Afraid of Interest Rate Hikes? Part 1: 2 Types of Dividend Stocks to Buy

Description

Historically, interest rate hikes have negatively affected dividend stocks. People see stocks as a high-risk alternative to earning income. If they could get the same income from interest via savings accounts, GICs, and even bonds, they would. Traditional finance translates high volatility to high risk, and since stocks have the highest volatility of the bunch, they are viewed as high risk.

The interest rates reported by the Bank of Canada have been in a downtrend for the past 25 years. During that time, it hit a high of 16% in 1991 and a low of 0.25% in 2009.

Still, there were ups and downs in between, and no one knows where it's going next. However, it is sitting at the low end at 0.75% and some people believe there is a higher chance of it going up than down. If investors are worried the interest rate will go up, what kind of stocks should they buy?

1. High earnings-growth stocks

High earnings-growth stocks are companies that are growing earnings per share at a rate of over 10% per year. That growth could come from a combination of organic business growth and share buybacks.

The idea is that high earnings-growth stocks grow their earnings at a much higher rate than the interest rate hike. Typically, these stocks may also have lower yields, and in that aspect, are also less affected by any interest rate hikes.

Companies that grow their earnings at a 10% rate or higher include the Canadian railroads, **Canadian National Railway Company** (TSX:CNR)(NYSE:CNI) and **Canadian Pacific Railway Limited** (TSX:CP)(NYSE:CP), the grocery store **Metro, Inc.** (TSX:MRU), and the pipeline leader, **Enbridge Inc.** (TSX:ENB)(NYSE:ENB).

Even though these companies are high growth, you still don't want to overpay for their shares. Right now, Metro is trading ahead of its earnings, and would be a fairer price closer to $30. Valuation aside, generally it's not a bad idea for investors to consider the shares in these companies on dips of 15% or more.

2. Companies priced at a discount

Companies priced at a discount are already priced with a margin of safety, given that it is temporarily mispriced due to short-term issues. So, a small interest rate hike should minimally affect these companies. One that comes to mind is **Canadian Western Bank** (TSX:CWB). It has been penalized by the drop in oil prices.

The regional bank has an impressive record of increasing dividends every year for the last 23 years during a time when the oil price hit a low of about US$12.50 and a high of roughly US$140.

Still, it could take the market years before realizing the value of the bank. In the meantime, investors can enjoy its 3% dividend.

In conclusion

If you’re worried about interest rate hikes negatively affecting your dividend stocks, you can consider buying the two types of stocks mentioned in this article.

However, in reality it is unlikely that interest rate hikes, when they do occur, will be big moves. After all, the big guys don’t want to shake up the economy. On top of that, if you have been maintaining a balanced and diversified portfolio, you should sit back and let your portfolio do what it does best in the long term: steadily go up.

A diversified income portfolio would comprise of stocks from different sectors and industries. It’s good to start with ones that are generally stable. They include high yielders that pay an income of 5%+ with slower growth, moderate yielders that pay an income of 3-4% with moderate earnings growth of 5 to 7%, and the rest are low yielders that pay an income of 1-2% with earnings growth of 10% or higher.

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1. Dividend Stocks
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5. TSX:CWB (Canadian Western Bank)
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