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Can Dividends Yield a Better Retirement?

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If you're getting up there in age, as I am, you are looking to eventually retire. And while that does not necessarily mean you will stop working, it does likely mean a reduction in current and expected income. It also means needing to live on what you will now be generating and protecting that income and principal.

Looking for income in today's low-rate environment, where the Fed has increased rates twice this year and is expected to do so one more, is a relatively poor search, as interest rates have actually declined year-to-date (the 10-year is at 2.30%, compared to 2.45% at year-end 2016 and 2.27% at year-end 2015). While some bank instruments have inched up, it is not enough to change the risk/reward tradeoff, as they remain uncompetitive with yields, especially given the reduced tax treatment of qualified dividends. Bonds yields are competitive, but with no tax advantage, and unless you are able to hold them until maturity, higher interest rates could erode your principal if you need to sell them; additionally, fixed rate instruments do not necessarily move up with interest rates. Preferred issues also tend to have a higher yield, but their rate may not be impacted by interest rates increases, with most not having a tax advantage. In the current environment, income seekers have very few choices, with dividends having very little in the way of competition, which could be adding to their lower growth rate. Adding to the current dividend bandwagon is the market, where the aging bull continues on, setting new highs, and companies slowly play catch-up with their yields, which have declined as prices outpaced dividend increases.

The way I look at it, dividends could become my "paycheck" in retirement, and while pay raises are nice, the paycheck needs to continue to come in, even without the raise. That means I could look to companies with a history of paying and increasing dividends, as well as sufficient earnings and cash flow (can't write a check against proforma earnings) from current operations to cover the dividend and grow the business. The company doesn't have to do great or even set records, but they do need to have a stable product line that I am comfortable with going forward, and the potential upside of longer-term capital appreciation (so they can increase the dividend).

Focusing on income and then potential longer-term gains may make the portfolio a bit boring, but that is fine with me since I have no intention of checking the daily prices.

First, the bad news on dividends – and there are a few items. Energy cuts, which had devastated so many LPs and MLPs—and caused significant cuts in major oil companies—appear to have subsided, at least for the Q4 2016 and year-to-date 2017 period. However, the rebuild could be slow, and could take time. More troubling of late is the slow rate of increase for issues that have increased their dividend. In 2016 the average S&P 500® dividend increase was 10.51%, down from 13.08% in 2015, and 17.50% in 2014. For 2017, however, the average increase has turned up, helped by record earnings, as the average year-to-date has increased to 11.69%. The impact of lower growth was to limit the 2016 dividend growth to 5.4%, after five years of double-digit growth. And while cuts have declined, so has growth, with 2017 estimated to come in slightly higher, in the 7% area. On the positive side, that actual 5.4% 2016 and estimated 7% 2017 growth rate is still significantly higher than the average (non-CEO) pay raise, and then there is the added benefit of lower taxes (already in the tax code, not promised or expected), which in this case stand at almost half the federal rate. Adding to the positive side are good earnings, steady cash flow, available cash-on-hand, and the growing number of issues using "shareholder return" in their releases and meetings (meaning dividends and buybacks).

If any new legislation were to incentivize repatriation, either separately or as part of tax reform, some of the cash might trickle down to dividends. So the bottom line for the market currently appears to be: slower dividend growth, with a tax advantage and a chance to improve, especially with repatriation.

When picking a dividend stock, chasing yield can yield issues where the price has declined, which may be an opportunity for capital appreciation, but may not meet the needs of lower-risk income seekers. It's important for investors to find a company they feel comfortable with, and whose product line they understand. Next, they can look at the company's ability to generate sufficient earnings and cash flow from operations to pay their dividends, run their business, and have enough left over to grow, remembering that not all quarters must set records or even indicate growth. Then comes that investor's particular situation:

(a) their required income need and liquidity, weighed against their desire for capital growth—typically, lower-growth segments, such as utilities, pay more;

(b) their specific risk/reward trade-off (and there is risk in all stocks), keeping in mind their ability to ride out a downturn without having to sell the stock (on the way down); and

(c) determining whether to buy a few stocks or invest in a fund, which may offer more protection, but also may reduce the yield.

When choosing a fund, lower fund costs are nice, but performance and the portfolio often outweigh the impact of fees. Funds also vary greatly, with some having limits on sector representation (an all-utility group will typically yield more than a mixed portfolio), some concentrating on dividend history (which show corporate culture, and to some degree the requirement to increase each year—in good times and bad), and others looking for those stocks likely to increase the fastest (such as energy issues if oil improves). Lastly, whatever dividend instruments are used, investors will need to consider how the investment fits into an overall portfolio, and allocate properly.

From my S&P 500 perch, as a starting place, and there are many starting places (if Macy's doesn't have it, Gimbels does), there are 177 issues that have increased their dividends for each of the last five years and have a 2017 indicated rate higher than their actual 2016 payment. This may imply that dividends are now part of their corporate culture, with 83 of them increasing for at least 10 years, 51 for at least 25 years (we call them the Dividend Aristocrats), and 38 increasing since even before I started working here, over 40 years ago (including the company I work for, S&P Global).

Growth has slowed:

S&P 500 Indicated Dividend Rate Changes

(Median and average exclude issues that have at least doubled)

Year	Median Increase	Average Increase	Doubled	Suspended
Q3 2017	9.76%	14.39%	1	0
Q2 2017	8.16%	10.50%	3	0
Q1 2017	7.86%	10.15%	2	0
Q4 2016	9.09%	11.71%	0	0
Q3 2016	8.11%	10.14%	1	0
Q2 2016	8.33%	10.39%	0	0
Q1 2016	8.00%	10.82%	1	2
2017 YTD	8.87%	11.69%	4	0
2016	8.20%	10.51%	2	2
2015	10.00%	13.08%	3	3
2014	11.11%	17.50%	8	1
2013	11.76%	20.38%	19	0
2012	12.50%	20.20%	14	1
2011	14.29%	26.46%	27	0
2010	10.00%	17.94%	10	2

Source: S&P Dow Jones Indices LLC. Data as of Sept. 30, 2017. Past performance is no guarantee of future results. Table is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

As shown in the table below, the larger-cap index pays more since most of the constituents pay, but size is less important once they pay:

S&P 500, S&P MidCap 400®, and S&P SmallCap 600® Dividends by Sector

SECTOR	S&P 500	S&P MidCap 400	S&P SmallCap 600	S&P 500	S&P MidCap 400	S&P SmallCap 600	S&P 500	S&P MidCap 400	S&P SmallCap 600	S&P 500	S&P MidCap 400	S&P SmallCap 600
	Total Issues	Total Issues	Total Issues	Yield	Yield	Yield	Dividend Payers	Dividend Payers	Dividend Payers	Payers Yield	Payers Yield	Payers Yield
Consumer Discretionary	83	58	112	1.46%	1.40%	1.08%	64	43	50	2.10%	1.86%	2.26%
Consumer Staples	34	19	17	2.81%	1.16%	1.61%	33	11	11	2.84%	1.89%	2.46%
Energy	32	24	28	2.83%	1.15%	0.35%	27	10	5	2.95%	2.42%	1.77%
Financials	67	58	88	1.79%	1.66%	2.04%	64	50	71	2.03%	1.98%	2.34%
Health Care	62	32	78	1.60%	0.34%	0.20%	35	7	16	2.11%	1.13%	1.14%
Industrials	68	57	102	2.07%	1.09%	0.84%	61	45	67	2.15%	1.34%	1.23%
Information Technology	69	64	89	1.36%	0.59%	0.34%	47	28	24	1.93%	1.28%	1.34%
Materials	25	29	36	2.06%	1.56%	1.03%	24	26	23	2.12%	1.71%	1.56%
Real Estate	33	39	34	3.31%	4.45%	4.64%	31	37	31	3.47%	4.58%	4.98%
Telecommunication Services	4	2	9	4.88%	7.04%	2.17%	3	2	4	5.05%	7.04%	4.73%
Utilities	28	18	8	3.47%	2.79%	2.67%	28	18	8	3.47%	2.79%	2.67%
INDEX	505	400	601	1.97%	1.54%	1.23%	417	277	310	2.37%	2.14%	2.22%

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S&P 500 Dividend Contribution Payments

	9/29/17	6/30/17	3/31/17	12/31/16	9/30/16	10 YR AVG
Consumer Discretionary	8.78%	9.04%	9.10%	8.86%	9.29%	7.97%
Consumer Staples	11.72%	12.29%	12.37%	12.49%	12.54%	13.97%
Energy	8.73%	8.93%	8.84%	9.06%	9.19%	10.70%
Financials	13.29%	12.32%	12.17%	12.15%	12.33%	14.84%
Health Care	11.75%	11.92%	11.94%	12.02%	11.78%	11.94%
Industrials	10.74%	10.81%	10.89%	10.98%	10.49%	11.75%
Information Technology	16.02%	15.86%	15.55%	15.49%	15.45%	11.72%
Materials	3.10%	2.89%	2.94%	2.93%	3.00%	3.43%
Real Estate	5.02%	4.87%	5.04%	4.79%	4.67%	4.79%
Telecommunication Services	5.37%	5.48%	5.55%	5.74%	5.77%	6.84%
Utilities	5.49%	5.59%	5.61%	5.47%	5.49%	6.36%
S&P 500	**100.00%**	**100.00%**	**100.00%**	**100.00%**	**100.00%**	**100.00%**

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S&P 500 Dividend Yields

	9/29/17	6/30/17	3/31/17	12/30/16	9/30/2016	10 YR AVG
Consumer Discretionary	1.46%	1.47%	1.49%	1.54%	1.57%	1.59%
Consumer Staples	2.81%	2.71%	2.68%	2.79%	2.68%	2.80%
Energy	2.83%	2.96%	2.70%	2.51%	2.67%	2.26%
Financials	1.79%	1.69%	1.71%	1.71%	2.04%	2.11%
Health Care	1.60%	1.64%	1.73%	1.84%	1.70%	1.98%
Industrials	2.07%	2.10%	2.17%	2.23%	2.28%	2.39%
Information Technology	1.36%	1.42%	1.42%	1.56%	1.54%	1.31%
Materials	2.06%	2.02%	2.08%	2.16%	2.19%	2.25%
Real Estate	3.31%	3.32%	3.45%	3.47%	3.23%	3.62%
Telecommunication Services	4.88%	5.10%	4.68%	4.52%	4.63%	4.96%
Utilities	3.47%	3.52%	3.54%	3.61%	3.54%	3.95%
S&P 500	**1.97%**	**1.99%**	**2.01%**	**2.09%**	**2.12%**	**2.15%**

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S&P Dow Jones Indices defines various dates to assist our clients in providing transparency. The First Value Date is the first day for which there is a calculated value (either live or back-tested) for a given index. The Base Date is the date at which the Index is set at a fixed value for calculation purposes. The Launch Date designates the date upon which the values of an index are first considered live: index values provided for any date or time period prior to the index's Launch Date are considered back-tested. S&P Dow Jones Indices defines the Launch Date as the date by which the values of an index are known to have been released to the public, for example via the company's public website or its datafeed to external parties. For Dow Jones-branded indices introduced prior to May 31, 2013, the Launch Date (which prior to May 31, 2013, was termed "Date of introduction") is set at a date upon which no further changes were permitted to be made to the index methodology, but that may have been prior to the Index's public release date.

Past performance of the Index is not an indication of future results. Prospective application of the methodology used to construct the Index may not result in performance commensurate with the back-test returns shown. The back-test period does not necessarily correspond to the entire available history of the Index. Please refer to the methodology paper for the Index, available at www.spdji.com for more details about the index, including the manner in which it is rebalanced, the timing of such rebalancing, criteria for additions and deletions, as well as all index calculations.

Another limitation of using back-tested information is that the back-tested calculation is generally prepared with the benefit of hindsight. Back-tested information reflects the application of the index methodology and selection of index constituents in hindsight. No hypothetical record can completely account for the impact of financial risk in actual trading. For example, there are numerous factors related to the equities, fixed income, or commodities markets in general which cannot be, and have not been accounted for in the preparation of the index information set forth, all of which can affect actual performance.

The Index returns shown do not represent the results of actual trading of investable assets/securities. S&P Dow Jones Indices LLC maintains the Index and calculates the Index levels and performance shown or discussed, but does not manage actual assets. Index returns do not reflect payment of any sales charges or fees an investor may pay to purchase the securities underlying the Index or investment funds that are intended to track the performance of the Index. The imposition of these fees and charges would cause actual and back-tested performance of the securities/fund to be lower than the Index performance shown. As a simple example, if an index returned 10% on a US $100,000 investment for a 12-month period (or US $10,000) and an actual asset-based fee of 1.5% was imposed at the end of the period on the investment plus accrued interest (or US $1,650), the net return would be 8.35% (or US $8,350) for the year. Over a three year period, an annual 1.5% fee taken at year end with an assumed 10% return per year would result in a cumulative gross return of 33.10%, a total fee of US $5,375, and a cumulative net return of 27.2% (or US $27,200).

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