Don't Get Caught in a High-Yield Dividend Trap

Description

Like any investment strategy, dividend investing has pros and cons. Being seduced by high yield without doing your homework is a trap you want to avoid falling into.

Companies know that shareholders want their investing dollars to work for them over *short* and *long* time horizons. A dividend payment is the short time horizon. Own a stock before the ex-dividend date and *voila*, you'll receive payment for every share you own. The long-term investment horizon is the hope and belief that the company will continue to thrive on the back of economic forces and solid management.

A company that pays a dividend that it cannot sustain is a bad long-term plan. In the long run, this could lead to a company flop and shareholders being fleeced. It's what Rosen & Rosen call *yield worship* in their book *Easy Prey Investors*. A company that pays a sustainable and modest dividend, while maintaining a solid balance sheet and growing the company is one you want to jump in to.

How do you spot dividend imposters? If only it were easy.

One thing you can do is track the dividend history. If the dividend payout is high, consistently above 100% of the company's free cash flow, then it raises the question, where is the company getting the money to pay the dividend? If the answer is issuing more shares, then you have to decide if this strategy is working well. Is the share price climbing over long periods of time? The company may also take on more debt through corporate bonds. This could work if the spread between the bond rate and the dividend rate is favourable. But why go to such lengths? Is this an enticing business model or part of a shell game?

Another gut-check test is the following: ask yourself whether you would still invest in the company if the dividend were zero! If the answer is no, then that is your gut telling you that you may have yield worship (an affliction that is easily cured)!

There are many investment instruments that placate to the yield-thirsty dividend crowd. The **iShares Canadian Select Dividend Index ETF** (TSX:XDV) and **iShares S&P/TSX Cdn Div Aristcr ETF Comm** (TSX:CDZ) are two examples.

Alaris Royalty Corp. (TSX:AD) is a small-cap company that is part of CDZ's holdings; it pays a juicy yield that is above 8%. With its annual dividend of $1.62 per share and 36 million shares, the company will pay out $59 million in dividend payments. This cuts directly into the $115 million in revenue over the trailing 12 months. The dividend cuts into the business operations, so it is not that surprising that Alaris's dividend payout has exceeded 100% in most of the last eight years (five-year average is 125%).

How about capital appreciation over this period? Nope. It's been the opposite. Alaris is down 39% over five years. This depreciation all but wipes out the dividend income. Reinvesting an 8% dividend could produce an income gain of 46%. Factoring the income with capital loss would be a 7% return over five years (tax considerations notwithstanding), or 1.5% annually, comparable to levels from some guaranteed investment certificates.

CATEGORY

1. Dividend Stocks
2. Investing

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1. TSX:AD.UN (Alaris Equity Partners Income Trust)
2. TSX:CDZ (iShares S&P/TSX Canadian Dividend Aristocrats Index ETF)
3. TSX:XDV (iShares Canadian Select Dividend Index ETF)

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