

# Income Investing for Retirement: The High Road of Growing Cash Flow Returns with Dividend Stocks

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September 2017

# Retirement Income Strategy

- Most investors have a significant percentage of their fixed retirement costs in fixed income products:
  - Social Security, Pension payments, bonds and fixed annuities
- Low yield on bonds and other fixed income investments have altered traditional view of asset allocation into more variable income products:
  - E.g. Dividend stocks or funds, Variable annuities, Charitable trusts, Real Estate Investment Trusts and others
- Emphasis today will be on how to potentially increase yield in a retirement portfolio

# Ways You Might Increase Cash Flow from Retirement Assets

- Take potentially more risk with Bonds
  - Lower credit quality
  - Leverage
  - Extend maturity
- Possibility to convert lower yield assets into higher yield assets

# Convert Lower Yield Assets Into Potentially Higher Yield Assets

- Potential candidates for conversion:
  - Bonds or CD's paying 1-2 percent
  - Low cash flow yielding assets: farmland, raw land, equity in home
- Alternative investments to consider:
  - Annuities
  - Charitable contributions
  - Dividend stocks

# Other sources of retirement income beyond Social Security and Pensions

**Bonds**: Pay cash upfront and received a fixed amount of interest as cash flow for term of bond

- Period of time
  - Various maturities
- Payments are fixed
  - Leverage can increase yield
- Other features
  - Repayment at maturity of face value
  - Risk of borrower and maturity determine yield
- Negative factors
  - Lack of escalation reduces inflation adjusted return

# Other sources of retirement income

**Annuities**: Pay cash upfront and receive payments over specified period of time

- Period of time
  - Immediate cash flow
  - Deferred cash flow
- Payments are fixed or variable
  - Fixed for term of bond
  - Increase with inflation over time
- Other features
  - Taking risk of insurance company's ability to provide cash payments
  - Life insurance wrapper provides payout upon death

# Other sources of retirement income

- **Charitable contributions**: Donate the money now and get cash flow for lifetime. Charity gets residual after lifetime or specified time period
- Period of Time
  - Specified period or one or two lifetimes
- Payments
  - Are fixed with annuities
  - Increase over time with unit trusts
- Other Features
  - No residual value to donor
  - Requires legal trust establishment
  - Tax advantages

# Types of Charitable Donations

- **Charitable Gift Annuity**: Gift of asset (stock, real estate) to charitable institution in exchange for a lifetime cash flow
- **Charitable Remainder Trust**: Donation of asset, receive cash flow for specified period of time with remainder then distributed to charity(ies)
  - CR Annuity Trust (CRAT): Fixed cash flow amount
  - CR Unit Trust (CRUT): Variable cash flow based on percent of remaining asset (5 percent minimum)



# Other Sources of Retirement Income

## Dividend Stocks

- Period of Time
  - Until sold
  - Immediate cash flow
- Payments may increase over time
- Other Features
  - Value of investment may increase over time
  - May allow protection against inflation
  - Can be sold at any time for emergency needs

# Value Proposition of Dividend Investing

## **Higher returns historically compared to market**

- Multiple studies show more positive performance
- Cash flow growth correlates with excess returns

## **May outperform bonds in low interest era**

- Helps prevent wealth destruction
- Bond payments are fixed but dividends may increase

## **Reduced risk**

- Lower volatility
- Return of cash

## **May grow cash flow over time**

- Utilize engine of compounding returns
- Might realize a 5%+ annual 'raise'

# Empirical Evidence on Dividend Stocks

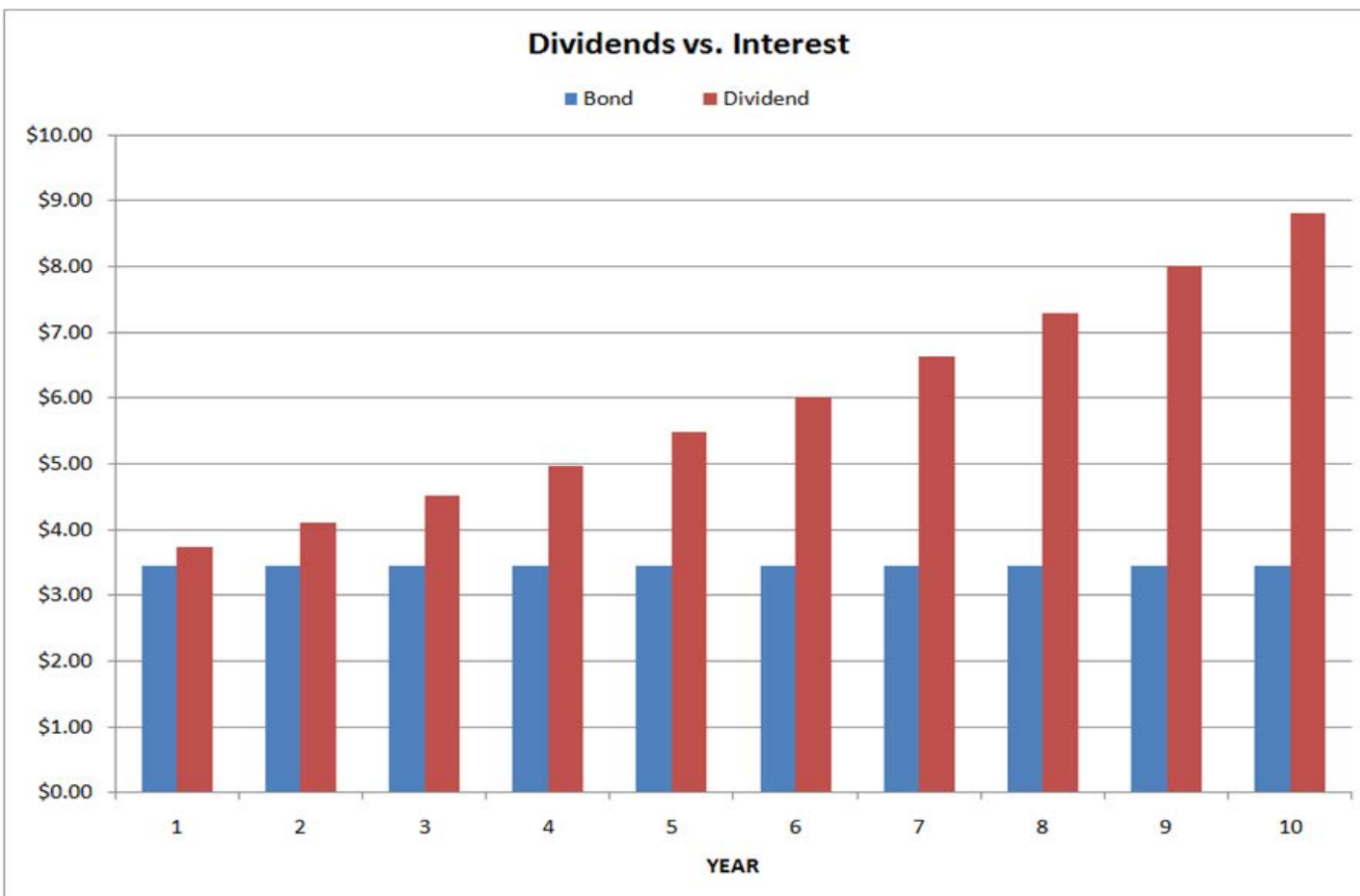
## Jeremy Siegel: The Future for Investors

- 97 percent of total real accumulation from stocks comes from reinvesting dividends and 3 percent from capital gains
- From initiation in 1958 to 2002, highest dividend yield quintile compounded to \$462,000 compared to \$130,000 for S&P 500

## Daniel Peris: The Strategic Dividend Investor

- 85 to 90 percent of S&P returns from 1926 to 2010 were from dividends

# Superior to an Individual Bond in Low Interest Rate Era



Assumes equal individual bond and dividend yield initially with dividends increasing at 12 percent

Source: "Preventing Wealth Destruction" article by Bruce A. Gulliver

# Reduced Risk of Dividend Stocks

	<u>Annual</u> <u>Return</u>	<u>Volatility</u>	<u>Sharpe</u> <u>Ratio</u>
<b>Dividend Growers and Initiators</b>	9.6%	16.2%	0.32
<b>All Dividend Paying Stocks</b>	8.8%	17.0%	0.26
<b>S&amp;P 500</b>	7.1%	18.0%	0.14

*Source: Goldman Sachs White Paper May 2013 "Why Dividend Growth Matters"*

Sharpe Ratio: A risk-adjusted measure developed by Nobel Laureate William Sharpe. It is calculated by using standard deviation and excess return to determine reward per unit of risk. The higher the Sharpe Ratio, the better the fund's historical risk-adjusted performance. The Sharpe ratio is calculated for the past 36-month period by dividing a fund's annualized excess returns by the standard deviation of a fund's annualized excess returns. Since this ratio uses standard deviation as its risk measure, it is most appropriately applied when analyzing a fund that is an investor's sole holding. The Sharpe Ratio can be used to compare two funds directly on how much risk a fund had to bear to earn excess return over the risk-free rate. Source: <https://www.fidelity.com>

# Compounding Effect of Yield and Growth Rate on Total Dividends Paid

**Cumulative Dividend Cash Paid Over 10 Years as % of Initial Investment**

		Dividend Growth Rate								
		1.00%	2.50%	5.00%	7.50%	10.00%	12.50%	15.00%	17.50%	20.00%
Dividend Yield	1.00%	10.5%	11.2%	12.6%	14.1%	15.9%	18.0%	20.3%	22.9%	26.0%
	1.50%	15.7%	16.8%	18.9%	21.2%	23.9%	27.0%	30.5%	34.4%	38.9%
	2.00%	20.9%	22.4%	25.2%	28.3%	31.9%	36.0%	40.6%	45.9%	51.9%
	2.50%	26.2%	28.0%	31.4%	35.4%	39.8%	44.9%	50.8%	57.4%	64.9%
	3.00%	31.4%	33.6%	37.7%	42.4%	47.8%	53.9%	60.9%	68.8%	77.9%
	3.50%	36.6%	39.2%	44.0%	49.5%	55.8%	62.9%	71.1%	80.3%	90.9%
	4.00%	41.8%	44.8%	50.3%	56.6%	63.7%	71.9%	81.2%	91.8%	103.8%
	4.50%	47.1%	50.4%	56.6%	63.7%	71.7%	80.9%	91.4%	103.3%	116.8%
	5.00%	52.3%	56.0%	62.9%	70.7%	79.7%	89.9%	101.5%	114.7%	129.8%

*S&P Capital IQ data, Jefferson Research data and calculations*

# Compounding Effect for Largest Fund and ETF Products

Cumulative Income as % of Initial Investment Over 10 Years

		Annualized Income Growth Rate								
		0.56%	3.85%	4.23%	6.92%	7.76%	8.26%	8.78%	9.01%	10.00%
Average Yield	2.08%	21.3%	24.8%	25.2%	28.6%	29.8%	30.5%	31.3%	31.6%	33.1%
	2.09%	21.4%	24.9%	25.4%	28.8%	29.9%	30.7%	31.4%	31.8%	33.3%
	2.44%	25.0%	29.1%	29.6%	33.6%	34.9%	35.8%	36.7%	37.1%	38.9%
	2.72%	27.9%	32.4%	33.0%	37.4%	39.0%	39.9%	40.9%	41.3%	43.3%
	2.93%	30.1%	34.9%	35.6%	40.3%	42.0%	43.0%	44.1%	44.5%	46.7%
	3.20%	32.8%	38.1%	38.8%	44.0%	45.8%	46.9%	48.1%	48.6%	51.0%
	3.33%	34.2%	39.7%	40.4%	45.8%	47.7%	48.8%	50.1%	50.6%	53.1%
	3.40%	34.9%	40.5%	41.3%	46.8%	48.7%	49.9%	51.1%	51.7%	54.2%
	3.60%	38.6%	44.8%	45.6%	51.7%	53.8%	55.2%	56.5%	57.2%	57.4%

*S&P Capital IQ data, Jefferson Research data and calculations*

S&P 500 Large Cap Index

Jefferson Research Index of High Yield and Growth Stocks

# Ways for Investors to Participate in Dividend Stock Investing

- Mutual funds
- ETF's
- Individual shares
- Combination of above



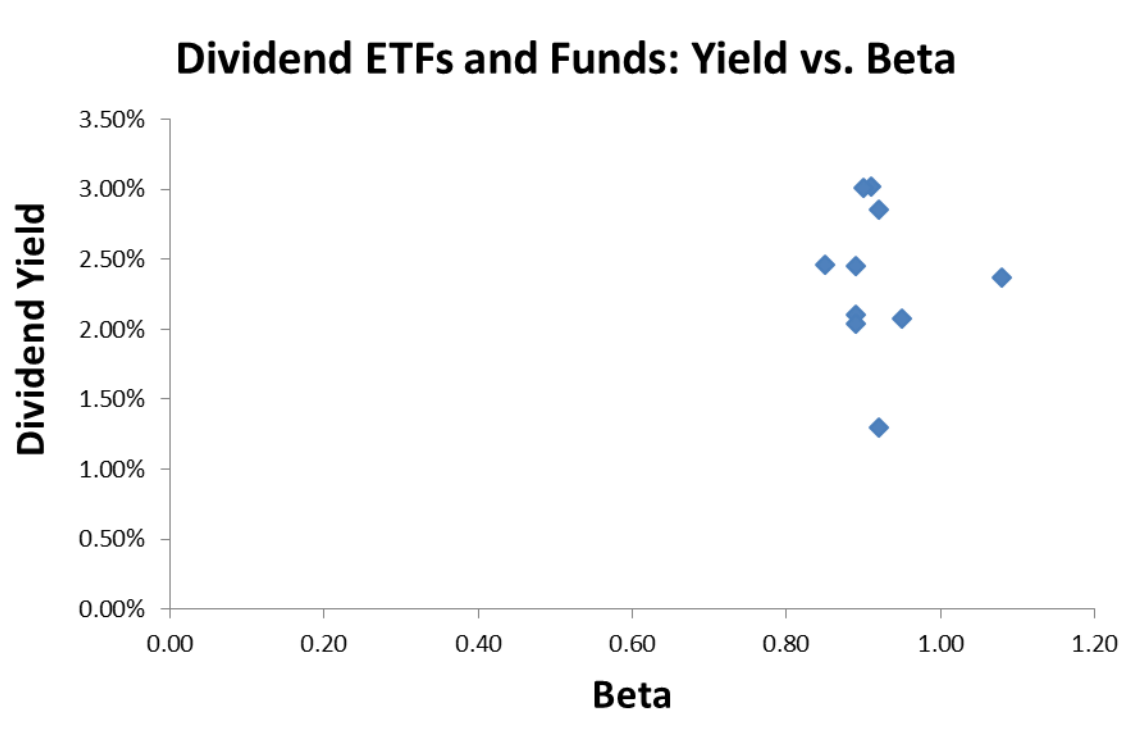
# Dividend Strategies for Funds and ETFs

- Historical
  - Dividend Achiever
  - Dividend Aristocrat
  - Dividend Ruler
- Dividend Growth
- Dividend Yield
- Dividend Yield and Growth

# How Dividend Strategies Might Go Wrong

- Failure to utilize recent information
  - Historical strategies react only to dividend payment
  - Reduces ability to manage risk
- Sector Allocation
  - Historical emphasis may lead to overweighting sectors that eventually underperform significantly
  - Many funds overweight financials prior to 2008
- Settling for low yield and growth
  - Minimizes the effect of compounding

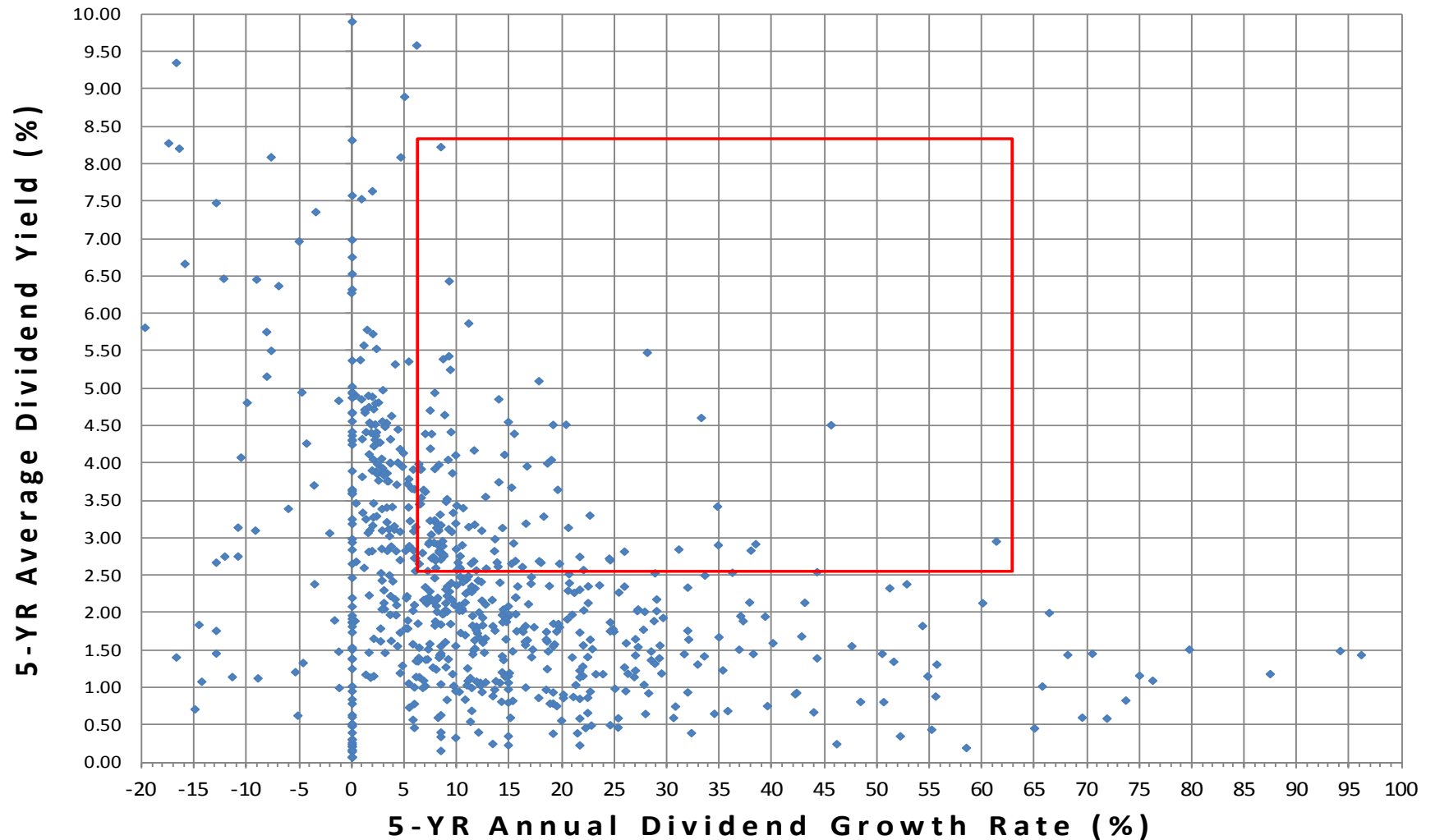
# Representative Yields for Dividend Funds and ETF's



Source: Jefferson Research graphs from Morningstar data

# Yield and Dividend Growth Universe

## Yield vs. Growth



# How Dividend Strategies Might Go Wrong

## – Using incomplete metrics

Using earnings instead of cash flow to determine ability to pay

- Dividends can only be paid with cash
- Failure to consider cash balances

## – Failure to distinguish recurring cash flow from one-time cash flow

Using operating cash flow without adjusting for non-recurring items

- Operating cash flow does not always reflect recurring or sustainable cash flow

# Why Some Common Dividend Metrics May Be Incomplete

- Dividend Payout Ratio: *percent of earnings paid out as dividends: **Earnings may be distorted by accounting policies; Dividends require cash and earnings are not the same as cash flow***
- Operating Cash Flow Payout : *percent of operating cash flow paid out as dividends: **Accounting standards and management discretion may distort***
- ***Usefulness of OCF without adjustments***
- ***Solution: Consider Adjusted Earnings and Adjusted Operating Cash Flow (Free Cash Flow)***

# Apply Meaningful Metrics to Stock Investing for Dividends

- Applying consistent, meaningful metrics to dividend stock decisions
  - Go beyond traditional measures
  - Things change over time
  - Accounting rules and management prerogatives may lead to misleading accounting if data used as presented and without proper adjustments

# Jefferson Research Newsletter

[www.jeffersonresearch.com](http://www.jeffersonresearch.com)

**Dividend Cash Flow Growth Newsletter:** Model portfolio designed for financial advisors and other investment professionals and individuals seeking portfolio of dividend yield and growth stocks



# Example of Use of Tools Available

- Example: Reynolds American(RAI)
  - Downgraded cash flow quality in Q4 2015
  - Resulting deterioration in dividend coverage using adjusted free cash flow
- See Financial Sonar Summary

# RAI: Fundamental Analysis from Financial Sonar Report

**Jefferson Research**

FINANCIAL SONAR™: REALITY RADAR ON COMPANY PERFORMANCE

NYSE **RAI**

**REYNOLDS AMERICAN INC**

**TOBACCO INDUSTRY**

OVERALL RATING FOR 4TH QUARTER 2015 **SELL**

## OUR EVALUATION OF RAI

REYNOLDS AMERICAN INC is showing strong Earnings Quality and Balance Sheet Quality, and Valuation suggests a lower amount of price risk, but Cash Flow Quality and Operating Efficiency are both weak. When combined, RAI deserves a SELL rating.

The Cash Flow Quality rating declined the most during the recent quarter. Though this dimension and all of the others were either down or unchanged at best, the overall rating is already a SELL, the worst rating available.

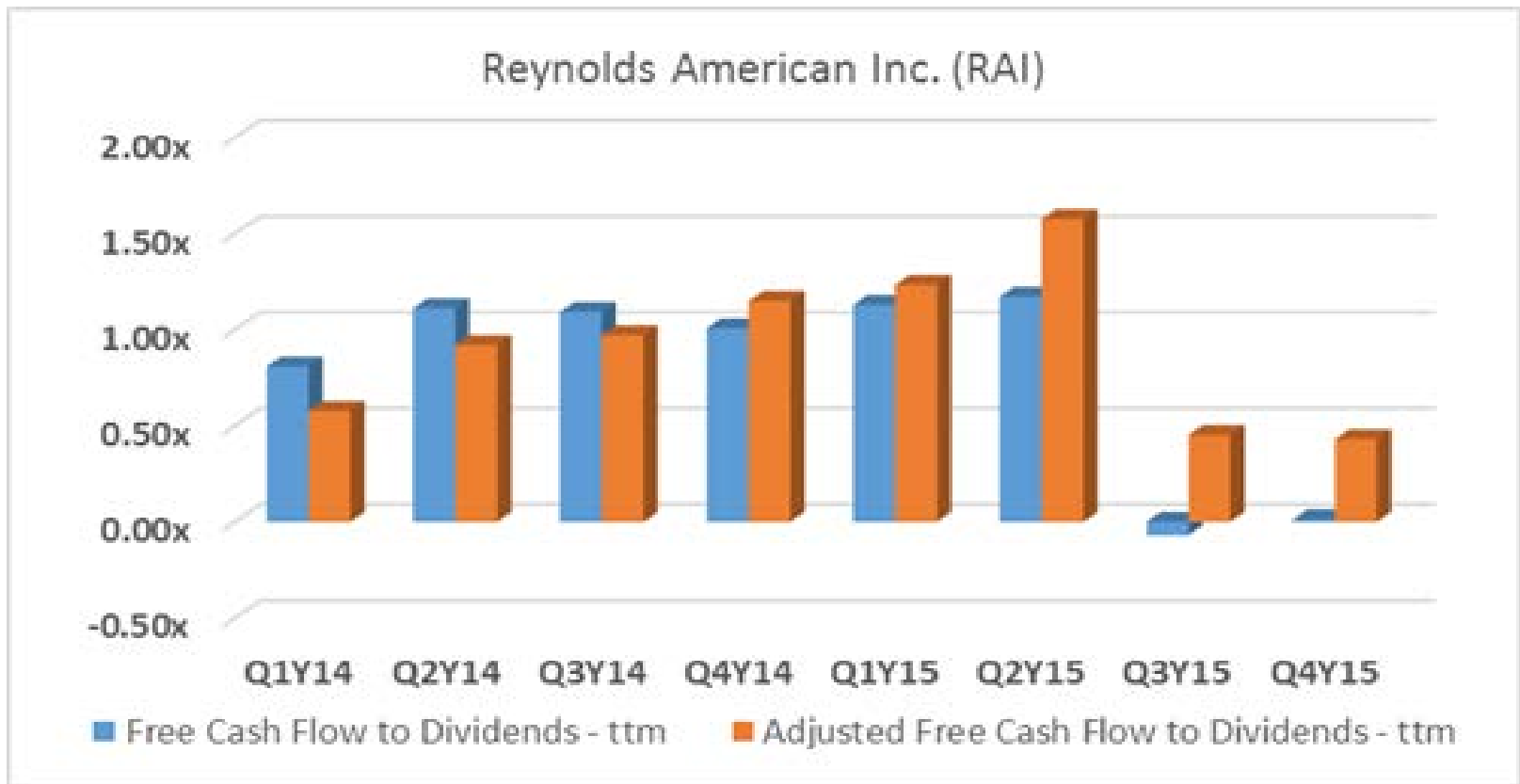
## HISTORICAL RATINGS

	Q1 2015	Q2 2015	Q3 2015	Q4 2015
<b>OVERALL RATING</b>	<b>HOLD</b>	<b>SELL</b>	<b>SELL</b>	<b>SELL</b>
<b>EARNINGS QUALITY</b>	<b>STRONGEST</b>	<b>WEAK</b>	<b>STRONG</b>	<b>STRONG</b>
<b>CASH FLOW QUALITY</b>	<b>STRONG</b>	<b>STRONG</b>	<b>STRONG</b>	<b>WEAK</b>
<b>OPERATING EFFICIENCY</b>	<b>WEAK</b>	<b>WEAKEST</b>	<b>WEAKEST</b>	<b>WEAKEST</b>
<b>BALANCE SHEET</b>	<b>STRONG</b>	<b>STRONG</b>	<b>STRONG</b>	<b>STRONG</b>
<b>VALUATION</b>	<b>MOST RISK</b>	<b>MEDIUM RISK</b>	<b>LOW RISK</b>	<b>LOW RISK</b>

## FINANCIAL SONAR™ FOR RAI 4TH QUARTER 2015



# RAI Adjusted Free Cash Flow to Dividends TTM



# Conclusion

- There are several alternatives for increasing cash flow in retirement
- Key is to reallocate into assets that fit acceptable risk profile
- Consideration should be given to dividend stocks as part of variable needs
- Dividend strategy has potential advantages for many investors: higher returns, lower volatility, better night's sleep
- Combination high yield and high growth strategy may enhance general benefits of dividend strategy

# Websites

- Jefferson Research Website:
  - [www.jeffersonresearch.com](http://www.jeffersonresearch.com)
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