Replacing an Income Stream in Retirement using Dividend Growth Stocks

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Most retirees today are faced with a difficult task- how to replace their employment income in retirement. Long ago, employees who 'did their time' had many avenues for which to retire comfortably. Social Security was reliable, Defined Benefit Plans (Pensions) were common and Bonds provided a positive real return (net of inflation). Today, retirees that need a reliable income stream are in a unique situation. Only 24% of Fortune 500 companies offer new hires a pension option, down from 60% in 1998*. Not everyone has or will have the luxury of Pension Income in retirement. Social Security is another dilemma. Do you have enough confidence that Social Security will last the rest of your lifetime? For someone retiring today, that could mean 40 years of Social Security Income that could make or break your retirement lifestyle. Investing in Bonds? In today's world, you can't simply go out and purchase 10-year U.S. Treasury bonds and ride off into the sunset. On a real return basis (net of inflation) bonds barely break even. With healthcare costs expected to increase 6% every year, bond investments aren't going to be very beneficial to retirement investors.

What about my 401(k) Retirement Plan or IRA?

Today, most retirement investors have saved through an Employer Retirement Plan, usually a 401(k). 401(k)'s are great for building a nest egg in your working years, but when it comes time for living off that nest egg, how do you go about it? Traditional portfolio management theory would point to the "4 Percent Rule", which states you can safely withdraw 4 percent of your portfolio per year and have it last 30 years without depleting your principal. The reality is, this rule doesn't apply to everyone. It makes assumptions about asset allocation and gives too much credit to bond returns. You may require a much larger amount than 4% to live on in retirement, especially in your "Go-Go" years where enhanced living expenses, such as traveling, are highly important to you. A portfolio that is too dependent on market returns could suffer in poor return environments.

Making the Case for Equities:

At its most basic form, when you purchase a stock, you are gaining *ownership* in a company, whereas with bonds you are a *lender* to that company. As a stock owner, you are essentially paying for a company's future earnings and dividend stream, which historically has kept up with inflation and grows over time. As a bond owner, you are lending money to a company for a fixed rate of return, or interest. Would you rather be an *Owner* or a *Loaner*?

Stock investments certainly get a bad reputation for being too "risky." Far too many investors view risk as the day-to-day volatility of their portfolio. While this is true, it's also important to pay attention to the other risk that sometimes goes unnoticed- *Longevity Risk* (a.k.a. out living your money in retirement). Stock investments have a higher historical return than bonds and provide you with a greater chance of *Living your Good Life*, if you can tolerate the added *price volatility*.

If we agree that equity investments make more sense to own in the longer term, where do we turn next? In a market full of buyers and sellers, your shares are only as valuable as what someone else will pay for them. What if instead of relying on the price return of the stock market we focused on the dividend return of companies that have a strong track-record of *growing dividend payments*?

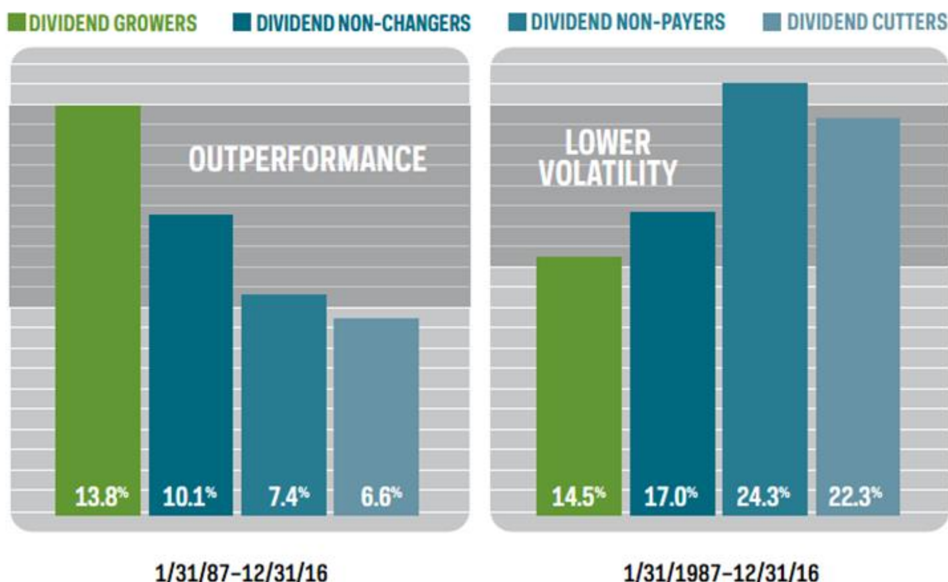
Why Dividends are Important:

At its core, a dividend is a distribution of a company's profits to their shareholders. What is so special about dividends? Dividends tell you the real story behind the profitability of a company. Companies that consistently reward shareholders through rising dividend payments are typically well-run, shareholder-friendly, profitable businesses. The ones who achieve this over various economic environments are especially attractive. Being able to consistently increase your dividend suggests that the earnings of the company are relatively stable.

Dividend payments are far more predictable and reliable than a stock's return. It's nearly impossible to predict what the stock price of Johnson & Johnson will be next year, but it's highly likely they will raise their dividend by ~7%, which they have done for over 50 consecutive years.

Furthermore, if we're able to identify *Dividend Growers*, we could achieve *outperformance* and *lower volatility*. What good is superior performance if it comes with high anxiety and night terrors? Sure, Bitcoin would have been a great investment to own five years ago, but could you really withstand the 50 percent swings in a week?

Historically, Dividend Growth stocks have shown to be less volatile than non-dividend payers and have outperformed over the long-run, especially in down markets. In a volatile market, are you more willing to sell your shares of Procter & Gamble or Netflix?



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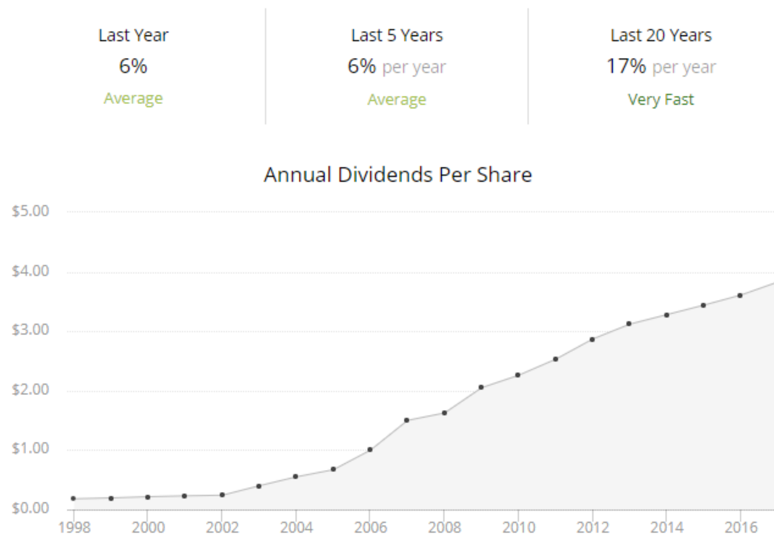
Let's look at an example using McDonalds (MCD), a company that has increased their dividend every year since 1977. More recently, McDonalds increased their dividend by an average of 17% in the last 20 years.



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Through the Great Recession (November 2007-February 2009), McDonalds' stock price remained relatively stable while the rest of the market sold off over 55%.

How was this possible? As it turns out, in a Recession most Americans will spend less on fine dining and opt for more fast food options. Makes sense. Over the two-year period, McDonalds increased earnings 35% and grew their dividend 34%. During the same period, the S&P 500 saw earnings shrink by 34% and the dividend income fell 19%. McDonalds was able to consistently grow their dividend 155% and their stock price more than tripled since 2008. Investors looking for a low volatility investment with a reliable income stream would have achieved that by investing in this blue chip, dividend growth stock.

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McDonalds is just one of the many great businesses that have a long track-record of rewarding shareholders through dividends in various market cycles and economic environments. A sound investment strategy is to identify and own a diversified basket of high-quality, dividend growth stocks that are resilient through stormy investment markets.

How can we apply this strategy for the Investor in-or-near Retirement?

Let's use a simple example of a client with a $1 million IRA who wants to retire in ten years at age 65 and needs the portfolio to support their active lifestyle. A portfolio of high quality, dividend growth stocks with an initial yield of just over 3%, which grows 10% per year would produce an annual income of $72,625 in their first year of retirement. That assumes no price appreciation of the portfolio & dividends not reinvested. That's a yield on cost of over 7%. Compared to purchasing a 10-year U.S. Treasury (current yield of 2.85%), the difference in potential retirement income is staggering. This is the magic of compound dividends at work.

Initial Investment:
$ 1,000,000

Dividend Growth Stocks			
Year	Income	Yield on Cost	Growth Rate
1	$ 30,800	3.08%	10%
2	$ 33,880	3.39%	
3	$ 37,268	3.73%	
4	$ 40,995	4.10%	
5	$ 45,094	4.51%	
6	$ 49,604	4.96%	
7	$ 54,564	5.46%	
8	$ 60,020	6.00%	
9	$ 66,023	6.60%	
10	$ 72,625	7.26%	
	Total Income: $ 490,873		

10-year Treasury			
Year	Income	Yield on Cost	Growth Rate
1	$ 28,500	2.85%	0%
2	$ 28,500	2.85%	
3	$ 28,500	2.85%	
4	$ 28,500	2.85%	
5	$ 28,500	2.85%	
6	$ 28,500	2.85%	
7	$ 28,500	2.85%	
8	$ 28,500	2.85%	
9	$ 28,500	2.85%	
10	$ 28,500	2.85%	
	Total Income: $ 285,000		

Conclusion:

Dividend growth stocks might not be exciting, and they might not be what immediately comes to mind as an income replacement in retirement. Dividend growth investing can truly build wealth over time and provide the income you need in retirement.

At McKinley Carter Wealth Services, we built such a portfolio using this criteria that we call *Dividend Focus*. In this portfolio, we focus on only those companies who have a strong track-record of rewarding shareholders with increasing dividends and those that will likely continue to have the ability to do so in the future. Our mission is to provide our clients with the resources necessary to *Invest in their Good Life.*

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