Stop Buying Stocks Based on a High Dividend Yield

Description

One of my biggest investment pet peeves is when investors talk about how bullish they are on a stock because of its high dividend yield. Of course, this does not mean you should only invest in companies with a low dividend yield. Instead, you need to consider a number of other factors when choosing dividend-paying companies to add to your portfolio.

First, we need to understand what dividend yield is and why some companies have higher yields than others. A company's dividend yield is calculated by the annual dividend-per-share it pays out relative to the stock price. Normally, when a company is in the growth stage, it chooses to re-invest more capital toward growth. This will result in a lower dividend yield as less capital is allocated towards divided distribution. In contrast, mature companies tend to have higher dividend allocations and yields.

Which stock would I avoid?

I tend to avoid companies with astonishingly high dividend yields. If you are attracted to a stock and the first thing you notice is its yield, I would hesitate to enter it. I previously wrote about **Vermilion Energy** (TSX:VET)(NYSE:VET) which saw its dividend yield skyrocket to 74.79% during the market crash in March.

During this time, retail investors flocked to the stock, seeing an opportunity to jump in while its dividend yield was ridiculously high. Unfortunately, Vermilion soon announced it would suspend dividend distributions.

This event left investors with no incoming dividends and shares of a company that has seen a net decline in its stock price of 94.34% over the past six years. Yet, investors still seem to think entering companies with high dividend yields is a good idea.

One stock that is frequently thrown around in financial discussions is **Enbridge** (TSX:ENB)(NYSE:ENB). Admittedly, it is currently listed as a Canadian Dividend Aristocrat, which speaks to its ability to raise dividends year after year. However, this will change soon.

Enbridge currently has a forward dividend yield of 7.94%. This is very enticing to dividend investors. However, a quick look tells us that its payout ratio is 329.36%. That is incredibly unsustainable. Because of the tough economic conditions, Enbridge had to cut its dividend. After the cut, its new five-year dividend growth rate plummeted to -2.76%. Not only is its dividend plummeting, Enbridge stock has returned a loss of -20.29% over the past five years, as of this writing.

None of this points to a promising future, yet it remains one of the big stocks among retail investors.

Choose this company instead

If you are determined to find a stock that has at least a moderate dividend yield, I would look at **TD Bank** (TSX:TD)(NYSE:TD). TD Bank currently has a forward dividend yield of 5.05%. The company manages to distribute this dividend while maintaining a dividend payout ratio of 59.30%.

Normally, I place a requirement that dividend companies I own have a payout ratio of no higher than 60%. In this case, TD Bank is cutting it real close. However, I do make exceptions in certain situations.

I believe TD Bank to be a solid dividend company because of its previous history of capital allocation. The company has paid dividends every year for over 160 years. Very few companies will be able to make that claim as well. Although TD's current dividend growth streak only stands at nine years, it is long enough to re-enter the list of Canadian Dividend Aristocrats.

The company has also needed to weather many storms over the past 160 years, which makes its consistent dividend payment all the more impressive.

Foolish takeaway

Do not fall victim to choosing dividend companies because of a high dividend yield. Instead, choose a company that has a solid history of paying dividends and one that has a reasonably low dividend payout ratio. A company like TD Bank would be a good place to start if you are set on finding a company with a higher dividend yield.

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Date
2025/08/12
Date Created

2020/09/30
Author
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