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Don't Trust Your Retirement to Dividends Alone

Dividends are not guaranteed payments, and if they get cut, it can affect your portfolio in more ways than one.

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IMAGE SOURCE: FLICK USER MIKE PORESKY.

A common dream for people approaching retirement is to be able to live off their dividend payments, use the growth in their dividends to cover inflation, and hold on to their shares, forever. It's a tempting strategy, but it's also very dangerous. There are two key reasons why:

- First, dividends are *not* guaranteed payments, but they are frequently viewed as a sign of the underlying company's overall health. In the event a company cuts its dividend, not only do you lose that income stream, but there's a very real risk that its shares will drop substantially, too. That reduces the capital you have available to reinvest in another company to make up the loss.

- Second, relying on a dividends-only retirement plan will likely force you to either *oversave* for your retirement or to *live on less* than you could really afford. The **PowerShares Dividend Achievers ETF** (NYSEMKT:PFM) is a fund designed around stocks with histories of increasing their dividends. That fund yields around 2.4%. While that's above the S&P 500's yield of around 2.2%, it's well below the 4% withdrawal rate that many planners view as sustainable for a typical retiree. Even in a fund like this that focuses on rising dividends, your take from dividends alone wouldn't reach that 4% level.

How can dividends go wrong?

Consider what happened to industrial titan **General Electric** (NYSE:GE) in the financial crisis. At one point during the Oct.-Dec. 2007 quarter, General Electric's shares closed above $42 per share, and it increased its quarterly dividend to $0.31 per share. Yet that dividend represented the last time General Electric was able to increase its payment until after the financial crisis passed.

Instead, its next dividend move was a drastic cut, to $0.10 per share in late Feb. 2009. The day it announced that cut, its shares closed at $8.51 per share. Prior to the cut, General Electric had a more than 30-year history of stable or increasing dividends. If you had bought its stock for income when its dividend was still rising, the dividend cut would have brought with it both a substantial income cut and a huge value haircut.

More recently, pipeline giant **Kinder Morgan** (NYSE:KMI) suffered a similar fate, though on a faster timeline. Despite the fact that Kinder Morgan *increased* its dividend to $0.51 per share per quarter in Oct. 2015, by Dec. 2015, that dividend was slashed by more than 75%, to $0.125 per share per quarter. The first trading day after the dividend hike, Kinder Morgan's shares closed at $29.75, and the first trading day after the subsequent dividend cut, its shares closed at $16.81.

In both cases, investors buying the companies' shares for their dividends were sorely disappointed by both the cuts in dividends and in their market prices dropping. Yet behind both dividend cuts are fundamentally strong companies.

In General Electric's case, it has been shedding problem business lines and has been able to resume increasing its dividend. In Kinder Morgan's, the company recently announced that its dividend cut will enable it to not have to access the capital markets for its 2016 operations or expansion plans. That's a sign that its fundamental business remains solid and provides hope that it, too, may be able to resume increasing its dividends in the not-too-distant future.

Both companies' shares may very well still be worth owning, but their dividends haven't provided reliable income. Investors relying on those dividends not only saw their income get slashed, but the value of their holdings as well, making it problematic to replace that lost income by buying shares elsewhere.

A better way to get current cash flow

It's because of the risk of dividend cuts that bonds still deserve a place in a retiree's portfolio. In today's low interest rate environment, however, high-quality bonds generally don't provide high enough interest payments to be used solely for income. Instead, the effective way to use bonds to get the cash you need for spending in this environment is via the use of a well-constructed bond ladder.

In a bond ladder, you buy high-quality investment-grade bonds that mature on a drumbeat schedule -- say, every six months -- starting with seven to 10 years' worth of bonds. Your goal is to use those maturing bonds to pay your costs of living until the next bond's maturity, so you'll want to factor in a reasonable estimate for inflation, particularly for the farther-out years.

The big challenge with a bond ladder is that every bond in your portfolio ticks closer to maturity every day. To keep the bond ladder going throughout your retirement, you use the interest you receive on your bonds and the dividends from your stock holdings to buy more bonds to extend the long-term end of it. Those dividends and interest payments alone may not be enough to keep your bond ladder fully topped off, so you'll likely need to sell a portion of your stock portfolio as well.

That's where the seven- to 10-year length comes in handy. In a normal year in the stock market, you can sell enough shares to keep your bond ladder steady. In a really good year in the stock market, you might even be able to extend the length of that bond ladder. But in a bad year in the market, you can simply let that bond ladder shrink, until the market starts to recover.

By starting with a seven- to 10-year bond ladder and aiming to maintain that length over time, you can deal with a lot of stock market volatility -- and dividend cuts -- and still maintain your lifestyle in retirement.

Strike the right balance to retire well

Dividend-paying stocks can still play an important part in your retirement portfolio. Just be careful to not depend on those dividends to pay your current expenses, but instead use them to help keep your bond ladder topped off. That way, you get all the benefits that come from getting part of your return from your stocks in cold, hard cash while protecting yourself from the worst impact of dividend cuts.

Chuck Saletta owns shares of General Electric Company and Kinder Morgan. Chuck also has the following options positions on Kinder Morgan: January 2017 $37.50 synthetic long and March 2016 $16 covered calls. The Motley Fool owns shares of and recommends Kinder Morgan. The Motley Fool owns shares of General Electric Company. Try any of our Foolish newsletter services free for 30 days. We Fools may not all hold the same opinions, but we all believe that considering a diverse range of insights makes us better investors. The Motley Fool has a disclosure policy.

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