3 Major Mistakes Investors Make When Buying Dividend Stocks

Description

With there being a wide range of dividend stocks that could be worth buying at the present time, finding the most appealing opportunities may prove to be somewhat challenging.

However, by avoiding common mistakes such as taking a short-term view, failing to consider the cyclicality of a business and having a portfolio that is concentrated on a small number of stocks, it may be possible to generate higher returns from dividend stocks the long term.

Time horizon

While a high dividend yield in the current year may be very enticing to many investors, considering how the business may change in the coming years could make the stock more or less appealing from an income perspective.

For example, a company may be unable to pay a high dividend at the present time due to investment opportunities that are available. They may lead to a step-up in profitability over the long run that eventually leads to a high dividend payout.

Likewise, a company may pay out a high proportion of its income as a dividend at the present time. But if it has a large amount of leverage, it may see a larger portion of its operating profit spent on debt servicing should interest rates move higher. Over time, this could negatively impact on its ability to pay a higher dividend.

Therefore, it is prudent to not only consider the current year's dividend, but focus on the long-term outlook for a business.

Cyclicality

The cyclicality of an industry could make it more or less appealing to an investor. For some industries, such as tobacco and healthcare, their returns are not as dependent upon the performance of the wider economy as is the case for other sectors such as travel & leisure and retail.

As such, investors who are seeking a resilient income from their portfolio may be better off buying stocks in companies that operate in defensive industries. By contrast, investing in cyclical stocks could lead to higher income returns if bought while they trade at a low ebb, but may also be a riskier move in the short run due to the potential for stock price volatility.

Ensuring that an investor buys dividend stocks within industries that fit with their own expectations and requirements could help them to find the most suitable income stocks over the long run.

Diversity

While it may be possible to obtain a higher income return from investing in a small number of the highest-yielding stocks, doing so can lead to significant risks. Should there be a profit warning or disappointing news from a company, for example, it may mean that the performance of the wider portfolio suffers to a much greater extent than if it had been diversified.

Of course, rewards are a far more interesting area to focus on than risk. But the reality is that stock prices often experience volatility, and reducing the impact of company-specific risk within a portfolio could help to produce smoother returns over the long run.

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