Dividend Stocks: The #1 Way to Earn Passive Income

Description

Many passive-income strategies introduced in YouTube videos or blogs aren't entirely passive. Most strategies require a lot of work, at least, initially. And many also require subsequent work periodically. No pain, no gain, right?

I hope you'll find ways to make (largely) passive income without feeling like they're extra work. I think dividend stocks are the number one way to earn passive income. You don't need a lot of money to get started with online brokerages that offer a free-trading platform. You can also learn and invest at the comfort of your home. Here are some tips to help you do well with this passive-income-generating endeavour.

Buy quality dividend stocks with high yields

Quality dividend stocks pay out safe dividends with sustainable payout ratios. They should also increase their earnings or cash flows in the long run to support an ideally growing dividend. Typically, dividend stocks with high stability in their earnings or cash flows can afford higher payout ratios. In contrast, dividend stocks that have cyclical or unpredictable earnings typically have lower payout ratios. If you're unsure, compare the payout ratio of the respective company with those of its peers.

For example, utilities have highly stable earnings. So, predictable regulated utility **Fortis** stock has maintained a relatively high payout ratio of 70-80% in the last few years. On the contrary, cyclical company **Magna International** stock keeps its payout ratio low to protect its dividend. To illustrate, in the last few years, its payout ratio has been between 24% and 41%. Its policy of keeping a low payout ratio has allowed the auto part maker to increase its dividend every year since 2010.

Earning passive income implies you're investing passively. So, you'd probably want to maximize your income generation. Consequently, you would want high dividend yields from your dividend stocks.

What's a high yield? Lowell Miller, the author of *The Single Best Investment*, suggests that a high yield is 1.5 to two times that of the market yield. The Canadian stock market yields about 2.7% at writing. So, a high yield would be approximately 4-5.4% in today's environment. Since Fortis and Magna offer dividend yields of about 3%, neither fits the bill.

Watch the valuations

Theoretically, if your focus is on passive income, all you need to watch for is the *valuation you're paying* for your stocks. Ideally, you would want to buy when stocks are cheap, such as during market corrections. However, that's not always possible. Depending on how rushed you are in wanting to create (or grow) your passive-income stream, you may or may not take opportunities in quality dividend stocks that are reasonably valued in a high market.

The most common valuation metric to check out is the price-to-earnings ratio (P/E). You can compare the P/E of a stock with its historical valuation or the industry valuation to get an idea if the stock is relatively cheap or not. Note that stocks that trade at a lower P/E than their peers typically do so for a reason. For example, it may have lower growth potential or is perceived to be a higher-risk investment. Another tricky thing is that the valuation can change widely for stocks with unpredictable earnings.

Have a long-term investment horizon

It should be straightforward that you got to hold dividend stocks to earn passive income. However, market volatility can trigger investors to trade instead of sticking with the passive-income plan. If you have a crystal-clear goal to generate passive income from dividend stocks, you should have a long-term investment horizon and a long-term investing mindset.

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