FACTORS IN FOCUS

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Spend It If You've Got It

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Last month's *Factors in Focus* article covered a topic that is regularly on the minds of investors—retirement and cash flow planning. We often advise clients and prospective clients: Just because you've saved diligently and planned frugally, that alone does not ensure you a successful retirement experience. You need to invest in a way that has a documented history of success in a variety of different scenarios and you need to stay committed to that approach (with our help) even during the most turbulent times.

In September's edition, we saw two extreme examples of how choosing the wrong strategy could actually lead to portfolio depletion well before your retirement ends. But what about other, more common retirement strategies? How do they compare to our "asset class" approach?

Popular Stocks Aren't Profitable Investments

We gravitate to safety and familiarity when faced with the uncertainty of investing and planning for multi-decade retirements. One example of this bias comes in the form of investor portfolios dominated by the most popular and well-established blue chip stocks. These companies have been around a long time, they're familiar to us and seem like they should always be great investments.

Wall Street brokers still "manage" portfolios with many individual blue chip stocks in them. The approach is an easy sell and the complexity of dozens of holdings is just enough to convince their clients that they are better off not trying this by themselves. However, popular stocks aren't profitable investments.

Let's look at the returns of the 10 largest and most popular stocks in the U.S. market in 2000: GE, Exxon, Pfizer, Citigroup, Cisco, Wal-Mart, Microsoft, AIG, Merck, and Intel. Imagine you retired in 2000 with a $1M portfolio, equally weighted in these companies, with the goal of pulling out $50,000 per year adjusted for inflation. Unless you had only a 15-year retirement horizon, you were in big trouble.

The popular stock portfolio would have run out of money, net of withdrawals, by mid-year 2015! Only one of the stocks—Exxon—even managed to outperform the S&P 500 Index, while GE (-0.1% per year), Citigroup (-10.3% per year), Cisco (-3.4% per year), and AIG (-16.4% per year) all had cumulative losses including their dividends.

Today's popular companies (Apple, Amazon, Facebook, Google, etc.) are not the same as the leaders in 2000, but it's unlikely that retirement plans based on this strategy will turn out much better. If you have a diversified asset allocation, these companies are already included in your portfolio. But not in amounts significant enough to derail your retirement when their popularity eventually fades.

Dividend Stocks Don't Always Pay Off

Another common retirement approach is basically a spin on the "popular stock" strategy except it specifically targets stocks that pay higher-than-average dividends. Retirees are often skeptical of stock prices, believing that their ebbs and flows are too speculative to rely on for regular income. But a stock that pays a regular and established dividend is easier to manage—simply calculate your desired cash flow, find a handful of companies who pay sufficient dividends, spend the payouts, and put it on autopilot.

This approach isn't as easy or nearly as successful as many assume. First, individual companies are not always able to maintain their dividend policy. As we've seen recently with General Electric, competition is fierce and companies sometimes find themselves in the position of having to cut their dividends when profits sag. Stocks that reduce their payouts often see dramatic price declines (GE is down about 35% this year). If you hold thousands of stocks, the misfortunes of one company can be offset by success in others. In a concentrated portfolio of only a dozen or so dividend payers, even one or two bad apples can spoil the the whole bunch.

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There's another risk to dividend-paying stocks that is frequently overlooked by almost all followers—dividend-paying portfolios often have exposure to just one asset class: US large cap stocks. We saw what can happen in last month's newsletter when you bet it all on a single asset class (the example was the S&P 500) and it fails to produce the expected returns that it has accomplished historically. Recent evidence shows that dividend-paying strategies have not been immune to this reality.

If you invested $1M into the Vanguard Dividend Growth Fund (the largest professionally-managed, dividend-based fund in the market) in 2000 with the same cash flow goals as our first example, you would be down to $704,278 by the end of September, a 30% decline in portfolio value. With inflation-adjusted withdrawals now more than $71,000 per year, your effective portfolio payout is over 10% a year and you're forced to permanently invade principal to make up for what dividends don't provide.

Different beginning periods (such as the mid-1990s or 2003) lead to different results. But how robust is a retirement strategy that is so sensitive to starting points?

Reaching For Yield Rarely Makes Sense

For some retirees, any stocks are too risky and unnecessary. They look to the perceived safety of bonds to achieve their cash flow goals. High-yield ("junk") bonds typically sport yields well above traditional government and investment-grade bonds due to considerably more risk. But some investors see the word "bond" and assume the risk cannot be that significant.

The first issue with high-yield bond investing is taxes. Bond interest is taxed as ordinary income, while stock dividends and appreciation are taxed at much lower long-term capital gains rates. Higher taxes on withdrawals mean you need more gross income just to net the same after-tax cash flow.

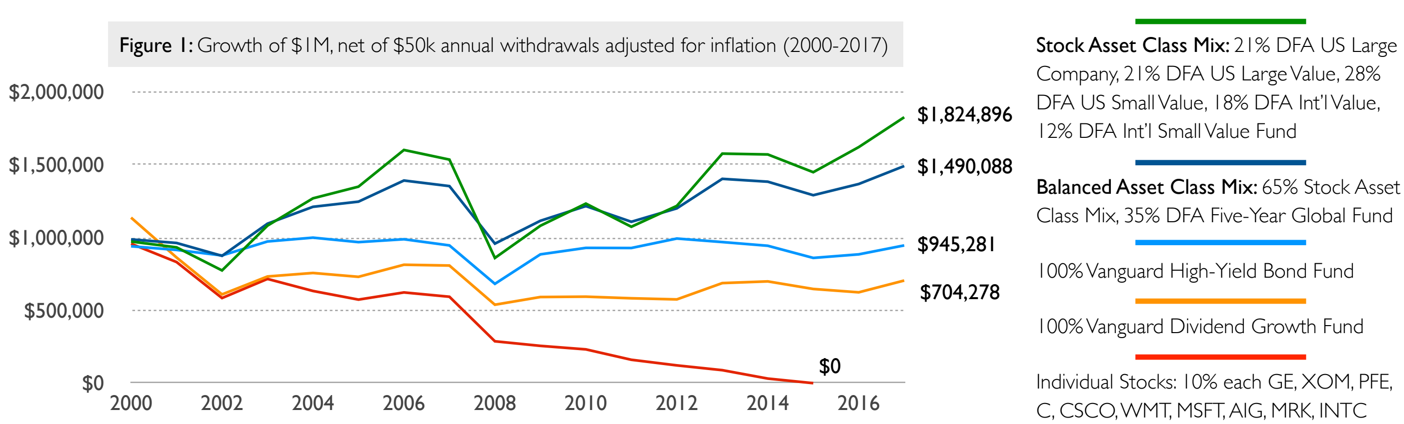
Even more problematic is the fact that interest rates don't follow typical retiree spending patterns. In 2000, the yield on the Vanguard High-Yield Corporate Bond Fund was over 9%, which means a retiree needing 5% a year from their portfolio could have spent half the yield and reinvested the other half. But by 2017, the annual yield had fallen to under 4.5%—a 50% decline in portfolio income. Yet after 17 years of compound inflation, a retiree's withdrawal rate would have needed to increase by over 40% (or $21,000, from $50,000 up to $71,000 a year) just to keep pace with inflation. Junk bond payouts went in the wrong direction.

Finally, the perceived safety of these bonds is just that, *perception*. In 2008, the Vanguard High-Yield Corporate Bond Fund lost almost 22% of its value, a significant decline for bonds and similar to the temporary loss (-25%) on a "balanced" asset class portfolio with 65% in stocks! Unfortunately, this stock-like risk came without stock-like rewards. Using our same retirement assumptions, a $1M investment in the Vanguard High-Yield Fund would be worth just $945,281 today, net of withdrawals, with an ever-increasing amount of future portfolio cash flow coming from liquidating principal instead of bond interest.

A Simple Approach To a Superior Outcome

Retirement planning and investing can be tricky. How much do you need? How much can you spend? What's the best way to invest? How should you generate cash flow? These are all topics we've discussed before and will revisit again. But the short answer is that we believe a balanced asset class approach, customized to your particular return goals and risk tolerance, when coupled with moderate spending levels—4% to 5% per year, represents the best and most sustainable approach for your retirement success. We've looked at countless other approaches, just a few of which are highlighted in this article, and have repeatedly come away more convinced than ever that we—and you—have the superior approach.

Figure 1: Growth of $1M, net of $50k annual withdrawals adjusted for inflation (2000-2017)



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