

Many years ago an older couple came into our office to discuss replacing their portfolio—the sole source of support for their retirement life—with our strategies. There were plenty of securities that we thought had meager prospects, and several speculative issues which really were inappropriate. However, much of the portfolio consisted of blue chips purchased in the nineteen fifties and sixties, names like Merck and General Electric, held through good times and bad for the companies, held through the Vietnam War, Arab oil embargoes, rampant inflation, stagflation, disinflation, bubbles up and bubbles down. They never sold anything—it was like a grandma’s attic of corporate equities.

There was a great treasure in that attic, great for them and enlightening for us. As we perused their assets and the cost of those assets, we began to connect the dots between what they had paid for the stocks and the dividends those companies were now paying. The so-called “current yield” on the portfolio was nothing to write home about, but the yield on what they had paid originally was astronomical. You might not notice that a certain stock was paying \$3 a share in dividends for a current yield of about 2%, until you realized that their cost for those shares, adjusted for splits, was, 30 years prior, also about \$3 per share. Not only had the stocks risen twenty- and thirty-fold over the decades, but their *return from income alone*, based on original cost, was in many cases over 100%. Each and every year they were making roughly 100% on those original investments no matter what the volatility of the stocks. Even adjusting for inflation, in current dollars their income return on cost was well over 30%.

Of course the stock prices grew because the underlying businesses grew. But could we separate that from the fact that dividends grew so much? Could Merck, Vioxx and all, possibly sell today at a price that would provide a dividend yield of 100%? Of course not. The stock price would rise if for no other reason than that the dividends increased. That, we saw, was the quantitative or numerical way of determining whether an investment was a good one: amidst the chaos of information and interpretation and competition and creative destruction and changes in the economy and the world, one principle stood out as elemental and immutable. *As the dividend increases, eventually the price of the stock producing that dividend will increase as well.*

The principle here is critical, both for investors seeking to accumulate wealth, and even more importantly today, for investors hoping that investment assets will support their later years. As the Baby Boom generation eases into retirement, the notion of distribution, of spending from assets, has become the subject of the day. Whereas in the past investment was all about accumulation and building, investors now realize that their investment capital must provide “life support” from now and into old age. The definition of “old age” itself has been greatly expanded by advances in medical science—and therefore the need for savings to support the distribution phase has stretched even further.

This problem is not simply a matter of scratching out numbers on a yellow pad. The problem is deep, and the proposed solutions that have been put forth to date don’t seem adequate to us. What’s deep is the “bag lady” fear that can afflict both men and women. What happens to me if I’m not working and the market crashes? What happens if I live to be 95 rather than the 85 I expect and I can’t pay anyone to help me? In the

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most subterranean levels of the unconscious, no matter how affluent we are today, we can imagine (and somewhere inside we have imagined) it all going horribly horribly wrong—our expenses got too high, our assets got too low, all the work and toil to build our wealth for naught, because it wasn't enough...

How can we make our savings last? A small industry of planners and advisors has arisen recently to address this problem, proposing plans that are, in our view, both overly complex and frighteningly fragile as solutions. Most suggest a withdrawal rate of 4-5% per year plus increases to reflect inflation, drawn from a portfolio of diverse assets that isn't very different from earlier portfolios recommended during the accumulation stage, just more conservative.

The question that arises when looking at these plans: will the assets be there to be withdrawn? Gains from stocks are always presumed, but history tells us that those gains don't necessarily arrive on a convenient schedule, and can be absent for years and years. This is a much trickier area than accumulation investment planning, because to some extent—through withdrawals and the steady increase of those withdrawals—the investor is always undermining the notion of long-term compounding. Without a presumption of rising equity markets there are fewer and fewer assets but the assets remaining are asked to produce higher and higher withdrawals. And rising markets must be part of the equation. If one relied only on bonds (which do not rise), for example, 5% withdrawals plus inflation increases could completely wipe out the portfolio in as little as 13 years during a period of normal inflation.

A 50-50 bond and equity portfolio using historical equity returns fares better, extending the assumed “life” of the portfolio to 20 years (though that's not exactly a “safe” duration for most people). The source of this duration extension is the assumed greater return from stocks. There is a further assumption that a portion of the gains from stocks can be captured and spent, an assumption that, essentially, stocks will grow enough after taxes to compensate

for the relentless withdrawals that attack the portfolio like carpenter ants.

Clearly, the more equity the longer the withdrawals may be sustained—in theory. But theory doesn't account for the realities a retiree will experience during a severe bear market. What if the market doesn't come back, or doesn't come back in time? A reasonable fear, for we've seen periods even in recent history where stocks have not performed according to theory. If you retired in 1968, for example, you would have, unbeknownst to you, embarked on a 14-year period in which stocks did not gain the proverbial 10% per year, but in which, point to point, they in fact gained *nothing*.

Putting aside for the moment the fact that there was some yield from equities during the period (though you might have invested in non-dividend-paying equities, anyway), at a withdrawal rate of 5% plus inflation you would not have lasted the entire “flat” period before ruin. You would at best have had almost no capital left to capture any gains from the bull market that began in 1982. You can see what we mean by suggesting most plans are frighteningly fragile. Over the past 100 years it has not been that uncommon for stocks to go 5 or even 10 years without gains. And all the while you're withdrawing. Gulp. If the “total returns” from which you are withdrawing do not arrive as predicted, and pretty much on a regular schedule, your plan risks failure. The results could be devastating.

In fact, it may be time to question the concept of total return itself, when it comes to a distribution portfolio. As any accountant will tell you, total return is the sum of income and capital appreciation, and, your accountant will further tell you, except for tax issues there's no difference between appreciation and income. Money is money. End of discussion.

But when it comes to investors with a spending need, there is something more that definitely needs to be said, and understood. There is, for a withdrawing investor, a qualitative difference between 1) total return and 2) a return made up of income plus appreciation. The difference is that the income *portion of the return is always positive*, whereas the

“appreciation” portion can fluctuate, and can be negative. Accumulators can and should tolerate some fluctuation in the interest of greater performance, but *withdrawers have to spend the money*. Now. And the income portion needs to grow even if the principal side doesn’t, because the spending need rises with inflation.

When our investments are in higher-yielding stocks, the income portion of the total return is well defined (as opposed to low yielding stocks where it plays a minor role). If your withdrawal need is the widely-accepted 4-5%, you can obtain that from the right portfolio of stocks. If your income need rises as a result of inflation (and we can expect that inflation may be higher than it is now, perhaps the same as the 1945-90 average of 4.7%), yield stocks that have increasing dividends can meet that increased spending need as well. A retiree can fund his or her living expenses without having to invade principal.

If you’re spending income, rather than “total return,” market fluctuations become irrelevant; if the portfolio is successfully managed for rising income the value of the stocks producing that income will ultimately

rise as well, though the schedule for that recedes in importance. It won’t matter whether growth is in vogue, or value, or mid-cap, or large—all that really matters to the value of the principal is that the income increases to pay expenses and meet inflation. The value of the principal will eventually reflect the rising positive income yield it delivers, and there is no need to invade it.

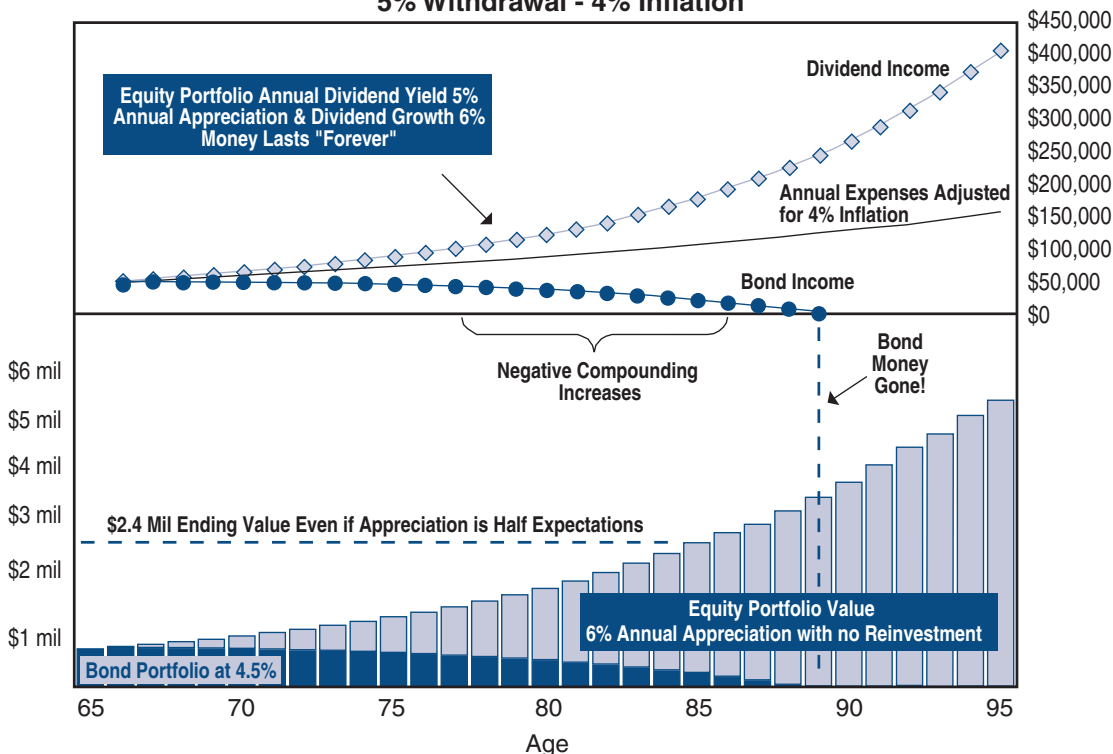
Clearly, an income-equity approach based on high current income is “built” for a retiree portfolio. Some diversification seems prudent, though we don’t know of any other plan with as high a probability of meeting spending needs and preserving capital indefinitely.

Not only is there no “exhaustion” date for the assets, they will be there in full, long after the retiree needs them, to help loved ones and charities.

And what about that older couple? The “good parts” of their portfolio, with triple-digit dividend yields on original investment, inspired us to design our Income-Equity Strategy. We’ve hitched our wagon to that horse, and clip-clop, clip-clop, it continues to forge ahead without getting tired.

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Pro-Forma Principal and Income Growth 5% Withdrawal - 4% Inflation



Pro-forma chart shown for illustrative purposes only. Actual returns may vary. There is no guarantee of future returns and none should be implied. Assumptions: \$1 million initial investment, bond coupon rate of 4.5%, annual dividend rate of 5%. Earnings, dividends, and price appreciation grow at the same rate of 6% annually. Assumed annual inflation rate of 4%. Income equity portfolio value is calculated with no income reinvested.

DISCLOSURE

Common stocks do not assure dividend payments. Dividends are paid only when declared by an issuer's board of directors and the amount of any dividend may vary over time.

There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of a downturn in the market.

Dividend yield is one component of performance and should not be the only consideration for investment. This information is intended solely to report on investment strategies as reported by the Investment Manager. Opinions and estimates offered constitute their judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. Equity portfolios are subject to the basic stock market risk that a particular security, or securities in general, may decrease in value. The stocks of small and medium-sized companies are often associated with higher risk than stocks of larger companies, including higher volatility. When investing in value securities, the market may not necessarily have the same value assessment as the manager, and, therefore, the performance of the securities may decline. Past performance is no guarantee of future results.

Fixed Income securities may be sensitive to changes in prevailing interest rates. When rates rise the value generally declines. There is no assurance that the private guarantors or insurers will meet their obligations. U.S. Treasuries are guaranteed by the U.S. government and, if held to maturity, offer a fixed rate of return and fixed principal value.

Miller/Howard Investments, Inc. manages dividend-focused portfolios.