INVESTOR CLINIC

Ten reasons to love dividend investing

JOHN HEINZL INVESTMENT REPORTER
PUBLISHED 15 HOURS AGO
COMMENTS

People occasionally accuse me of being obsessed with dividends. I have only one thing to say to these people: You are correct.

Dividend investing isn't the only strategy that works, but I believe it is one of the simplest and most effective ways for small investors to build wealth. I hear from people all the time who have used the dividend approach with excellent results.

Here are 10 reasons to love dividend investing.

IT'S EASY TO UNDERSTAND

A company makes a profit. It plows some of that money back into its business, and it sends the rest to shareholders in the form of a dividend. Simple, right? But here's the best part: A well-run company that reinvests in its business will, over time, generate higher profits and pay bigger dividends, both of which will be reflected in a higher share price. So, in addition to enjoying a rising income, dividend investors benefit from capital growth as well.

IT HAS PRODUCED SUPERIOR RETURNS

As an investing columnist at The Globe and Mail, I've managed a couple of model dividend portfolios, and both have handily beaten the S&P/TSX composite index. (View the current portfolio at tgam.ca/dividendportfolio.) This shouldn't be surprising, given the stellar track record of dividend stocks in general. RBC Capital Markets studied the 30-year period from 1986 through 2016 and found that stocks with growing dividends posted a total annualized return of 11.7 per cent. That compares with 9.9 per cent for stocks that paid dividends but did not raise them, 6.6 per cent for the S&P/TSX composite index, 2 per cent for dividend cutters and 1.3 per cent for companies that paid no dividends at all. Why fight history? (All return figures include dividends and assume they were reinvested.)

DIVIDENDS HELP YOU STAY OUT OF TROUBLE

It isn't necessarily the dividend, per se, that makes a stock attractive. Rather, it's the fact that dividend-paying businesses tend to share certain desirable attributes. "Dividend-paying companies … are typically well-established, soundly-managed companies with stable businesses," the RBC study said. There are exceptions, of course. Occasionally a dividend-paying company will suffer a serious downturn in its business and have to chop its payout, but a cut is a rare event for conservative dividend stocks such as utilities, power producers, banks and telecoms.

DIVIDENDS ARE STABLE

Stock prices constantly bounce up and down, but dividend payments are much more stable and predictable. What's more, according to the RBC study, dividend stocks exhibit lower price volatility than non-dividend payers. So, if you're looking for a smoother ride, focus on dividends.

DIVIDENDS REINFORCE BUY-AND-HOLD

Trading too much is one of the most common self-defeating behaviours of investors. Regular dividend payments help to tame your inner trading beast because they reward you for staying the course. After all, it's a lot easier to deal with a slumping stock price if you know you'll be getting a chunk of cash deposited into your account every quarter or every month. The last thing you want to do is sell when one of your companies is experiencing what could well turn out to be only a temporary setback.

DIVERSIFICATION IS A SNAP

Not comfortable managing a portfolio of individual stocks? As my colleague Rob Carrick points out in the latest instalment of his ETF Buyer's Guide, investors can choose from more than 10 exchange-traded funds that provide one-stop exposure to a diversified basket of dividend stocks. Each ETF is a little bit different, so for added diversification there's no reason you can't hold two or three dividend ETFs in your portfolio.

TAX BENEFITS

Canadian-listed corporations benefit from the dividend tax credit (DTC), which reduces – in some cases dramatically – the amount of tax investors pay. An investor in Ontario with $80,000 of taxable income, for example, pays marginal tax of just 8.92 per cent on eligible dividends, compared with 31.48 per cent for interest and other income. At low income levels, the tax rate on dividends can actually be negative owing to the DTC. The government won't send you a cheque for the negative tax – the DTC is a non-refundable credit – but you can use the credit to offset other taxes payable.

DIVIDEND GROWTH FIGHTS INFLATION

The problem with fixed-income securities is that the income is, well, fixed. That means the interest from a bond or guaranteed investment certificate will lose spending power over time at the hands of inflation. A stock that pays a rising dividend, on the other hand, will preserve your spending power – and, in many cases, increase it – even after inflation.

IT UNHOOKS YOU FROM "THE MARKET"

People are always asking: "Where's the market heading?" The only thing we know for sure is that the market tends to rise over the long run, but in the short run it is completely unpredictable. A better question to ask is: "Where is my portfolio's income heading?" If you own high-quality companies that raise their dividends regularly, your income should continue to grow – during bull markets, bear markets and sideways markets.

IT'S FUN

The beauty of dividend investing is that, after you buy a stock, you don't have to do anything; the company just sends you money. Then, after a few months, it sends even more money. After a while, you may start to feel guilty about all the money you are receiving for doing absolutely nothing. Actually, not really.

Read more on income investing: Rob Carrick's 2019 ETF Buyer's Guide: Best Canadian dividend funds

E-mail your questions to jheinzl@globeandmail.com.