WARNING: 2 Mistakes You Should Avoid When Buying Dividend Stocks

Description

Adding a dividend stock to your Tax-Free Savings Account (TFSA) is a solid way to add income to your portfolio. But if you're not careful, you could end up with a nasty surprise like a dividend cut or suspension that could make your payouts disappear.

There's never a guarantee that a dividend will continue, and it's a risk that dividend investors simply have to accept. However, there are ways to minimize the possibility of investing in a stock that could trim or eliminate its payouts.

Here are two mistakes that investors should avoid when buying dividend stocks:

Buying shares of high-yielding stocks that can't support their dividend payments

American Hotel Income Properties REIT (TSX:HOT.UN) stopped paying its dividend payments earlier this year. With "Hotel" in its name, it's pretty obvious that the company wasn't going to be able to continue paying dividends during the COVID-19 pandemic. But the reality is that the problems were there even before the pandemic hit. COVID-19 just sealed the stock's fate.

When I last wrote about the stock back in January, I'd noted that the dividend was at risk of being cut. The warning signs were already there — the company had posted a loss in three of its past five quarters. It also wasn't generating enough free cash flow to support its dividend payments. While its 11% yield may have attracted investors, the company's fundamentals were there telling investors that the dividend was high risk.

That's why when investors look at a dividend stock to invest in, they need to consider the financial health of the company. If the company is not reporting a profit and not generating sufficient free cash flow to cover dividend payments, a dividend cut could be around the corner.

While it was surprising what ultimately led to American Hotel stopping its dividend payments (COVID-

19), it wasn't a surprise that there was some sort of adjustment to its payouts.

Investing in a struggling industry

Another stock that stopped paying a dividend this year was **Vermilion Energy** (TSX:VET)(NYSE:VET). This was another high-yielding stock that in December was paying 14%. That was months before the pandemic hit, and I'd warned investors that the stock could be in danger of being slashed as well. The problem there was that the oil and gas industry was and continues to be a very risky place to invest in.

Low oil prices make it imperative that companies are as lean as possible. And paying a dividend is not optimal and can tie up a valuable resource — cash.

The oil and gas producer would ultimately go on to cut its dividend multiple times in March before eventually suspending its payouts entirely in April. Falling oil prices made it only a matter of time before Vermilion would've had to do something. While its CEO didn't want to make any change, there wasn't much of an alternative when oil prices crashed in March as a result of price war involving Russia and Saudi Arabia, which happened before health officials labelled COVID-19 a pandemic.

The takeaway here for investors is to avoid risky industries like oil and gas. If the outlook for the industry isn't good, it'll be hard to be optimistic about an individual company.

Bottom line

By avoiding the mistakes noted above, investors can make safer investment decisions, especially when buying dividend stocks. And that can prevent losses later on. When payouts are cut, share prices normally tumble soon after. Shares of both Vermilion and American Hotel are down more than 60% since the start of the year.

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