KEATING WEALTH MANAGEMENT

NEWSLETTER

3rd Quarter 2019

Living on Dividends

This is a condensed version of a blog published in May 2019.
For the complete article, please visit the Blog section of our website.

The power of dividend growth is perhaps the most easily understood yet most underappreciated feature of equity investing, and it has profound implications for people who are considering their asset allocation for retirement. Let's start with the basics.

Since 2001, the average dividend yield of the S&P 500 index has been slightly below 2%. Though it's rarely described this way in the financial media, the full-year 2018 S&P 500 dividend was $53.86. Relative to a Dec. 31, 2018 closing S&P price of about 2,507, the dividend yield for 2018 was 2.1%.

Since 1975, when the S&P 500 dividend was about $3.70, dividends have increased over 14x, or at a compounded growth rate of 6.4%. This is about double the rate of inflation over the same time period.

How and why have dividends compounded at this rate? Since 1975, the earnings of S&P companies have increased by 21x, or at a compounded growth rate of about 7.3%. Assuming that companies maintain a steady payout ratio of cash dividends relative to their earnings, it follows that the dividend growth rate should reflect the earnings growth rate. The charts below illustrate how earnings and dividends have largely followed the same trajectory for the last four decades.

Changing Nature of Cash Return to Shareholders

Over time, however, dividend yields have declined as companies return cash to shareholders in the form of *both* cash dividends and stock buybacks.

According to research by New York University Professor Aswath Damodaran, since 2001 S&P 500 companies have paid out about 85% of their net income as cash, consisting of (i) average dividends payouts of 35.5% plus (ii) average buyback payouts of 49.0%.

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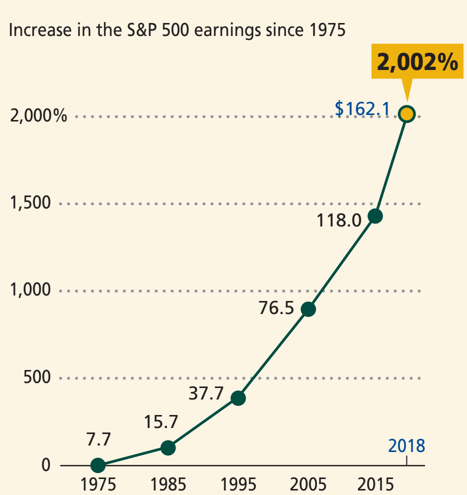
S&P 500 Earnings and Dividends

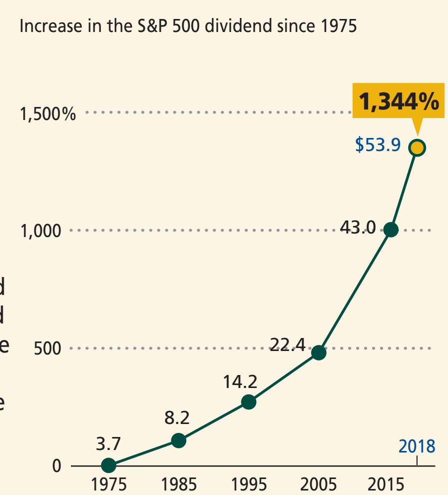
S&P 500 Earnings

Earnings have increased by 21x, or at a compounded growth rate of just over 7%



S&P 500 Dividend

Dividends have increased 14x, or at a compounded growth rate of just above 6%—about double the rate of inflation over the same time period



Avoid the Target-Date Fund Trap

Conventional investment wisdom states that as you near retirement, you should adjust the allocation of your investments to a supposedly safer mix of assets that favors bonds over equities. This solidly ingrained tenet has fueled the popularity of target-date investment funds, which purport to be optimized for specific retirement years.

Introduced in the early 1990s, target-date funds each own a group of other funds and adjust the proportions of assets allocated to each sub-fund as time progresses. Investors choose a fund with a date matching their anticipated retirement year. A fund with 2040 in its name, for example, is geared for people planning to retire in or near that year.

According to Morningstar, assets managed using target-date strategies totaled more than $1.7 trillion at the end of 2018, including $1.1 trillion in mutual funds and $660 billion in collective investment trusts. The mutual fund segment alone has experienced a seven-fold increase from the $158 billion invested at the end of 2008. In 2018, there was a $55 billion net inflow to target-date mutual funds.

Meanwhile, the Investment Company Institute reports that 70% of all large 401(k) retirement plans now offer target-date funds as options. Indeed, the most recent data from the Employee Benefit Research Institute and the Investment Company Institute show that target-date funds held 21% of all 401(k) plan assets as of year-end 2016, quadruple their 5% share in 2006. About half of all plan participants now elect target-date funds for some part of their portfolios.

Similarly, Vanguard reports that half of its 401(k) plan participants currently invest their entire accounts in a single target-date fund. Vanguard projects that this figure will rise to 70% by 2022. At the current trajectory, it's only a short matter of time until target-date funds cross the 50% threshold of all 401(k) assets.

A big factor in the explosive growth of target-date funds is the fact that they are usually the default investment setting for new hires automatically enrolled in their employers' retirement plans. This has been the case since the implementation of the Pension Protection Act during the Obama administration.

Compelling Features as Default Choice

Target-date funds are clearly superior to the previous status quo: either not saving for retirement at all or accumulating cash through inattention to investments.

Moreover, target-date funds have many compelling features. Through a single, low-cost mutual fund, an investor can own a diversified portfolio and put all investment and rebalancing decisions on autopilot. You can't beat these funds for simplicity, and when investors combine them with a "set it and forget it" discipline, they avoid many behavioral errors, such as trying to time the market.

The Downside: Savings Need to Last Longer and Grow

The deadly trap of target-date funds is that once investors reach their target retirement year, their allocation to bonds is always too high.

Consider, for example, the Vanguard Target Retirement 2040 Fund (VFORX). The fund invests in four Vanguard index funds, and at the end of May 2019, it held approximately 85% of its assets in stocks (51% domestic and 34% international) and 15% in bonds (10% domestic and 5% international).

The fund slides to a more "conservative" asset allocation over time, so that in 2040, it will consist of 49% stocks, 43% bonds, and 9% short-term Treasury inflation-protected securities, or TIPS. Five years later, the portfolio will be allocated 37% to stocks, 49% to bonds, and 14% to short-term TIPS, which are designed to provide a "real" return and protect investors from the eroding effect of inflation. As of May 31, 2019, the 30-day SEC yield of Vanguard's TIPS fund (VIPSX) was 0.38%.

Longevity Risk

The problem with bond-heavy portfolios in retirement can be distilled to a single word: longevity. Average life expectancies continue to increase. As J.P. Morgan Asset Management notes: "You may need to plan on the probability of living much longer—perhaps 30+ years in retirement—and invest a portion of your portfolio for growth [that is, in equities] to maintain your purchasing power over time."

While there is no guarantee that historical equity returns will continue indefinitely into the future, a century of experience suggests that the compounded return of equities will very likely exceed that of a bond-dominated portfolio over any 20- to 30-year time horizon.

A Good Nudge Gone Awry

Richard Thaler was awarded the 2017 Nobel Prize in Economic Sciences for his work persuading economists to pay more attention to human behavior—and for governments to pay more attention to economics. His best-selling book, "Nudge," was about helping people make better decisions.

A typical 401(k) plan menu typically offers dozens of fund choices, each with its own array of disclosures and fees. The idea of reviewing all these individual funds in detail to find the "right" investment mix can be overwhelming. Many people become paralyzed with this abundance of choice and stick with the default option: the target-date fund.

Thaler's retirement plan nudges have undoubtedly improved the lot of many who, left to their own devices, would not have participated in their companies' 401(k) plans at all or, if they participated, would not have invested in equities.

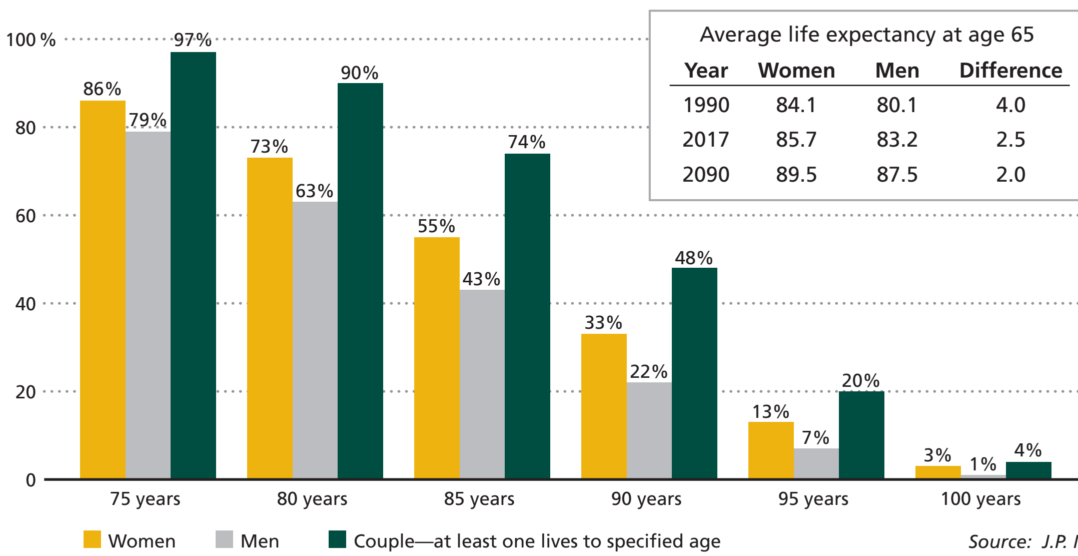
On the other hand, this same nudge toward target-date funds as the default and often only retirement plan selection has set the stage for a different crisis: too many retirees outlasting their money in longer retirement periods.

Sophisticated investors, either on their own or with the support of a knowledgeable financial adviser, should adopt a radically different asset allocation methodology that is much more heavily weighted toward equities. Our "Asset Allocation Made Easy" article describes one such methodology.

Behavioral Takeaway

Choice architecture is the design of different ways in which choices can be presented to consumers and considers the impact of that presentation on decision making. The number of choices, the description of attributes, and the presence of a default choice all make a difference. Before selecting the default choice, it's critical to understand all the implications and long-term consequences of that choice.

If you're 65 today, the probability of living to a specific age or beyond



Average life expectancy at age 65

Year	Women	Men	Difference
1990	84.1	80.1	4.0
2017	85.7	83.2	2.5
2090	89.5	87.5	2.0

Plan for Longevity

Average life expectancy continues to increase and is a midpoint, not an endpoint. You may need to plan on the probability of living much longer—perhaps 30+ years in retirement—and invest a portion of your portfolio for growth to maintain your purchasing power over time.

Source: J.P. Morgan Guide to Retirement, 2019 Edition

DIVIDENDS

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From a stockholder's perspective, the average dividend yield as a percentage of market capitalization has been 1.9% and the average buyback yield has been 2.8%, resulting in a total effective "cash yield" of 4.7%. For the past nine years, the buyback yield has been higher than the dividend yield.

Of the 10.9% S&P 500 total average annualized return since 1950, 7.5% is attributable to capital appreciation and 3.4% is attributable to dividends.

In short, primarily for reasons of tax efficiency to their shareholders, American companies are now returning more cash to investors in the form of buybacks than in dividends.

Income Yield on Original Investment

When the S&P 500 SPDR ETF (SPY) was first introduced in 1993, the fund paid a total of $1.10 in dividends per share, for a dividend yield of 3.8%. By the end of 2018, SPY paid a total of $5.10 in dividends per share, representing total growth of 360%, or compounded growth of 6.1% per year. So even though the dividend yield had declined to just over 2%, the $5.10 in 2018 dividends represented a yield on original investment of nearly 18%.

If you own a $1 million stock portfolio yielding 2% and used the dividends for living expenses, in the first year your dividend income would be $20,000. Assuming dividends grew by 6.5% annually and with no reinvestment, by year 12 your annual dividend income would be just about $40,000, and by year 25 almost $91,000 (for a yield on original investment of 9.1%).

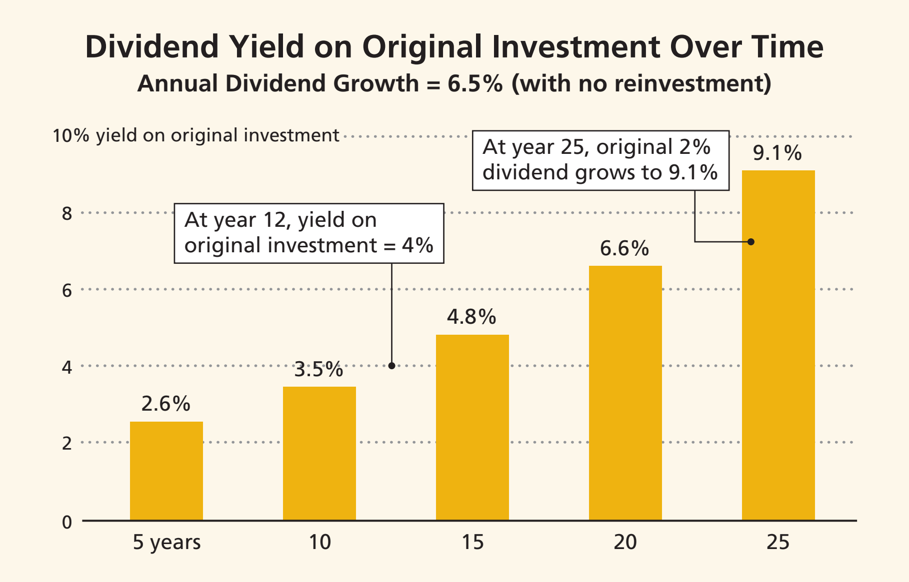
Dividends as a Growing Source of Income

Most people think about risk and safety in terms of principal—the risk that you'll lose your money and the search for assurance that you won't. That's second nature to us, and it's probably what's uppermost in our minds when we think about retirement investing.

However, retirees have to pay as much attention to the risk of outliving their money as they do to the risk of losing it. In other words, we have to define risk not just in terms of principal but in terms of purchasing power. And when it comes to building purchasing power, one asset class vanquishes all others: equities.

Moreover, a common misperception is that there are only two basic investment objectives: growth and income. But in modern three-decade retirements, where the maintenance of purchasing power becomes a fundamental objective, there's a third, very critical, investment objective: growth of income.

Purely from a purchasing power perspective, it is a better choice to forego the "safety" of clipping bond coupons and instead let the magic of growing dividends provide growth in income over time.



8400 East Crescent Parkway, Suite 600
Greenwood Village, CO 80111

KEATING WEALTH MANAGEMENT

www.keatingwealth.com
(720) 408-5250