Passive Income Investors: Don’t Make This 1 Mistake

Description

Earning passive income is a great way for investors to grow their portfolios over time, in addition to any increase in share price that happens. And if you’re in need of recurring cash flow, it can help inject some much-needed cash to help pay bills or other day-to-day needs.

Passive income is important for a variety of reasons, but what can sometimes make it difficult is selecting which stock to invest in.

The problem is that a dividend is not a guarantee to continue. While some dividend stocks have better odds for success than others, things like poor quarterly results, changing economic conditions, or poor commodity prices are just some of the reasons why a company may decide that it needs to hold the cash rather than to distribute it out.

However, there are warning signs for investors that a dividend may be in trouble, and one of the biggest may be when a stock has a high yield.

How high of a yield should be a concern for investors?

The short answer is that I’d consider anything at more than a 5% dividend yield to be worthy of a closer look. That’s not to say that anything over 5% is unsustainable, but it’s a good benchmark to consider.

While a high-yielding stock may look very appealing to investors focused on dividends, that shouldn’t cloud whether the stock is a good investment all on its own, even if the dividend were cut or eliminated.

A dividend stock that reduces its payout could hit its shareholders twice — once with lower dividend income and a second time by a drop in share price, as investors could react very negatively to the news.

In some cases, investors can even sell in advance of a dividend cut knowing that the yield is simply too high and is becoming a burden for the company, which is when a cut in price can sometimes help a stock. The stakes are high for investors, as selecting a bad dividend stock can lead to some big problems later on.

What should investors do?

While there's no guarantee that a dividend is safe just because its yield is safe, a stock like **Fortis Inc** (TSX:FTS)(NYSE:FTS) could be an example of a good compromise.

The stock is one of the largest on the TSX, and the utility company has a lot of stability and recurring revenue, making it less of a risky buy than other dividend stocks. With its dividend yielding around 3.4%, it's also a modest amount confirmed by a payout ratio close to 50%.

These are examples of some numbers investors can look at to minimize their risk. However, it's just not ratios that matter as investors should also assess the overall strength of the business.

When you look at Fortis and see that not only have sales increased over the years but profits have as well, that's also a good indicator that the company has a good business and that simply growing isn't going to cause its bottom line to bleed.

Fortis is definitely one of the best dividend stocks to own on the TSX with a strong track record for dividend growth. While it may not offer the highest yield, it may be one of the best options for dividend investors out there.

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djagielski