High Dividend Stocks in Retirement Strategies

By Steven Holt Abernathy

Steve Holt Abernathy discusses the value of considering company dividends in the evaluation of company management and personal investment decisions.

Advisors I manage money for tell me one of the toughest aspects of retirement planning is overcoming client resistance to adequately balanced asset allocation. Fearful of eroding their capital and outliving their assets, retirees tend to overload their portfolios with fixed income products, Monte Carlo simulations and similar analytic tools notwithstanding.

As we know, retirement portfolios top-heavy with fixed income investments run the very real risk of buying power erosion due to inflationary pressures. As retirees live longer and through more economic cycles, inflation becomes an ever-larger concern imperiling principal and income streams alike. So the conundrum for advisors becomes how to convince retirees to allocate an appropriate portion of their portfolio to equities without the anxiety associated with day-to-day stock market fluctuations.

One solution lies in finding equities that display investment traits satisfying both income requirements and risk parameters. The stocks should:

- Contribute a reliable income stream;
- Provide opportunities for appreciation that offset inflation and sustain buying power needed for lifestyle maintenance, and;
- Display less than market volatility.

From an advisory perspective, issues meeting these criteria would make planning easier and more accurate.

Steven Holt Abernathy is principal and portfolio manager of The Abernathy Group in New York, NY. The firm specializes in asset protection and wealth management. For information on dividend and income strategies, contact Mr. Scarfo at 800-342-0956, info@abbygroup.com or at www.abernathyfinancial.com.

Historical Confirmation

In searching for these characteristics, consider that since 1900, almost two-thirds of total equity returns have been delivered from dividends. Of the 9 percent in approximate annual return, almost 6 percent has come from dividends. As a percentage of total equity yields, however, dividends have steadily declined through the decades, falling from over 5 percent to below 2 percent currently, an historic low.

Writing in BUSINESS ECONOMICS, Henry Townsend comments, "…over the 107 years 1872 through 1978, total return was due to two sources, earnings growth and reinvested dividends; the contribution of PE growth to total return was a negative factor, minus 0.4 points a year. But the great market rise beginning in 1979 was due not only to strong earnings growth, more than double the historical norm through 1978, but also to a great change in investors' perceptions of the stock market. At year-end 1978, the PE was 7.8; by year-end 1999 it was 30.5. Investors in 1999 were willing to pay four times as much as in 1978 for a dollar of earnings. PE growth, which contributed less than nothing to total return over the whole pre-boom period 1872-1978, has made up 48 percent of total return thereafter. The year-end dividend yield fell from 5.3 percent in 1978 to 1.1 percent in 1999. From 1979 through 1999, reinvested dividends made up only 20 percent of total return rather than the pre-boom average of 63 percent."[1]

Danger of Speculation

Today, speculation fuels most stock appreciation. Most people in the market think they are inves-

©2007 S.H. Abernathy

CCH a Wolters Kluwer business

tors, but they are not; they are guessing the future. Someone searching for a stock selling at 25 that will be worth 30 next week is not an investor but a speculator.

For retirees, the most important investment considerations are (A) not losing money, and (B) generating sufficient income/appreciation on capital to maintain their lifestyle. It is the earnings generated by their investable assets that allow retirees to sustain their lifestyle. If their assets are lost or diminished, their lifestyle will disappear. Given the choice of a government bond or a stock in a company with whom they are not familiar, they will logically choose the bond.

Prior to 1956, stock dividends always yielded more than bonds. That is as it should be, since stocks are innately riskier than bonds. A company's common stock is not obligated to pay its dividend. A company's bond, on the other hand, is a contractual obligation. The company either pays it or declares bankruptcy. When in 1956, stocks paid less than bonds for the first time, it marked an event of immense importance and consequences. It was the spark that ignited the fires of speculation. Investors began to think differently, to regard stocks as safer than they actually were. They stopped worrying about companies going bankrupt, about the possibility of losing their investment. Instead, they began to focus almost exclusively on stocks' potential for growth through capital appreciation.

Someone searching for a stock selling at 25 that will be worth 30 next week is not an investor but a speculator.

CCH a Wolters Kluwer business

In the years after WWII leading up to the mid-fifties, investors had grown accustomed to seeing their stocks not only pay dividends, but also generate substantial appreciation. They came to believe that stocks were not as risky as once thought. About two-thirds of the time, the combination of stock dividends and appreciation outperformed high-rated fixed-income investments. Investors rationalized, "I am getting 5 percent return on my bonds and 6 percent on my stocks, but I am also getting another 3 or 4 percent growth on my stocks. Add up the 4 percent and 6 percent and stocks are paying double what bonds are paying. Maybe I should shift 80 or 90 percent into stocks; why not? Why not get 10 percent on all my money? I will put it all into stocks. I have two ways to earn money instead of one."

As more and more investors reached that conclusion and moved into equities, it drove stock prices up, reducing their dividend yields. Higher valuations meant stocks were not paying those juicy 6 percent dividends anymore; they were paying less. Some had their dividends cut in half or more. As a result, investors had to rely on even greater stock appreciation to get them to that magic 10 percent return. They now needed their stocks to grow at 6 or 7 or even 8 percent annually to make up for the diminished dividends and maintain a premium over bonds.

This was no longer stock investing, it was becoming speculation. While bond yields moved upward slightly in response, equity prices had been bid up to such ridiculous heights that stocks once selling at 20 and paying a one dollar dividend (5 percent annual yield) were now selling at 50 but still paying the same one dollar dividend, yielding just 2 percent. Those fat dividends have rarely returned. There have been periods since when stock dividends yielded more than bonds, particularly during the huge bear market in the early seventies. But the stock yields inevitably retreated.

Dividend Alternative

In his newsletter, eminent investor John Bogle writes, "We know that the present dividend yield is slightly less than 2 percent. While we don't know what future earnings growth will be, let's assume that the past trend of about 6 percent growth per year will continue. Result: reasonable expectations suggest an annual investment return of about 8 percent in the coming decade, or about 2 ½ points less than the earlier decades—all accounted for by the simple fact that the initial dividend yield is 2 ½ points less."[2]

Today, companies that pay above-average dividends tend to be solid businesses with competent management and the continuing ability to withstand economic and competitive challenges. These are the stocks that should form the bedrock of retirement portfolios designed to avoid destructive losses. Joseph McKittrick writes in SFO Magazine, "Dividend-paying stocks are more stable than alternatives and, in many cases, they exhibit warning indicators prior to problems. During a bull market, the saying 'a rising tide lifts all boats' certainly has

proven to be true. There also is a saying that it is never a bad time to own and hold quality. This becomes especially true when you are regularly paid cash in the process."[3] To paraphrase one of the most respected investors and financial authors of the last century, John Williams, if you are counting on anything other than dividends for investment returns, you are speculating.

Double-Barreled Benefit

There is ample evidence to support the contention that companies paying out a higher portion of their cash flow or after-tax earnings tend to appreciate more than companies that do not pay out dividends. In their landmark article for the Association of Investment Management & Research (AIMR) titled, "Surprise! Higher Dividends = Higher earnings Growth," Robert Arnott and Clifford Asness say …"the relationship of current payout to future earnings growth is strongly positive." In the article's summary, based on their empirical evidence, the authors conclude:

"We did not start out trying to forecast gloom and doom. We started out by looking at the optimists' assertion that today's low payout ratios are a strong positive signal for future growth. Unfortunately, this view is emphatically inconsistent with the historical evidence. Unlike optimistic new-paradigm advocates, we found that low payout ratios (high retention rates) historically precede low earnings growth."[4]

The subtle benefit implied in this research, and a critical fact most investors fail to realize, is that dividend-paying stocks not only provide more income, but if chosen correctly, produce greater appreciation. In addition, the prices of dividend stocks are less volatile and less risky, so retirees are less likely to suffer losses to their irreplaceable investment capital.

Every company runs into bad news at one time or another. Paying consistent dividends helps cushion the impact on the stock price. Suppose ABC Company's stock is $100 and paying a 4 percent dividend. A new product launch goes poorly, causing the stock to drop to $80. The $4 dividend remains the same, however, and is now a 6.25 percent dividend because of lower stock price. At some point, no mater how bad the news, the stock will level off because every drop increases the dividend ratio, making the stock more appealing to investors. When 10 year bonds are paying 5 percent and the income is taxed at normal rates, a stock with a 4 or 5 percent dividend taxed at 15 percent offers a huge advantage.

Fostering Management Accountability

Corporate managers are notoriously poor managers of capital. Rather than trust them not to do something dumb with the company's profits, shareholders should insist the company distribute the money it earns each year in the form of dividends or a stock repurchases, which achieves the same effect, typically in a more tax efficient manner. This way, retirees get their vital earnings distribution each year and can decide whether to reinvest or do something else with their money the following year. Forcing companies to pay dividends each year not only makes their stock more attractive by paying current income and providing greater flexibility for investors; it also benefits the corporate management team, albeit by default rather than intention.

Management tends to view retained earnings as their own money. The money is just sitting there on the balance sheets with easy access and no cost: "free money" if you will. But it is not free. And it is not theirs. It belongs to the shareholders; it just has not been distributed. Management can easily rationalize spending the money on new equipment, opening new markets, buying another business or a host of other exciting projects that will ostensibly increase sales and further entrench the corporate management team. Higher sales volume makes management look good and since they believe the money is not costing them anything, analysis of whether the new expenditures will generate an acceptable rate of return gets short shrift. The shareholders, to whom that money rightly belongs, are rarely consulted.

If, however, management is *forced* to dividend that money back to shareholders or use it to buy back stock, they no longer have access to it. If they want money for a new project, they are now compelled to borrow it or issue debt, which means they must first determine whether the project will justify the cost of the debt. If the venture only promises to return 4 percent on the capital required for the business, and the cost of money is 6 percent, the project is unlikely to be funded. And that is a good thing. If the money had been sitting on the balance sheet, chances are the project would have gone forward because the consequences of a paltry 4 percent return are much less when management perceives the funding to be free money! Earning a 4 percent return on a weighted average cost of capital of 6 percent destroys value every day. When management is made to understand

CCH a Wolters Kluwer business

that there is an interest rate attached to the money it takes to enter a new business, they are reminded that they are literally destroying value, even when sales increase.

Management may sulk over not being able to launch their new enterprise, but the shareholders do not get hurt by having to foot the bill for management follies. The ironic aspect of this is the dividend policy forced management to face the fact that there is a cost to the money they are using. That makes them more accountable and better managers. It is a win for shareholders and a win for management.

If they make good decisions and the company continues to generate an acceptable return, investors are likely to reinvest their dividends and the firm will attract new investors. Why would anyone remove their money from a business earning 10 percent to put it into a money market earning 5 percent?

The Optimism Factor

Another important point: Companies do not pay dividends unless they are optimistic and secure about their future. Management will always put on a happy face, but companies that pay high dividends back up their rhetoric. As they say, actions speak louder than words.

In their AIMR article, Arnott and Asness conclude, "We found that the empirical facts conform to a world in which managers possess private information that causes them to pay out a large share of earnings when they are optimistic that dividend cuts will not be necessary and to pay out a small share when they are pessimistic, perhaps so that they can be confident of maintaining the dividend payouts. Alternatively, the facts also fit a world in which low payout ratios lead to, or come with, inefficient empire building and the funding of less-than-ideal projects and investments, leading to poor subsequent growth, whereas high payout ratios lead to more carefully chosen projects."[5]

The authors are being quite diplomatic here. The unspoken message, with which I concur, is that executives may be adept at running a business but they are not good asset allocators or stewards of money. It burns a hole in their pocket; they feel obliged to spend it lest their shareholders take it away from them. They have the wrong attitude. However, after sitting on several boards and having listened to the discourse between management and directors, I can tell you this is what happens. "We have all this cash; what are we doing with it? We better get on this fast and find something to do with it because if we don't the shareholders are going to ask for it back…or we are going to be acquired, and then we will all lose our jobs." Typically, management does not think the way shareholders do because they do not own enough stock as a percentage of their net worth to know how shareholders feel. If we, as shareholders, mandated that management own and receive stock, not cash, as a salary and bonus, they would think differently.

Planning Made Easier

High dividend stocks also facilitate retirement planning simulations. Many retirees hesitate to choose an asset allocation that maximizes their chance of achieving successful retirement income for life. Dividend stocks, with their lower volatility, can help advisors ease clients into higher equity ratio asset allocations, increasing retiree chances for not outliving their assets.

Then too, basing retirement planning choices on a Monte Carlo simulation can have unintended negative consequences if the common stock portion of the portfolio relies on appreciation without current income. Here you are really rolling the dice. Between now and the time any meaningful appreciation occurs, there could be an international political uprising, a confrontation with a global power, a stateside terrorist act, the real estate downturn or other events that could trigger a depressed economy. There are any number of events that could occur with erosive effects on stock appreciation assumptions. In addition, companies are sued, markets evaporate, competitors seize market share, CEOs step down, vital management members defect. These are all potential events that can eviscerate portfolio return. Granted they can occur anytime and to any company, but companies with a history of paying dividends are providing their shareholders with a current income stream that helps offset any deleterious effects.

From the brilliant investor John Barre Williams in 1938: "An investor holds a stock or bond. The more important are the dividends or coupons while he owns it and the less important is the price when he sells it. In the extreme case where the security is held by the same family for generations, a practice by no means uncommon, the selling price in the end is a minor matter. For this reason we shall define an investor as a buyer interested in dividends or coupons

CCH a Wolters Kluwer business

and principal, and a speculator as a buyer interested in the resale price."[6]

Seventy years later, the message remains true and I doubt it can be expressed any more clearly.

Dividend/Appreciation Link

Interest rates and inflation are the biggest enemies of retirees. Investors who overload their portfolio with bonds and fixed income instruments believe they are safely allocating assets. What they are actually doing is guaranteeing they are not going to keep up with long-term inflation, much less generate any real returns. Bond interest rates are static, unvarying. A dividend from a well-chosen company will grow as the company grows. Some companies increase dividends by 5, 10, even 20 percent per year. As advisors, we counsel clients on the power of compounding interest over time; sometimes we forget just how potent it can be. A dividend that compounds for 6 years at 20 percent a year triples in size.

Let us say you bought the stock at $10 with a 4 percent dividend yielding 40 cents per year, and it compounded at 20 percent annually for 6 years, not uncommon for well-chosen stocks. After 6 years, that dividend is 12 percent. So even if the price of the stock has not risen in value, you now own an investment that's paying 12 percent annually at a 15 percent tax rate or 10.2 percent after taxes.

One of two things is going to happen to your investment: Either it will appreciate in value to keep the dividend at 3 to4 percent, or you will own one of the very few stocks that currently pays a 12 percent dividend. In other words, you will either enjoy some significant appreciation or some significant dividends—or more likely, some of both.

Investors who buy stocks that pay no dividends must hope for some exciting news to emerge every six months or so in order to buoy the price of that stock. Without any good news or hot rumors, the stock will depreciate. If there really is some good news to report, why isn't the company paying a dividend? If there is no good news, why should investors hang on to a stock destined to lose value? There is no reason, other than the faint hope that something will happen to boost value. Once again, that is not investment, that is speculation. For retirees, well-chosen companies paying dividends are an infinitely more conservative and safer equity investment than companies not paying dividends.

Not the Golden Goose

With all the advantages dividend-paying stocks offer for retirement planning and portfolio asset allocation, there is a downside, as there is to any investment or financial strategy. The potential downside to owning stocks purely for their dividends involves increases in tax rates on dividends or interest rate hikes. Increases in tax rates on dividends will lower the after tax value to investors. The changes in tax law, enacted in 2003 and implemented in 2004, reduced the taxes on dividend income from the "normal income tax" rate to 15 percent. This tax reduction significantly increased the attractiveness of dividends to all taxable investors. There is talk of increasing the tax rate on dividends in 2010 back to the old tax rates based on current income tax categories. Were this to happen, it would have a negative effect on dividend paying stocks. The potential downside to owning stocks purely for their dividends is if taxes or interest rates rise dramatically, that portion of the investor base is likely to be hurt more than some others. It may be temporary pain, but advisors and investors should be aware of the possibility.

Today, companies that pay above-average dividends tend to be solid businesses with competent management and the continuing ability to withstand economic and competitive challenges. These are the stocks that should form the bedrock of retirement portfolios designed to avoid destructive losses.

Just as bondholders see the value of their holdings temporarily drop when interest rates rise, investors holding dividend-paying stocks will experience a similar interim loss in value. A 10-year bond paying 5 percent interest will be worth 10 to 20 percent less if interest rates go up to 6 percent. Held to maturity, the bond will pay its par value of course. Similarly, a utility company paying a 5 percent dividend in the same environment will see investors looking elsewhere for that increased yield until interest rates recede.

CCH® a Wolters Kluwer business

Obviously, higher tax rates on dividends will affect dividend payers more than non-dividend payers in the short term. Similarly, higher interest rates will affect dividend stocks more than non-dividend stocks. But a compensation for investors holding dividend stocks is that in the long run, they tend to perform better than non-dividend paying stocks because they represent better managed companies. When rates rise, virtually all financial assets, fixed income and equities alike, are worth less. However, an increasing dividend stock is comparable to a bond with an increasing coupon. Of course, there is no such animal.

Summary

Historically, dividends represent the only reliable return on equity investments. Any anticipation of stock appreciation is a speculative exercise, one that has frequently proven imprudent. Companies that pay high dividends tend to be have better, more optimistic management. Their stocks are more attractive to retirees because of the current income at tax-advantaged rates, and their ability to cushion bad news, which occurs during the life of any company. Stocks with consistent rising dividends tend to appreciate more as dividend increases make them increasingly attractive.

Paying dividends (or repurchasing stock) versus retaining earnings makes management teams more accountable and helps avoid empire-building, which is counterproductive for shareholders.

The bottom line is there are no investment strategies that work in all market environments. The best that advisors can do for their clients is to find a sensible strategy that controls risks so that little capital is lost when mistakes are made; a strategy that works in most stock market scenarios.

Since 1996, companies that paid out at least 25 percent of their net income in dividends delivered total shareholder returns *in excess of 400 percent* versus approximately 120 percent for the S&P 500, three times the return of the S&P 500. Dividend paying stocks were also less risky than the S&P 500 and less volatile.

Chart 1 Dividend Paying Stocks

	25% Payout Ratio	35% Payout Ratio	45% Payout Ratio	S&P 500
Total Return	412%	431%	542%	120%
Average Return	18.6%	19.0%	21.4%	9.8%
Median Return	19.4%	21.2%	23.8%	13.0%
Highest Return Year	44.9%	39.2%	43.9%	33.5%
Lowest Return Year	-5.7%	-5.6%	-5.9%	-21.6%
% of Years Up	90%	90%	90%	70%
% of Years Down	10%	10%	10%	30%
Price to Book	3.23	2.84	2.16	2.85
Beta	0.91	0.89	0.87	1.05

Advisors pursuing investment strategies with higher returns, less risk and less volatility for their clients should seek quality companies that consistently pay high dividends.

ENDNOTES

1 Harry Townsend, *The Expected Rate of Return for Equities,* Business Economics, Oct 2003.

2 J Bogle, VANGUARD GROUP NEWSLETTER, February 2, 2005.

3 J McKittrick, *Getting Back to Basics: Dividend Investing*, SFO Stocks, Futures and Options Magazine, September 2006.

4 Robert Arnott and Clifford Asness, *Surprise! Higher Dividends = Higher Earnings Growth,* Association for Investment Management and Research (AIMR), Jan. –Feb. 2003.

5 *Id.*

6 JOHN BARRE WILLIAMS, THE THEORY OF INVESTMENT VALUE, 1938.

This article is reprinted with the publisher's permission from the JOURNAL OF RETIREMENT PLANNING, a bi-monthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher's permission is prohibited. To subscribe to the JOURNAL OF RETIREMENT PLANNING or other CCH Journals please call 800-449-8114 or visit www.CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH.