



INCOME FOR
THE AGES

INVESTMENT STRATEGY GROUP



The year was 1976—America’s 200th birthday. The Dow Jones Industrial Average closed the year at 1004 and the Federal Reserve had established its overnight interest rate at 6.25%. Gasoline cost \$0.59 a gallon and inflation was running at 5.75%. Needless to say, much has changed since then. The Dow closed the month of January with an index value of 12,633, and the Federal Reserve is hosting a near-zero percent interest rate policy. In the meantime, inflation has been trimmed to about 3%, but prices of most things have gone up. Some have risen a lot, not the least of which is gasoline, which is averaging \$3.51/gallon nationwide according to AAA.

In 1976, McDonald’s was the top fast food franchise in the world, and the familiar “golden arches” were populating the landscapes of many a town throughout the country. The U.S. Bicentennial was also the first year the company known for advertising how many hamburgers it had sold instituted a dividend.

It was a small amount, really, just \$10 a year for the proud owner of 100 shares—which was enough to buy around 15 of their increasingly-popular Big Mac sandwiches. Yet as McDonald’s continued to grow, so did its dividend—which has increased *every* year since then. And for the investor that purchased and held on to those 100 shares? On the back of dividends alone, this shareholder has enough to buy around 2,800 Big Macs, for the dividend now received is around \$11,300 per year.

It is an interesting battle between stock dividends and bonds. For stocks, there is certainly the concern of a dividend being cut—with the additional risk of the stock declining in value. For bonds, reinvestment risk is surely an issue, as is inflation and credit quality. If our same McDonald’s investor, instead of buying stock, purchased a 35-year bond for \$1,000, the original principal received back at maturity in 2011, assuming the creditworthiness of the issuer afforded it, would only buy around \$250 worth of 1976 goods—as inflation erodes the purchasing power of money.

John D. Rockefeller is often quoted as saying “Do you know the only thing that gives me pleasure? It’s to see my dividends coming in.” Dividends have always been important to investors. Our research shows that the first dividend was paid in 1813 to investors in City Bank of New York (which eventually became Citibank). This dividend was paid for well over 100 years, surviving the Civil War, two World Wars and the Great Depression. Yet the dividend could not survive the financial crisis of 2008 and, as a result, the company failed to pay a quarterly dividend for the first time in 195 years. For the record, the bank now known as Citigroup Inc. did reinstate a dividend about a year ago.

THE RETIREMENT DILEMMA

A young investor with many years to go before retirement is, presumably, able to take on more risk than an investor nearing retirement for two main reasons: a) there is enough time to dive in to the equity market, enabling the investor to “ride out” periodic losses and volatility, and, b) historically, the longer an investor stays in the market, the greater the potential has been for positive returns (stocks have produced an average return of 9.8% from 1926-2011). In fact, stocks have produced positive returns over every fifteen-year period since 1926. But what about someone nearing or in retirement? Is such an individual able to absorb the same type of risk as a younger investor? A textbook response is generally no, but depending on the situation, he or she may be forced to do so. And predicated upon circumstances in the capital markets, they may best be served to accept it and perhaps even benefit from it.

The statistics that relate to solving for the retirement equation are startling. According to McKinsey & Co., all of the baby boomers will be 54 to 73 years old in less than six years. Over 45 million households will have people in this age group by 2015, compared to 25 million in the previous generation. But a report in 2007 by this same group called the baby boomer generation unprepared for retirement. And this was before the sizeable stock market decline in 2008 and the contemporaneous decline in home values.

After review of information supplied by the Employee Benefit Research Institute (“EBRI”), we concur with the opinion that far too many Americans are not well prepared for retirement. What is especially troublesome to us is that the figures—as shown below—are based on minimum expenditures (a “combination of basic expenses from the Bureau of Labor Statistics’ Consumer Expenditure Survey and some health insurance and out-of-pocket health-related expenses plus expenses from nursing home and home health care expenses, at least until the point they are picked up by Medicaid.”).

Prospects of Running Short of Money in Retirement, by Income Quartile

	10 Years of Retirement	20 Years of Retirement
Lowest-income quartile	41%	57%
2nd income quartile	23%	44%
3rd income quartile	13%	29%
Highest-income quartile	5%	13%

(Source: July 2010 EBRI Issue Brief, www.ebri.org)

What is most disconcerting about this table are the percentages assigned to the prospect of running short of money in just twenty years of retirement. Think about it. The Society of Actuaries places the likelihood of a 65-year old man living to age 85 at 41%, a same-aged female 53%, and the chance that as a couple at least one of them will live to age 85 at 72%. That means a portfolio has to be cared for and productive enough to last not five, nor ten, but rather twenty years or more in a period during which income may be fixed (from pensions) or small cost-of-living adjustments might be made to Social Security checks.

It is our view, then, that additional risk commensurate with the possibility of growth needs to be considered if many in this group are to comfortably survive an extended and possibly unexpectedly large number of years.

THE 4% SOLUTION—FACT OR FICTION?

A thought going around the financial industry at present is that an investor will not run out of money if they would target withdrawals to 4% of their investments. Is this fact or fiction? It is well supported in practice, as the spending policy of many endowments and foundations has historically been established at a rate of 5%. Only more recently has 4% become the new 5%—since bond yields have drifted lower, making a 5% hurdle rate harder to achieve without expecting incrementally-higher equity returns. Our experience leads us to answer this question in the same way we address most questions of this sort. It depends. Back in 1995, *Worth* magazine produced a famous article by Peter Lynch that claimed an investor should be in stocks, withdraw 7% of their money each year and be comfortable. The only problem is that data are skewed, as data often are. Most periods under study don't take into consideration fat-tail risks, which are rare occurrences that do happen—with cataclysmic results. In other words, low probability, high impact events can affect the outcome.

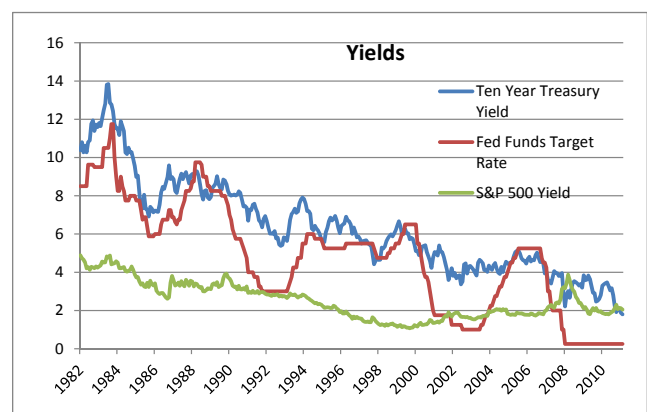
We will look at a recent example for a simple illustration. Let's say that an investor has \$1,000,000 and is withdrawing 4% (\$40,000) a year in pre-tax income—which is invested in a balanced mix of stocks and bonds. Not only does the investor need additional growth due to rising costs (at 3% inflation, an extra \$1,200 would be needed annually just to maintain purchasing power parity)—but a market tumble could impair the value of the portfolio for some time. Imagine, for instance, that this money was invested in the beginning of 2008. A balanced portfolio would have lost around 14.5% (starting the year in an equal mix of an S&P 500 index fund [symbol: SPY] and a general fixed income fund [symbol: AGG], both exchange-traded stock and bond funds). At the start of the next year, the portfolio would be close to \$815,000 and distributing the same \$40,000 would now require a withdrawal rate of

4.9%. What had begun as a seemingly safe hurdle rate has been transformed into a stretch goal. Obviously, portfolio adjustments can be made or income compromises can be agreed upon, but neither is a welcome intrusion at a time when income and capital preservation are a dual mandate.

We believe the 4% withdrawal argument is largely valid—but each individual's circumstance is different—so the portfolio architecture needs to work in concert with the risk and investment objectives. Obviously, emergencies often force individuals to reach into their savings—no matter how well intentioned their original plans were—which further complicates the income solution. Therefore, from a financial planning perspective, it is far better to satisfy a budget by “under-withdrawing” if possible—and allow for a surplus to build for additional future distributions, planned or otherwise.

WHAT DOES THIS HAVE TO DO WITH DIVIDENDS?

To begin, we are optimistic about the U.S. markets over the long term. Stocks have proven to be excellent instruments for capital growth and inflation protection. Currently, corporate profits are at all-time highs, valuations are undemanding, and cash as a percentage of tangible assets is the highest it has been in sixty years. Additionally, for the first time in a half century, the dividend yield on the S&P 500 index is higher than the 10-year Treasury bond yield (first occurring in late 2008 and then again in 2010). Note in the graph below that the Federal Funds rate, which the Federal Reserve uses to establish shorter-term interest rates, is currently pegged close to zero. This is likely to continue to be the case for some time. The magnetic quality of the Fed's tool is to pin yields on most other bonds close to its rate, if not exactly, at least directionally. Therefore, the real yield, which is the yield on a bond minus the rate of inflation, in many cases is below zero percent today. That is obviously an unwelcome scenario for an investor seeking to keep up with price inflation—let alone exceed it.



(Source: Janney ICG, Bloomberg, Federal Reserve)

Meanwhile, dividends are on the rise among current payers and payout ratios in the aggregate are still some 30% below their average level over the past two decades—so there remains plenty of room for further increases. Some, like Cisco, have even instituted dividends for the first time—much like McDonald’s did decades before. This time, however, dividends are rising from sectors that historically have not been prone to paying out part of their profits to shareholders. So Cisco’s move merely puts it in the company of other large and highly profitable technology franchises that pay handsome dividends, such as Microsoft and Intel. We would not be shocked to see Apple become part of the brethren in the future as well.

Dividends are generally perceived as a signal of company strength and consistency. Earnings can be manipulated through various accounting mechanisms, that while legitimate, make interpretation a case of judgment. Dividends, on the other hand, are cold, hard cash. While evaluating the company’s ability to sustain or increase its dividend payout is a judgment, history is often a guide for evaluating management’s adherence to its policy. There is no substitute for the investor getting a tangible piece of the profits in lieu of the promise that management knows better what to do with all of it.

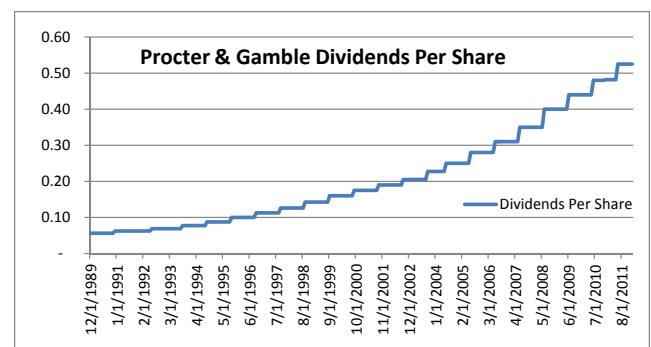
WHY NOW?

Most investors will need to participate in a vehicle that holds the potential for growth. Arguably, that includes those that might be profiled as risk-averse. An optimal portfolio, even for a conservative investor, using the Nobel Prize winning formula that became the foundation of modern portfolio theory, suggests employing an approximate mix of 20% stocks and 80% bonds. This combination has historically produced no more volatility than a portfolio geared 100% to bonds and yet generated better returns. That may seem counterintuitive, but it is basically due to the correlation factor—stocks and bonds don’t always move in the same direction. But the answer is also provided by the investment climate that we find today. Cash and equivalents earn very little, and the Federal Reserve has made it clear that it intends to sit on its low interest rate policy possibly into late 2014. There are no guarantees, of course, but even if a change were advanced to next year, cash yields have a long way to rise to even match today’s headline inflation—let alone exceed it. Bonds are useful instruments for providing a steady and predictable stream of income, and return of principal, assuming the issuer’s solvency outlives the bond’s maturity. But yields on most high-quality bonds have been driven lower, as rates have dropped. Recently, Procter & Gamble, a well-known consumer products company, issued a 10-year bond with a record-low yield of 2.3%, just 0.55% above a 10-year Treasury bond yield. In the meantime, Procter

& Gamble’s common stock pays a dividend of \$2.10, which at its January 31 closing price of \$63.04, gives the shares a yield of 3.3%, or 1% higher than the company’s aforementioned debt. Admittedly, not all corporate bonds warrant that same yield. The average yield for all investment-grade corporate bonds as of January 31 stood at 3.55%, according to index data provided by Bank of America. We do find corporate bonds attractive given the healthy state of many U.S. companies, but locking in even a 3.55% yield still doesn’t offer much clearance to fend off inflation.

In such a low-interest rate environment, investors would be ill-served to ignore the dividend yields offered by many high quality stocks and instead place an inordinately and perhaps unnecessarily high portion of net worth into bonds. This is so both because of the absolute yields, which are historically low, and because of the lack of protection if rates were to jump unexpectedly. Granted, certain bonds offer features that can help preserve value in a rising inflation environment. Treasury Inflation-Protected Securities (TIPs) are useful in that purpose. Therefore, the advocacy of dividend-paying stocks for income is not mutually exclusive of other options, but rather, in conjunction with them.

Dividend-yielding stocks can serve another purpose besides providing an income source to complement bonds in a diversified portfolio—and that is to grow the income stream. Coming back to Procter & Gamble one more time, it is merely one of many companies that has a history of giving its shareholders a “raise” with a high degree of regularity. The chart below depicts the dollar-based dividend stream provided to Procter & Gamble shareholders for the last several decades. What cannot be lost on the observer is the increasing cash stream—which, by the way, grew at a pace of over 11% during the last five years.



(Source: Janney ISG, Bloomberg, Federal Reserve)

More broadly, research from Yale professor Robert Shiller shows that from 1957 through 2011, the S&P 500 index has seen its dividend grow by about 5% annually, as companies within the index have raised their dividend. Over this same time frame, inflation

has averaged approximately 4%. In other words, even putting aside whether the S&P's index value gained anything, this makes a case for long-term investors to consider dividend-paying stocks as a tool for defending against rising prices. As it happens, investors would have also been rewarded with a handsome gain as well. If you bought the index at the end of 1957, when it traded at a whopping price of 40 and its yield of just over 4% produced about \$1.70 in dividends—and held it through the end of 2011 when the S&P closed at 1258 (then yielding slightly below 2% to produce about \$25 in dividends), simple price appreciation provided a gain of 3,045%. That translates into an annualized return of 6.6% without dividends. Add on the jump in dividends from below \$2 to more than \$25—and that underscores the income-producing, inflation-fighting power of dividend-friendly companies. To help make this even more tangible, we have included in the table on this page the positions that represent the top 25 holdings of an exchange-traded fund by the name of SPDR S&P Dividend ETF (symbol: SDY). The fund is designed to replicate the S&P High Yield Dividend Aristocrats index. This index represents the performance of the sixty highest-yielding constituents held in the S&P Composite 1500 that have consistently increased dividends every year for the last quarter century. The purpose of providing the list is to demonstrate the industry diversity that can be achieved and the attractive yields offered amongst so many companies that have a demonstrable history of increasing their payout to shareholders. It is probably reasonable to assume that most readers have the products of some of these companies in their homes today.

Ticker	Name	Yield
PBI	PITNEY BOWES INC.	8.06
CINF	CINCINNATI FINANCIAL CORP.	4.64
T	AT&T INC.	5.76
HCP	HCP INC.	4.72
ORI	OLD REPUBLIC INTL CORP.	6.74
LEG	LEGGETT & PLATT INC.	5.14
NUE	NUCOR CORP.	3.37
RPM	RPM INTERNATIONAL INC.	3.32
ED	CONSOLIDATED EDISON INC.	4.17
KMB	KIMBERLY-CLARK CORP.	3.91
ITW	ILLINOIS TOOL WORKS	2.52
SYY	SYSCO CORP.	3.60
CLX	CLOROX COMPANY	3.44
ABT	ABBOTT LABORATORIES	3.49
SON	SONOCO PRODUCTS CO.	3.51
JNJ	JOHNSON & JOHNSON	3.48
BMS	BEMIS COMPANY	3.09
AFL	AFLAC INC.	2.61
GPC	GENUINE PARTS CO.	2.79
STR	QUESTAR CORP.	3.15
ADP	AUTOMATIC DATA PROCESSING	2.72
PG	PROCTER & GAMBLE	3.26
PEP	PEPSICO INC.	3.18
EMR	EMERSON ELECTRIC CO.	2.13

(Source: Janney ISG, Bloomberg, Standard & Poor's)

We encourage readers to review with their Janney Financial Advisor the variety of individual companies, mutual funds, exchange-traded funds, and managed accounts that can provide the rewards of dividend income with the potential to grow. While the convention is that limits the pool of candidates to Utilities and Telecommunication stocks, the reality is that sectors such as Energy, Health Care and Technology now boast quality and stable franchises that are accompanied by rich dividend yields. A broadly-diversified portfolio of dividend-paying companies can help to deliver the income needed to meet today's expenses as well as those in the years to come.

Past performance is not indicative of future results.



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