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4 Reasons Why a High-Dividend Stock Isn't Worth It

When it comes to investing, high-dividend yields don't always equal high success.

By **Debbie Carlson**, Contributor April 18, 2019, at 3:46 p.m.

Higher risk is a major factor to consider when investing in dividend stocks. (GETTY IMAGES)

INVESTORS WHO WANT TO amp up their income with high-dividend-yield stocks should think twice before buying a stock for its attractive payout.

With the 10-year U.S. Treasury note yielding 2.5%, buying a stock with a yield north of 4% looks like a no-brainer for an income investor. But just as in Greek mythology when the sirens lured passing sailors to their deaths by singing irresistible songs, companies with high dividends can be as just as harmful to an investor's portfolio.

That's because not all higher yield stocks are safe.

Here are a few reasons when investors should question the benefits of dividend investing:

- The company may not be doing well.
- The stock may not generate an income stream for shareholders.
- Dividend stocks are riskier than bonds.
- Certain industries may be overrepresented.

The Company May Not Be Doing Well

There may be disconcerting reasons the company is paying a higher rate. Pat O'Hare, chief market analyst for Briefing.com in Chicago, says investors need to ask themselves why there is a high yield.

"Is it because of just the generosity of the company, where they want to pay out a whole lot of their earnings in dividends, or is it because the company's not doing so well," O'Hare says.

Financial sources say not every high-yielding stock is dangerous, but dividend investors need to know what's behind a juicy payout by understanding the company's circumstances, the sector it is in and potential risks.

The Stock May Not Generate an Income Stream

The dividend yield is a component of the stock price. Take the dividends being paid and divide it by the stock price to get the yield, O'Hare says.

"If you have a much lower stock price, then that can lead to a false conclusion on the part of the investor that you're getting a really easy income stream, say 7, 8, 9%," he says. "And usually nothing's so easy on Wall Street, in that respect."

Craig Bolanos, CEO of Wealth Management Group in suburban Chicago, says he defines a high-yield stock as anything molre than 4%. "As soon as there's a yield above 4% we need to look beneath the surface," he says.

When it comes to investing, mature businesses with few future growth catalysts, such as utilities, will pay higher dividends as a way to return money to shareholders and are unlikely to have wild price swings.

"That's what makes utility stocks wonderful, stodgy investments for those who are retired and need cash flow," he says.

These high-dividend payments are the "glue" for their shareholders, O'Hare says, who otherwise might not invest.

Tax structure may also explain why companies offer high yields. Business development companies, real estate investment trusts, known as REITs, and master limited partnerships are another example. These entities have a lower cost of capital because these businesses pay no corporate income tax, but pass the tax on to unit holders.

Dividend-Paying Stocks Can Be Riskier Than Bonds

What makes dividend-paying stocks overall attractive is that academic research shows that over long periods of time, a diversified portfolio of dividend stocks should outperform the broader market, says Chuck Self, chief investment officer at iSectors. Self says his firm's equity strategy has a tilt toward dividend-paying exchange-traded funds, but there's a right way and a wrong way to go about it.

People who are saving for long-term goals need to think about total return, the stock's price and payout ratio, he says. Trouble begins when people only focus on the yield for dividend stocks, considering these assets to be a bond substitute. In fixed-income investments, the yield is the return, but for dividend stocks, the stock price is just as important, which makes dividend stocks riskier than bonds.

O'Hare says equities are subject to both company risk and event risk. A recent example are the troubles of California utility PG&E (ticker: PCG). It filed for bankruptcy after the recent California wildfires and saw its share prices tumble. Although utilities' high dividends are popular among income investors, even these mostly steady companies can get hurt.

"You had an event risk that really just clobbered that stock and probably took away all of the income you had gotten from dividends in a few days," he says.

O'Hare says when researching dividend stocks, investors need to compare a company's dividend to the firm's sector to see if the yield is unusual. The S&P 500 utility sector yield is near 3.5%, so any utility company with a dividend above that level requires a closer look.

Certain Industries May Be Overrepresented

Another problem with seeking out only high-dividend stocks or funds is that an investor's portfolio can become too concentrated, Self says. He pointed to Global X SuperDividend ETF (SDIV). It has a yield of 7.9%, but about 40% of the fund's portfolio is in REITs. Comparatively, the 2019 S&P 500 sector weight for the real estate sector is only 3%.

"You end up concentrating in industries that are really volatile," he says.

Because dividend yields are a component of stock prices, if share values fall because the company is struggling, management needs to make a decision of what to do with the dividend payout because the cash flow might not be there to support the distribution since dividends are paid out of earnings, O'Hare says. The firm may have to cut or suspend its dividend.

He pointed to the energy sector, which saw steep valuation drops when crude oil prices fell a few years ago. Many income investors owned master limited partnerships, which are oil-infrastructure companies. MLPs' share prices fell and many also cut their dividends to stay in business, so investors lost on both ends.

Right now, Bolanos and O'Hare say there's an open question about the sustainability of dividend payments for retail companies, which are facing challenges with the rise of online shopping.

To find the best dividend stocks, look for firms that have low debt loads and a history of growing dividends, experts say. The top dividend stocks "have a nice history – a good track record of steady earnings growth," O'Hare says.