Are These 5% Dividend Yields Safe?

Description

In today's low interest rate environment, one word seems to dominate the discussion whenever I talk to investors—yield.

In a world where five-year GICs yield less than 2% and government bonds yield even less, it's little wonder why investors are interested in stocks that pay more than 5% annually. Even if they're not looking to spend the income, reinvesting a nice dividend is an effective way of diversifying a portfolio. Plus, if you compare the tax consequences, a 5% dividend is like earning a return of 6.5% from a bond or GIC.

But investors often get a little greedy when it comes to yield. Instead of getting a 4-5% dividend that's safe, they'll stretch and choose a stock with a 6-7% yield that doesn't have the free cash flow to support such a generous payout. This is the kind of mistake that can ultimately do some pretty serious damage to a portfolio, since stocks tend to plunge anywhere from 5-20% in reaction to a dividend cut.

With that in mind, let's take a closer look at three high-yielding stocks to see whether investors can count on the dividends to continue.

IGM Financial

IGM Financial Inc. (TSX:IGM) is the parent company of Investors Group, one of Canada's leading wealth managers with more than 5,000 consultants nationwide. The company sells mutual funds, insurance, mortgages, and financial planning services to Canadians.

It's been a great business for years and has paid investors steady dividends since 2002. But as the popularity of mutual funds have declined in favour of exchange-traded funds and other lower-cost options, the company is having challenges growing assets under management. Additionally, more strict disclosure laws are coming into place possibly as early as 2016, which will require an advisor to do a much better job telling a client the total cost to their portfolio. That's bad news for a company dependent on expensive mutual funds.

But it's not all bad news for investors. The company still has nearly $150 billion under management and trades at a pretty reasonable 15 times earnings. Plus, it pays investors a generous 5% dividend.

Upon closer inspection, the dividend looks to be safe as well. The company generated $680 million in free cash flow in 2014, while only paying out $550 million in dividends. That payout ratio is a little high, but should be safe even if business declines a bit.

TransAlta

TransAlta Corporation (TSX:TA)(NYSE:TAC) is Canada's largest generator of coal-fired power, with most of its Canadian assets located in Alberta. It also has plants in the northwest United States and Australia.

There were a few issues weighing down the stock. Firstly, it experienced difficulties because of unplanned, expensive maintenance. Secondly, the strong Canadian dollar weighed down U.S. results. And finally, power prices in Alberta were weak, thanks to new capacity coming on the market. All these factors contributed to the company slashing its quarterly dividend in 2014 from $0.29 per share to $0.18.

But the new dividend looks to be sustainable. In 2014 the company generated $275 million in free cash flow, while only paying $181 million in dividends. A 66% payout ratio is solid for a company with a 6.1% yield.

Crescent Point

While the first two dividends listed look to be pretty safe, I can't say the same about **Crescent Point Energy Corp.** (TSX:CPG)(NYSE:CPG) and its 9% payout.

In a recent article, I estimated the company's 2015 numbers to be as follows: it would generate $2 billion in cash from operations and spend $1.45 billion on capital expenditures. That would leave it with $550 million to pay shareholders, which works out to $1.20 per share. The problem? The company's dividend is $2.76 per share.

Over the short term, this isn't such a big deal. The company has the ability to borrow to finance its dividend, at least over a few months. Even for all of 2015, this shouldn't be a problem.

But unless crude recovers, Crescent Point does not have a sustainable dividend. And if crude remains weak throughout 2015, the company will spend millions paying dividends that could be put to better use elsewhere. That's not an ideal situation for any dividend investor.

CATEGORY

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1. NYSE:TAC (TransAlta Corporation)
2. NYSE:VRN (Veren)
3. TSX:IGM (IGM Financial Inc.)
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