Tangible Investing in Retirement Using a Global Dividend Income Strategy

By Jack Gardner, CIMA®, AIFA®

As financial markets continue to mend following the disruption of 2007–2009, many investment consultants are rethinking how to help baby-boomer clients build sustainable retirement plans. For clients who are within five years of retirement, investment consultants would be wise to heed that well-known value investor Benjamin Graham, who said, "The investor will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies." I believe that a tangible investment strategy that cultivates a substantial and growing cash flow via dividend and interest income can be an attractive solution for retirees who are trying to balance present spending needs with future purchasing power. The combined focus on a rising income stream plus acceptable risk-adjusted total return may help keep retirees on plan during difficult markets.

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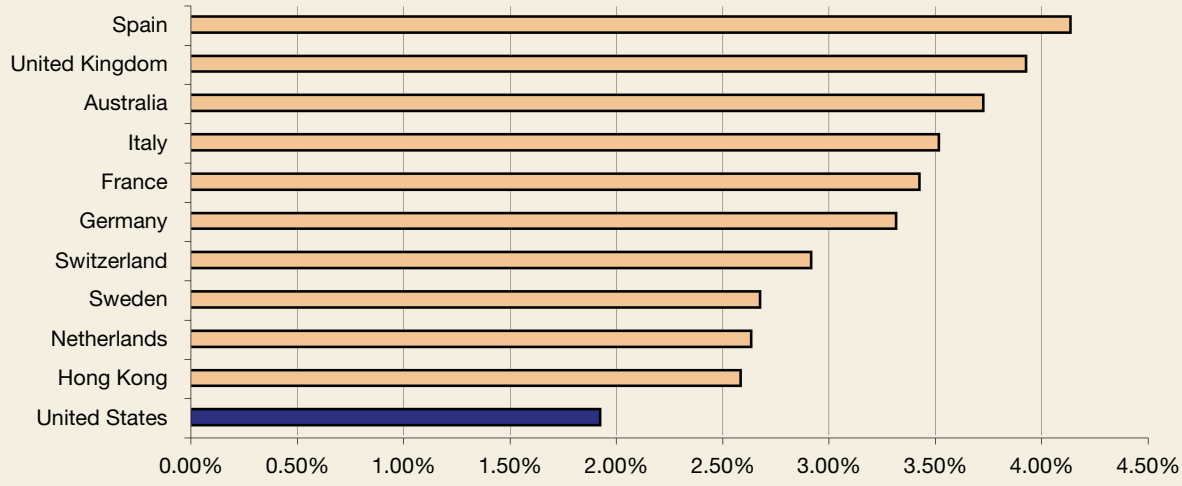
The cornerstone of such a tangible investment strategy for retirement includes the use of equity dividend income derived via a global investing strategy. This article will review how to structure, allocate, and monitor the results of such a tangible investment strategy for retirees.

Opportunities of a Global Dividend Strategy

Dividends are viewed differently depending upon the country. Among many U.S.-domiciled companies, where executive compensation is tied to growing the share price, dividends are a sign of limited reinvestment opportunities. Arnott and Asness (2003)[1] showed, however, that companies with high dividend payout ratios tend to subsequently have higher earnings growth than companies with

FIGURE 1: DIVIDEND YIELDS BY COUNTRY



As of December 31, 2009
Past performance does not guarantee future results.

Sources: FactSet, S&P 500, and MSCI.com.

1. This study contains the most current data available at the time of publication.

TABLE 1: GLOBAL DIVIDEND YIELDS BY SECTOR (2010E DIVIDEND YIELDS) AS OF DECEMBER 31, 2009

Sectors	United States	Europe	Asia (ex-Japan)
Financials	1.7%	4.2%*	3.7%
• Banks	2.0%	2.3%	3.8%*
• Diversified Financials	0.8%	2.6%	3.0%*
• Insurance & Other	2.1%	3.8%*	2.2%
• Real Estate	5.1%*	4.6%	2.9%
Materials	5.1%*	4.8%	4.0%
Telecom	4.6%	6.0%*	4.5%
Utilities	4.2%	5.2%*	2.9%
Industrials	3.3%	3.8%*	3.4%
Consumer Staples	2.7%	3.3%*	2.7%
Consumer Discretionary	2.2%	3.4%*	2.9%
Energy	1.9%	5.3%*	3.5%
Health Care	1.9%	3.6%*	1.3%
Information Technology	1.1%	2.4%	3.3%*
Market Average	3.3%	4.9%	3.1%

*Best opportunity by sector
Past performance does not guarantee future results.
Sources: Reuters, FactSet

lower payout ratios, and that the higher earnings growth may be due to better allocation of capital. This view of dividend payout is more prevalent outside the United States, where payment of high and growing dividends is viewed as a sign of financial strength. A comparison of dividend yields among countries illustrates this cultural difference (figure 1).

A global dividend income strategy also provides an opportunity to improve a portfolio's diversification by sector. This is because U.S. dividends typically have been more-available via the financial and utility sectors, but attractive dividends are available in many different sectors of the international market (table 1).

Thus a global approach to dividend investing may provide more-attractive dividend yields as well as improved portfolio diversification by industry sectors and countries.

Performance of Dividend Investing during the Lost Decade

Most academic studies about dividend-centric strategies have focused on the accumulation phase of investing. My interest, however, is in utilizing a high and growing global dividend income strategy to build growing dividend and interest income streams for retirees (Gardner 2008). I use the following dividend indexes, now available from Standard and Poor's:

S&P 500 Dividend Aristocrats Index. This is an equal-weighted index of large, blue chip companies from the S&P 500 Index that have consistently increased dividends annually for the past 25 years. The index is diversified by sector, reconstituted each December, and includes 43 companies for 2010.

S&P Global Dividend Opportunities Index. This is a yield-weighted index of 100 exchange-listed common stocks and American Depositary Receipts from around the world that offer high dividend yield opportunities. The index is designed to provide diversification by country and industry and is rebalanced twice a year.

Comparing the nominal performance of these two dividend-centric indexes to the S&P 500 for the period of 2000–2009 (table 2) shows that both had positive returns and positive Sharpe ratios during this difficult decade (unlike the S&P 500 Index).

The Dividend Aristocrats Index had an income return that was 98 basis points (54 percent) better than the S&P 500 Index. It accomplished this better return with a lower standard deviation. The Dividend Aristocrats Index had 6.43-percent of additional price return over the S&P (3.71 percent versus –2.72 percent); this should appeal to retirees who need to preserve purchasing power while putting their dividend income toward spending.

The Global Dividend Index had an even more significant increase in income, price, and total return. The Global Dividend Index total return was 4.83 percent per year better than the Dividend Aristocrats Index (11.32 percent versus 6.49 percent) and 12.25 percent per year better than the S&P 500 Index (11.32 percent versus –0.93 percent). This outperformance can be attributed to both the income and price returns. Note that the Global Dividend Index had a higher

TABLE 2: ANNUALIZED RETURNS, STANDARD DEVIATIONS, AND SHARPE RATIOS FOR 2000–2009

Annualized Returns	Price Return	Income Return	Total Return	Standard Deviation	Sharpe Ratio
S&P 500 Index	–2.72%	1.80%	–0.93%	16.13	–0.23
Dividend Aristocrats Index	3.71%	2.78%	6.49%	14.76	0.25
Global Dividend Index	4.81%	6.51%	11.32%	20.39	0.42

Past performance does not guarantee future results.
Sources: S&P 500 and calculated by author

TABLE 3: COMPONENTS OF RETURN AND STANDARD DEVIATIONS, 2000–2009

	Price		Income		Total	
	Return	STDEV	Return	STDEV	Return	STDEV
S&P 500 Index	–2.72%	16.12	1.80%	0.19	–0.93%	16.13
Dividend Aristocrats Index	3.71%	14.75	2.78%	0.39	6.49%	14.76
Global Dividend Index	4.81%	20.14	6.51%	1.07	11.32%	20.39
Barclays 10-yr. Muni Bond Index	0.93%	1.43	4.88%	0.02	5.81%	1.43
Barclays 5-yr. Muni Bond Index	0.39%	3.44	4.85%	0.06	5.24%	3.45

Past performance does not guarantee future results. Individuals cannot invest directly into an index.
Source: S&P 500 and Barclays, and calculated by author

TABLE 4: YIELD ON ORIGINAL COST ANALYSIS

Year	Spending Rate	Hypothetical Yield on Original Cost				
		S&P 500	Dividend Aristocrats	Global Dividend	Barclays 10-year Municipal	Barclays 5-year Municipal
2000	5.00%	1.12%	2.58%	4.87%	5.24%	5.22%
2001	5.17%	1.07%	2.66%	4.90%	5.25%	5.12%
2002	5.31%	1.09%	2.69%	5.21%	5.20%	4.98%
2003	5.40%	1.20%	2.76%	5.80%	5.08%	4.82%
2004	5.52%	1.32%	2.96%	6.91%	5.10%	4.84%
2005	5.67%	1.50%	3.29%	10.10%	5.05%	4.87%
2006	5.87%	1.70%	3.83%	12.10%	5.02%	4.81%
2007	6.05%	1.89%	4.08%	15.90%	4.97%	4.75%
2008	6.22%	1.93%	4.56%	14.82%	4.95%	4.70%
2009	6.46%	1.52%	4.20%	8.15%	4.98%	4.61%
2000–2009 Cum. Appreciation—Price-only		–24%	44%	60%	10%	4%
Purchasing Power (Loss) / Gain		–53%	15%	31%	–19%	–25%

Past performance does not guarantee future results.
Sources: S&P 500, Barclays, and calculated by author

standard deviation, but the investor was compensated for this additional risk with an improved Sharpe ratio.

Allocating the Retirement Portfolio

Retirees can benefit from a global dividend income strategy for higher income potential while using price return to preserve purchasing power. The increased volatility in the global equity investment strategy primarily comes from the price-return portion of total return. To illustrate, table 3 shows standard deviations for 2000–2009, segregated by income and price return components of the total return for the S&P 500 Index, the two dividend indexes, and two municipal bond indexes we will use later in this article to construct a diversified portfolio.

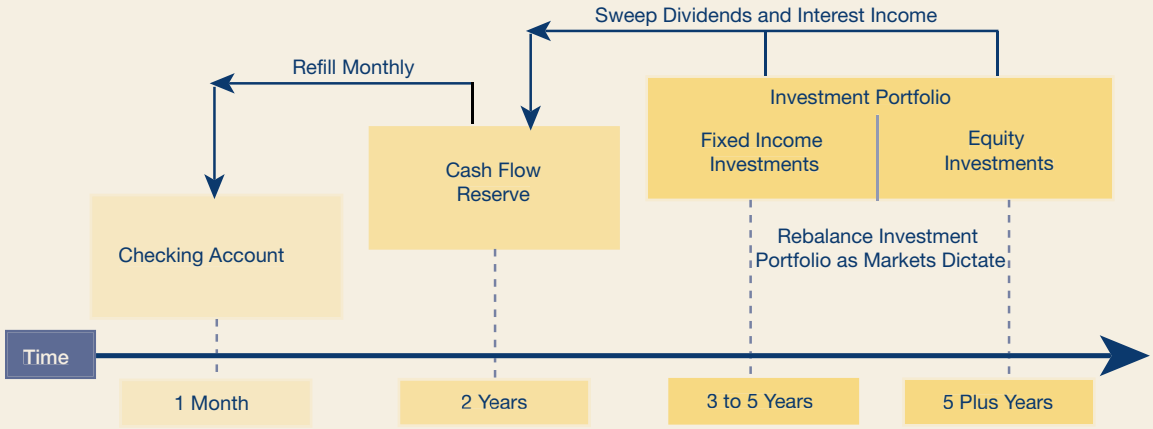
Table 3 shows that most of the volatility for the Dividend Aristocrats and Global Dividend indexes is derived from the price return rather than the income return. To put the standard deviations for the income returns into perspective, a one- to three-month Treasury bill with a total return of 2.85 percent had a standard deviation of 0.56 over this same time period.

When using a growing dividend strategy for retirement-income planning, it is also important to understand the possible increases and decreases in the dollar amount of income by year. Table 4 gives a useful illustration of these potential income changes that is based on a "yield on original cost" analysis that assumes an investment made on January 1, 2000.

Table 4 compares the hypothetical yield of an investment in various dividend and fixed income strategies to the 5-percent initial spending rate grown at inflation. The cumulative appreciation is from the price-only return, which is relevant for retirees assuming they are spending the income-only return. The purchasing power loss/gain is the cumulative price appreciation less the 29-percent cumulative inflation realized during the 10 years per the Consumer Price Index–All Urban Consumers (CPI-U).

Table 4 shows that dividend strategies may help preserve purchasing power and provide increasing income over time, but they are susceptible to decreases in the dollar amount of income, as seen in 2008–2009. Using a fixed income strategy for more-steady

FIGURE 2: CASH-FLOW RESERVE LADDER



Source: Thornburg Investment Management

income exposes an investor to erosion of purchasing power. The key: Use a diversified mix of dividend strategies and fixed income strategies in a retirement portfolio. This combination has potential for growth of the income stream while preserving purchasing power.

Structuring the Portfolio

Structuring the portfolio to achieve this combination is the next step. To align assets with these objectives, I used a cash-flow reserve ladder that segregates the retirement portfolio into three rungs: a checking account, a two-year cash-flow reserve, and the investment portfolio (figure 2).

At the beginning of each month, the retiree writes a check from the cash-flow reserve for the budgeted monthly spending amount and deposits it into the checking account. From a behavioral standpoint, this monthly deposit can provide a level of certainty for retirees. It also segregates the month's spending from the larger pools of capital and helps curb any desire to overspend.

The cash-flow reserve typically includes a money market account and some form of relatively stable, high-quality, fixed income investments. This reserve is intended to have sufficient capital to cover approximately two full years of spending to help alleviate worry about covering near-term spending needs. It also may help an investment consultant avoid pressured selling of assets in a down market, which could result in the negative effects of reverse dollar-cost averaging.

TABLE 5: ASSET ALLOCATION EXAMPLE

	Allocation
Cash Flow Reserve	
Municipal Money Market	5%
5-year Municipal Bond Portfolio	5%
Investment Portfolio	
10-year Municipal Bond Portfolio	25%
Dividend Growers Portfolio	15%
Global Dividend Portfolio	50%
Total	100%

Assumes that the 5-year municipal bond portfolio performed similarly to the Barclays 5-year Muni Bond Index; the 10-year municipal bond portfolio performed similarly to the Barclays 10-year Muni Bond Index; the dividend growers portfolio performed similarly to the S&P 500 Dividends Aristocrats Index; and the global dividend portfolio performed similarly to the Global Dividend Index. Diversification cannot guarantee a profit or protect against a loss. Individuals cannot invest directly into an index.
Source: S&P 500 and FactSet

The longer-term investment portfolio allocation should be designed to meet the client's specific needs and tax sensitivities. The fixed income allocation represents roughly five additional years of income. For a retiree spending 5 percent of a portfolio in year one, that would equate to a 25-percent allocation to fixed income. The balance of the investment portfolio is invested in equity to provide growth and to capture the dividend stream associated with a global dividend income strategy. The dividend income from the equity portion and the interest income from the fixed income investments aren't reinvested; they are swept into the cash-flow reserve, which in turn funds the checking account. In the earlier years of retirement, when the portfolio's income is more likely not to cover the next year's spending, this cash-flow approach reduces the amount of assets that need to be liquidated at any one time to cover spending needs. In years when income exceeds annual spending, the investment consultant can reinvest the excess.

A Hypothetical Retiree

For this example, I assumed that a hypothetical retiree has a $1-million

retirement portfolio and plans to spend $50,000 (or 5 percent) in the first year of retirement. This amount is adjusted annually for inflation as measured by CPI-U. I have used a simple allocation example that includes dividend growers and global dividend opportunities (table 5). For the fixed income portion of the investment portfolio and the cash-flow reserve, I have allocated municipal bond funds assuming a need for tax sensitivity of the income.

Historically, municipal bond indexes have had relatively low standard deviations and very low correlation to the dividend equity indexes (table 6).

With the cash flow generated via dividend and interest income, plus the two years of liquidity in the cash-flow reserve and the additional five years of income in the municipal bond portion of the portfolio, the retiree has more than seven years before the higher-volatility equity investments would need to be sold. As demonstrated in 2000–2002 and again in 2007–2009, having the opportunity to hold assets is critical to circumventing irreparable harm to the portfolio, which is especially important for retirees.

Let's assume that our hypothetical retiree began retirement on January 1, 2000, using a cash-flow reserve ladder (figure 2) with the asset allocation shown in table 5. Table 7 shows this retiree's interest and dividends, planned spending, and returns by year.

TABLE 6: CORRELATIONS FOR 2000–2009

Index	Correlation to Dividend Aristocrats Index
S&P 500 Index	0.80
Global Dividend Index	0.77
Barclays 10-year Municipal Bond Index	0.01
Barclays 5-year Municipal Bond Index	0.03

Source: S&P 500, Barclays, and calculated by the author

The income/spending ratio shows how well annual income covers budgeted annual spending. Note that this ratio is consistently greater than 85 percent and has been greater than 100 percent during the past five years.

Table 7's section on the account status shows how the annual spending rate is recalculated at the beginning of each year by dividing the budgeted spending amount by the portfolio's market value. This percentage is an excellent gauge of the retirement plan's sustainability.

Table 7 also shows the cumulative amount of interest and dividend income, budgeted spending amount, and total annual return since retirement. For this hypothetical retiree, who has experienced two very significant bear markets during the first 10 years of retirement, this strategy has provided $632,680 of income, $1.573 million in account value (as of December 2009), and a very healthy 5.49 percent current spending rate.

Conclusion

The much anticipated retirement of baby boomers will be officially underway when the oldest boomers turn 65 in 2011. Much has been written about how ill-prepared these folks are for retirements that could last 30–40 years. Trusted investment consultants are needed to help boomers in this new stage of investing. Investment consultants must treat the retirement income distribution stage as a process, not just a product; a path, not just a destination. I&W

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TABLE 7: HYPOTHETICAL INCOME, BALANCE AND RETURN SHEET

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Cumulative
Income Statement											
Interest Income	$17,249	$16,845	$15,715	$13,802	$16,419	$19,939	$22,143	$25,135	$25,139	$16,822	$189,209
Dividend Income	28,218	28,107	30,072	34,184	36,621	47,523	54,964	67,447	62,921	53,414	443,471
Total Income	$45,467	$44,953	$45,786	$47,985	$53,040	$67,462	$77,108	$92,581	$88,061	$70,237	$632,680
Budgeted Spending Amount	$50,000	$51,700	$53,148	$53,998	$55,240	$56,731	$58,660	$60,537	$62,232	$64,597	$566,844
Income/ Spending Ratio	91%	87%	86%	89%	96%	119%	131%	153%	142%	109%	112%
Account Status											
Annual Return	10.29%	2.83%	0.39%	24.19%	20.21%	8.88%	16.89%	9.46%	-27.29%	39.61%	9.53%
YE Account Value	$1,045,837	$1,027,412	$982,592	$1,166,050	$1,346,887	$1,412,407	$1,593,436	$1,686,482	$1,175,771	$1,573,225	
Spending Rate by Year *	5.00%	4.94%	5.17%	5.50%	4.74%	4.21%	4.15%	3.80%	3.69%	5.49%	

* Current spending rate is current year's spending amount divided by the account value on January 1st of each year.
Past performance does not guarantee future results. For illustration purposes only. Data is derived from the allocation of investments used in table 5.
Source: Calculated by author

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Within the context of this article the reference to "tangible" equates to dividends.

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Special risks may be associated with investments outside the United States, especially in emerging markets, including currency fluctuations, illiquidity and volatility.

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Investments in mutual funds carry risks, including possible loss of principal. Bond funds have the same interest rate, inflation, and credit risks that are associated with the underlying bonds. The principal value of bond funds will fluctuate relative to changes in interest rates, decreasing when interest rates rise. Unlike bonds, bond funds have ongoing fees and expenses. Investments in equity securities are subject to additional risks, such as greater market fluctuations. Investments in mutual funds are not FDIC insured, nor are they deposits of or guaranteed by a bank or any other entity.

Dividend yield is the financial ratio that shows how much a company pays out in dividends each year relative to its share price. In the absence of any capital gains, the dividend yield is the return on investment for a stock.

Reverse dollar cost averaging is the negative effect upon a retirement portfolio of having to sell more shares of an investment in a down market to provide for spending.

Purchasing power is the value of a dollar in correlation to the amount of goods or services that it can buy at a given time.

Sharpe Ratio is the risk-adjusted measure developed by Nobel Laureate William Sharpe. It is calculated by using standard deviation and excess return to determine reward per unit of risk. The higher the Sharpe Ratio, the better a portfolio's historical risk-adjusted performance.

Standard Deviation is a statistical measurement of dispersion about an average which, for an investment, depicts how widely the returns varied over a certain period of time. When an investment has a high standard deviation, the predicted range of performance is wide, implying greater volatility.

Yield on Cost (YOC) is the most recent 12-month dividend payment per share divided by original share price paid.

The Consumer Price Index (CPI) measures prices of a fixed basket of goods bought by a typical consumer, including food, transportation, shelter, utilities, clothing, medical care, entertainment and other items. The CPI, published by the Bureau of Labor Statistics in the Department of Labor, is based at 100 in 1982 and is released monthly. It is widely used as a cost-of-living benchmark to adjust Social Security payments and other payment schedules, union contracts and tax brackets. Also known as the cost-of-living index.

The CPI-U is a subset of CPI that measures the effects of inflation on all urban consumers.

A Treasury bill is a debt obligation of the US government backed by the "full faith and credit" of the government. Bills are short-term instruments with maturities of no more than one year. Treasury bills function like zero-coupon bonds. Investors buy bills at a discount from the par, or face value and then receive the full amount when the bill matures.

Country indices are MSCI free float-adjusted market capitalization indices that are designed to measure equity market performance in that specific country.

The S&P 500 Index is an unmanaged broad measure of the U.S. stock market.

Barclays Capital 5-Year Municipal Bond Index covers USD-denominated, investment-grade, tax-exempt bonds with maturities between four and six years. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

Barclays Capital 10-Year Municipal Bond Index covers USD-denominated, investment-grade, tax-exempt bonds with maturities between nine and eleven years. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

Morningstar Municipal Money Market category covers portfolios that invest in short-term municipal money market securities that are often exempt from some federal and state taxes. These funds provide current income and aim to preserve capital.

The performance of any index is not indicative of the performance of any particular investment. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments into any index.

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