How to Limit These 5 Risks in Your Dividend Portfolio

Description

Headlines in the news most likely talk about how a stock dropped by 5% before market opened or how another stock rose by 15% in a day.

As much as we like returns, it's just as important to assess the risks of our dividend portfolios. First, let's identify the risks associated with our dividend portfolio.

1. Risk of dividend freeze, cut, or slow growth

The dividend stocks I buy fall likely in two categories: ones that pay a high yield with no growth, such as **Dream Global REIT**, which pays out an 8% yiel, and ones that pay a relatively high dividend that grows faster than inflation. A relatively high yield is one that pays at least 1.5 times higher than the index.

For instance, **Royal Bank of Canada** (TSX:RY)(NYSE:RY) is a market leader in the banking industry. The bank pays out 3.9% today, and its last annualized dividend hike was 8.5%.

Assuming inflation comes in at 4%, then Dream Global is already maintaining my purchasing power two times over, with my expectation that in the long term, its properties will also grow at least at the pace of inflation, which should reflect in the stock price.

Royal Bank of Canada provides my portfolio with steady price appreciation as well as steady dividend growth that outpaces inflation.

2. Volatility of the portfolio

Our emotions might take over if our stock holdings are too volatile. One way to counter this is to look at our dividend portfolio as a whole and not zoom in on individual holdings on a daily basis.

Your portfolio has an average beta based on your stock holdings, accounting for the weights of each one. If you're mostly buying stocks that have a beta of less than one, then your portfolio as a whole would be less volatile than the market.

For example, **Telus Corporation** (TSX:T)(NYSE:TU) has a beta of 0.08 as shown on Google Finance. So, its stock price should be much steadier than the market's.

3. Risk of capital loss

If we lower the volatility of our portfolio and look at it as a whole instead of zooming in on individual holdings, we should have a lower chance of selling at a loss based on a single stock's performance.

Once you sell, you realize your loss, and there's no turning back. So, think hard before you act. A good practice is to determine your goal before any purchase. If the buy is for short-term trading purpose, determine the sale price ahead of time, so emotions don't get in the way later.

4. Valuation risk

By buying at too high a valuation, you risk experiencing substantial capital loss if earnings growth doesn't materialize. Even if you stick to the company, it could trade sideways or decline in price for years, while earnings play catch up. In the meantime you would only be able to watch it. The plus with dividend stocks is that you will continue receiving your regular dividend paycheck.

This is different from buying a company at historically low multiples while it is transforming. I believe this is what is happening to **International Business Machines Corp.** (NYSE:IBM) and why Warren Buffett continues to purchase its shares even though it's been trading sideways.

5. Quality risk

Sometimes, we may be tempted to go for the high-risk, high-returns route. However, we risk lowering the quality of our portfolios. If you decide to go the dividend growth path, I highly recommend first building a foundation upon high-quality companies that pay a growing dividend before diversifying into riskier stocks.

After the foundation is set, you can consider making perhaps 10% of your portfolio high-risk, high-return stocks. Most likely, these are ones with high near-term earnings growth that may or may not materialize.

In conclusion

Almost all the risks above can be mitigated by diversifying your holdings into a portfolio of dividend stocks that have as little correlation with each other as possible.

Further, buy high-quality industry leaders that have a lower beta than the market to decrease volatility.

Lastly, hold for a long time. Any valuation risk that maybe associated with your stock purchases will be negligible in 10, 20, or 30 years.

CATEGORY

1. Dividend Stocks
2. Investing
3. Stocks for Beginners

TICKERS GLOBAL

1. NYSE:IBM (International Business Machines Corporation)
2. NYSE:RY (Royal Bank of Canada)
3. NYSE:TU (TELUS)
4. TSX:RY (Royal Bank of Canada)
5. TSX:T (TELUS)

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