The Importance of Dividend-Growth Investing In Retirement

Stock market investors are not a homogenous lot. They vary greatly in their investment styles, risk tolerance levels, industry preferences and geographic concentration. However, one aspect that's common to most investors is their focus on stock price appreciation as the primary measure of investment success. While dividends are given cursory importance, they are seldom the primary investment objective. This is not to say that share price appreciation is not an important factor, but in retirement, dividends can play a vital role in creating a stable income, a less volatile portfolio and prevent principle liquidation at the wrong time.

There are two ways in which shareholders of common stocks get compensated for the risk they take. The first is purely through the appreciation in the price of the stocks they own. This is commonly known as growth investing. The second is through a combination of the dividends that some companies pay on a periodic basis in addition to any price appreciation that their stocks experience. This combination of dividend plus price appreciation is collectively known as dividend-growth or **total return** investing. This strategy combines aspects of both income and growth. It provides the investor with a stream of income and the potential of price and dividend appreciation over time.

Companies pay a dividend to their shareholders as a means of returning excess capital to them. Every company has the option to either reinvest its profits back into the businesses or pay some or all of those profits to their shareholders. Typically, more established companies with a long track record of doing business pay dividends. However, there are also certain investment vehicles such as Real Estate Investment Trusts (REITs) and Master Limited Partnerships (MLPs) that are structured to pay most of their earnings as distributions to shareholders in order to avoid double-taxation.

During the early investing years of an individual, it matters not how investment returns are achieved. The young or even middle-aged investor has a long-term time horizon and the ability to make periodic contributions to their portfolio from the income they receive through their job or other sources. They have no need for tapping into their investments to supplement living expenses. This gives them the opportunity to buy into a mutual fund or a diversified basket of individual stocks at various periods and through various business and economic cycles. As such, any market declines become excellent opportunities to buy stocks or mutual funds at a "cheaper" price.

Things get tricky as the investor gets closer to retirement or enters retirement age. At this stage, they are past the "accumulation phase" and may need to start relying on their investments to fund their living expenses or supplement a reduced income. This is when stability and consistency become crucial. Total return investing, i.e. a combination of dividend income and growth can prove useful at this stage in life.

There are many reasons why dividend paying stocks are an attractive asset to invest during the retirement phase of an investor. Some of these include...

a) Companies that pay dividends are usually at a more mature phase in their business life. They are well established and usually have a history of being profitable over long periods of time.

b) Once a company starts paying a dividend, management is reluctant to reduce or eliminate it. Any adverse change in the dividend can have a negative impact on the price of the company's stock and invite shareholder ire.

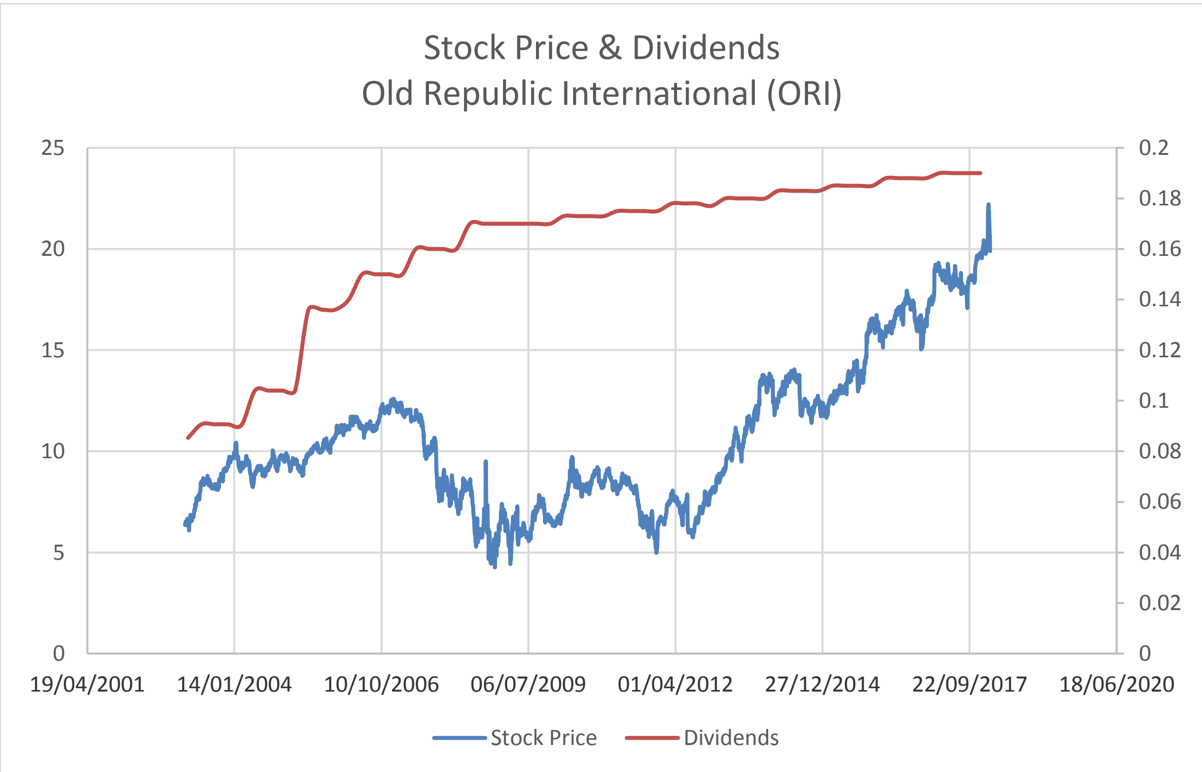
c) Dividends create more accountably as the company management's first priority becomes paying the dividend and not taking undue business risks that may or may not pay off in the future.

d) With dividends, shareholders receive income now versus selling the stock for a gain which may or may not materialize in the future.

e) Dividend stocks tend to be less volatile than growth socks. According to a study by Ned Davis Research, between 1972 and 2012, dividend paying stocks in aggregate returned 8.8% annualized with a standard deviation (measure of volatility) of 8.8%. On the other hand, non-dividend paying stocks returned only 1.6% annualized with a higher standard deviation of 25.6%.

f) A dividend yield can create a theoretical floor on the stock price. For example if a stock has a dividend yield of 4% and its price drops without any fundamental changes to its business, the higher yield that results can attract bargain buyers to the stock.

There are a number of great companies that have a history of paying and raising their dividends over a long period of time. To illustrate, below is a chart that shows the stock price (blue) and the dividend payment (red) of Old Republic International (ORI) over a 15 year period. Note how the dividend has consistently increased over that period despite what the share price has done. An investor in ORI continued to collect a growing stream of income from the stock despite what its stock price did and despite what the overall market did.



You might wonder if this approach still holds merit if an investor does not need income from their portfolio? It absolutely does. An investor can choose to reinvest all the dividends they receive back into the stock of the company that pays it. This can help compound their investment at an even faster pace as the number of shares owned by the investor increases over time. When done prudently, this can create a virtuous cycle of growing dividends and a higher portfolio value over time. In the above illustration, ORI continued paying a dividend and even increased it when the price of the stock dropped significantly like it did during the financial crisis in 2008-09. An investor who reinvested their dividends back into the stock increased their dividend income and the value of their total investment as the stock price recovered.

Stock market investing is a risky endeavour but dividend investing, if done wisely, can help mitigate some of that risk over time. A stable income and less volatility are of great importance during the later years of an investor’s life and can play an important role in making investing less stressful and more rewarding.