Is a Growing Dividend Better Than a High Yield?

Description

Dividends are a great way for investors to pad their returns, and a stock that grows its payouts could be even more appealing. However, investors should consider both the yield and the average rate of growth before deciding to invest in a dividend stock. After all, a stock that pays a minimal yield but grows could take a very long time to surpass a high dividend with no growth.

It's tempting to assume that just because a company raises its payouts that it is the better dividend, but that isn't necessarily the case. Below, I'm going to take a look at two different dividend stocks and analyze their returns today, as well as what you could be earning 20 years from now, assuming you were to invest $10,000.

Fortis Inc. (TSX:FTS)(NYSE:FTS) is one of the most popular blue-chip stocks that you can invest in on the TSX. The utility company provides lots of stability to its shareholders while also paying a solid, growing dividend. Currently, the stock pays investors 4.2%, which is a very good payout, although there are much higher-yielding investments out there.

Investing $10,000 in Fortis would allow you to purchase about 246 shares, and you would earn $418.20 per year. Over the past five years, the company's payouts have risen by 37%, averaging a compounded annual growth rate (CAGR) of 6.5%. If Fortis were to continue that rate of increase for 10 years, its dividend payments would rise to $785 every year for a yield of nearly 8% on your original investment.

If that rate of increase were to continue for another 10 years, Fortis would be paying you $1,473 on your original investment for a yield of nearly 15% per year. This is on top of the capital appreciation you will earn over the years.

Dollarama Inc. (TSX:DOL) pays a very low dividend of just $0.48 per year, which amounts to a tiny yield of just 0.3%. At its current price, you would be able to afford about 67 shares, meaning you would earn $32.16 every year in dividend income. Dollarama has raised its payouts by more than 70% since 2013 for a CAGR 11.4%.

In 10 years, your annual dividend income would rise to roughly $95 a year, which would still be a shade under 1%. If you'd held the stock for 20 years, then the dividend would grow to $278 a year, and your yield would now be almost 2.8%.

Takeaway for investors

What we see here is that although Dollarama had a much higher rate of increase than Fortis, even after 20 years of holding the stock, you would not even be earning as much as Fortis is paying today. A growing dividend sounds great, but investors should always be careful to consider the context and look at the full picture before making a decision.

Ultimately, you should consider both the current dividend as well as the rate of growth.

However, one big caveat is that there is no guarantee that a company will be able to continue to grow its dividend, much less at its current rate of increase. Companies can also reduce their dividends or stop payouts entirely if times get tough.

A dividend can be a great feature of a stock, but it shouldn't be the sole reason you decide to invest in a company.

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