How I'd Aim to Generate a Growing Passive Income From Dividend Shares

Description

Generating a growing passive income from dividend shares is a realistic goal for most investors.

Buying companies that have affordable dividend payouts as a proportion of profit could indicate they have scope to raise shareholder payments. Similarly, stocks with impressive profit forecasts may be able to raise their dividends at a relatively fast pace.

Through buying a diverse range of such companies, it could be possible to build a strong income portfolio in a low interest rate environment.

Buying shares with low dividend payout ratios

A company's dividend payout ratio can provide guidance on its passive income prospects. The ratio is calculated by dividing dividends paid in the most recent financial year by net profit from the same year. The result is a percentage figure. A figure below 100% shows that the company had headroom when making its most recent dividend payments out of net profit.

Clearly, company profitability can change – especially in the current economic environment. However, businesses with low payout ratios may find it easier to grow their dividends at a fast pace than those companies that have higher payout ratios. They may be less reliant on rising profits to fund dividend growth. As such, they could be a more promising means of obtaining a rising passive income in the coming years.

Earnings growth can catalyse a company's passive income

Companies that have attractive earnings growth prospects may also offer a higher chance of providing a rising passive income. For example, two companies with the same payout ratios may have very different financial outlooks due to industry conditions and their strategies. The stock with a moreupbeat operating outlook may find it easier to raise dividends without compromising the affordability ofits shareholder payouts.

Of course, assessing the profit potential of any business is a known unknown. It's especially difficult at the present time to judge whether a company has scope to raise profitability. However, by focusing on the track record of profit growth for a specific stock versus its peers, it may be possible to deduce whether it has a competitive advantage. This may indicate that it is able to offer more resilient sales growth, higher margins and a rising passive income in the long run.

Buying dividend shares today

The uncertain economic outlook makes it more important than ever to diversify among a range of dividend shares when seeking to make a passive income. Otherwise, an investor may be too reliant on a small number of holdings for their income.

Even after the stock market's rally since the 2020 stock market crash, a number of companies appear to be trading on low valuations given their long-term dividend prospects. As such, there seem to be opportunities to build a diverse income portfolio that can provide strong growth in a low interest rate environment.

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