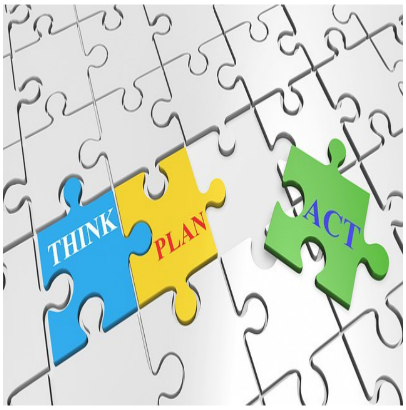

How Much Margin of Safety Do You Demand From Dividend Stocks?

Description

Dividend investing is popular because investors like the idea of cash going into their accounts periodically. The dividend yield tells investors how much income they'd receive from a stock. If they buy $1,000 in a 5% yield stock, they'd receive $50 per year, assuming the stock maintains its dividend.

However, on top of the dividend yield, investors should also watch out for how much they pay for a stock. Depending on the riskiness of the stock, investors should demand a different margin of safety before buying.

How much margin of safety should you demand from a quality stock?

For quality dividend stocks, such as **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD), investors may be willing to pay a fair price for them.

At $75 and change per share, Toronto-Dominion Bank trades at a multiple of roughly 13.1, which is within its fair valuation. Moreover, the company is estimated to grow its earnings per share by at least 9% per year on average for the next three to five years.

Furthermore, Toronto-Dominion Bank has maintained returns on equity (ROE) of at least 13% for seven consecutive years. In 2009, during the last financial crisis, its ROE was 9%, which was still very impressive.

The bank currently offers a 3.5% yield and pays out ~46% of its earnings. So, its dividend is very safe. The high single-digit earnings growth should lead to similar dividend growth as well.

If an investor waits for a big margin of safety in a quality company, they may be waiting for a long time. Toronto-Dominion Bank traded 40% below its intrinsic value in 2009, and it hasn't traded at that low a valuation since.

Demand a bigger margin of safety for riskier stocks

For riskier dividend stocks, such as **Alaris Royalty Corp.** (TSX:AD), investors should demand a bigger margin of safety before buying. A risky dividend stock typically has a high yield. However, not all risky dividend stocks have high yields, and not all low-risk dividend stocks have low yields.

Alaris may offer a compelling yield of 9%. However, it's riskier than the likes of Toronto-Dominion Bank. For example, Alaris has a much higher payout ratio of ~93%, which makes its dividend more susceptible to a cut when the company runs into trouble.

Yet, in the next 12 months, an investment in Alaris can deliver much higher returns than an investment in Toronto-Dominion Bank. On a forward basis, Alaris trades at a multiple of 10.4 at ~$18 per share.

Yet, the company has traded at much higher multiples before. So, it wouldn't be far-fetched for the company to turn around and trade at a multiple of, say, 13, which would indicate a 12-month target price of ~$22.50, or 25% upside potential on top of the rich dividend.

Investor takeaway

Are you a conservative investor who would pay a fair price for Toronto-Dominion Bank today? Or will you take on more risk and invest in Alaris, which looks cheap, for a 9% yield and double-digit upside?

CATEGORY

1. Bank Stocks
2. Dividend Stocks
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