Income Investors: Be Wary of These 3 Huge Yields

Description

If math tells us anything, it's this: a 6% yield is twice as good as a 3% yield.

Unfortunately, life isn't quite that simple. Yes, all things being equal, higher yields are better than lower yields, especially for retirees who are living off their dividends. The problem is that higher yields often come with a greater risk of being cut. When a company runs into problems and the choice is to cut the dividend or face insolvency, it's a pretty easy choice.

Saying all of that, I'm a firm believer that the world of high yield gets a bad rap. If an investor is careful and does their due diligence, there are dozens of stocks with high yields that pay sustainable dividends. It is very possible to build a portfolio averaging a 5-6% yield that's filled with good stocks that slowly increase their dividends over time.

There's just one problem with a portfolio like that. You have to be diligent in making sure the earnings power of the company is still intact, which is how a dividend gets paid. Even a cash-rich company can only tolerate a payout ratio over 100% for a short time.

Here are three stocks I would avoid if I were building a high-yield portfolio today.

Potash

Potash Corporation of Saskatchewan Inc. (TSX:POT)(NYSE:POT) owns some of the world's finest potash mines in a world where fertilizer has become more and more important for farmers. The price of farmland has shot up over the last decade, meaning it's doubly important for farmers to get the most possible out of their land.

So why is the price of potash down some 30% in North America over the last 18 months? There are a few reasons for this, including general commodity weakness, additional supply on the worldwide market from Russian producers, and a decrease in overall farm income from a lack of oil royalties.

Potash has already responded to this weakness by slashing its quarterly dividend once already from US$0.38 to US$0.25 per share. Analysts are predicting the company will earn enough to cover the dividend in 2016, but there won't be much wiggle room. Considering the company's more than US$4.5 billion in total debt, management could very well make the decision to slash the payout once again.

Student Transportation

Student Transportation Inc. (TSX:STB)(NASDAQ:STB) gets contracts from cities and towns all over North America to transport children to and from school. Its fleet consists of some 13,000 buses.

The issue with the company is that it doesn't earn enough free cash flow to cover the dividend. During its last fiscal year, it earned approximately US$16 million in free cash flow while paying out US$33 million in dividends. The year before was even worse with free cash flow coming in negative.

The company has been able to fund its 9.1% yield with a combination of equity issues and new debt. This type of business model does tend to work in good times, but as we saw with the energy market in 2015, it can be snubbed out by nervous investors very quickly if things start to go bad.

Veresen

Although **Veresen Inc.** (TSX:VSN) shares have moved up some 35% off of February lows, the company's 9.9% dividend is still the riskiest of Canada's pipeline stocks.

The company is sticking with its guidance of having between $0.94 and $1.08 per share in distributable cash for 2016, which should be enough for it to cover its $1.00 per share annual dividend. That's a yield of 9.9%.

Veresen is currently finalizing its massive Jordan Cove natural gas terminal, a LNG project that will cost approximately US$7 billion. It also has $1.4 billion in other joint ventures planned in Australia. It's very easy to envision a scenario where management will slash the very generous dividend to free up capital for these new projects, even if it can earn enough cash to cover it. Besides, most of its competitors yield between 5% and 6%.

CATEGORY

1. Dividend Stocks
2. Energy Stocks
3. Investing
4. Metals and Mining Stocks

POST TAG

1. Editor's Choice

Category

1. Dividend Stocks
2. Energy Stocks
3. Investing
4. Metals and Mining Stocks

Tags

1. Editor's Choice

Date
2025/08/03
Date Created
2016/05/30
Author
nelsonpsmith