3 Steps I’d Take When Buying Dividend Shares for Income in 2021

Description

Buying dividend shares for income in 2021 could be a sound move. In many cases, they offer significantly higher yields than are available on other income-producing assets such as cash, bonds or property.

However, due to the uncertain economic outlook, it is crucial to check that a company can afford its dividends.

Similarly, diversifying across a wide range of income shares with dividend growth potential could be a shrewd move that leads to less risk, as well as higher returns, in the long run.

Checking affordability among dividend shares

Buying dividend shares with high yields may sound like a simple solution to a common problem in a low interest rate environment. While this strategy can be successful, in some cases stocks with high yields are facing difficult operating outlooks that could weigh on their capacity to pay dividends at the expected rate.

As such, it is sensible to check how affordable a company’s dividend is before buying it. Otherwise, an investor may buy high-yielding stocks that ultimately need to reduce dividends to pay their other expenses.

Checking dividend shares for affordability can be done by comparing net profit with dividends. If shareholder payouts are covered more than once by net profit, there is headroom in case profitability falls in future. A figure below one suggests dividends may need to be cut at some point in future – unless there is a material improvement in profitability.

Dividend growth opportunities

As well as checking the financial standing of dividend shares, it could be prudent to understand the likelihood of them increasing shareholder payouts in future. Some high-yielding stocks may be attractive this year, but could become far less popular if their dividend growth is unable to match, or even beat, inflation over the coming years.

Clearly, dividend growth is closely linked to profit growth. As such, an investor must determine the prospects for improved earnings in the long run. Through analysing a company's industry growth trends, its strategy and capacity to invest in new growth areas, it is possible to assess the likelihood of dividend growth in the long term.

Diversifying among income shares

Generating an income from a limited number of dividend shares is a risky process. It can mean that difficulties encountered by a small number of holdings have a large impact on the income generated by the entire portfolio.

Therefore, it is logical to diversify among a wide range of companies, sectors and regions when investing in dividend stocks. Doing so could be especially relevant right now, since many countries and sectors are experiencing more difficult operating conditions that others due to coronavirus. By diversifying, an investor can also obtain a more resilient income that grows at a faster pace, since they will be exposed to a wider range of dividend growth opportunities over the long term.

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