Income Investors: Be Wary About These 3 Risky Dividends

Description

There are millions of investors out there who depend on the dividends paid out by Canada's largest companies.

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For the most part, these dividends are a safe, steady source of income. And thanks to the dividend tax credit, they serve as a very tax-efficient way of generating income. Depending on an investor's tax bracket, a 4% dividend can be the equivalent of a 6% or a 7% yield from an equivalent investment that pays interest.

But for some investors, a yield of 4% just isn't enough. These investors are looking to really goose their income, so they invest in stocks that yield anywhere from 6% all the way up to double digits. While I'd agree there's a certain logic in going after these high yielders–since they often represent terrific value–they're a pretty poor way to get consistent dividend income.

In other words, there's a reason why these stocks have such attractive yields. The market is pricing in a cut, and the market is usually right about these things.

Here are three of the scariest dividends out there.

Husky

With the price of crude recovering to over $50 per barrel, and **Suncor's** bid for **Canadian Oil Sands,** Canada's energy sector is having its best week in a long time. Shares of some of the most beleaguered producers are up 30% or 40% this week alone.

But that doesn't mean they're out of the woods yet. The price of crude could remain low for months longer. Heck, there's even an argument to be made that crude will remain depressed for years. I'm not sure I buy it, but it's a valid opinion.

If oil remains low, it's likely that **Husky Energy Inc.** (TSX:HSE) will be the next producer to slash its dividend. The payout is currently $0.30 per share per quarter, good enough for a yield of 5.3%.

It's obvious Husky needs a higher oil price to maintain the payout. In the first half of 2015, the company generated $1.76 billion in cash from operations, while paying out $1.56 billion in capital expenditures. That leaves just $200 million in free cash flow for dividends that have cost it $600 million thus far in 2015.

That kind of scenario isn't feasible in the long term, even if Husky has the ability to borrow money to pay the dividend. At some point, management will realize shoring up the balance sheet is more important than paying such a high yield.

IGM Financial

IGM Financial Inc. (TSX:IGM) is one of Canada's largest wealth managers, with more than 5,000 Investors Group advisors serving clients from coast to coast. It's been a very good business over the years.

Unfortunately, the future doesn't look quite so rosy. The company's bread and butter is selling expensive mutual funds to retail investors. In 2016, advisors will be forced to disclose how much it costs to own a fund in dollar terms, rather than percentage terms. Investors fear this will cause clients to leave en masse for cheaper options like ETFs.

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There are other things that are putting the 6.2% yield at risk. It has a much higher yield than peers, which means management might cut it just to bring it in line with others in the same industry. The company has also taken on billions in new debt over the last few years, without growing earnings. Some of the cash currently used to pay the dividend could be redirected to debt repayment.

TransAlta

The downfall of **TransAlta Corporation** (TSX:TA)(NYSE:TAC) has been well documented. The company is getting punished extra hard lately because of uncertainty surrounding the future of coal-fired power in Alberta. Shares have sold off to the point where the company's dividend is now 10.2%.

While I think there are compelling reasons to buy TransAlta at these levels, the dividend isn't one of them. Sure, the company has been able to generate enough free cash flow to cover the payout through the first half of 2015, the $170 million the company pays annually to common shareholders would be put to much better use shoring up the balance sheet.

Besides, TransAlta's yield is by far the highest in the sector. Cutting it to a level comparable with its peers makes sense. They can always raise it in the future when the stock recovers.

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2. TSX:IGM (IGM Financial Inc.)
3. TSX:TA (TransAlta Corporation)

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