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Portfolio Perspectives

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Take The Bittersweet out of Retirement with Dividends

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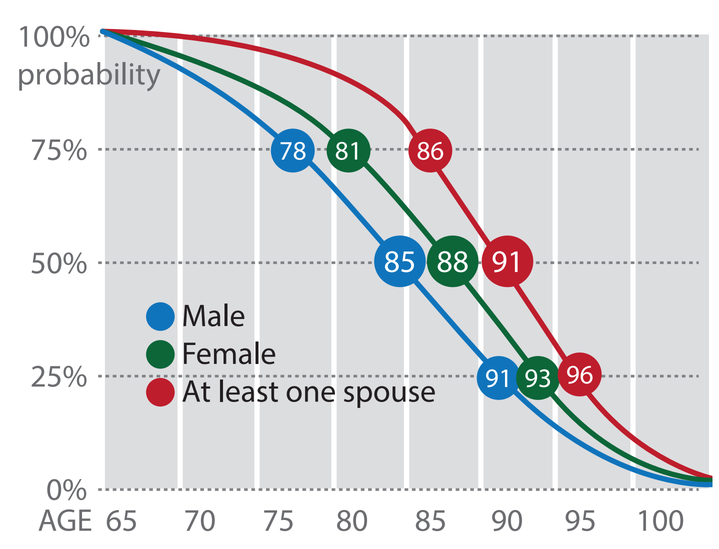
Bittersweet is a word we use to describe fresh-squeezed lemonade, dark chocolate, or maybe even a past romance…but bittersweet can also be associated with retirement. The sweet part is we live longer, but the bitter is that by living longer we risk outliving our retirement savings. More years in retirement mean more years of expenses and more years for inflation to work on eroding our hard-earned savings.

PROBABILITY OF A 65-YEAR-OLD LIVING TO VARIOUS AGE



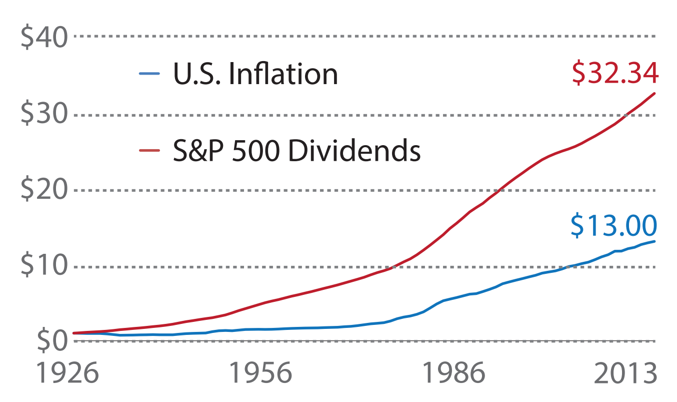
Source: Annuity 2000 Mortality Tables — Transactions, Society of Actuaries, 1995–1996 Reports.

Mortality data shown in the table indicate that retirees should plan for a retirement that will last 20 years or more. Inflation can do a lot of damage in 20-30 years.

On average, inflation will erode 59% of a retiree's savings over 30 years. So something that costs $1 at the beginning of retirement will cost $2.45 in 30 years. That's a big problem for individuals entering retirement in the current low-yielding bond environment. With bonds at historically low yields and interest rates poised to rise (which deflates bond prices), strategies that worked in the past may not work now.

The problem with bonds is that most pay fixed coupon payments — that's why they are grouped into the asset class called "fixed income." But retirement expenses are not "fixed." Consider the case of a couple who begin retirement with $50,000 of annual living expenses. The couple buys enough bonds to receive $50,000 in annual coupon payments. All is good, right? Wrong! Since living expenses will likely grow on average by 3% per year, their annual expenses will be $67,448 after 10 years, $90,984 after 20 years, and $122,733 after 30 years, yet their income will still be $50,000. Do you taste the bitter yet?

GROWTH OF $1 FROM 1926 THROUGH 2013



Source: Morningstar Direct March 2013. US Inflation represented by the Ibbotson and Associates SBBI Inflation Index. S&P 500 Dividends represented by the Ibbotson and Associates SBBI S&P 500 Income Return Index. Hypothetical value of $1 and kept invested through December 31, 2013 from the respective dates. Assumes reinvestment of income and no transaction costs or taxes. This is for illustrative purposes only and not indicative of any investment. Indexes are unmanaged baskets of securities that are not

available for direct investment by investors. Index performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results. Stock investing involves risks, including volatility (up and down movement in the value of your assets) and loss of principal.

Luckily, there is another source of income that has the potential to fight off the erosive effects of inflation. Since 1926, inflation has averaged 3.0% per year and turned $1 of expenses into $13 today. Compare that to the average dividend rate on the S&P 500 Index since 1926, which averaged 4.0% per year and could have grown $1 of income in 1926 to over $32.34 today. That's potential inflation protection and then some.

But before you rush to add a bunch of dividend paying stocks to your portfolio, keep in mind there are no guarantees. A company can increase, decrease, and even eliminate dividends altogether, depending on its financial situation.

This is why diversification is so important and why asset class investing can help. Since many different types of companies comprise an asset class, there is always a high likelihood that some of the companies in the asset class will pay dividends.

Dividend income isn't the only benefit of investing in stocks. Stock prices have the potential to appreciate over time and historically the price appreciation has been significant. The average price appreciation since 1926 for the S&P 500 Index is 7.7% compared to 3.0% for inflation over this same time. While stock prices tend to be volatile, they may provide better inflation protection compared with bonds.

Between 1974 and 1980 the average rate of inflation was 9.3%, much higher than the historical rate of 3%. During this time, bonds yielded 7.9% from income, but prices declined by 2.7%[1], resulting in a total return of 5.6% — way short of inflation. On the contrary, stocks returned a total of 10%: 5.0% from dividend income and 4.8% from price return, outpacing inflation for this time period.

Investors who enter retirement with a fixed income may taste the bittersweet savor of longevity, while those who include a healthy dose of stocks in a well-diversified asset class portfolio could help offset inflation.

[1]Source: Morningstar Dividends and Inflation

Neither diversification nor asset class investing assure a profit or guarantee against loss in a declining market.
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