Passive Income: 3 Important Tips for Buying Dividend Stocks

Description

Dividend stocks are some of the best investments to make for the long-term, but they're also ideal for the passive income you can earn today.

There's nothing better than putting your money to work and having cash continuously returned to you, which you can use to reinvest and compound your money.

As with buying any other type of stock, though, some companies are a lot better investments than others.

So here are three rules for buying dividend stocks and building yourself the optimal passive income stream.

Look for businesses with solid and stable operations

Without a doubt, the best dividend stocks are those with highly stable and defensive operations. At the end of the day, investing is about owning the best companies.

So before you even look at a company's dividend yield, it's crucial to analyze the business and its operations.

This way, you can ensure that the business is a high-quality company with strong margins and growing sales.

You also want to make sure it can continue to grow and operate, even though it's returning cash to investors.

Earning passive income is great, but not if the company is paying out more than it's earning and it's depleting the company of all its capital.

Yield isn’t everything when it comes to passive income

Another thing you may find when you research the business and look at its financials is that some of the riskiest stocks have the highest dividend yields.

This is important to remember, especially for passive income seekers who are looking for high dividend yields.

It’s entirely possible to find high-quality stocks paying out an attractive amount of money. However, more often than not, these stocks are the riskiest and could be at risk of a dividend cut in the future.

This is why once again, it’s so important to look for strong businesses in industries that are stable and can continue to grow for years.

Dividend growth stocks are some of the best long-term investments

In addition to high-yield dividend stocks often having more risk, the more a company pays out, the less it has to invest in growth.

So for some investors, especially with a longer investment timeline, it could make sense to give up some passive income potential today to look for companies with a slightly lower yield but are consistently increasing their dividends and growing their businesses.

A perfect example is a company like **Canadian Tire** (TSX:CTC.A). A simple glance at Canadian Tire stock would show that the stock only yields 2.5% at its current market price. That’s not too shabby, but there are definitely several other Canadian stocks out there that offer higher yields.

What’s attractive about the massive retail stock, though, is that it pays out just 30% of its earnings and less than 20% of its cash flow.

This allows the company to continue to invest in growth, which in turn allows it to increase the dividend more often.

In just the last five years, Canadian Tire has increased its payout to investors by more than 100%. In 2016 Canadian Tire was paying out $2.30 annually. Today it pays out $4.70 per share on a yearly basis.

So for investors who have held this incredible dividend stock, they’ve seen their passive income from this investment more than double in just five years.

Canadian Tire is not slowing down either. As I mentioned before, the company retains most of its earnings, giving it the potential to invest in more growth or make an attractive acquisition.

So if you have a longer time horizon, you may want to consider a lower-yield, higher-growth dividend stock such as Canadian Tire. You may give up some passive income today, but you have the opportunity for a lot more growth down the road.

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