How to Use the Power of Compounding to Build Retirement Wealth

Description

Canadian TFSA and RRSP investors are looking for ways to make their hard-earned savings grow into substantial funds for a comfortable retirement. One popular investing strategy involves owning top dividend stocks and using the distributions to buy new shares.

How the power of compounding works

Investors who take advantage of a company's dividend-reinvestment plan (DRIP) can use distributions to purchase new shares without incurring a commission charge, and the shares are often purchased at a discount of up to 5%. Each new share that is acquired will increase the amount of dividends paid in the next distribution. Those extra dividends buy even more shares that pay even more dividends, and so on. The process starts out slowly, but the compounding effect can eventually turn a small initial investment into a significant sum. This is particularly true when the company raises the payout on a regular basis and the stock price moves higher over time.

Good stocks to own tend to be ones that have great records of dividend growth supported by rising earnings. Let's look one top TSX dividend stock that has made some long-term investors rich.

Fortis

Fortis (TSX:FTS)(NYSE:FTS) is a utility company with power generation, electric transmission, and natural gas distribution assets. These might not be very exciting businesses, but they generate reliable revenue that is nearly all regulated. This means Fortis has a good idea of its expected cash flow every year, making it relatively easy to plan investments and commit to dividend payments.

Fortis grows through a combination of strategic acquisitions and internal projects. The current $20 billion capital program will increase the rate base from $31 billion to above $40 billion from 2022 to 2026. Management expects the new assets to generate enough revenue growth to support average annual dividend increases of 6% through 2025. That's great guidance for dividend investors. Fortis raised the dividend in each of the past 48 years.

The company has a number of extra capital projects under consideration that could get added to the investment program in the next few years. It also wouldn't be a surprise to see Fortis make another large acquisition as the utility sector consolidates. If either scenario pans out, the size of the dividend increases could grow, and the guidance could be extended.

Investors who'd bought $10,000 of Fortis stock 25 years ago would have about $200,000 today with the dividends reinvested. The current dividend yield is 3.35%, so the annual dividends received on the holdings today would be about $6,700. That's pretty good return on an initial investment of just $10,000!

The bottom line on harnessing the power of compounding

Buying stocks and sitting on them for decades takes discipline. Investors need to have the patience to ride out the downturns and let the compounding process perform its magic.

There is no guarantee that Fortis will deliver the same returns in the next 25 years, but the stock still looks attractive for a dividend portfolio. The **TSX Index** is home to many top dividend stocks that would be good to buy for a diversified retirement portfolio, and some have generated even better returns than Fortis over the years.

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