

Three reasons to be wary of chasing dividend yield for income

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Rod Greenshields, CFA
Consulting Director
U.S. Private Client
Services

Much of the attraction of using dividend yield for retirement income stems from the classic wisdom voiced by experts, family and friends – never invade principal.

Advisors use a variety of investment strategies to replace retired clients' employment salaries or business income. These include bond ladders, systematic withdrawal programs (SWPs), guaranteed minimum withdrawal benefit products (GMWBs), and even strategies in the relatively new category of target payout products. But one of the most common approaches is the dividend yield strategy.

Relying on dividends for income is a strategy that has served investors well in the past. Who hasn't heard of the proverbial elderly widow living off the steady stream of GE dividend checks? And many investors believe that high-dividend-paying stocks are preferable to low- or non-dividend-paying stocks for portfolios intended to meet income needs.

This strategy has been so attractive because it professes to meet the "golden three" outcomes for retirement-oriented investing—income, capital preservation/growth and liquidity. But as markets have evolved and the retirement investing landscape has shifted, is there anything about this strategy that should concern advisors and their clients?

REASON #1 – THERE'S NO FREE LUNCH

It's not hard to see why investors are attracted to the idea of high-dividend-paying stocks. On the surface, these investments seem to offer the best of both worlds: the potential for long-term capital appreciation *and* a steady income stream. But this perception rests on a fundamental misunderstanding of how dividends work.

Dividends come from profits that a company distributes to shareholders. Faced with the decision to reinvest the surplus into business projects, use it to repurchase their own stock or pay it out to shareholders, dividend-paying companies emphasize the latter.

Paying out dividends means that a company will have less capital to fund new or existing opportunities (assuming it doesn't raise capital by issuing additional equity). Consequently, paying out is likely to dampen future business growth. All else being equal, when a company declares a dividend, that company's inherent value immediately declines by the amount of the distribution on the dividend record date. That's a clear sign that dividends aren't free.

Dividend yield vs. total return

A different approach to framing the income replacement issue is through the lens of total return: the sum of both dividends and capital appreciation. According to this perspective, receiving dividends isn't necessary in order to receive money from a

portfolio. If shareholders need income, they can “manufacture” their own “dividends” at any time by selling shares. Keep in mind, however, that a stock’s value may decline and be worth less than when it was originally purchased, in which case the sale would be at a loss.

In 1958, Franco Modigliani and Merton Miller published “The Cost of Capital Corporation Finance and the Theory of Investment,” a seminal paper on capital structure and dividend theory.¹ Their assessment of optimal capital structures argues that companies should be indifferent to how they raise capital (whether through issuing more debt, selling stock, or issuing new stock) and that dividend policy doesn’t affect the value of a firm.

Most individual investors, however, don’t consider capital structure when evaluating high-dividend-paying stocks. Rather, they make their decisions according to more tangible criteria. And dividends are attractive because they create a mental accounting framework that is more psychologically tolerable. The rules of this game are simple: spend the dividend check and leave the rest alone.

Do dividends signal a better investment opportunity?

Some might argue that dividend-paying stocks are more attractive than other investments, and that when a company pays a dividend it signals something about its future prospects. For example, it could mean that the company is confident about its future earnings.

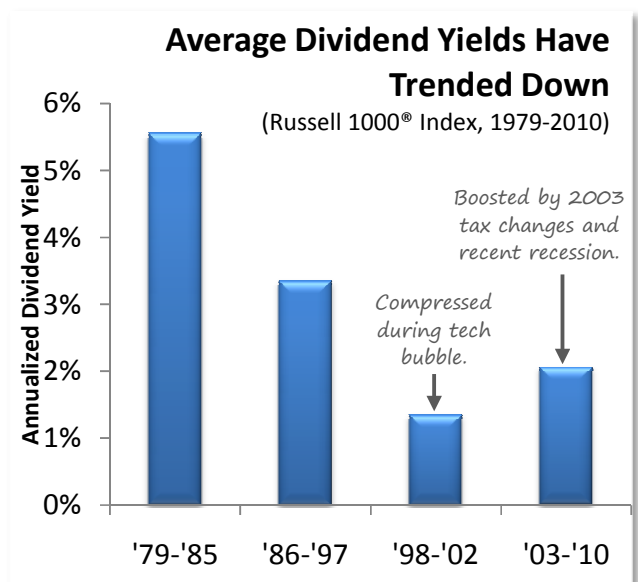
At Russell, we’ve conducted our own research and reviewed that of others, but haven’t found a compelling case for the view that dividend-paying companies are better long-term investment opportunities. We believe that at best there’s modest support for a view that some companies which *increase their dividends over time* may have better future prospects. But we think this is more appropriately treated as an *investment* management decision rather than an *income* management decision. Be careful not to let a convenient quarterly payment accidentally drive an active management strategy.

REASON #2 — DIVIDENDS HAVE BEEN DECLINING

A few decades ago, it was reasonable to invest in a broadly diversified pool of stocks and still earn a healthy dividend. From 1979 to 1985, the average yield for the Russell 1000® Index exceeded 5.5%.

Since then, however, dividend yields have dropped significantly. The lowest range was in the 1998–2002 tech bubble period, when yields averaged less than 1.5%.

The most recent range, 2004 through 2010, does, however, show a modest bump in dividends. But two



Indexes are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

¹ F. Modigliani and M. Miller, "The Cost of Capital, Corporation Finance and the Theory of Investment," American Economic Review (June 1958).

factors likely drove this change. First, the Jobs and Growth Tax Reconciliation Relief Act of 2003 (JGTRRA) equalized the earlier income tax penalty for dividends. Second, 2009 marked the highest average dividend yield since 1995, 2.96%. But this may have been the temporary effect of companies having limited reinvestment opportunities in the midst of a broad recession. (To that point, the average dividend yield declined to 2.23% in 2010.)

Relying on dividends to provide a level and large-enough income isn't as easy as it used to be. And while it's difficult to predict the exact dividend policies companies will adopt in the coming years, it's unlikely that dividends will be as high or as stable as they have been in previous decades.

REASON #3 — CONCENTRATION RISK IS COMMON

In order to achieve a dividend yield level even close to what a broadly diversified investor could have received a few decades ago, an investor would need to concentrate their portfolio in no more than the highest 10% of dividend-paying stocks, as represented by the Russell 1000[®] Index. (Keep in mind that indexes are unmanaged and cannot be invested in directly.)

	Annualized Dividend Yield
Russell 1000 [®] Index (1979–1985)	5.6%
Russell 1000 [®] Index (2010)	2.2%
Top 100 Russell 1000 [®] Index dividend-yielding stocks (2010)	5.1%

Note that at present, 71 of the top-yielding securities in the Russell 1000[®] Index are in the financial services and utility sectors. Pursuing this strategy would allocate nearly three-quarters of a stock portfolio to two narrow sectors. And as history has proven time and again, unexpected events can devastate narrow areas of the market and individual securities. For example, it's an understatement to say that the financial sector has delivered a bumpy ride the past couple of years. And BP's June 17, 2010 announcement that it would suspend its dividend payments was unwelcome news to many shareholders.

Finally, don't forget that dividend yield is defined as a company's dividend payments divided by its share price. A high dividend yield might not equal a high dividend payment; it could result from the plummeting share price of a troubled company.

A lesson learned too well?

One of the more perplexing questions about the dividend yield approach is why dividends were so popular before the 2003 tax changes equalized their tax treatment.² It suggests that strong psychological or emotional factors are at work. If dividends can be considered a zero-sum game, or a worse choice in historical tax environments, then why has dividend-yield investing been so attractive in the past?

We believe much of the attraction undoubtedly stems from the conventional wisdom voiced by experts, family and friends: **never invade principal**. This tenet of responsible investing is ingrained so deeply and so effectively, it's difficult to dispel. For many wealthy individuals, it's a core belief that helped them create their wealth in the first

² Before the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), dividends were taxed at ordinary income rates. While still technically classified as ordinary income after the act, their effective tax rate became the same as the capital gains rate, with a maximum of 15%. Although these were scheduled to expire in 2010, the Tax Relief Act of 2010 extended this rate equalization through the end of 2012.

place. Manufacturing dividends feels like robbing the nest egg; harvesting company profits a bit at a time does not. And so emotion trumps theoretical investment rationale.

In defense of total return

As more investors enter retirement and need to replace substantial proportions of their working-years income by using their investment portfolios, a dividend-yield strategy is likely to fall short. There may simply be no alternative to adopting some form of total-return investing. Even more worrisome for the never-invade-principal adherents: the time may come when prudently drawing down a portfolio becomes necessary to fund living expenses.

When we consider the risks of a dividend-yield strategy as discussed above, a total-return approach that relies on a combination of dividends and capital gains to fund retirement income needs is compelling. With the help of an advisor, an investor can pursue it by using traditional systematic withdrawal programs or conditional asset-allocation strategies and products built around this investment approach.

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No investment strategy can guarantee a profit or protect against a loss.

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