beta is one. If a stock also has a beta of one, then as the market goes up 1%, so does the stock. And if the market goes down 1%, the stock more or less follows.

If you invest in low-yield, high-growth companies in terms of volatility, you could be taking on less risk than if you were to invest in the market. Today Google Finance shows **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI) with a beta of 0.38, while **Enbridge Inc.** (TSX:ENB)(NYSE:ENB) has a beta of -0.13. Interestingly, on a down market day, Enbridge should be green.

Investing in high dividend-growth companies vs. 10-year bonds

The 10-year bond rate is around 1.9% today. If you invest in bonds, you're guaranteed the 1.9% interest rate.

However, if you invest in equal dollar amounts in Canadian National Railway and Enbridge today, you get an average yield of 2.2%, or 15.8% higher than the 10-year bond rate. As a business becomes more profitable, the share price would follow, and earnings growth is one of the most fundamental indicators to monitor.

Both Canadian National and Enbridge expect earnings to grow at least 10% in the foreseeable future, so their stock prices should appreciate around 10% in the long term as well.

At the same time, given that these companies keep their payout ratios the same, their dividends would grow at least 10%, too.

So, the estimated return for investing in these high dividend-growth companies would be roughly 12% per year, and this is all based on the earnings growth of at least 10%. Compare this estimated 12% return with the 10-year bond's rate of 1.9%.

High quality, high growth, and fairly valued

Both Canadian National Railway and Enbridge are well-run companies. Otherwise, they wouldn't have paid growing dividends for 19 consecutive years. Canadian National's most recent dividend increase was an impressive 25%, while Enbridge's was a whopping 33%.

Going forward, I expect both to grow their dividends in a double-digit rate, but more likely between 10% and the teens range in alignment with their earnings growth.

Canadian National and Enbridge has an S&P credit rating of A, and A-, respectively. Furthermore, according to their price-to-cash-flow ratios and their historical ratios, they are also fairly priced.

High dividend growth supported by high earnings growth leads to higher prices. Buying such high-growth companies in a TFSA allows for tax-free capital gains if you decide to sell some shares, while earning a growing income tax-free.

Notes of caution

Higher return usually means higher risk. It is possible that these high-growth companies miss their earnings estimates, which would likely lead to share price drops.

However, if you buy the above securities at fair prices, your diversified, conservative equity portfolio should give you higher returns in the long term, complementing interest-producing vehicles you may already have.

If you have never invested in the stock market before, I would suggest investing in a non-registered account first to get a feel of it. Once you feel comfortable, consider investing equities in a TFSA. The reason for this is because income and gains are tax free in a TFSA, just as capital losses can't be reported to the Canadian Revenue Agency to apply against a corresponding capital gain, while capital losses in a non-registered account can be written off.

Buying high dividend-growth companies is just one way to invest in the TFSA. Learn other ways to take advantage of your TFSA for higher returns.

Lastly, make sure you don't make these TFSA mistakes.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:CNI (Canadian National Railway Company)
2. NYSE:ENB (Enbridge Inc.)
3. TSX:CNR (Canadian National Railway Company)
4. TSX:ENB (Enbridge Inc.)

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