TFSA Investors: 3 Facts You Should Know Before Investing in Dividend Stocks

Description

The Tax-Free Savings Account (TFSA) is one of the most flexible investment vehicles for Canadians. While contributions to this account are not tax deductible, any withdrawals in the form of dividends or capital gains are tax-free.

It makes perfect sense to allocate dividend stocks in your TFSA; the contribution limit for 2020 stands at $6,000. For Canadians who were eligible to contribute to the TFSA since its inception, the total contribution limit is $69,500.

Long-term investors can benefit from regular dividend payouts as well as capital appreciation. The current market weakness has dragged stocks lower and increased forward yields. The market correction also provides investors an opportunity to buy quality stocks at a cheap valuation.

While dividend stocks are attractive, investors need to consider various factors before taking this plunge.

Dividend payments are not guaranteed

Companies start paying dividends to shareholders, as they have excess cash and liquidity. Generally, companies that are part of mature industries pay dividends. These companies have a steady stream of cash flows and low capital expenditure, enabling them to distribute a part of the net profits to shareholders.

However, in an economic downturn, companies want to conserve cash and may cut or entirely suspend these payouts. The COVID-19 pandemic has completely decimated several sectors. Oil companies have been hurt further by falling prices due to lower demand and oversupply.

Several energy heavyweights, including **Suncor Energy** and **Vermilion Energy** announced dividend cuts. Last year, networking giant **Nokia** suspended its dividend program due to low profitability and an increase in capital expenditure to build its 5G infrastructure.

Avoid the high yield trap

Often, investors are attracted to companies with high dividend yields. Several companies on the **TSX** such as **Chemtrade** and **Alaris Royalty** had double-digit yields at the end of March. Chemtrade paid investors a monthly dividend of $0.10 at the start of the year. This indicated a forward yield of a whopping 37% when shares hit a 52-week low of $3.26 in mid-March.

However, this yield was unsustainable, resulting in Chemtrade cutting its monthly dividend by 50% to $0.05. Its forward yield now stands at 10.85%.

While its yield is still attractive, investors should note Chemtrade stock has lost 73% in market value since June 2015 and has wiped out significant investor wealth.

Cash flow is critical

Investors should look at a company's business model and cash flow before investing in a dividend stock. Canada's energy giant **Enbridge** (TSX:ENB)(NYSE:ENB) has been paying dividends for 69 years and is a Dividend Aristocrat. It has in fact increased dividends for 25 consecutive years.

Since 1995, Enbridge's dividends have increased at an annual rate of 11%. Enbridge's fee-based business generates a steady stream of cash flow that helps it maintain dividend payouts. Enbridge stock has a dividend yield north of 7% and is one of the top companies on the **TSX**.

It generates 90% of EBITDA from fee-based contracts and 93% of its clientele are investment-grade companies. We can see why the energy heavyweight has managed to be a top pick among income investors amid plunging oil prices.

If you invest $69,500 in Enbridge, you can generate over $5,200 in annual dividend payments. Investors can reinvest these dividends to benefit from the power of compounding in the long term.

Enbridge is just an example of a quality dividend company. As seen above, dividend yields should not be looked at in isolation.

You need to consider several factors such as the strength of the balance sheet, payout ratios, and cash flows to create a portfolio of top dividend-paying companies for your TFSA.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:ENB (Enbridge Inc.)
2. TSX:ENB (Enbridge Inc.)

PARTNER-FEEDS

1. Business Insider

2. Koyfin
3. Msn
4. Newscred
5. Sharewise
6. Yahoo CA

Category

1. Investing

Date
2025/09/17
Date Created
2020/06/18
Author
araghunath