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Investing for income? Don't give in to temptation of risk

VIEWPOINT
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It may be blasphemy, but I'm going to say it anyway: I don't like dividends.

It is difficult to open an investment magazine or newspaper these days without seeing an article on the merits of generating investment income. The main argument usually is that since the largest part of our population is at or nearing retirement, investors will need to begin drawing income from their investments to meet their living expenses. Accordingly, stocks paying dividends and bonds paying high rates of interest should be a primary focus in portfolio design. Adherents also note that dividend-paying stocks have historically outpaced non-dividend-paying stocks by a healthy margin.

High-income investing has entered the zeitgeist. Clients frequently ask me about the income their portfolios generate and whether we should be looking for higher-yielding investments. Because I have seen the downside to this approach, I take a dim view of it. I purchased a small investment firm a couple of years ago and integrated it into my company. The acquired company had an investment philosophy focused almost exclusively on producing current income, primarily through stock dividends. Other considerations, however, like long-term growth and risk, were largely ignored, as they often are with an income-centered investment strategy.

Just before the most recent economic crisis, the firm I acquired was heavily concentrated in the stocks of financial companies and real estate investment trusts, which paid high dividends at the time. Ultimately, these stocks declined even more than the overall stock market, which was down more than 50 percent during the 2007-09 bear market. Even worse, the dividends on many of these stocks were cut severely or eliminated altogether as the companies struggled to remain solvent. Thus, investors got hit with a double whammy of steep capital losses and a substantial decline in income. Those dependent on their portfolios to meet their living expenses had few options but to sell stocks at depressed levels, making it hard to recoup losses when the stock market did ultimately recover.

Risk is a huge problem. Many investors focus only on income generation, but they leave themselves open to all manner of risks in this pursuit. Today it is not difficult to imagine interest rates rising substantially over the coming years. An environment of rising interest rates would likely result in underperformance, if not outright losses, for those concentrated in high-yield bonds, REITs and even stocks paying high dividends.

There are other problems as well, such as the impact of taxes. While it is taboo to suggest spending portfolio principal, that is usually the most tax-efficient way to access your money. In fact, I believe this is really the crux of the issue. Investors don't need income from their portfolios; they just need money to spend.

So rather than maximizing income, they should think about how best to grow their assets and then how to access those assets in the most efficient manner. Drawing principal from a portfolio is fine, as long as the portfolio continues to grow. But even taking capital gains is often less costly than drawing dividend and interest income. Starting this year, higher tax rates and a new investment tax on those in higher income brackets make tax-smart investing even more important.

Rather than focus on current income, investors can build portfolios that aim for long-term growth, that balance return and risk, that deliver "total return." Total return means striving for the best return possible and being agnostic between income and capital appreciation (though for the tax reasons discussed above, capital appreciation is still better).

For example, it makes sense to set specific asset allocation targets for stocks and bonds. The percentages will depend on individual circumstances, but a balanced mix of 60 percent in stocks and 40 percent in bonds is a popular choice for both individual and institutional investors. Then diversifying and reaching for the highest return possible, within reasonable risk constraints, is the best approach, paying no attention to the level of income produced.

Returning to the previous example, during the 2007-09 bear market, the stock component of such a portfolio would have lost roughly 50 percent, but the bond component would have earned just over 6 percent. For clients who need money from their investments, bonds can be sold to generate cash. This provides access to money, but without jeopardizing future growth potential by selling stocks at depressed levels.

But what about the performance advantage of high-dividend investment strategies? Studies dating back to 1920 show how investment strategies focused on dividend-paying stocks provide superior returns. Data also shows, however, that it is not because of the dividend payments that these stocks outperformed. It is because many high-dividend payers are "value" stocks, which tend to outperform the overall stock market, likely because of the higher risks they pose.

Additionally, regardless of past performance, it is unlikely that performance in the coming decade will be similarly strong for stocks paying high dividends. Because of their recent popularity, income-generating investments have been bid up to relatively high levels. We all know that no investment can defy gravity forever. This is another risk of a high-income strategy. Eventually the fad will end and these strategies will rotate out of favor, potentially causing significant losses for those worshiping at the altar of high income.

In today's ultralow interest rate environment, it has been tempting for investors to take additional risks to generate the income they need from their portfolios. While this may seem like a rational response to today's economic realities, there are too many pitfalls with such an approach. Those reading from the gospel according to income investing should beware.

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