How to Navigate Your Company’s Dividend Strategy

Description

Dividends are the cornerstone of investing and have been for as long as the stock market has been in existence.

A dividend payout, or distribution, is where the company pays out a portion of its earnings to shareholders.

Those shareholders can then take use the cash received from the dividend payment to reinvest in more shares of the company’s stock, they can use the cash to buy shares of another company, or they can withdraw the cash to pay for living expenses or a one-time payment on an automobile or a child’s college tuition.

Dividends are, in fact, the only sure-fire way to earn a return on your investment when you buy shares in a publicly traded security.

Without dividends, the only way to make a profit on an investment in the stock market is to sell your shares for more than you bought them for; however, this plan is completely dependent on the fact that you will be able to find a buyer for your shares when you want to sell them.

This phenomenon is often cynically referred to as “playing a game of musical chairs,” as many investors have found out the hard way that when it comes time to sell, or “when the music stops,” sometimes there aren’t any buyers in the market to be found.

With that in mind, there are two key elements to consider when buying a dividend stock: the current dividend yield and the potential for future dividend increases.

Evaluating the dividend today

A company’s dividend yield, quoted in percentage terms, tells you what proportion of the company’s value is being paid out, or returned to shareholders, annually.

For example, **Toronto-Dominion Bank’s** (TSX:TD)(NYSE:TD) dividend yield as of close on October

6was 3.41%. This means that against a share price of $70.40, the company's shares are expected to "yield," or pay out $2.41 in dividends this year.

When considering a company's dividend, it's important to consider the relative safety of the dividend as well, or the likelihood the dividend will be maintained for the foreseeable future.

One of the best ways to evaluate the safety of a company's dividend is by reviewing the company's payout ratio, or the percentage of earnings that are being paid out as dividends.

The idea is that if a company is paying out 100% of its earnings or more, it will have little cash left over to reinvest in the business, and the company may have to cut its payout to preserve cash.

Cameco Corp. (TSX:CCO)(NYSE:CCJ), which owns some of the world's largest uranium mines, paid a dividend last year that was 222% of its earnings. This should be a warning sign to investors that unless the company can dramatically increase its earnings in the coming years, there may be a dividend cut looming on the horizon.

Measuring the potential for future dividend increases

For retirees or income investors that at least partially live off the income from their portfolios, a high dividend yield may be the pre-eminent factor to consider when buying a dividend stock.

For investors with a longer time horizon, whether they're saving for retirement or a child's education, the potential of a company to sustainably increase its dividend year in and year out offers the opportunity to take advantage of compounded interest.

In these situations, investors will be asking the company to balance the current payout with retaining earnings to reinvest in its business, with those retained earnings being used to provide a dividend distribution years into the future.

For example, last year, **Canadian Pacific Railway Limited** (TSX:CP)(NYSE:CP) paid a dividend of $2.06 for a yield of 1.09%, which won't exactly knock your socks off, but the company actually earned $11.06 per share, which means it held on to $9, or 81%, of those earnings, which can be used to reinvest in capital expenditures, research and development, or even mergers and acquisitions.

In fact, we can actually take our analysis one step further and combine CP's 81% retention ratio with the return on equity (ROE) to come up a with an estimate for how much we can expect the company to sustainably grow its dividend in perpetuity.

In the case of CP, its ROE was 34% in 2016, which suggests a very impressive 27% sustainable growth rate.

Conclusion

While there's no evidence to suggest favouring either a dividend yield or growth strategy, there is plenty of evidence to suggest that dividends play a critical role in generating returns in excess of the market.

When making a purchase, investors should carefully consider both the safety of the current dividend payout and the ability of the company to grow its distribution over time.

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