Investing for Retirement Income:
Straw, Sticks or Bricks?

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Dividend-Yielding Stocks – A Straw Strategy

If ever there were an appropriate analogy for how to invest for retirement, it would be the classic fable of The Three Little Pigs . As you may recall, those three little pigs tried three different structures to protect against the Big Bad Wolf. Similarly, there are at least three kinds of "building materials" that investors typically employ as they try to prevent today's low interest rates from consuming their sources for retirement income:

1. **Dividend-yielding stocks**

2. **High-yield bonds**

3. **Total-return investing**

We will explore each of these common strategies and explain why the evidence supports building and preserving your retirement reserve through **total-return investing.** The approach may require a bit more prep work and a little extra explanation, but like solid brick, we believe it offers the most durable and dependable protection when those hungry wolves are huffing and puffing at your retirement-planning door.

We understand why bulking up on dividend-yielding stocks can seem like a tempting way to enhance your retirement income, especially when interest rates are low. You buy into select stocks that have been spinning off dependable dividends at prescribed times. The dividend payments appear to leave your principal intact, while promising better income than a low-yielding short-term government bond has to offer.

Safe, easy money … or so the fable goes. Unfortunately, the reasoning doesn't hold up as well upon evidence-based inspection. Let's dive in and take a closer look at that income stream you're hoping to generate from dividend-yielding stocks.

Dividends Don't Grow on Trees.

It's common for investors to mentally account for a dividend payout as if it's found money that leaves their principal untouched. In reality, a company's dividends have to come from somewhere. That "somewhere" is either the company's profits or its capital reserves.

This push-pull relationship between stockholder dividends and company capital has been rigorously studied and empirically assessed. In the 1960s, Nobel laureates Merton Miller and Franco Modigliani published a landmark study on the subject, " Dividend Policy, Growth, and the Valuation of Shares ." In " Capital Ideas " (a recommended read on capital market history), Peter Bernstein explains one of the study's key findings: "Stockholders like to receive cash dividends. But dividends paid today shrink the assets of the company and reduce its future earning power."

Here's how this MoneySense article, " The income illusion ," explained it: "If a company pays you a $1,000 cash dividend, it must be worth $1,000 less than it was before. That's why you'll often see a company's share price decline a few days before an announced dividend is paid."

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Dividend Income Incurs a Capital Price.

So, yes, you can find stocks or stock funds whose dividend payments are expected to provide a higher income stream than you can earn from an essentially risk-free government bond. But it's important to be aware of the trade-offs involved.

As described above, rather than thinking about a stock's dividends and its share value as mutually exclusive sources of return – income ***versus*** principal – it's better to think of them as an interconnected seesaw of income ***and*** principal. The combined balance represents the holding's total worth to you. (If you're reading closely, you may notice that we've just foreshadowed our future discussion about adopting a total-return outlook in your investment strategy!)

"Safe" Stocks? Not so Fast.

In addition, dividend-yielding stocks may not be as sturdy or as appropriate as you might think for generating a reliable retirement cash flow. Even if those stocks have dependably delivered their dividends in the past, assuming they are as secure as a government bond is like assuming that a Big Bad Wolf is harmless because he hasn't bitten you yet.

The evidence is clear, and it has been for decades: Stocks are a riskier investment than bonds. This in turn has contributed to their higher expected long-term returns, to compensate investors who agree to take on that extra risk.

Dividend stocks may offer a slightly more consistent cash flow than their non-dividend counterparts, but at the end of the day, they are still stocks, with the usual stock risks and expected returns. As this Monevator (not so) "brief guide to the point of bonds" describes, "The key to (most) bonds is they aim to pay you a fixed income until a certain date, at which point you get your initial money back. That is very different to equities, which offer no such certainty of income or capital returns."

In " The Dividend-Fund Dilemma ," *Wall Street Journal's* financial columnist Jason Zweig explains it similarly: "When you buy a Treasury, you collect interest and get your money back (not counting inflation) when the bond matures. When you buy a dividend-paying stock, you collect a quarterly payment – but that certainly doesn't mean the stock price will be stable."

Nor is there any guarantee that the dividends will flow forever. Zweig described a lesson that many investors learned the hard way during the Great Recession: "In 2007, 29% of the S&P 500's dividend income came from banks and other financial stocks, according to Howard Silverblatt, senior index analyst at Standard & Poor's. That didn't end well. Many banks that had been paying steady income to shareholders suspended their dividends – or even went bust. Their investors suffered."

Our capital markets rarely offer a free ride. If you're taking stock dividend income today, you're likely paying for it in the form of lower share value moving forward. And if you're invested in the stock market, you are exposing your nest egg to all the usual risks (and expected returns) that comes with that exposure. That's how markets work.

The fixed income bond markets offer their share of risks as well, but in a different form, which tends to make them a better choice for helping you dampen your total risk exposure as you pursue expected market returns.

High-Yield Bonds – Sticks and Stones Can Break You

Another popular tactic is to move your retirement reserves into high-yield, low-quality bonds. Let's explain why we don't typically recommend this approach either. Stretching for high-yield, higher-risk bond income begins to shift your bond holdings away from their most appropriate role in your total portfolio.

We can see why it would be appealing to try to have your bonds pull double-duty when interest rates are low: protecting what you've invested *and* delivering higher yields. The problem is, the more you try to position your fixed income to fulfill two essentially incompatible roles at once, the more likely you will underperform at both.

Risk and Return: The Same, Old Story (Sort of)

In investing and many other walks of life, there's nothing to be gained when nothing has been ventured. This relationship between risk and expected return is one of the strongest forces driving capital markets. But decades of academic inquiry helps us understand that the risks involved when investing in a bond – any bond – are inherently different from those associated with investing in stocks. These subtle differences make a big difference when it comes to combining stocks and bonds into an effective total portfolio.

Because a company's stock represents an ownership stake, your greatest rewards come when a company's expected worth continues to improve, so you can eventually sell your stake for more than you paid for it, and/or receive "profit-sharing" dividends along the way. Your biggest risk is that the opposite may occur instead.

A bond is not an ownership stake; it's a loan with interest, which defines its two biggest risks:

1. **Bond defaults –** If all goes well, you get your principal back when the loan comes due. But if the borrower defaults on the loan, you can lose your nest egg entirely.

2. **Market movement –** You would like your bond's interest rate to remain better than, or at least comparable to those available from other, similarly structured bonds. Otherwise, if rates increase, you're left locked into relatively lower payments until your bond comes due.

As such, two factors contribute to your bond portfolio's risks and expected returns:

1. **Credit premium** – Bonds with low credit ratings ("junk" or "high-yield" bonds) are more likely to go into default. To attract your investment dollars despite the higher risk, they typically offer higher yields.

2. **Term premium** – The longer your money is out on loan, the more time there is for the market to shift out from under you, leaving you locked into a lower rate. That's why bonds with longer terms typically offer higher yields than bonds that come due quickly.

Bond Market Risks and Returns

If you're connecting the dots we've drawn, you may be one step ahead of us in realizing that, just like any other investment, bonds don't offer higher expected returns without also exposing you to higher risks. So, just as we do with your stock holdings, we must identify the best balance between seeking higher bond yields while keeping a lid on the credit and term risks involved.

With stocks – Taking on added stock market risk has rewarded stalwart investors over time. The evidence is compelling that it will continue to do so moving forward (assuming you adopt a well-planned, "buy, hold and rebalance" approach as a patient, long-term investor).

With bonds – Taking on extra bond market risk is not expected to add more value than could be had by building an appropriately allocated stock portfolio. Moreover, it is expected to detract from your bond holding's primary role as a stabilizing force in your total portfolio … and it often does so just when you most want to depend on that cushioning stability.

For example, in " Five Myths of Bond Investing ," *Wall Street Journal* columnist Jason Zweig dispels the myth that "investors who need income must own 'bond alternatives'" (such as high-yield bonds). He cites BAM ALLIANCE Director of Research Larry Swedroe, who observes that "popular bond alternatives … provide extra income in good times – but won't act like bonds during bad times."

The Monevator piece we referenced offers a similar perspective: "Bonds are meant to be the counter-weight to shares in a portfolio. They are the stabilizing influence that tempers the turbulence. Equities are from Mars and bonds are from Venus, if you will. … Use Equities to deliver growth, and domestic government bonds to reduce risk."

Given these insights, logic dictates:

If you must accept higher risks in search of higher returns, take those risks on the equity (stock) side of your portfolio; use high-quality fixed income (bonds) to offset the risks.

As we've been hinting at there is one more critical component to investing for retirement income. Beyond optimizing your bond portfolio with the right kind of bonds (high-quality, short- to mid-term), and avoiding chasing dividend stocks for their pay-offs, among the most important steps you can take with your retirement income is to adopt a portfolio-wide approach to money management, instead of viewing your income and principal as two isolated islands of assets.

Total-Return Investing for Solid Construction

As we've discussed we do not recommend turning to dividend-yielding stocks or high-yield ("junk") bonds to buttress your retirement income, even in low-yield environments. So what do we recommend? We will answer that question for you by describing **total-return investing .**

If you think it through, there are three essential variables that determine the total return on nearly any given investment:

1. Interest or dividends paid out or reinvested along the way
2. The increase or decrease in underlying share value: how much you paid per share versus how much those shares are now worth
3. The damage done by taxes and other expenses

Total-Return Investing, Defined

Instead of seeking to isolate and maximize interest or dividend income – i.e., only one of three possible sources for strengthening your retirement income – total-return investing looks for the best balance among all three, ***as they apply to your unique financial circumstances .*** Which strategy is expected to give you the highest total return for the amount of market risk you're willing to bear? Which is expected to deliver the most bang for your buck, in whatever form it may come?

If you're thinking this seems like nothing but common sense, you're on the right track. Last we checked, money is money. In the end, who wouldn't want to choose the outcome that is expected to yield the biggest pot given the necessary risks involved? Why would it matter whether that pot gets filled by dividends, interest, increased share value, or cost savings from tax-wise tactics?

In Total-return investing: An enduring solution for low yields ," Vanguard describes the strategy as follows: "Many investors focus on the yield or income generated from their investments as the foundation for what they have available to spend. ... The challenge today, and going forward, is that yields for most investments are historically low. ... We conclude that moving from an income or 'yield' focus to a total-return approach may be the better solution."

And yet, many investors continue to favor generating retirement cash-flow in ways that put them at higher risk for overspending on taxes, chipping away at their net worth and weakening the longevity of their portfolio.

We're not saying you should entirely avoid dividend-yielding stocks or modestly higher-yielding bonds. With total-return investing, these securities often still play an important role. But they do so in the appropriate context of your wider portfolio management. Let's take a look at that next.

The Related Role of Portfolio Management

The tool for implementing total-return investing is portfolio-wide investment management. Decades of evidence-based inquiry informs us that there are three ways to manage your portfolio (the sum of your investment parts) to pursue higher expected returns; more stable preservation of existing assets; or, usually, a bit of both. The most powerful strategies in this pursuit include:

1. **Asset allocation** – Tilting your investments toward or away from asset classes that are expected to deliver higher returns … but with higher risk to your wealth as the tradeoff

2. **Diversification** – Managing for market risks by spreading your holdings across multiple asset classes in domestic and international markets alike

3. **Asset location** – Minimizing taxes by placing tax- *inefficient* holdings in tax-favored accounts, and tax- *efficient* holdings in taxable accounts

By focusing on these key strategies as the horses that drive the proverbial cart, we can best manage a portfolio's expected returns. This, in turn, helps us best position the portfolio to generate an efficient cash flow when the time comes.

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Your Essential Take-Home

Bottom line, there is no such thing as a crystal ball that will guarantee financial success or a happily-ever-after retirement. But we believe that total-return investing offers the best odds for achieving your retirement-spending goals – more so than pursuing isolated tactics such as chasing dividends or high-yielding bonds without considering their portfolio-wide role.

With that in mind, the next time the market is huffing and puffing and threatening to blow your retirement down, we suggest you throw another log on the fire that fuels your total return investment strategy, shore up your solidly built portfolio, and depend on the structured strength to keep that wolf at bay. Better yet, be in touch with us to lend you a hand.