Adam Smith Advisors

A Cherry Tree Affiliate

March 2017

ADAM SMITH INSIGHTS: *Published by Keith Tufte, President of Adam Smith Advisors, LLC, with insights on investing and wealth management.*

INVESTING QUOTE OF THE MONTH:
"Money isn't everything, but it sure keeps you in touch with your children." — J Paul Getty.

CREATE YOUR OWN PENSION PLAN

Very few people have the good fortune of having a pension plan these days. Pension plans have been replaced by 401(k) type plans by nearly all employers. The risk of providing a secure retirement has been transferred from the employer to the employees. The lack of a reliable and steady income source (like a pension plan) has caused many people to worry more about how they will maintain their lifestyle in retirement. People are now on their own to be sure they save enough during their working years, and to figure out a way to translate those savings into a retirement income that will last over the rest of their lives. Wouldn't it be nice if there was a way to create your own "pension plan" for your retirement, so you would have a reliable income source in retirement and could enjoy more peace of mind in retirement? We think a great retirement income "pension" plan would provide enough income to live on, it would reduce the risk that you will run out of money in old age, and it would provide retirement income that grows as fast as inflation.

THE DIVIDEND PORTFOLIO RETIREMENT PENSION PLAN

One way to create a reliable income source in retirement is to have a large portfolio of dividend paying stocks, and live off the stock dividend distributions and your social security. This plan will probably only work for wealthier people who spend a relatively low percentage of their wealth in retirement, and can live with some volatility in their investment portfolio and dividend income stream. A collection of high dividend paying funds today can produce a dividend yield of around 3% per year. Therefore, you would only be able to spend approximately $30,000 per year in retirement for each $1 million you have saved by retirement age.

DIVIDEND GROWTH

The good news about this strategy is that the dividends of the U.S. Standard & Poor's 500 stock index have grown about 2.5% above the rate of inflation over the past 70 years (since 1946). Inflation (CPI index) over the past 70 years has been 4.1% per year, so nominal dividends (actual dividends paid out) have grown at about a 6.6% rate per year. This is excellent growth in dividends over time (about 6%+ per year), well ahead of the rate of inflation. If you are retired and living on your dividend "pension" payments, you will likely increase your spending over time ahead of the rate of inflation.

DIVIDEND STABILITY

One of the negatives of this plan (compared to a real pension plan) is that dividends on the stock market do not always go up. In fact, they tend to decline some during recessions. Historically, the dividends on the U.S. stock index have declined on an annual basis (in real terms) seven times since 1945, and the average drop in dividend payments during downturns has been about 12% from peak to trough. The worst drops in dividend payments were during 1968-1976 and from 2009-2011 when dividends dropped 23% in real terms. One way to help stabilize the volatility of your dividend stream from year to year is to have a portfolio which is diversified globally by adding international high dividend funds. Other ways to increase the stability of your retirement income stream is to increase your bond allocation somewhat, or use part of your portfolio at retirement to buy an immediate fixed annuity.

HOW FAST CAN YOUR PROJECTED DIVIDEND PENSION INCOME GROW WHILE WORKING?

You increase your dividend pension stream by the dividend yield on your portfolio, plus the dividend growth of your portfolio, plus your contributions (savings) per year as a percentage of your existing portfolio size. Let's say your current portfolio has a 3% dividend yield and all dividends are reinvested. Let's further assume the dividends in your portfolio are growing at 3% per year. If you are saving $40,000 per year and your current portfolio size is $1 million, you are contributing at a 4% rate. If you add all those numbers up,

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your dividend stream is growing at a 3% (dividend yield reinvested), plus 3% (dividend growth rate), plus 4% (your contribution rate) for a total of 10% per year. That is an excellent growth rate in your dividend stream each year. How many people have an actual pension plan where their retirement income stream goes up by 10% per year?

POSITIVES OF THE DIVIDEND INCOME PENSION PLAN

1. Your income in retirement is likely to stay ahead of inflation. Most actual pension plans make payments that do not increase with inflation each year, which can become a problem over a 20-30 year retirement timeframe. Your dividend income payments are likely to be significantly higher over a 20+ year time period.

2. Your dividend income is dependent on the earnings and growth of a diversified set of hundreds of companies around the world, not just one company. When you have an actual pension, your payments are dependent on the financial success of just your former employer which is much risker, should your employer run into financial difficulties.

3. You are in control of the plan. You can save more and make your dividend income stream very large, and you can increase your dividend pension income stream at a high rate each year while working if you choose.

4. Most stock dividends are taxed at a fairly low income tax rate of 15% (federal), unless your income is extremely high. Most income from a pension plan (or annuity) is taxed at the higher ordinary income tax rate.

5. This is a very conservative plan. It assumes you are only spending the dividend income of your portfolio, and that you are not spending any of the principal. Using this plan it is highly unlikely that you would run out of money in old age, and you will likely have a very large legacy to leave to your children and/or favorite charities.

NEGATIVES OF THE DIVIDEND INCOME PENSION PLAN

1. It will probably only work for wealthier families who plan to live on a smaller (3% or less) percentage of their investment portfolio in retirement. This plan may be too conservative for many people, who will likely need or want to spend some of their portfolio principal in retirement to maintain their lifestyle.

2. Dividend yields are currently below the historical average, because U.S. stock valuations are above average. Bond yields are also currently below average and don't produce much income.

3. It is not a real pension plan in terms of fixed steady payments for the rest of your lifetime. Your income stream is more volatile in retirement, and can decline by as much as 5%-23% (historically anyway) for a few years during recessions. You must be able to cut back on your discretionary spending somewhat during the tough times to make this plan work.

4. It is all up to you to save enough money while working to make this work. There is no company paying you a pension income in retirement based on the number of years you worked.

5. If your portfolio is heavy on dividend paying stocks to provide the income, and lighter on bonds, the portfolio will be fairly volatile (risky) on a daily/yearly basis. Focusing on the relative stability of your dividends (compared to stock prices) can help.

While this retirement income "pension" strategy is not applicable to all investors, it does have some interesting conceptual appeal for the super-savers who live well below their means.

Adam Smith Advisors, LLC (ASA) provides unique wealth management services for a select group of client families to help give them peace of mind. Author Keith Tufte, (CIO of ASA) has over 25 years of successful investment management experience as a Wall Street Analyst, Mutual Fund Portfolio Manager, Director of Equity Research for a major mutual fund firm, Hedge Fund Portfolio Manager, and Wealth Management Advisor. Please FORWARD this e-mail to friends/relatives/business associates that you think may have an interest. Please see our website at http://www.cherrytree.com.

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