Warning: 3 Common Mistakes Passive-Income Investors Make

Description

The notion of earning passive income is tempting. Visualize generating income when you eat or sleep. If you're relatively new to earning passive income from dividend stocks, it's easy to make mistakes. The passive-income side hustle might require more work initially than you think. Common mistakes include not choosing the right dividend stocks, reaching for high yields, and ignoring the stock valuation.

Not choosing the right dividend stocks

Getting passive income from dividend stocks is more complex than simply buying dividend stocks and be done with it. You can't just pick any dividend stocks for passive income. Only certain dividend stocks are suitable for passive income.

Here's a counterexample. **Chorus Aviation** (TSX:CHR) used to pay a nice dividend. However, if you study the historical financial results of the business, you'll notice it is cyclical. Additionally, it has cut its dividend in the past multiple times. So, it wasn't too surprising when it cut its dividend during the onset of the COVID-19 pandemic in 2020. However, before it eliminated its dividend in early 2020, it had a dividend yielding north of 10%, and some analysts at the time still believed the dividend was safe. It was impossible to foresee the pandemic impacts on the economy.

How does Chorus Aviation make money? It provides regional aviation services, including contract flying, aircraft leasing, and maintenance and repair. It consists of regional airlines Jazz and Voyageur. Under Chorus Aviation Capital, it leases regional aircraft to airlines globally. Chorus Aviation also provides a full suite of regional aviation support services. Under the cloud of COVID-19, the demand for the airline industry continues to be below normal levels.

So, Chorus Aviation is a COVID turnaround stock for price appreciation instead of a dividend stock now. However, there's hope that it will re-initiate a dividend down the road.

Passive-income investors should make sure to pick dividend stocks that are suitable for buying and holding (i.e., passive investing). These dividend stocks should pay safe dividends throughout market cycles.

Reaching for high yields

It's all right for passive-income investors to hold high-yield dividend stocks in their income portfolios. Just make sure they pay safe dividends! It's no joke when stocks cut their dividends. In the Chorus Aviation case, the stock eliminated the dividend while it fell as much as 90% from peak to trough during the pandemic. The drop of the stock had more to do with the poor operating environment during the pandemic than its dividend cut.

A high dividend yield from energy infrastructure stocks like **Enbridge** is much safer. Currently, Enbridge yields 6.5%. And it should be able to increase its dividend by about 3-5% annually over the next few years. That said, if you have an investment horizon of decades, you should make more money by holding higher-growth dividend stocks that typically have lower yields.

Ignoring valuation

Fortis (TSX:FTS)(NYSE:FTS) is a popular dividend stock for passive income. In contrast to Chorus Aviation, Fortis is an essential business that's needed in all economic environments. The regulated utility aims for its customers to have uninterrupted access to its electricity and gas.

Although Fortis is an excellent passive-income stock, its valuation can be stretched sometimes. Its 10-year normal price-to-earnings ratio is approximately 19.5. It trades at about 21.9 times its earnings at $58.44 per share. So, it's overvalued by about 12%.

Ignoring its valuation and buying it at recent prices could result in below-average total returns and dividend income. It would be ideal to start buying the dividend stock at a yield of close to 4%, which would imply a buy target of below $54 based on its current quarterly dividend.

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