Why Avoiding Dividend Stocks Is A Major Mistake

Description

Buying dividend stocks today could be a good idea in my opinion. On a relative basis, they seem to offer an appealing risk/reward ratio, with bonds and cash having lower income returns and growth stocks potentially being impacted by an uncertain outlook for the world economy.

Furthermore, the pullback in global stock markets during 2018 may have caused valuations to become increasingly attractive across dividend stocks. This could mean that, alongside a high income return, they may offer impressive capital growth.

Income potential

For investors who are seeking a passive income at the present time, there are few appealing options other than dividend stocks. Certainly, bonds have historically been a part of income portfolios, and it is possible to buy corporate bonds that offer returns which exceed inflation. However, with interest rates continuing to be relatively low, there is a significant opportunity cost from buying bonds when compared to income stocks.

Over the long run, this opportunity cost could prove to be significant. When the compounding of returns is factored in over a five or ten-year time period, even a difference in income return of 2-3% per year can lead to a significant difference in portfolio size. And since bond prices could be negatively impacted by future interest rate rises to a greater extent than stock prices, dividend stocks may be the best means of generating an income return over the medium term.

Growth prospects

While the decade-long bull market since the financial crisis may yet continue over the course of 2019, it is very unlikely to last for another decade. Recessions and bear markets have historically come along with surprising regularity, and there is nothing to suggest that the world economy has become immune from such events. Therefore, after a decade of growth, there may be a natural shift among investors to less risky assets.

This could be bad news for cyclical stocks that are positively correlated to the performance of the wider economy. However, many dividend stocks such as those operating in the healthcare, tobacco and other more stable industries are less positively correlated to the macroeconomic outlook. This could mean that their financial performance, and dividends, are less impacted by the potential downturn that may be ahead for the world economy.

Balanced portfolio

While some investors prefer growth to income and vice-versa, dividend stocks appear to offer a potent mix of the two. They provide investors with access to the stock market's growth potential, with it having a strong track record of delivering capital growth. However, they also provide a short-term return in the form of dividend payments.

Therefore, to avoid them – especially at the present time – could be a major mistake. Economic conditions can change rapidly and different assets may change in terms of their relative appeal. However, from a long-term perspective, dividend stocks could offer a balanced approach to income and growth which produces a simpler, and more generous, return than when investors seek to time the market with growth stocks, or generate an income through buying bonds. As such, now could be the right time for investors to pivot towards dividend stocks.

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Author
peterstephens