Here's How to Make a Million by Investing in Dividend Stocks

Description

Although dividend stocks are often lauded for their income potential, their ability to produce sizeable capital returns over the long run is often overlooked.

Indeed, many investors who attempt to make a million from the stock market reject dividend stocks in favour of growth companies. While this strategy may pay off for some investors, it can lead to greater volatility and risk – especially during periods of economic difficulties.

As such, buying dividend stocks that have sound financial standing and that offer rising shareholder payouts could be a worthwhile strategy for all investors looking to make a million.

Financial strength

While it is easy to solely focus on a company's yield when assessing its value and overall appeal, considering its financial strength is paramount to being a successful dividend investor. There is little to be gained from an investment in companies that are ultimately unable to afford their current level of dividend payments. Not only could this lead to a disappointing income return, it may also cause their stock prices to decline as investor sentiment weakens.

As such, focusing on a company's dividend affordability is a logical first step to take when determining which stocks to purchase within a portfolio. Ratios such as dividend cover (net profit divided by dividends paid) and debt to equity (total debt dividend by total equity) provide guidance on the financial standing of a business. From there an investor may wish to consider the level of interest payments that a company makes on its debt, as well as its free cash flow, in deciding whether its dividend prospects are bright.

Dividend growth

As well as a high yield, the rate of dividend growth that is ahead for a stock could make a significant impact on its total return. Not only will a higher dividend growth rate lead to a larger income return, it could also lead to improving investor sentiment over the long run.

Investors are often attracted to companies that are able to raise their shareholder payouts at a rapid rate. They may be viewed as financially sound by investors, or their management may seem confident in the prospects for the business. Likewise, with many investors seeking to generate a passive income from their portfolio, a fast-rising dividend may create a buzz among income investors that pushes its stock price higher.

Reinvestment of dividends

Compounding can have a surprisingly powerful impact on a portfolio's value in the long run. As such, reinvesting any dividends received during periods where a passive income is not required by an investor is a worthwhile move.

Furthermore, since dividends are often still paid by companies during bear markets, they provide an investor with cash flow to buy more stocks during the most opportune moments to do so in the economic cycle. This may mean that they are in a strong position to capitalise on lower stock prices which may only be on offer for a limited period of time. In the long run, this can catalyse their overall returns and improve the prospect of them becoming a millionaire.

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