

Are Capital Gains a Good Source of Income?

Description

Some investors can't earn enough income from dividends for their needs. So, they may turn to selling shares to get capital gains for income.

For example, although **Northland Power Inc.** ([TSX:NPI](#)) offers a nice yield of 4.4%, an investor who bought its shares a year ago would have enjoyed price appreciation of 13.1% in the investment, which is nearly three times the current yield.

To be fair, utilities probably won't be the first place to look for investors looking for strong capital gains. Instead, investors may consider speculative stocks, value stocks, or growth stocks.

Capital gains are generally not a good source of income because even if a business is fundamentally fine, the market can still drag its share price down.

Obviously, out of the three types of stocks mentioned, speculative stocks are the riskiest.

Speculative stocks

The elevated share prices of speculative stocks are due to the market expecting that these stocks will have bright futures.

I put weed stocks, such as **Canopy Growth Corp.** ([TSX:WEED](#)), in this category. The business isn't profitable yet, but the market expects it to benefit from the legalization of marijuana. Since last summer, the stock has been a two-bagger from price appreciation.

For speculative stocks, the joke tends to be on the latecomer who buys at a high and ends up taking a loss — never mind getting income from capital gains. Unfortunately, it's quite common to get an income cut from realizing a loss.

It's safer to look for capital gains from value stocks.

money found or type unknown

Value stocks

The idea with value investing is that you look for a stock that's trading below what the business is worth. The cheaper you buy the shares, the higher your capital gains can be.

The problem with this strategy is that even if you're right about a stock being undervalued, you can't control when the shares will appreciate.

Here's a tip. If you buy quality dividend-growth stocks at a discount, their growing dividends should help push the share price in the right direction.

That's exactly what happened with the big Canadian banks recently. In 2015, they underperformed as the market was worried about loan losses from energy-related businesses.

Since 2016, the banks rallied with a vengeance as oil prices stabilized. For example, **Bank of Montreal** ([TSX:BMO](#))([NYSE:BMO](#)) appreciated about 35% while growing its dividend.

Growth stocks

Investors can also earn capital gains from growth stocks, such as **Facebook Inc.** (NASDAQ:FB). Although it trades at a high multiple of about 31, it's supported by estimated earnings growth of at least 24% per year on a per-share basis in the next two years.

As long as share prices continue to go higher, you can sell a partial position for income. You can see that Facebook shares have been in a long-term uptrend since mid-2013. In the last 12 months, it has appreciated 22%.

A growth stock can run out of steam, though. Slower growth can cause multiple contractions, leading to price declines.

Investor takeaway

If you're using capital gains as a part of your strategy to generate income, expect bumpiness in that income. Avoid speculating, but do consider the strategies of value and growth investing in quality companies.

CATEGORY

1. Investing

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1. NASDAQ:META (Meta Platforms Inc.)
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3. TSX:BMO (Bank Of Montreal)
4. TSX:NPI (Northland Power Inc.)
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Author

kayng

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