Investments: Dividend Investing

Why Is Dividend Investing So Popular?
By: Joe the Investor

There was once a time when people never invested in equities. There was ample interest earned through bonds, bank accounts and Guaranteed Investment Certificates (GICs) such that buying equities was not necessary. As inflation and interest rates went down and stayed low for a long time, people began searching for other ways of creating income. The two most popular methods are rent generated from real estate and dividend investing. Real estate investment involves buying properties and renting them, and will not be discussed further in this write-up. Dividend investing through buying of equities will be explored in this article.

There are some key things to remember when it comes to dividend investments:

Dividends are Not Guaranteed

Most people know that equities and mutual funds are not guaranteed, unless there is a situation where Canadian deposit insurance takes effect. This is generally when institutions which hold your investments go bankrupt. (1) The same thing holds true for mutual funds as for dividends. A company can change its dividend payout or cancel it altogether without a lot of notice. This is generally communicated at shareholders meetings and via media releases. It is true that companies who discard or reduce dividends tend to get bad publicity from the marketplace, thereby discouraging them from doing this, but it still happens. When dividends are cut, it could mean a change in company direction. A possible scenario is when a company decides to invest a lot of idle cash into a new product, a new line of business or another company which requires money to allow it to grow. Rather than pay dividends, the company has now decided to conserve capital and let the profits generate capital gains instead. A second scenario is that the company is not making as much money as it used to, and it cannot afford to pay dividends any longer. A third situation is when a company has a negative surprise occur, like a lawsuit, a change in regulation that adversely affects its business, a merger, a takeover or a natural disaster that causes the company to change its course on dividends. There are also scenarios when dividends increase more than expected, such as unforeseen extra profits, a onetime dividend payout resulting from a takeover deal, a lawsuit victory or a change in regulation favouring the company resulting in a large profit increase. To find out what is going on with a company, read the media reports and decipher what the current situation is.

Dividends May or May Not Keep Up With Inflation

Many companies will increase dividends each year. In some cases, people expect this to happen since it has happened for many years. These increases are designed to keep the income from the dividends steady as the stock price rises, thereby paying more dollars for each share of stock that you own. These larger payouts serve to keep up with inflation and allow your investment to maintain its value over a long period of time. If the share price is stagnant, and the dividend payouts are stagnant, this situation will not keep up with inflation as you would receive the same dollar amounts over many years. As the prices of things go up, you will find that your money will buy fewer and fewer things, resulting in a cash squeeze. This issue is particularly important if the dividends are your only source of income, or if you are living on a fixed sum of money. Many senior citizens and people on fixed government benefits fall into this category. To find out what is happening in this case, observe the dividend payout history for the company you are investing in, and find out if there are predictable increases in payouts. If they are mostly predictable, but there are a few unexpected changes in the trend, find out what happened to the company at those times. These periods will determine how reliable the stock is when paying dividends, and when they are not reliable.

Dividend Yields are Inversely Affected by the Stock Price

The dividend dollar amount received divided by the share price at the time of the dividend payout gives you a percentage called the “dividend yield”. This calculation allows you to compare this yield to other investments, like a yield on bonds or a yield on GICs. This yield can also be compared over time to see what range the yield can obtain. Since the price of the stock is the denominator of this calculation; as the stock price goes up, the percentage given to you or the dividend yield would go down. Conversely, as the price of the stock goes down, this dividend yield would go up. If you are investing for steady income and you already own the shares, this calculation would not matter to you unless you want to change investments, or would need a certain amount of principle (money invested) for an alternative to owning dividend stocks. If you are putting new money into dividend stocks, this yield serves as a comparison to tell you if the stock you want to buy is “cheap” (the yield is high) or “expensive” (the yield is low). There are many things that affect the price of the stock, so this yield will fluctuate a lot depending on the stock price at a given time. The dividend payout would not fluctuate much unless there is something unusual going on – as explained in the prior paragraphs.

What About Interest Rates?

Interest rates should be watched carefully when investing in dividend paying stocks. The higher interest rates rise, the more likely it is that dividend stocks will be sold, because someone can buy an alternative, which is bonds or other interest bearing securities. It is like a substitution effect – if one thing becomes really expensive and a cheaper version of that thing comes around, you will buy the cheaper version of that thing instead. In this case, if a dividend stock gives you a 5% income stream, and a bond gives you a 2% income stream, you would likely buy the dividend stock after weighing risks, cost and taxes. Should the bond then give you a 4% income stream due to rising interest rates, this dividend stock does not look as attractive. If the bond then returns a 6% income stream, this would now be a better yield that the dividend paying stock. People would then sell the dividend stock until the price goes down enough that the dividend yield is close to 6%, or an equivalent return after risk, costs and taxes. Since the dividend payout does not change that quickly, the only other way for the markets to balance the two alternatives is to change the price – in this case the price of the dividend stock.

The Mechanics of Dividend Investing

So how do you go about getting these dividends? The traditional way is to open up a trading account with a bank or brokerage firm. The account has to be such that it allows you to buy individual stocks. You can buy these stocks yourself or have someone do it for you. Make sure you ask questions about costs, account access restrictions and taxes before you set up the account. You would buy shares in each individual company. As an example, you would buy 100 shares of Bell Canada Enterprises (the trading symbol is BCE). These shares would cost you $50 per share as an example. If you buy 100 shares, the amount invested would be $5000 plus any fees to buy the shares. Some accounts also have fees to keep the account open, so ask questions upfront before you start buying stock because these fees will reduce the amount of money you are getting out of the whole exercise. Once the shares are in your name, you would be entitled to a dividend payment each quarter. The quarter end date is the company fiscal quarter end date, not necessarily the calendar quarter end dates. If you own the shares, your name or the name of the brokerage account will be registered with the company and when the dividend payment date approaches, the name of the account holding the shares will be scheduled to receive the payment. If you buy shares before this date, you would receive the dividend. (2) You would then see a cash payment in your account where the shares are held. In some cases, you can have the dividends reinvested into more shares of stock instead of cash to make sure you continue to buy more shares instead of doing this yourself. This method is good if you want to grow your stock holding. If you want to use the income, this shouldn't be done because shares would have to be sold periodically to generate cash, which would incur a lot of trading fees as well as headaches trying to time your trades to get the best price. Timing the market is very difficult to do, so it should be avoided unless you have some skill in doing it.

When Should You Not Invest in Dividends?

The answer to this question depends on what your reasons are for buying dividend yielding stocks in the first place, as well as your risk tolerance. If you are only looking for income, and you can get that income through buying bonds, the latter would be a safer bet. If you are very risk averse to losing your money, and a guaranteed alternative investment presents itself to you, the guaranteed alternative should be bought instead. If you prefer dividend income but also like the capital gain that sometimes come with it, you may want to keep your dividend stocks even if other alternatives present themselves to you. If interest rates rise sharply and you take a large loss on your dividend stocks, this may be a turn off on the whole idea of dividend investing. If you love real estate and can create similar income through real estate as opposed to dividend investing, real estate investing is the way to go for you since you are more familiar with how it works.

How to Tie This All Together

Investing in dividends should always be considered along with everything else that is going on in your life, both financial and otherwise. Take note of what you want to achieve with dividend investing, what your options are, and how comfortable you feel about each of the options. The amount of knowledge you have about each alternative should also be considered. The more you know about something, the better you will be at it. If you know little about something, treat it as an experiment and wade in slowly with whatever help can be found until you know a fair amount about it.

Contact me, Joe Barbieri by email at joetheinvestor.today@gmail.com, or by telephone at 647-286-8020 for an independent consultation on what these options are. **Note: This article is intended for people who want to learn about the world of investments and how to research for themselves. If you would like to buy or sell investment products, or specific advice on investment products, tax or legal issues, please consult your investment advisor, accountant or legal counsel.**

Sources:

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