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SPECIAL REPORT: FOCUSING ON INCOME FROM EQUITY INVESTMENTS

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Investment advisors will be faced with a serious dilemma in coming years as a huge demographic group moves towards retirement. In the next 15 years, the majority of the post World War II "baby boom" generation will reach their mid 60's…a group of roughly 40 million people. This will greatly affect many parts of the economy including social security, Medicare and other government services.

The challenges faced by this generation in retirement planning will be significantly different from previous generations. Most importantly, life expectancies have expanded significantly. As Ross Perot has pointed out, the original actuarial assumptions of the Social Security program were roughly based on a retirement age of 65 and a life expectancy of 66. While, of course, there were many Americans who lived much longer, as a whole there was not a great need for long-term planning for retirees. Furthermore, investors more frequently were participants in "defined benefit" retirement plans, under which responsibility for retirement investing was assumed by the employer.

The retirees of tomorrow face a different situation. First, they are statistically likely to live substantially longer than those in the past. This has many implications, with the long-term impact of inflation being perhaps the most significant. Secondly, most retirees now have their assets in a combination of individual retirement accounts (IRA's) and some sort of "defined contribution" plan through their employer. The difference is that the responsibility and risk for making investment decisions now falls directly on the employee. Thirdly, this is all happening after a generation-long bull market in financial assets which saw the Dow Jones average rise 15 fold over a 25 year period. It is certainly possible that the returns from financial assets in coming years will be significantly lower than in recent years. As Ralph Wanger has pointed out, there have been significant periods in the past where the stock market has provided meager returns. In the last century, the Dow Jones average stood at roughly 100 in 1905 and was at the same level 38 years later. Similarly, the Dow stood at 1000 in 1967 and was actually lower than that level when the new bull market began in 1982.

PRUDENT PLANNING, NOT MARKET TIMING, IS KEY

While it is not our intent to forecast stock prices, prudent planning would certainly involve considering a scenario of prolonged poor returns from equities. What would be the proper course of action under such a scenario?

As Ralph Wanger has pointed out in a 2007 article in the CFA digest, the expected return from stocks can be broken into two components: the income component and the growth component. In selecting securities, investors may look for stocks with good expected total returns, but the mix between the two types of returns is likely to be affected by their personal circumstances. Each component of growth has its own important characteristics. The growth component is particularly attractive due to its ability to compound tax free until a security is sold. Managers can presumably be counted on to make wise decisions regarding the reinvestment of capital, the results of which accrue to long-term shareholders. When securities are sold, the increase in value is taxed at the capital gains rate, which is usually lower than the rate on ordinary income. The disadvantage of this portion of the return, of course, is that it is highly uncertain in the short term. As Warren Buffet has said, “In the long term the stock market is a weighing machine, but in the short term it is a voting machine.” The short-term returns may be impacted by many factors, both related and unrelated to the company. While this isn’t a big problem for younger investors, it may present a significant issue for those who depend on their investment for income to meet everyday expenses.

The income portion of the return has the advantage of being substantially more predictable than the growth component. Numerous studies have shown that companies are highly resistant to reducing or eliminating their dividends, and can be expected to set dividends at a rate at which they are sustainable. A key disadvantage of the income portion of the returns is that it is taxable each year, although the rate is currently favorable in cases where double taxation would apply. Some other asset classes, such as publicly traded master limited partnerships, may qualify for favorable tax treatment.

As investors move towards retirement, they are likely to focus on the income portion of the return more than the growth component. Equities such as REIT’s and MLP’s (for which the income portion of the return accounts for 60-70% of the total) may be more appropriate than many common stocks with low yields and highly variable total returns.

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