2 Dividend Danger Signs

Description

Dividend investing may appear to be rather easy. After all, finding stocks with high yields is not particularly challenging. However, a high dividend yield may offer a strong income return, but it can also indicate potential problems with the business. Alongside a high dividend payout ratio, this could suggest a stock is worth avoiding for the long term.

An impressive yield

Certainly, buying a company which has a high yield can be a logical move. It can allow you to generate an inflation-beating income return which provides cash flow to pay the bills, or even invest in other shares. However, it can also mean that a company is in trouble.

For example, a company's dividend yield often rises significantly due to poor share price performance. This could be from a profit warning, or potential challenges it faces within the industry in which it operates. While such issues do not necessarily mean that a company's dividends will be cut, a high yield is normally the precursor to a reduction in dividends. In other words, the market often prices in a dividend cut before it even happens.

That's not to say only lower-yielding shares should be purchased. Clearly, buying higher-yielding shares can make sense. However, the key takeaway is that an investor should delve deeper than the headline yield and instead focus on the wider performance of the company in question, since that will have a major bearing on how sustainable and affordable the company's current payout really is.

A generous payout

As well as a high yield being a potential danger sign for dividend investors, so too is a high dividend payout ratio. This is calculated by dividend dividends per share by earnings per share. The resulting percentage shows the proportion of net profit which is paid out to shareholders as a dividend. If the figure is too high, it could indicate either slower dividend growth in future, or even a dividend cut.

Clearly, a figure above 100% is unsustainable and can only be afforded if earnings growth is higher than dividend growth in future. In such a scenario, a company would normally need to borrow to fund the shortfall, which increases its risk profile. However, just because a company's payout ratio is less than 100% does not mean it can continue to pay a dividend of that level in perpetuity.

For example, all companies require reinvestment in order to maintain their asset base and deliver future growth. If a business is overly generous and fails to reinvest adequately, it could lead to lower profit growth in future years. This would not be good news for dividends, and so could lead to a reduction in shareholder payouts.

Therefore, it is prudent to consider not only how high a company's yield is, but also how affordable it could prove to be. Comparing a company's payout ratio to its historic level and to industry rivals could be a logical place to start for Foolish investors.

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