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Five reasons to (still) love dividend stocks

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As crazy as this sounds, not everyone loves dividends as much as I do.

Some people have even suggested that I suffer from a case of DTV – dividend tunnel vision. By focusing on dividend stocks, they say, I miss out on all the fast-growing companies that don't pay a dividend but generate big capital gains.

Others have said that, because dividend stocks are concentrated in a handful of sectors, the strategy can lead to poor diversification. Still others have pointed out that dividend stocks often struggle when interest rates rise.

So, first, let me respond to these critics by saying … I agree with you. To an extent.

As much as I love dividend investing – and I'll outline all the reasons why in a moment – it isn't perfect. Nor is it the only investing strategy that works. Heck, I'm in third place in the Strategy Lab rankings behind the growth and value portfolios, which are obviously doing a lot of things right.

As for the specific criticisms, one oft-cited drawback of owning dividend stocks – which tend to be mature, established companies – is that the odds of hitting a home run are greatly diminished. But that's okay. I'm happy to hit lots of singles and doubles.

It's also true that dividend stocks in Canada tend to be concentrated in sectors such as utilities, pipelines and power generation that are susceptible to rising interest rates. This is also not a deal-breaker for me by any means.

One way to counter concentration and interest-rate risk – and the method I use personally – is to supplement my dividend holdings with diversified exchange-traded funds that provide exposure to cyclical sectors such as resources and industrials. Some investors prefer to use index funds for their entire portfolio, and I have no problem with that.

But for me, the benefits of dividend investing far outweigh the drawbacks. Here are five reasons that dividend stocks are still a great choice for people who want to build wealth over the long run.

Dividends are fun
Fun? Yes, fun. Maybe I'm easily amused, but seeing a dividend land in my account – or, better yet, getting a dividend increase – is more entertaining than a trip to Disney World. I could do it all day long. What's more, every dividend payment and increase acts as a reward for sticking with the strategy. In Psychology 101, it's called "positive reinforcement." And it is one of the key reasons that dividend investors are able to stay committed to the cause over the long run, whether the market goes up, down or sideways.

Dividends are easy to understand
Dividend investing is such a simple concept, even a kid operating a lemonade stand can understand it. As I explained to my daughter last summer: “Say you spend $1 to buy a can of frozen lemonade that brings in $2.50 in sales. You’ll make a profit of $1.50. You can then use $1 of that profit to buy another can of frozen lemonade – that’s called reinvesting in your business – and pay yourself a dividend of 50 cents with what’s left over.” My kids just love it when I talk about dividends!

Dividends are tax-friendly
Thanks to the dividend tax credit, dividends are taxed less heavily than interest or other income. For example, if you live in Ontario and have taxable income of $100,000, the marginal tax rate on eligible dividends is just 25.4 per cent, compared with 43.4 per cent for other income. At lower income levels, the marginal tax rate on dividends can be in the single digits – or even negative. The government won’t send you a cheque for the negative tax, but you can use it to offset your other taxes owing. (To find dividend tax rates in your province, check out taxtips.ca).

Rising dividends combat inflation
With a bond or guaranteed investment certificate, your income is fixed over the life of the security. But with dividend stocks that regularly raise their payouts, your income grows over time. That’s important because inflation would otherwise eat away at your purchasing power. Since I started my Strategy Lab model dividend portfolio in September, 2012, I have received 57 dividend increases and my annual income has grown by 70 per cent, which also reflects the impact of dividend reinvestment and a falling loonie. (For the record, I’m not suggesting people abandon bonds and GICs, which still have a role to play in a diversified portfolio.)

Dividend stocks deliver
According to Ned Davis Research, since 1972 dividend-growing stocks on the S&P 500 posted compound annualized total returns of 9.7 per cent. That compares with 7.1 per cent for stocks that maintained their dividends and 2.2 per cent for those that paid no dividends at all. As the old saying goes, past returns are no guarantee of future performance, but those are not the sorts of numbers I want to bet against.

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