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This dividend strategy can pay off magnificently if you stick with it

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If you are young and manage to invest money each year – perhaps in your tax-free savings account – you can build enduring wealth, wealth that you and your spouse can live on after you have quit working decades hence. You might even have cash left over to give to your children or your favourite charity.

The strategy is simple: Buy dividend growth stocks and hold them for the rest of your life. Don't touch the money. And reinvest the dividends without fail.

As the years roll by, your investments will grow in amounts you might not have thought possible, thanks to the high and rising yield you will earn on your original investment 10, 20 or 30 years from now. This is the magic of dividend growth stocks, equities with an unbroken history of raising dividends, a strong balance sheet and solid long-term growth prospects.

Patrick McHugh, chief investment strategist at Kaspardlov & Associates of Windsor, Ont., is a big proponent of the dividend growth strategy.

"Our take is, find the consistent dividend growers, own them and think of them as a portfolio as opposed to a collection of individual stocks," says Mr. McHugh, who manages Kaspardlov's Predictable Dividend Growth portfolio.

Among his holdings are Atco Ltd., Toronto-Dominion Bank, Canadian Tire Corp. Ltd. and Finning International Inc. To illustrate how yield on cost grows over time, Mr. McHugh dug into research from Morningstar Inc. to show how the stocks have performed since Jan. 23, 2001.

Atco (about $48) is yielding 2.34 per cent. But the annual dividend of $1.14 per share is yielding 10.5 per cent on cost to investors who bought the stock in January of 2001 at $10.83 a share. The other three stocks also have a yield on cost in the double digits to people who bought them 15 years ago.

"I chose these stocks based on their consistent five- and three-year dividend growth rate, a reasonable dividend payout ratio and a solid level of profitability based on the expected return on equity," Mr. McHugh said.

Atco, a global player in modular buildings and services for industry, also owns half of Canadian Utilities Ltd. In January, despite weaker profit, Atco raised its quarterly dividend by 15 per cent. The company has raised its dividend each year for the past 23 years.

In choosing stocks, the outlook for the industry is critical, analysts say. The company's growth prospects should be strong and it should not need to raise more capital.

Atco's stock "got hammered" when oil prices tumbled late in 2014, Mr. McHugh said. "I went back and looked at its history, and it has been increasing its dividend by 13 per cent to 15 per cent for the past

five years," he said. "Wouldn't you want to own it? They've got the money, the balance sheet, the discipline."

Emphasis on 'predictable'

Nicholas Majendie, senior portfolio manager at Scotia Wealth Management in Vancouver, is another long-time fan of dividend growth stocks. He has his eye on some alluring global infrastructure plays, among them Brookfield Infrastructure Partners, Enbridge Inc. and Algonquin Power & Utilities Corp.

In May, his firm launched a new portfolio for high-net-worth clients through Forthbridge Wealth Management that focuses on global infrastructure investments. From interviews with CEOs and CFOs of target companies, Mr. Majendie identified 12 to 15 Canadian companies that are world leaders in the infrastructure sector, from pipelines to roads and rails to telecom.

The prime feature of these companies is their predictable and strongly growing dividends, Mr. Majendie said in an interview. Note the emphasis on predictable. The dividends are predictable because nearly three-quarters of the companies' next five- and 10-year cash flow is either regulated or covered by long-term contracts, the analyst said.

"Canada has a number of very competitive companies that get very good returns on capital invested and also have very good balance sheets," Mr. Majendie said. "Infrastructure spending will be increasingly important to them over the next 10 years, if not longer."

The infrastructure portfolio currently yields 4.5 per cent, but with the growth in dividends, he estimated that five years from now, the dividend yield on cost will be in the range of 6 to 6.5 per cent, and in 10 years, around 8.5 to 9 per cent.

On average, that's a yield of more than 6.5 per cent over the next 10 years, "immensely powerful compared with a 10-year Government of Canada bond yielding around 1 per cent," Mr. Majendie said. "Money at 6.5 per cent doubles in 11 years. That's just from dividends alone, leaving aside [potential] capital gains."

How the money rolls in

To appreciate the value of dividend growth stocks over time, consider your good fortune if you had bought 100 shares of TD at the beginning of 1983, more than 30 years ago, Mr. McHugh says.

Thanks to stock splits, you would have 2,400 shares today. Based on TD's dividend of $2.20 a share, you would be receiving $5,280 a year in dividends. Meanwhile, your cost after stock splits would be about $1.66 a share, or $166 for the 100 shares. TD is trading at about $57 a share.

"This means that every year you are getting back almost 32 times your initial investment," Mr. McHugh says. "So your yield on cost, based on your original investment, is 138 per cent."

The bank has a history of raising its dividend by 10 to 11 per cent a year. If it can keep up that rate of growth, you could expect to double your annual dividends every seven years.

TD isn't the only dividend gem. Consider Enbridge, lauded by the Motley Fool investment letter in March of 2015 – "How to earn a 90 per cent yield ... from Enbridge?" At the time, the stock was yielding 3.2 per cent (it's now 3.87 per cent).

"Given enough time, even an income trickle can transform into a raging river of cash flow," the newsletter says. "Growing payouts also ensure our income stream can keep up with rising prices."

Since 1995, Enbridge had increased its dividend by 644 per cent, the newsletter said. “If you had bought and held the stock over that time, while reinvesting all of your distributions, the yield on your original investment would be 89.5 per cent today.”