Young Investors: Don’t Ignore the Power of Your TFSA

Description

Canadian investors are searching for ways to set aside adequate cash for retirement.

This is especially true for those under 35.

Why?

In the past, companies hired new grads to full-time jobs right out of school, and many positions came with attractive pension benefits.

Today, young Canadians are faced with a world of increasing contract work and no benefits at all. When people do score a full-time job, the odds of getting a decent company pension are slim.

In addition, sky-high house prices mean new buyers might not be able to rely on their homes as retirement safety nets, as is the case with their parents and grandparents.

Fortunately, young Canadians have a powerful savings tool that wasn’t available to previous generations. It’s called the Tax-Free Savings Account (TFSA).

Power of compounding

Any Canadian who was at least 18 years old in 2009 now has up to $52,000 in TFSA contribution room available.

Many people use the TFSA as a place to stash some cash for a rainy day, but the real advantage of the TFSA lies in the ability to use it for retirement planning.

How?

The TFSA allows investors to keep all of the returns earned inside the account. As a result, Canadians can buy dividend-growth stocks and reinvest the full value of the distributions into new shares without having to set some aside for the taxman.

This sets off a powerful compounding process that can turn a modest initial investment into a serious stash for retirement over the long haul.

Which stocks should you buy?

The best stocks have strong track records of dividend growth supported by rising revenue and earnings. Ideally, these companies also hold leadership positions in industries with high barriers to entry.

Canadian National Railway Company (TSX:CNR)(NYSE:CNI) is a good example.

The company serves as the literal backbone of the Canadian and American economies with tracks running throughout both countries. In fact, CN is the only railway company that can provide its customers with access to three coasts.

The odds of new rail lines being built along the same routes are pretty slim, and rail mergers tend to run into significant regulatory roadblocks.

CN still has to compete with trucking companies and other railways on some routes, so management works hard to make the business as efficient as possible.

The company regularly reports an industry-leading operating ratio and generates significant free cash flow.

Investors are rewarded through dividend increases and share buybacks. CN's compound average dividend-growth rate over the past decade is about 16% per year.

What about returns?

Long-term investors have enjoyed some impressive returns. A $5,000 investment in CN just 20 years ago would be worth about $150,000 today with the dividends reinvested.

The bottom line

Past performance is no guarantee of future returns, but the strategy of buying reliable dividend-growth stocks and reinvesting the dividends is a proven one.

Now, all the gains can be protected inside the TFSA.

CATEGORY

1. Dividend Stocks
2. Investing

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1. NYSE:CNI (Canadian National Railway Company)
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