4 Dividend Traps To Avoid

High yielding dividend stocks hold great appeal for some investors. The regular payments mean you can earn steady income even if the market goes down, and, in general, companies with high dividends are thought to be comparatively safe. Most are willing to assume that if a company can pay out a significant amount of cash to investors, it must have ample cash stored or be quite profitable.

Unfortunately, the correlation between dividends and cash flow does not always hold true. There are many companies that continue to pay high dividends even as the underlying business does not produce the cash flows to sustain them. These companies can prop up the stock by borrowing money or drawing down stored cash to pay dividends, but eventually the money runs out, they're forced to cut the dividend, and the stock price falls with it.

There are definitely dividend stocks out there we like, but investors need to be careful in this area and make sure they do more research beyond just looking at the yield. Here are four stocks with high dividends that can burn unwary investors.

Welltower Inc. (HCN)

Welltower (formerly Healthcare REIT) last earned positive free cash flow in 2001. In every year since, the increase in invested capital has outweighed operating profit (NOPAT). Despite this cash outflow, HCN has continued to make significant distributions and currently sports a dividend yield of 4.84%.

How is this possible? Simple, the company just keeps selling more shares. Over the past five years, HCN's share count has increased more than 150% as it continues diluting its equity so that it can maintain that high dividend. The whole arrangement is very similar to a Ponzi scheme, where new investors are subsidizing the distributions made to old ones.

If the company was growing rapidly and earning significant returns on its capital, this head fake would not be such a big problem. However, in the past fiscal year HCN earned a return on invested capital (ROIC) of just 4%. All that money being raised from new investors is not earning a large enough return to support the dividend, which means that when the company stops attracting new investors it's going to have to cut back distributions.

TAL International Group (TAL)

TAL International, which leases intermodal freight containers, has unbelievably good-looking metrics. It sports a dividend yield of nearly 17% and has a P/E below 5. As always, when something looks too good to be true, it probably isn't true. A closer look shows that TAL's impressive-looking metrics don't hold up under proper scrutiny.

First, the company's business has been in decline over the past few years, as its ROIC has fallen from 8% in 2011 to 5% last year. With increasing competition and falling steel prices, TAL's business has experienced significant pricing pressure, which only intensifies as margins narrow and operating profit declines.

On the cash flow side, TAL has earned negative free cash flow in nine of the past 10 years. It continues to fund its extremely high dividend by borrowing money and racking up $3.2 billion in debt (475% of market cap) in the process. The stock has been in free-fall this year and is down over 60% so far. Investors should stay away and not be seduced by the high dividend yield and low PE.

American Campus Communities (ACC)

ACC has a bottom-quintile ROIC of 3%, and that's not just the effect of a down year. Since 2007, ACC has topped out at a max ROIC of just 4%. It'll have to earn a better return if it's going to sustain a 4.23% dividend yield.

With negative free cash flow for five straight years (cumulative -$3.1 billion) and $2.8 billion in total debt (66% of market cap), ACC continues to depend on cheap credit to fund its expansion plans and dividend. If interest rates start to rise, it's going to become much more difficult for this company to raise debt at a sustainable rate, especially given its low return on invested capital.

ALLETE Inc. (ALE)

ALE is a utility that provides mostly coal-generated power to customers throughout the upper Midwest. Dependence on coal-fired power plants is a major long-term question given increasing environmental regulations. Another red flag is the fact that 54% of the company's sales come from industrial customers, mostly large miners that are currently struggling due to weak commodity prices.

These issues wouldn't be of such significant concern if ALE weren't already delivering consistently poor results. ROIC has not topped 5% since before the recession and free cash flow has been negative for the past nine years (-$1.9 billion cumulatively). Again, the funds for ALE's 4% dividend yield come almost entirely from long-term debt (total debt is $1.6 billion or 65% or market cap), which has been growing at a significantly faster pace than NOPAT for the past decade.

ALE, like the other companies on this list, could continue to pay out its dividend for a time. For the long-term investor, though, the writing's on the wall. The underlying economics of their businesses are simply not strong enough to sustain the high dividends they pay. Trying to chase that yield could leave you holding the bag once dividends get cut and share prices fall.

Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

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