Young Investors: Why Dividend-Growth Stocks Are the Best Source of Income

Description

When it comes to monthly investment income, many retirees and other income-focused investors favour higher upfront yields and safety above all else.

While safety and a high yield may seem like the best (or only) attributes worth considering when hunting for new positions, I believe investors, particularly younger ones who are more than a decade away from retirement, can do profoundly better over the long term by considering dividend-growth rates, despite smaller upfront yields.

Many young investors like millennials have grown incredibly risk averse over the years, but really, who can blame them after a big chunk of them graduated into one of the worst recessions in recent memory? As a result, many millennials may be shying away from dividend-growth stocks and instead look to "safer" investments that are better suited for their retired parents or grandparents. Think REITs, bond funds, and other high-payout securities. These are known as "safe" investments, and the income stream they provide can really dampen volatile times.

I'm sure you've heard of the 4% rule of thumb, whereby a retiree should only expect to have an annual income stream that's approximately equivalent to 4% of their invested principal. With many REITs, you can get yields that are far above the 4% mark, and best of all, you're really not at a high risk of cuts, like some dividend stocks may be, since such REITs are required to distribute 90% of their taxable earnings to shareholders.

Consider the **BMO Equal Weight REITs Index ETF** (TSX:ZRE), which is a diversified basket of REITs with an overall yield of 5% at the time of writing. That's better than the 4% rule, and since it's diversified across various quality REITs, one would assume that they're receiving a terrific deal in spite of rising interest rates, which are typically bad news for high-capex businesses like REITs.

What many new investors may be forgetting, though, is the fact that distribution raises will come at a ridiculously slow pace than that of dividend-paying stocks. Sure, you'll get a high yield up front, but it's a trade-off! Over the next decade, very modest distribution raises can be expected, but it's more conservative to think of these distributions as static and not dynamic, like many dividend-growth stocks, which clock in double-digit percentage dividend hikes year after year.

Some REITs, like **Crombie Real Estate Investment Trust** (TSX:CRR.UN) an equal-weight component in the ZRE ETF, has not raised its distribution over the last decade!

On the other end of the spectrum, **H&R Real Estate Investment Trust** (TSX:HR.UN), another equal-weight ZRE holding, has hiked its distribution by a double-digit annualized percentage over the last few years, which may seem impressive until you discover that its distribution got cut in the midst of the financial crisis a decade ago! You'll then see that the distribution is hovering right around the levels it was prior to this cut.

The distribution will barely grow with time, and it's just because of the nature of the industry. Growth is limited when you're paying out 90% of your earnings. And in a rising interest rate environment, such growth stands to be even more stunted. Thus, those attracted by the high upfront yields need to consider the fact that the distribution will likely remain the same in a decade from now.

If you're a retiree, that's fine, since upfront yield and relative safety are attributes that are valued most. For younger investors who aren't even close to retirement, though, investing in REITs is not a great long-term investment, especially since, as a young person, you really shouldn't be spending the distributions or dividends if you're looking to compound your wealth at a rapid rate over the long haul.

Instead of REITs, young investors should be buying dividend-growth stocks, like **Waste Connections Inc.** (TSX:WCN)(NYSE:WCN), which has an unremarkable upfront yield, but over the long term, the dividend could stand to grow at a rapid rate, such that over the next decade or so the yield relative to the original principal invested will surpass that of your average REIT!

In effect, buying such a dividend-growth stock today is akin to purchasing an income stock on steroids for your future self!

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