3 Mistakes Passive-Income Investors Can Make When Investing in Dividend Stocks

Description

Buying dividend stocks to make a passive income can be a worthwhile move. It may allow an investor to generate significantly higher returns than those available from other income-producing assets.

However, shares are much riskier than assets such as bonds. There is always scope to lose money on them over any time period. Therefore, by avoiding these three common mistakes, it may be possible to reduce risks, improve returns and enjoy a growing income stream over the long run.

Accessing an affordable passive income

A common mistake made by passive income investors is failing to check the reliability of a company's dividend. It is all too easy to become focused on yields and how much a dividend could potentially grow by in future. As such, analysing a company's dividend in terms of its affordability can easily be overlooked – especially during a bull market when many investors are upbeat about the future prospects for the stock market.

Assessing a company's dividend affordability can be undertaken by comparing its shareholder payouts to cash flow or net profit. This provides guidance on how many times it was able to pay its dividend. A figure of less than one is clearly a red flag, since it means a company's profits were insufficient to make dividend payouts. However, investors may wish to demand a figure of more than one at the present time due to the uncertain economic outlook.

Building a concentrated portfolio

Obtaining a passive income from shares is a risky pursuit. Any company can experience tough operating conditions at any time. This can compromise its capacity to pay a dividend.

Therefore, it is important to avoid building a concentrated portfolio of stocks. Many investors hold too few companies in their portfolios because they do not wish to dilute their overall yield by purchasing businesses with lower yields. However, this can be a dangerous move, since it means they are reliant on a relatively small number of companies through which to generate an income over the long run.

Forgetting about everything else

It is easy to have tunnel vision when seeking to make a passive income from dividend shares. In other words, investors sometimes forget about everything other than a company's income prospects. For example, they may fail to check its valuation, the strength of its balance sheet, or a variety of other factors that matter to its future performance.

Of course, dividends are likely to be most important to an income-seeking investor when buying dividend shares. However, it is imperative to check all aspects of a business in order to build an accurate picture of its strengths and weaknesses. Through undertaking this process, it may be possible to obtain a higher income stream that is more resilient in the coming years.

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