TFSA Investing: How To Turn $6,000 Into $195,000

Description

Canadians use their Tax Free Savings Account (TFSA) to put cash aside for a house, cottage, or retirement income. One TFSA investing strategy can turn relatively small initial sums into a substantial portfolio.

TFSA basics

The Canadian government created the TFSA in 2009. Each year the TFSA contribution limit increases and the current cumulative space is as high as $69,500. The TFSA limit hike in 2021 will probably be $6,000, bringing the total space to $75,500.

Retirees use the TFSA to generate tax-free income from dividends. This helps to avoid being bumped into a higher tax bracket or triggering the OAS clawback.

Younger investors with a plan to use the TFSA to build a personal pension portfolio can harness the power of compounding. All dividends and capital gains created inside a TFSA remain beyond the reach of the CRA. This means the full value of distributions can be used to buy new shares. It takes time, but the snowball effect has the potential to turn small investments into significant savings.

Each new share pays additional dividends, which in turn acquires even more stock. Investors can normally ask to set their self-directed online broker accounts to make the process automatic. Some companies offer a discount on the shares purchased under their dividend reinvestment plans and there is no fee to buy the extra stock.

Best stocks to own in a TFSA

Advisers recommend owning a balanced stock portfolio. It makes sense to focus on high-quality dividend stocks when you want to harness the power of compounding. The top companies pay reliable and growing dividends supported by increased revenue and profit. The best stocks don't always have the highest yields. They do, however, demonstrate strong track records of dividend growth.

Let's take a look at **Canadian National Railway** (TSX:CNR) (NYSE:CNI) to see how the strategy works and why CN might be a good pick to get the TFSA savings fund started.

CN

CN is a leader in the North American rail industry. The company is the only one in the sector with tracks that connect ports on three coasts — an important competitive advantage.

CN transports a wide variety of cargo from coal and crude oil to grain, cars, forestry products, and finished goods. The railway makes good money in both Canada and the United States and generates carloads of free cash flow. In fact, the Q3 report shows that CN generated $2 billion in free cash flow in the first nine months of 2020, enabling CN to give investors a good dividend raise each year. The compound annual dividend growth rate since the company went public is about 16%.

The dividend yield is only 1.6%, but the growth rate of the distribution and the steady increase in the stock price over the years make up for the lower yield.

Buying CN on dips tends to be a rewarding move for TFSA investors. The stock normally bounces back quickly when there is a market crash. CN also came through the financial crisis in solid shape.

Long-term investors have enjoyed great returns. A $6,000 investment in CN just 20 years ago would be worth $195,000 today with the dividends reinvested!

The bottom line

The strategy of buying top-quality dividend stocks and using the distributions to acquire additional shares is a proven one. CN is just one name in the **TSX Index** that has delivered fantastic long-term returns for investors and should be a top TFSA pick.

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