Guide to income investing and dividend stocks

Whether you're approaching retirement, or you want to preserve your capital, income investing can be an effective strategy for accumulating passive earnings.

Qtrade Direct Investing

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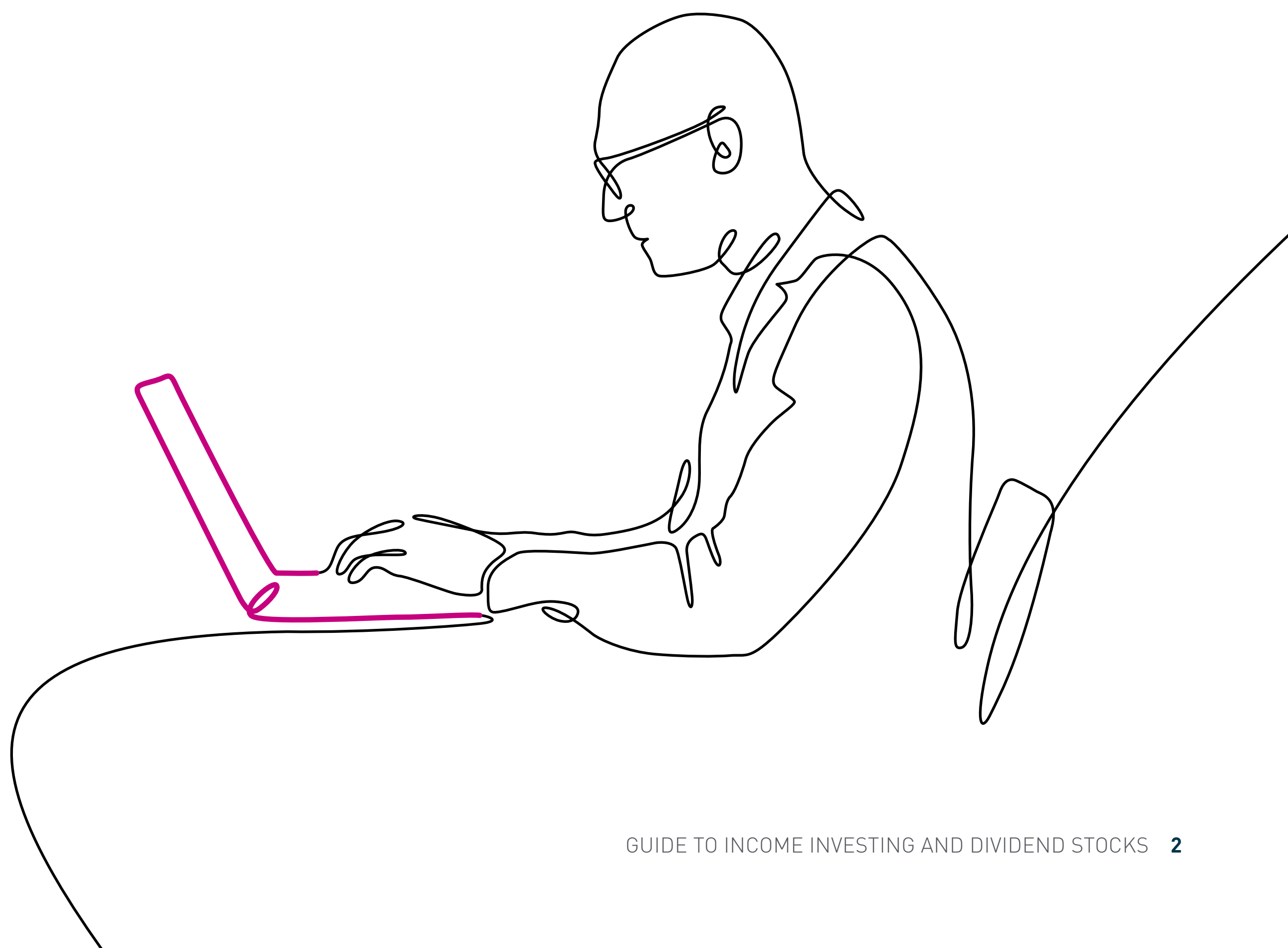
There are many reasons why you may want to follow an **income investing** strategy.

This informative guide will walk you through the basics of what income investing is, what types of securities are often used, risk and return considerations, tax implications and more.



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What is income investing?

An income-based investing strategy involves building a portfolio that will deliver a consistent flow of passive income. Whereas growth investors aim to achieve capital gains, income investors prioritize income and safety of principal.

The regular cash payments provide an income that can be spent as it is needed and is often used as retirement income.

Who would benefit from an income-based investing strategy?

Both retirees and people approaching retirement are a typical demographic for an income investing strategy. They often need the investment income to replace their salaries, cover day-to-day needs and enable them to maintain their lifestyle in retirement. They also want to be sure that the bulk of their savings remain safe.

Every bull market comes to an end, and anyone who is approaching retirement and preparing to draw an income from their savings should focus on risk mitigation to protect themselves against a downswing. With cash or cash equivalents paying nominal returns, moving investments to a portfolio of low-risk, income-earning assets can be a more effective option to replace lost wages and salaries in retirement.

Retirees are not the only people who could benefit from this strategy. Anyone who has received a windfall—for example from an inheritance or sale of a business—may want to use that money to boost their income. This could considerably improve their standard of living while preserving their original capital. There are also affluent people who don't necessarily need to build their wealth, but rather see an income investing strategy as a way to safely preserve their capital while generating returns that outpace inflation.

Defined

At par

At par is a term used for income investment assets such as bonds and preferred shares. An asset's par value is the value at which it was originally issued and is a static amount. Depending on how interest rates fluctuate, these assets can trade below, above or at par. Regardless of its market value, however, when it reaches maturity, the asset is bought back by the issuer at par.

The Dogs of Dow

The 'Dogs of the Dow' is a classic investing strategy first made popular in 1991. It involves buying the 10 stocks from the Dow Jones Industrial Average (DJIA) that have the highest dividend yield. (The DJIA is a long-running stock index comprising 30 large U.S.-based companies.) While this strategy has not outperformed the Dow every year, it has performed well over longer time frames. Through the end of 2018, for example, the Dogs had outperformed the DJIA in four of the last five years and outperformed both the DJIA and S&P 500 on 1, 3, 5- and 10-year measures.[1]

[1] Dogs of the Dow. "Dogs of the Dow Total Return: Dog Years." http://www.dogsofthedow.com/dogyrs.htm. Accessed July 4, 2019.

Setting goals for your income investing strategy

The simplest way to work out which goals to aim for in your income investing strategy is to work backwards. Calculate your annual expenses so you know exactly how much money you will need annually.

Note that this will be a post-tax amount, so for example, if you have annual expenses of $30,000, your pre-tax amount could be as much as $40,000, depending on your tax bracket. Your financial advisor or accountant should be able to help you estimate the actual amount that pertains to you and your tax situation.

As with any investment plan, the keys to a successful income investing strategy are asset allocation and diversification.

What does income investing asset allocation look like?

Asset allocation is an investment strategy for diversifying exposure to investment opportunities that do not move in sync. Using a prudent asset allocation methodology can help investors calibrate their portfolios to an optimal balance between risk and return. The strategy entails establishing a target percentage for each asset class in your portfolio, according to your goals and personal tolerance for risk. For example, income investors might design a portfolio with target proportions for bonds, dividend-paying stocks, real estate, and cash equivalents.

As with any investment portfolio, asset allocation will depend on several factors that relate to your unique situation. Considerations that will have an impact on how various assets are allocated include age, current savings, future savings, spending time frame, expected lifespan, and other financial obligations.

In most cases, the older you are, the more likely you are to be concerned about capital preservation and bringing in a steady income. Having a large percentage of your assets in bonds or guaranteed investment certificates (GICs) could make sense. Younger income investors, with plenty of years ahead to ride out stock market fluctuations, might prefer to focus more on growth-oriented investments which tend to be more volatile and lower exposure to bonds and/or GICs. These investments could be complemented with a higher percentage of dividend-paying stocks, which provide income along with growth potential.

Diversification: assets suited to an income investing portfolio

There are plenty of options that can be used to provide a regular income stream while protecting your principal from undue risk.

Dividend-paying stocks

Some, but not all, companies make regular dividend payments to distribute a portion of their profits to their shareholders. High-growth companies, usually smaller, newer companies in emerging industries, tend not to make dividend payments to investors as they perceive greater value in re-investing capital to fund their accelerating growth.

But well-established companies in mature sectors may choose to provide value to shareholders by paying a regular dividend.

There's an ETF or mutual fund for that

There are many exchange-traded fund (ETF) and mutual funds specifically designed for income investing, including those for Canadian, U.S. and foreign bonds, as well as dividend stocks and real estate investment trusts (REIT).

There are a number of ways to build a portfolio that includes dividend-paying shares. You could buy individual stocks, basing your decisions on companies with a track record of delivering higher dividend yields.

You could also buy funds that provide exposure to high-quality dividend-paying stocks. There are a range of mutual fund and ETF options. Yields can be attractive plus you get the potential for long-term capital growth. All else being equal, choose funds with lower management fees in order to maximize your net yield.

Bonds

There are several types of bonds, which are effectively loans, with the borrower usually being a government or corporation. Most bonds have specified maturity dates, at which time the loans are paid back in full. They also have guaranteed interest rates, and payments—called coupons—are paid out periodically during the term of the loan—usually semi-annually, but sometimes quarterly or annually. The various bond types bring with them different levels of risk and return.

Government bonds

These are available for a variety of term lengths (up to 30 years). Government of Canada Marketable Bonds, for example, guarantee regular interest payments (usually twice a year) until the bonds mature.

The principal and interest payments are guaranteed by the credit worthiness of the Government of Canada, regardless of the amount invested, so these bonds come as close to being risk-free as is possible. This low level of risk usually brings low yields. You can sell them before the maturity date if required, as they are fully marketable. If you do sell them prior to maturity, be aware that you may get less (or more) than you originally paid for them. If you wait for the maturity date, you will receive their full face value.

Municipal and provincial bonds

These bonds are issued by a city, township or province. They typically pay interest twice a year and return the full principal at maturity.

While traditionally considered a safe investment, municipal bonds are not as rock solid as government bonds. The city of Detroit filed for bankruptcy in 2013 and did not pay back its bond obligations, leaving creditors with $7 billion in losses.[1] Canadian cities, however, haven't defaulted since the 1950s. Municipal bonds can bring higher returns than federal government bonds due to their slightly higher risk.

How business credit ratings work in Canada and why they're important for income investing

Credit scores for companies are a little different to personal credit scores.There are several credit reporting companies in Canada, such as Equifax, Experian, TransUnion, and Dun & Bradstreet. Each one has a different method for calculating scores.

Scores are typically from 0 to 100, but Equifax, for example, gives three scores: credit risk, business failure and payment index, each with different scales.

Unlike personal credit scores, anyone can check a company's credit score without permission by buying the credit report. A company's credit score is particularly important information if you are considering buying their company bonds. You need to feel confident that the debt will be repaid.

[1] Marc Joffe, "Detroit and the lost history of Canadian municipal insolvencies." Maclean's, July 31, 2013. https://www.macleans.ca/economy/business/detroit-and-the-lost-history-of-canadian-municipal-insolvencies/ (Accessed June 14, 2019).

Corporate bonds

These work in a similar way to government bonds, except the borrowers are private sector corporations. The bonds are backed either by money earned from the company's future operations, their credit worthiness, or by the company's physical assets.

Because companies go bankrupt far more regularly than countries or municipalities, corporate bonds are considered riskier and interest rates are almost always higher than with government bonds. You can minimize this risk by opting for bonds from companies with a high credit rating (or high bond rating).

A company's corporate credit rating is determined by its credit payment history, revenue, capital structure, and earnings. While a triple-A-rated company is considered to be a safe investment, the lower risk is likely to come with lower yields.

If a company does go into bankruptcy, its bondholders get paid first, along with its other creditors. Common shareholders receive residual payments from whatever remains after satisfying the bondholder debt, making bonds to some degree safer than stock issued by the same company.

You can find out about a bond's or bond issuer's creditworthiness from its rating. The chart below shows the different ratings of two primary North American rating agencies.

Bond laddering

A bond ladder is a portfolio of bonds, each with a different maturity date. By using a bond ladder, you can reduce interest rate risk in your portfolio because you have a bond maturing every year or so. This technique also provides greater liquidity, with cash being made available again when each bond matures.

Example:

If rates start to rise, you can invest in the new, higher rate when one of your bonds matures. If rates begin to fall, the bonds within your ladder will maintain your exposure to higher yields than you would have had with simple, one-year renewable investments.

Individual bonds can be purchased directly through Qtrade. An alternative to buying individual bonds is to buy an ETF or a mutual fund of bonds.

Rating

Standard & Poor's	Moody's	Bond grade	Risk level
AAA	Aaa	investment	lowest risk
AA	Aa	investment	very low risk
A	A	investment	low risk
BBB	Baa	investment	medium risk
BB, B	Ba, B	speculative	high risk
CCC/CC/C	Caa	speculative	highest risk
D	Ca, C	speculative	in default

Bond ETFs and mutual funds

If you would like to diversify your bond investments, there is a good range of ETFs and mutual funds that provide exposure to corporate, government and municipal bonds. Some of these are index funds that simply track the returns from established bond indexes. Others are actively managed funds that aim to beat the returns of a stated benchmark. Funds provide more diversification than you're likely to get by directly buying individual bonds, but some of the inherent risks are the same: rising interest rates and other market forces could cause the market value of your funds to drop below what you paid for them.

Real estate

There are several ways you can invest in the real estate market. You could directly buy a property and rent it out, which would give you rental income every month. However, this can be a time-consuming process and cash flow can be impacted if the property lies vacant or unexpected repair bills arise.

Alternatively, you could invest in a REIT: a real estate investment trust. REITs are companies that manage a collection of industrial, commercial and/or residential properties. As an investor in a REIT, you effectively become a part owner of those properties.

In this sense, it is far less risky to own a small share of many properties instead of just one property outright. Any costs, such as vacant units or legal expenses are spread across the whole portfolio of properties and the REIT's other shareholders. The REIT manages everything, so you don't have to worry about late-paying tenants, flooded basements or leaking roofs—you just sit back and watch your monthly or quarterly distributions roll in.

There are also plenty of REIT exchange-traded funds, which allow you to invest in numerous property-owning real estate companies at once. They bring even further diversification and can lower your risk considerably. There are a range of REITs that have delivered attractive dividend yields.

GICs

GICs are similar to savings accounts in that they are very low-risk investments, but they have a couple of key differences. With a GIC, you are effectively agreeing to lend the bank, credit union or other financial institution a specified amount of money, for a set amount of time (from several months up to five years). The longer the term, the higher the interest rate. At the end of the term, you receive your principal plus interest.

A traditional GIC locks your money in for the specified time. If you withdraw it early, you will have to pay a penalty or you may lose all your interest earned to date. Redeemable GICs do offer the flexibility of withdrawing your money early, but their interest rates are considerably lower. While most GICs offer fixed interest rates, some index- or market-linked GICs offer variable rates or rates tied to the performance of the stock market.

GICs are extremely safe investments: the Canada Deposit Insurance Corporation (CDIC) protects its members' customers' deposits of up to $100,000 per issuer (members are Canadian banks and trust companies). Credit unions are insured provincially, with protection on deposits ranging from $100,000 in some provinces to almost unlimited in others.

Preferred shares

Preferred shares, or "preferreds," are a kind of hybrid investment between fixed income and equities. Their share dividends are determined in advance and preferred shareholders have a higher claim on dividends than common shareholders.

Preferreds typically have no maturity date and, unlike most normal shares, usually carry no voting rights. Under regular market conditions, preferred shares tend to have less price volatility. Their yield and price will fluctuate as interest rates change. Other features of a preferred share will also reflect the pricing and yield of the issue, such as a callable date. Due to the regular distribution schedule, this makes them less volatile than common shares.

Some preferreds have a cumulative provision, which means that if any dividends are missed, they have to be paid out before common shareholders receive their payments. This is a big incentive for companies not to miss a dividend payment.

Preferred shares can therefore deliver a higher yield than most other income investing options, while bringing less risk than common shares.

What to look for when assessing returns and risks

One of the biggest risks of an income investing strategy is choosing a very conservative portfolio mix and receiving a yield that won't provide sufficient income. Bond yields have been low in recent years and, if inflation rises dramatically, bond holders could achieve a negative real rate of return. While bonds are often part of an income investing portfolio, it's important to include a healthy amount of higher-yielding assets.

When it comes to dividend-earning stocks, it's recommended to look beyond the dividend yield. If a company is dishing out dividends of 8% but that yield is based on a significant drop in its stock price, there may be fundamental issues with the company that could lead to a dividend cut or even bankruptcy.

Getting punished by success

Stocks that see a significant jump in their trading price, but which do not deliver an equivalent increase in their dividend, will see their current yield fall. Yield-focused investors may therefore want to take their profits and re-deploy the capital into higher-yielding stock.

There are a number of other factors to consider with dividend-earning stocks, which are covered below (see "What you need to look for in dividend stocks").

With REITs, some of the risks involve a hike in mortgage interest rates or declining occupancy rates in a recession. Both off these could reduce the dividend amount or see dividends disappear altogether.

With preferred shares, the lower a company's credit rating, the greater the risk. When considering an ETF or mutual fund of preferred shares, it's important to know how many of the companies represented are investment grade and how many would be considered speculative (and therefore a considerably higher risk).

What you need to look for in dividend stocks

As we mentioned earlier, while dividend yield is an important measure of a dividend stock's worth, it is just one of several criteria that you need to consider.

Dividend yield

This is the expected yearly dividend per share, divided by the current share price and expressed as a percentage. Yield can change if there are fluctuations in the stock price or changes in the dividend amount.

Some investors may for example look for dividend yields exceeding 3%, depending on the sector. If a company is offering dividends of 10% or even 20%, this could be an indicator that the stock price should be looked at, because there may have been a significant decline and the dividend amount has yet to be cut to normalize the yield.

Payout ratio

This is the amount of the company's annual profit that is paid out in dividends. For long-established companies, this can be as much as 50%, with the remaining profit being reinvested into the company.

Very low payout ratios could signal that the company is still growing. Very high payout ratios could suggest that the company is not investing enough in itself, which would in turn lead to reduced dividend payouts. Generally, a payout ratio of less than 50% is considered a safe dividend payout ratio.

Dividend sustainability

This involves choosing companies that consistently pay out dividends or consistently grow their dividend.

Sustainability is key when choosing dividend stocks. Johnson and Johnson (JNJ), for example, has seen over 50 years of dividend growth. Picking stocks that have a long history of maintaining or increasing dividend payouts, even during a recession, is a key strategy.

If you choose a stock based purely on its dividend yield, you could find your dividends being reduced or completely removed. This could have a big impact if you rely on your investment income to pay for your day-to-day expenses.

Return on Equity (ROE)

This is a way of measuring how effectively a company is managing its assets to create profits. It's calculated by dividing the company's net income by its shareholders' equity. If a company can bring high returns on equity with little debt, this usually means it has a solid business.

A high ROE can also provide a bigger cushion so that dividends keep coming in, even during a recession.

Track record

Savvy income investors have special names for the most dependable dividend stocks. "Dividend achievers" are companies that have raised their dividends for at least 10 consecutive years, and "dividend aristocrats," have done so for 25 years or more. You can search for funds that track these companies.

Tax implications and considerations

Moving your current portfolio of stocks over to income-generating assets will have an impact on your tax return, whenever those investments are not held in a tax-sheltered account, such as a registered retirement savings plan (RRSP), tax-free savings account (TFSA) or registered retirement income fund (RRIF).

Revenue from pure GICs and bonds are taxed as income (at your marginal tax rate), so a move to more of these assets will likely have the biggest effect on your tax bill.

Dividend aristocrats: what and who are they?

"Dividend aristocrats" usually refer to stocks that have delivered 25 or more years of consecutive dividend increases. Dividend aristocrats typically outperform their respective index, with less volatility. American aristocrats include AbbVie (ABBV), Walgreens Boots Alliance (WBA) and AT&T (T). Some Canadian aristocrats include Enbridge (ENB), Suncor (SU) and CIBC (CM).

Capital gains have the most favourable tax rate, with only half of the gains being taxable (and you only pay the tax when you sell the stock and realize those gains). Taxpayers who hold Canadian dividend-paying stocks also get a tax break. The dividend tax credit means that dividend income is taxed at a significantly lower rate than revenue from GICs or bonds (the actual amount varies by province).

You will pay a withholding tax on dividends and interest from U.S. and foreign stocks and bonds. There is a tax treaty between the U.S. and Canada that reduces this amount if you submit form W-8BEN. Qtrade accounts automatically receive this tax treaty benefit by virtue of meeting acceptable IRS identity requirements when opening the account. You will then pay a withholding tax of 15% on dividends earned and 10% on interest. Without submitting the form or meeting ID requirements, you would be charged a withholding tax of 30% for both dividends and interest. U.S. investments in RRSPs are exempt from withholding tax.

The risks and downsides of income investing

One of the key risks when moving from growth investing to income investing is having the perception that a specific amount of income will always serve you in the future.

Because we have lived through a long period of low inflation, many people may be unprepared if inflation rises. All of a sudden, investors' money would not go as far as before. It's important to realize that with an income investing strategy, what your financial needs are today may be very different in a few years' time.

In an up-swinging bull market, assets in an income investing portfolio will not grow as much as assets geared towards capital appreciation. However, in a market downturn, income-oriented assets are likely to hold on to their value better than growth-oriented assets.

Why bond market values rise and fall

While your bond's coupon is guaranteed until the maturity date (unless the company or municipality declares bankruptcy) a bond's market value can rise and fall.

If interest rates rise, the **yield on your bond will be lower** than comparable market rates. Investors will immediately bid down the price of your bond until its yield matches the market rate.

If interest rates drop, **the yield on your bond will be higher** than comparable market rates, so investors will bid up the price of your bond until it matches the market rate. Note that prices for longer-term bonds fluctuate more dramatically than shorter-term bonds.

If you hold onto your bonds until maturity, however, you will still **receive the exact face value of the bond**, regardless of how much you paid for it, assuming the company does not default.

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