Yield Lovers: Are You Buying the Wrong Dividend Stocks?

Description

Dividend stocks are among the most popular investments out there, and it's easy to see why.

As exciting as a sexy tech or marijuana stock might be, there are a few issues with stuffing your portfolio full of growth stocks. It's a volatile strategy, for one thing. When the market sells off, these sectors often get hit harder than the average name.

These stocks also don't mesh well with retirement goals. Sure, you can always sell a stock that's doing well and pocket the cash, rather than collecting a steady dividend. But sometimes share prices don't cooperate. As we've all seen countless times, a quality stock can stay depressed for years, as short-term issues weigh down the company. Nobody wants to be selling shares then.

We must also remember that not every dividend stock is created the same. Many are solid companies — the kinds of stocks you want to own over the long term. But some aren't. This distinction is important, since the latter group will undoubtedly lose you money over time.

Let's take a closer look at what differentiates a good dividend payer from a bad one, and how you can avoid these duds in your own portfolio.

The best dividend stocks

The finest dividend stocks have a few distinct features that separate them from their less-desirable peers.

Let's start with Warren Buffett's favourite investment quality. Buffett looks for a sustainable competitive advantage, something that protects a company from competition. This moat could be anything, including a strong brand, regulations limiting competition, or even physical control of some scarce commodity. Some moats exist because it simply doesn't make sense to invest the capital needed to compete.

A solid competitive advantage is a good start, but an organization needs more than that to be a truly great dividend stock. We must also see ample growth opportunities — which could come from both acquiring new customers and raising prices to existing ones. A growth-oriented company could also look to expand into related verticals, although that comes with some risk.

Finally, I'm convinced the best dividend stocks have low payout ratios. This leaves plenty of room for dividend raises in the future as well as flexibility just in case the economy tanks. It's no coincidence these kinds of stocks have outperformed lately.

The worst dividend stocks

Once you know how to determine the best kinds of dividend stocks, it's not hard to identify the worst. You simply look for stocks that lack those good features.

I believe **IGM Financial** (TSX:IGM) is among Canada's worst dividend stocks. The parent company of Investors Group and Mackenzie Financial is being attacked on several fronts. Investors now realize fees matter, so they're pulling assets away from Investors Group and its high-priced mutual funds. The company is trying to adapt by lowering fees and pivoting to a more financial planning approach, but that's a tough slog.

Even IGM's parent sees the writing on the wall. **Power Corporation** — which is IGM's largest shareholder — has invested in Wealthsimple, which is one of North America's leading low-cost roboadvisors. These roboadvisors use software to make investment decisions, keeping costs down for customers. That's a winning strategy over the long term.

As a company with very little organic growth, IGM has fallen into a high-dividend trap. The company currently pays an eye-popping 7.7% yield. Yes, the payout is sustainable for now, with a trailing payout ratio in the 70% range. But earnings look likely to fall over time. That'll make the dividend more risky, which will then put pressure on the share price.

The bottom line

I won't pretend the difference between a good dividend stock and a bad one is simple. If it were, investing wouldn't be as much fun.

Just remember one thing: although it's not an iron-clad rule, the relationship between yield and the strength of the dividend is very real. Not every high-yield stock will cut its payout, but as a whole, these companies offer less-secure dividends. Keep that in mind before you go chasing a higher yield.

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