



STOCK DIVIDENDS AS RETIREMENT INCOME

“TO HELL WITH BONDS!”

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Al did not mince words about what scared him and Helen, during our first discovery meeting. After long careers spent building and blowing up rockets, Al and Helen were ready to relax, yet they were frustrated with their investment options. Al said, “I can’t get enough income from bonds, and stocks are scary. I need someone to talk to.”

In the wake of the financial crisis of 2008, Certified Financial Planner practitioners and investors alike worry that their stock investments are too risky and their fixed-income (bonds or otherwise) investments pay too little. Many retirees are in a similar situation as the rocket scientists, Helen and Al. They don’t know where to turn.

What follows is a basic retirement income plan for Al and Helen. We will look at a traditional approach to an asset allocation. Then we discuss a simple two-bucket approach. Along the way, we’ll tip our hats to today’s research being done by our CFP colleagues.

Traditional asset allocation

The traditional approach to asset allocation divides the larger half of a retiree’s investments into stocks, maybe 60%, and the remainder into bonds. This 60/40 approach worked well, back when bonds paid 6% and stocks paid 10%. Al and Helen could expect a diversified portfolio to deliver something in between. If inflation averaged less than 4%, this portfolio’s real return was north of 4%. Using a withdrawal rate of 4%, Al and Helen could have reasonably assumed their money would outlive them.

Today, stocks’ long-term average returns are still 10%, even after the crisis, over very long periods of time (30 years or more). However, the long-term average returns of bonds are dramatically lower. Some research says that 0% is the normal rate for the Federal Reserve Interbank lending rate. Other researchers believe that interest rates are bound to rise, but when? Rates remain persistently low.

Persistently low interest rates put serious pressure on a retiree’s living income.

Adding to that pressure, the rules relating to safe withdrawal rates are changing for the worse. An increasing body of evidence suggests that retirees should increase their stock allocations in response. Research done by Michael Kitces and Wade Pfau promotes a rising equity glide path: Instead of reducing stocks in retirement, increase that allocation with age. This, and other research, has caused a lot of thinking, and rethinking, among professional financial planners regarding the future of income for our retirees.

The longer interest rates stay low, the lower our withdrawal rates must be so that retirees do not run out of money.

Fixed income is not what it used to be

Bonds pay back the investor’s every dollar upon maturity and provide regular income until that date. Bonds trade money for time. For the assurance of receiving our initial investment in the future, bonds offer a steady income. Bond funds

diversify investors' risk across a large number of companies. Buying bonds and bond funds today presents three big risks, however.

First, today's bonds and bond funds don't pay much income. In 1996, a millionaire received \$64,400 in annual income for his \$1 million in 10 Year U.S. Treasuries. A \$1 million investor today receives only \$17,800 of annual income. A U.S. Treasury today pays one fourth of what it paid 20 years ago.

The second risk is inflation. Inflation's long-term average is greater than 3%. Even a modest inflation rate feels worse for a retiree than for a person still in her working years. Over the past 20 years, even this modest inflation rate has reduced our purchasing power by one-third; it takes \$153 to buy what \$100 bought in 1996. During the same time, Treasury yields have been cut by three-fourths.

As time goes by, bond investors lose purchasing power. That \$64,000 income from 1996 has the same purchasing power as \$40,000 today. What will \$17,800 purchase in 20 years? This bond dog won't hunt.

The third risk is the one everyone talks about, when we talk about the Federal Reserve: Interest rates are going to rise someday. As interest rates rise, bond and bond fund prices are pushed down. Investors like Al and Helen want bond funds that pay high interest rates, but they are leery of holding the bond funds during the run-up, or they will see their principal decrease. Someday they will have a reinvestment opportunity to buy bonds with reasonable yields. But when?

Retirees like Al and Helen are backed into a corner. They have to buy investments that provide income and an opportunity to grow, even if the investments are riskier than they prefer. Many Americans have not saved enough for retirement to live off the meager withdrawal rates provided by today's bonds. Like Al and Helen, these retirees must invest in stocks.

Dividend-paying stocks

Many stocks pay dividends to their investors. Usually quarterly, perhaps every six months, the investment sends cash to the investor's account. These dividends may be reinvested in the issuing stock, used to purchase other stocks, or sent to the investor's checking account.

Dividend-paying stocks are subject to stock market volatility, but research shows that stocks that increase their dividends are well-suited for retirement accounts. Rob Arnott's research shows that dividend stocks both grow—appreciate in value—faster and have less volatility than other stocks. Thomas Howard, Ph.D., at Athena Invest, finds that income from dividend-paying stocks may be sustainable at rates as high as 6% per year, for the duration of a couple's retirement. That sounds like a retirement plan worth investigating.

So what will Al and Helen do? Divide and conquer. For Al and Helen, we create two portfolios, one short-term money bucket and one long-term money bucket.

The safe money in a two-bucket strategy

Al and Helen make sure they can pay for their immediate and near-term expenses by creating a safe-money, short-term bucket. Together, we sum all of the money they will spend in the next two years. We account for medical emergencies. We acquire the correct amount of insurance, including long-term care insurance. We put all this money in time-certain investments.

What is a time-certain investment?

One example of a time-certain investment is a checking account. Another might be short-term government bonds held to maturity. Another example might be a certificate of deposit (CD). The rate of return on the short term bucket is going to be very low, close to zero.

The purpose of the safe bucket of time-certain money is not to make money. Instead, it provides for Al and Helen's short-term expenses. Having safe money also protects against the inevitable roller coaster ride of their long-term money.

The long-term money bucket

For the second bucket, Al and Helen invest in a diverse pool of dividend-paying stocks. We start their income at, or lower than, their dividend yield. If they invest \$1 million in stocks with a 5% dividend yield, then they have an annual income of \$50,000, before taxes. If they pull out less than that, they have a buffer, which they can reinvest. A lower withdrawal rate allows more of their money to compound every year.

Al and Helen pull their income from bucket No. 1. As dividends are paid into bucket No. 2, we move cash into bucket No. 1.

The risks of the second bucket are the dips and dives of the stock market. To assure that Al and Helen are not selling their stocks, and only pulling out the income, we put 24 months of dividend income in bucket No. 1. Let's look closely at the math.

2008 all over again

The math shows that Helen and Al need to put at least one year, preferably two years, of annual expenses into cash to meet their financial needs during dramatic declines, like 2008.

2008 was the worst stock market decline in 75 years. During that time, stock prices were briefly cut in half. S&P 500 companies reduced their dividends by about 25%. A person living off this plan would have experienced about a 25% income cut for as long as four years. Companies started raising their dividends two years after the crash, but for some companies, dividends remained lower than their prior peak for four years.

This two-bucket plan would have helped Al and Helen navigate that period of time successfully. The cumulative cost of losing 25% for two years is six months of income. With 12 months in income in cash, our friends could ride through four years of reduced dividend income, and the worst stock market crash of our lifetimes.

Tucking away one year of living expenses provides for the worst case. Tucking away two years of income provides liquidity for life events outside of the stock market. More than likely, dividends are not drawn down as much or as for long as the once-in-a-lifetime events of 2008.

The two-bucket plan, simple as it seems, appears to give Al and Helen their cake and let them eat it too.

Risks of dividend stocks

Many investors struggle with sticking to a retirement income plan based off dividend-paying stocks for several reasons.

Stock prices dip and dive with the stock markets. Short-term loss of principal is the No.1 reason people fear the stock market. Clearly, stocks fall and bounce, down and up. If Al and Helen do not keep enough money in cash to supplement the income they might lose with a dividend cut, then they may have to sell stocks, either because they feel anxiety or because they need to pay their expenses. The outcome, either way, is selling low. A bad idea. Bucket No. 1, the emergency money, is their solution. Draw down the safe money in the down times to keep the stocks invested, allowing enough time for prices to recover.

Stock prices move all around, but over history, stock dividends are steady. Dividend income is much more stable than many people realize. Companies may reduce or discontinue their dividends, but research shows that this happens only 4% of the time. In fact, dividends increase 60% of the time. In other words, the simple two-bucket plan provides a 60% chance of a pay raise. If Al and Helen stay within their budgets, they have a 96% chance that today's income will outlive them. Furthermore, over long periods of time, stocks appreciate, and their legacy may continue to grow.

Concentration and its opposite, over-diversification, are risks for dividend income investors. Chasing dividend-paying stocks can be dangerous. Often the highest dividend-payers are companies under duress; their stock prices have been beaten down for a reason. Dividends may be cut. One potential solution is diversification with mutual funds, ETFs, and/or owning at least 11 stocks. At our firm, we usually hold around 20 positions in stocks, funds or ETFs. Too many holdings—or owning funds that hold hundreds of stocks—reduces dividends and total return. We call that global mush: an overly diverse, complex mess.

The largest risk is behavioral. Stock dividends are stable, falling only 4% of the time. Stock prices can make large, nauseating swings. The riskiness of a strategy that depends upon dividends as retirement income is that Al and Helen may act on panic

and sell out. To make this work, they have to change their perspective and look at the portfolio as an income source, not a lump sum of money. If Al and Helen can ignore the principal, they have a 96% chance of success. The larger their safe/secure bucket, the larger their buffer, and the lower the emotional risk.

Increasing income faster than inflation

Historically, dividends are an inflation-busting, growing source of income.

Over the years, dividend-paying companies increase their dividends at rates that are faster than the inflation rate. The long-term average rate of dividend growth is 6% per year. Inflation, over long periods of time, has averaged between 3% and 4%. The dividend-income investor who can overcome all the risks above will likely look back, after many years of pay raises, with great pride.

Again, the greatest risk of following a dividend-income portfolio is emotional. Dividend-paying stocks often have less volatility than the overall market. Sometimes their total return is better than the market, sometimes worse. But the price the dividend-income investor pays is that the principal value is largely outside of their control. While dividend income is steady—and the safety bucket assures that their retirement expenses will be paid, even in the hard times—the preponderance of news about the stock market is, and will continue to be, scary. Al's and Helen's inclination to check their portfolio value, and to act on that panic, is the greatest threat to their success.

For a diverse stock portfolio, declines are temporary and the rise is permanent. For an inexperienced investor, the bad feelings are often permanent and the good feelings are usually temporary.

Al and Helen decide to look at their stock portfolio as an income portfolio first, and a capital appreciation vehicle second. They have a better chance at overcoming misperceptions with perspective. Stock prices, over long periods of time, increase. Declines are temporary. Dividends are persistent.

Conclusion

The best investment portfolio is the one in alignment with your long-term values, goals and relationships. Most Americans have not accumulated a portfolio large enough to live off the income provided by bonds, and require an income that keeps pace with inflation. Over our lifetimes, stocks can potentially provide price appreciation and growing dividends. The greatest risk to using dividends as retirement income is emotional; if we can avoid acting on our panic, we have a very good chance of our money successfully outliving us instead of the other way around. Demographics may push investors into dividend paying stocks and support even higher long-term stock prices as well.

As Al says, "It's not rocket surgery."

Resources

- C. Thomas Howard, Growing Income and Wealth with High-Dividend Equities, Sept. 9, 2014
- Rob Arnott, Dividends and the Three Dwarfs, Financial Analysts Journal, 2003
- Historical rates for 10 Year Treasuries: Stockcharts.com
- Wade D. Pfau, and Michael E. Kitces, Reducing Retirement Risk with a Rising Equity Glide Path, Journal of Financial Planning

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