TFSA: Why Irresistible Yields Like Algonquin’s Can Get You in Trouble

Description

These days, “passive income” is all the rage among TFSA investors. Tech stocks crashed earlier this year, while dividend stocks performed relatively well. So now, everybody is chasing after high yield. Articles all across the internet are talking about how you can get many hundreds of dollars in passive income every month. That’s quite possible if you invest $100,000 or more, but it isn’t going to happen with just a few thousand bucks.

The problem with excessive passive income goals

The problem with excessive passive income goals is that the higher the yield, the higher the risk. Yields are a function of income and stock price. The lower the stock price, the higher the yield – holding dividends constant. If the yield is outrageously high, then, it’s quite likely that the stock is riskier than average.

There’s nothing wrong with high-yielding dividend stocks in themselves. I have a few in my own portfolio. However, many people on the internet these days are deliberately chasing the very highest-yielding stocks they can find, hoping to collect life-changing amounts of money. If you frequent popular stock communities like **Twitter’s** *Fintwit,* you may have heard of names like Brazilian oil giant **Petrobras** (40% yield) or shipping service **ZIM** (110% yield). These stocks do have high yields if the dividends continue to be paid. The trouble is that the dividends are risky. Petrobras is at the mercy of Brazil’s government. ZIM faces declining shipping fees. Seeing a 100% yield and instantly buying is the dividend investing equivalent of chasing unprofitable tech stocks in 2021. We saw how *that* party ended; the current high-yield obsession might produce similar results.

Petrobras and ZIM may or may not actually pay out the amount in dividends that financial data platforms claim they have. I’m no expert on them, but I am fairly familiar with a high-yield Canadian stock that burned quite a few Canadian investors this month. Based on what I know about that stock, I would not advise chasing after stratospheric dividend income, preferring instead an approach based on dividend safety and growth.

The Algonquin story

Algonquin Power & Utilities Corp (TSX:AQN) (NYSE:AQN) is a high-yield dividend stock that blew up in many Canadians' faces this month. It has a 10% yield now, yet it had a 6.5% yield a few weeks ago.

Why did the yield suddenly increase?

Because Algonquin's stock crashed. After it put out a disappointing earnings release showing a large net loss, AQN stock tumbled in the markets. It fell 20% the day after the release came out, and it kept on falling in the days afterward. The stock was at $15.29 before the release came out; it only trades for $10 now.

What kinds of stocks are best?

If you want to collect passive dividend income, you might want to look at stocks like **Fortis Inc** (TSX:FTS)(NYSE:FTS). Fortis is a dividend stock with a 4.23% yield. That's not the highest yield out there, but it's fairly safe. The North American gas and electric utility has a 70% payout ratio, meaning that it pays 70% of its earnings as dividends. That isn't an outrageously high percentage. In the exact same quarter when Algonquin posted its large loss, Fortis delivered modestly positive growth. So, it looks like Fortis' dividend will continue being paid at its current level. The same cannot be said for AQN.

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