TSX Dividend Stocks vs. Bonds: Which Is the Better Buy?

Description

Do you want to earn passive income?

In a way, it's a silly question — pretty much everybody would like to make money while they sleep. But most people never bother pursuing passive-income opportunities, which is just as well, since most of them aren't effective. Affiliate marketing, putting ads on social media sites, sending chain letters — these methods don't work for 90% of people. For the 5% or 10% that they do work for, they are just as labour intensive as any regular job — there's money being made, but the people making it are not being "passive."

There is, however, one passive-income opportunity that is legitimate and does allow you to accumulate money while you sleep: income-paying investments. Bonds and dividend stocks pay cash income without you having to do any work after you make the up-front investment.

Now, with investing, the catch is that you need some money to get started with up front. If you want an amount of income you can live off, expect to invest at least a few hundred thousand dollars. Once you have the savings in place, you need to decide whether you'll be investing in dividend stocks, bonds, or both. There's a big difference between the two asset classes, and understanding the difference can make all the difference in your returns.

In this article, I'll explain the pros and cons of dividends and interest, so you can decide which is best for you.

The case for dividends

The case for dividends rests on growth potential. With dividend stocks, income can rise just like prices rise. With interest bearing bonds, that's much less likely to happen. There are certain kinds of bonds (e.g., step-up bonds) that raise their payouts over time, but they're pretty rare. Most of the time the payout is fixed.

If you want an example of the growth potential of dividend income, look no further than **Royal Bank of Canada**

(TSX:RY). It's a dividend stock that currently yields 4.12% ("dividend yield" means the percentage of your investment paid back to you in dividends). Not only does RY have a high dividend yield, but its dividend has also grown over time. Over the last five years, the dividend payout has increased by 6.3% per year. In other words, it has increased 35% over half a decade. That's a substantial increase in income that you're not likely to get from bonds.

The case for interest

The case for interest income over dividends is pretty simple.

It's much safer. If you invest in a GIC at your bank and hold it to maturity, you're nearly guaranteed to get the return you signed up for. Whether that return beats inflation is another matter, but you'll get some kind of return.

In the meantime, with stocks like RY, you sometimes have to deal with the price going down. Over the long run, these price fluctuations aren't very meaningful, but they can be scary to look at. Consider the chart of Royal Bank of Canada shown below:

As you can see, RY stock is down quite a bit this year. In fact, it's down by more than what you can collect off it in income. If you're investing purely for cash flow, that doesn't really matter, but volatility can be nerve racking when you're in the thick of it. Perhaps a mix of stocks *and* bonds is ideal.

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Author
andrewbutton