I'm Not Biting on This 9% Yield (Why You Shouldn't Either)

Description

Hunting for yield can be dangerous, especially if you go after the bigger beasts — securities with dividend (or distribution) yields well north of the 6% mark.

While such "artificially high" yields may suggest you're initiating a contrarian position in a potential value play, I'd argue that without proper due diligence, you're taking a contrarian bet, but not in the way a seasoned value investor like Warren Buffett would.

At best, you're bottom-fishing, and at worst, you're speculating and not really investing. It doesn't matter how "cheap" a stock's traditional valuation metrics may seem; there's no excuse for not doing your homework and just biting on a yield that may be slashed at some point down the road.

Consider **Alaris Royalty Corp.** (TSX:AD), a 9%-yielding collector of royalties that has been punished over the last few years but has since begun to bounce back.

In a previous piece, I'd noted my distaste of management's strategy of providing capital to a very broad range of clientele that span a considerable number of different industries. While I'm sure there are a select few analysts that are proficient at spotting opportunities across multiple industries, you'd probably agree that it's typically best to specialize and improve your skill set within a niche area to provide better results.

If Alaris had done that from the get-go, the probability of capturing a "bad-egg" (less-solvent) partner probably would have been reduced, as projecting future cash flow streams probably would have been more accurate given a higher level of specialty and expertise in aggregate.

Is Alaris's turnaround and distribution worth betting on?

If you're a retiree who relies on their income stream, you shouldn't risk your capital on Alaris, as its distribution is definitely not the safest in the world. The free cash flow payout ratio had been at 100% in the past and although there's a bit of wiggle room now, I think all it'll take is one or two more bad eggs to trigger a distribution reduction.

Given Alaris's track record, I wouldn't rule that out, especially if you haven't analyzed the solvency of each one of Alaris's partners.

Moreover, Alaris ditched its investments in both Labstat and End of the Roll, which could be a cause for concern if the company can't get its new-found cash hoard to work.

Foolish takeaway

The 9% yield may be compelling to more aggressive bottom-fishers, but for everybody else, the yield isn't worth biting on, especially if you're in the camp of "invest in what you know."

Two out of 14 partners were "spoiled" and had to reduce their distributions to Alaris. That's a fantastic track record in investing! But it's not great when it comes to lending capital to clientele. As such, I'm not at all impressed by management's prior track record or the nature of its business, so I'm not biting on the 9% yield, no matter how much the story improves.

I think there are far better risk/reward scenarios out there.

Stay hungry. Stay Foolish.

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