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Income Investors: Be Wary of “Safe” Dividend Stocks

Description

As interest rates continue to creep closer and closer to zero, retirees and other income investors everywhere are bidding up the price of so-called safe dividend-paying assets.

Perhaps my favourite example of this is from an American stock, **Realty Income Corp.** (NYSE:O). This REIT, which has a demonstrated history of hiking its dividend, has gone up to the point where it’s only yielding 3.7%. The stock is historically expensive on virtually every metric, including price-to-book value and price-to-earnings.

Sure, the company will likely continue to pay its dividend, perhaps even keeping up its impressive record of dividend raises. But investors searching for yield need to remember that the price they pay matters, too. In fact, you can even make the argument it matters more than the yield itself.

Look at it this way.

At a 3.7% yield, it would take a Realty Income shareholder almost three years in dividends to make up for just a 10% decline in the price of the stock.

Investors are willing to bid up the price of Realty Income–and hundreds of stocks just like it–because they’re viewed as safe. And when it comes to their dividends, these investors are 100% right. Most of these stocks have rock-solid dividends.

But these investors aren’t properly factoring in the risk of multiple compression. A million different factors could cause stocks to fall as investors rush out of equities into the safety of government bonds.

There’s one important thing investors can do to protect themselves, and that’s insist on a reasonable valuation. Sure, cheap stocks can go down if the overall market goes down. But oftentimes they’ll buck the trend and at least tread water while their more expensive competitors sell off.

Here are two additional stocks I think income investors should be careful with, along with two cheaper replacements that should perform better when markets inevitably start sliding again.

Buy: Slate Retail REIT (TSX:SRT.UN)
Avoid: Smart REIT (TSX:SRU.UN)

I think the management team of Smart REIT has done a terrific job. The company has one of the newest portfolios in all of Canada, mostly anchored by **Wal-Mart** stores. The anchor tenant attracts foot traffic, which then brings in other retailers. No wonder Smart has a 99% occupancy rate.

It's just too expensive. Shares only yield 4.6%, which is the company's lowest yield ever. Shares are also historically expensive on a price-to-funds-from-operations perspective.

Slate Retail REIT is much cheaper. The company has a 7.4% yield, almost double that of Smart. It has that yield even after posting a payout ratio of just 66% in 2015. To compare, Smart's 2015 payout ratio was 80%.

Slate's management team is focusing on expanding its grocery-anchored portfolio into smaller U.S. markets. These locations offer much more attractive cap rates than primary markets.

Buy: Empire Company Limited (TSX:EMP.A)
Avoid: Loblaw Companies Limited (TSX:L)

Like with Smart REIT, investors have bid up Loblaw shares to high levels because they're excited about the quality of the company. With its acquisition of Shoppers Drug Mart now complete, the company is poised to dominate the pharmacy sector, an area of the market that looks like a good secular growth story.

Loblaw shares aren't even that expensive either, trading hands at approximately 19 times trailing earnings once you get rid of all the one-time charges. They trade at approximately 17 times analyst expectations for 2016 as well.

While Loblaw shares are fairly valued, Empire shares are quite cheap. Shares of Canada's second-largest grocery chain trade hands at less than 13 times projected earnings. The stock is cheap on other metrics too, like price-to-sales, price-to-book value, and even the dividend yield. Empire shares yield 1.9%; Loblaw shares yield 1.5%.

This doesn't mean investors should automatically sell their Smart REIT or Loblaw shares. Rather, it's more of a word of caution for investors looking to get into the market today. When valuations are stretched, it's important to protect yourself on the downside. One of the ways to do this is to insist on stocks that offer better value–like Slate Retail or Empire.

CATEGORY

1. Dividend Stocks
2. Investing

TICKERS GLOBAL

1. NYSE:O (Realty Income Corporation)
2. TSX:EMP.A (Empire Company Limited)
3. TSX:L (Loblaw Companies Limited)

4. TSX:SGR.UN (Slate Retail REIT)
5. TSX:SRU.UN (SmartCentres Real Estate Investment Trust)

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Date
2025/08/25
Date Created
2016/06/17
Author
nelsonpsmith