

SHOULD YOU SEEK YIELD FOR RETIREMENT INCOME?

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"The use of money is all the advantage there is in having it." - Benjamin Franklin

The question posed in the title of this article would seem to have only one logical answer...of course you should seek yield for retirement income! Unfortunately, like much financial conventional wisdom, the easy answer isn't necessarily the right answer. To help you understand why that is the case, let's do a little exercise to clear our minds of the noise we commonly hear, so we can look at this completely objectively.

Here is the exercise (pay attention to the instructions because there is a quiz at the end). Open your wallet and take out two bills of equal denomination, say \$1 bills. Place one under your right hand and one under your left on the table or desk in front of you. Now, presume for a moment that the \$1 bill under your left hand is what is left from a dividend that was taxed at the current maximum qualified dividend tax rate of 15%. Then, presume that the \$1 bill under your right hand is what is left after a realized long term capital gain taxed at the maximum 15% rate, just like the dividend. Finally, assume you are retired. So, here is the question for you. How much more gasoline, groceries, clothing, transportation, travel and entertainment does the dollar under your left hand buy than the dollar under your right hand? The painfully obvious answer is of course, NONE. Both dollars are taxed at the same rate and spend identically. A dollar of dividend yield is worth no more than a dollar of capital gain. So why is the common wisdom that you need a higher yielding portfolio in retirement? The answer, like much generally accepted financial conventional wisdom, is marketing.

Some firms create special portfolio allocations for various targeted risk tolerances designed to generate higher yields just for retirees. Special ETFs and mutual funds targeting higher dividend yields are promoted to retirees. But the dividend dollars they generate do not buy any more than the long term capital gains dollars the portfolios might otherwise generate. Furthermore, doing so increases your risk because betting on overweighting a group of stocks leaves you less diversified, something retirees should avoid.

IN DEFENSE OF DIVIDENDS

The purveyors of such portfolios do make some arguments in support of seeking higher yields. First, they argue that in declining markets, a higher dividend yield will protect your portfolio from losses. It is curious to me that if this were indeed the case, why would they have different portfolios for younger investors who are not seeking these higher yields? Doesn't everyone want the portfolio protection of dividend yields as much as retirees? The reality of this idea hasn't really played out in recent history (not that that is an indication of future results).

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Admittedly, 2011 was a great year for high dividend yielding stocks. For example, Wisdom Tree's Equity Income ETF (DHS) produced a total return in 2011 of 14.22%. It yields about 1.5% above the more diversified Vanguard Total Market Index (VTI) which returned only 0.93% in 2011. DHS's 2011 return was nearly as much as the 7-10 Year Treasury ETF (IEF) we use in our portfolios (usually in tax deferred accounts), which had a total return of 15.65% (remember total return includes yield AND capital gains). However, DHS also costs more than five times as much as VTI and two and a half times more than IEF.

Of course, 2011 wasn't a down year, it was up a little. How much protection from those dividends did we get when, for example, the market first started to get shaken up by sub-prime mortgages in 2007, crashed in 2008 and bottomed in 2009 only to partially recover by the end of the year? Over the three years of 2007 through 2009, \$1 million invested in the high yielding DHS would have declined to \$681,643, a loss of more than \$318,000, which is more than twice that of VTI's loss of \$143,923... including dividends.

I'm the last person in the world to say that past performance has anything to do with future results; but how could one in good conscience represent that high dividend yields protect you from losses, considering that during some of the worst markets we've had they more than DOUBLED the losses? The argument that dividends help protect you from losses doesn't seem to hold up to recent historical data. Maybe it will in the future, but that is always uncertain.

The other argument dividend purveyors make for getting income from dividend yields is that you don't want to be forced into selling positions when they are down, and higher dividend yields help protect you from this. This is curious to me as well, since one would presume that over the course of a year or so your portfolio will likely become out of balance relative to its target allocation. To correct for this, are you really going to sell the asset class that is already underweighted when it comes time to generate a capital gain for you to spend? Wouldn't that make it even more underweighted? Wouldn't you instead sell the better performing asset that outperformed and is over weighted? On a relative basis, isn't that selling high, not low?

Take for example a portfolio that starts the year at 50% in Stocks and 50% in 7-10 Year Treasuries (your targeted allocation) and you use VTI and IEF to fulfill that targeted allocation. The current yield on this portfolio would be around 1.81%. Replacing VTI in this portfolio with DHS would increase the yield to 2.45%. This amounts to a difference in yield of 0.64%. In theory, that is how much less in capital gains you would need to realize to meet spending needs with DHS versus VTI, assuming *everything else were equal and you ignored the fact that your portfolio is going to need some rebalancing*.

Here again, the historical evidence doesn't support the argument. Assume you are withdrawing 4% a year to meet your spending goals. Assuming everything else is equal except for DHS's 0.64% higher dividend, in theory the amount of capital gains you would have to realize to meet your spending goals would be that much less than the lower yielding VTI portfolio, or so they would like you to believe. But this ignores the need to rebalance.

The reality is you will likely have to realize gains larger than the entire 4% withdrawal just to keep your portfolio in balance. If your portfolio was in balance at the beginning of each calendar year, in four out of the last five years, you would have to realize a capital gain of more than 4% in the over weighted position just to get back in balance. This is true regardless of whether you used VTI or DHS for the equity position. Instead of being forced to sell the security that was down—as the dividend advocates claim in the theory—in four of the last five years, rebalancing to your target allocation would actually have you buying the security that was down (or underperformed) on a relative basis, even after using gains to meet your entire spending need. This is exactly opposite of what they claim! And, in the one in five years where you would have to sell both positions to meet your spending target and rebalance, both would have had capital gains for the year.

But, even if the last five years are outlier examples, what would be so bad about realizing a 0.64% additional capital loss? A portion of realized capital losses can be used to offset current income and if there are additional losses beyond that, they shelter either additional income or gains from taxation in future years. In some cases, we even intentionally harvest losses to capitalize on tax loss carry forward opportunities.

So, while everyone knows the common rule of thumb is to seek higher yield for retirees, advisors and investors who think about it more objectively will realize that “what everyone knows often isn’t worth knowing.” (quote attributed to Andrew Lanyi, and others). It is what makes real Wealthcare better for clients, and advisors and why we DEFY THE COMMON™.

(For more information read my Forbes article, [Beware of Yield Bribery](#).)

A popular industry speaker and writer, DAVID B. LOEPER is the CEO and founder of Wealthcare Capital Management, Inc. in Richmond, VA. He is author of the top selling book [Stop the 401\(k\) Rip-off!](#), three other books released in 2009 by John Wiley & Sons ([Stop the Retirement Rip-off](#), [Stop the Investing Rip-off](#) and [The Four Pillars of Retirement Plans](#)) and numerous whitepapers. He has appeared on CNBC, CNN, Fox Business and Bloomberg TV, served on the Investment Advisory Committee of the \$30 billion Virginia Retirement System, and was chairman of the Advisory Council for the Investment Management Consultants Association (IMCA). Before founding the company in 1999 he was Managing Director of Strategic Planning for Wheat First Union. He earned the CIMA® designation (Certified Investment Management Analyst) from Wharton Business School in 1990 in conjunction with IMCA.

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