Retirement: Are Dividends the Answer?

The unedited version of this Dividend.com Oct. 23rd newsletter was forwarded from a Quest Opportunity Fund (QOF) Member. (Hughes Capital Management is a sub-advisor to QOF.) Our parenthetical comments are shown in red.

You May Be Too Conservative With Your Investments

Ask any retired person or investor nearing retirement what their greatest fear would be, and odds are they'd say something about a catastrophic market downturn that wipes out their savings. The fear of loss is particularly great for any investor, but it is especially so for those near or in retirement. After all, when you are not working or are getting ready to stop punching the clock, there isn't much time to make up for a large stock market crash or downturn.

Or at least that's what we think.

The truth is, we do have a long time – even during retirement. And that focus on preservation and conservative investing could significantly hurt our nest eggs.

The Longevity Problem

Given how hard it is to save up a tidy sum in order to retire, it's understandable that investors would want to protect their savings from market losses. It's why bonds and other fixed-income products are huge draws for retirees. There's even that conventional financial planning tool that says you should have your age in bonds ....

However, the problem with such conservatism – even for investors in retirement – is a concept called longevity risk.

Thanks to advances in medicine, we are living longer. Back in the early 1900s, the average life expectancy was just 50 years. An American child born today can expect to live, on average, to the age of 79. Those numbers are even higher if you're married: there's a 72% chance that a spouse will live to the age of 85 and a 45% chance that one will live to the age of 90. ...

Now, think about that for a second. Then think about the average retirement age of 65 years old. That's a 30 year difference. You can literally be in retirement for as long as you worked saving for your nest egg.

This is the longevity problem in a nutshell. ... And yet, we're still investing as though our retirements will be relatively short. ...

Avoiding Losses

According to a new **Wells Fargo** (WFC) Wealth Management survey, nearly 59% of investors are more focused on avoiding losses than maximizing growth in their retirement investments. That includes holding a higher proportion of cash and bonds than equities. The scary thing about Wells Fargo's survey is that it found no differentiation among the ages – young Millennials have the same kind of investing strategy as those who are 70.

This is dangerous thinking for everyone.

The avoidance of loss could actually cost you more than the losses themselves considering that even retirees are long-term investors. And 20 or 30 years is a long time. For example, from January 1, 1976, through September 30th, 2016, $10,000 in a 30% stocks and 70% bonds portfolio would have grown to $336,716. Over that same time period, a 70% stock, 30% bond mix would have grown to $581,295. That's a huge difference (Especially considering that the last 30 years was a historic bull market in Bonds.), and it highlights that the correct mix of investments for a certain time horizon is important.

Living in retirement is a long-term game, and the real story is that you need more stocks than you actually think.

Breaking out of Your Comfort Zone

Given the risks of running out of money thanks to longevity, investors should consider upping their exposure to stocks. ...

We all know about the power of dividends to improve compounding (compared to what?), beat inflation (depends on how high inflation is) and act as a cushion in downturns ("WRONG," to quote the Donald). In this instance, they can be the extra oomph that investors need to boost their stock exposure without betting on super risky sectors of the market. And when dividends are compounded in a dividend growth strength (huh?), it works even faster. While we're fans of individual stocks here at Dividend.com (as are we when they meet our investment criteria), an ETF like Vanguard Dividend Appreciation or iShares Core Dividend Growth ETF is an easy way to boost your percentage of stocks and to break out of the comfort zone. ...

Bottom Line

In the end, your conservatism – when it comes to retirement and investing in or near that goal – could actually hurt you. Even in retirement, we are long-term investors, and that means holding a larger stake in equities than we have traditionally thought was ok.

Our thoughts:

While we agree that the answer to the Longevity Problem includes more equity exposure, focusing on Dividends is not the answer. The unedited version of the following blog post is at http://www.factorinvestor.com/blog/2016/10/12/the-illusion-of-choice-in-etfs

The illusion of choice in ETF's

October 13, 2016 by Ehren Stanhope

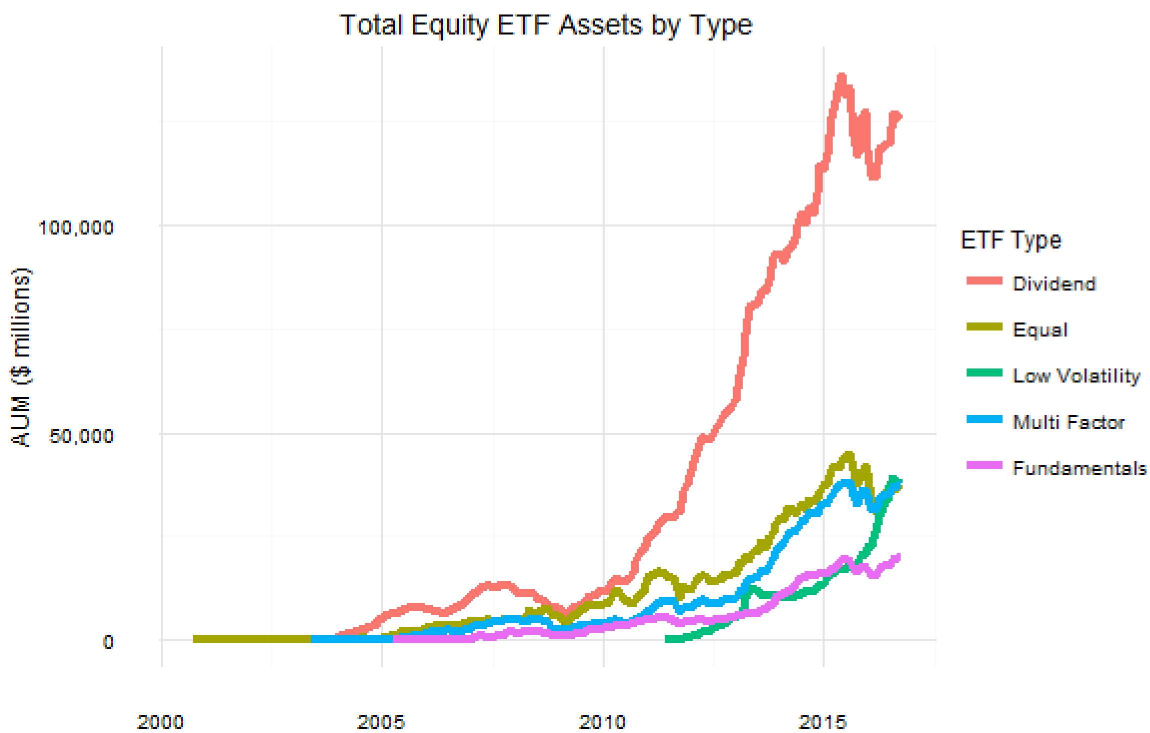
A search for all equity ETF's available to U.S. investors in Bloomberg leads to a list of 969 candidates, a surprisingly large number of options for a relatively new investment vehicle. Given that most focus on large capitalization stocks here in the U.S. (not all, but most), this means that there has to be overlap in the underlying stock holdings...in some cases a lot of overlap.

The unfortunate result is that investors are lured into believing that 1) there exists choice within ETF categories, and 2) building portfolios of ETF's represent a diversified set of exposures. This is generally not the case.

A distinction without a difference

When I wrote about my concerns with Low Volatility ETF's ... I noticed that the turnover in those ETF's was very low, which suggested that the billions of dollars flowing into the low volatility theme were being channeled into a relatively concentrated group of stocks. It turns out, dividend ETF's are more popular by a factor of five, and there tends to be a lot of overlap in the underlying holdings.

As you can tell from the chart below, dividend ETF's are by far the largest "Smart Beta" ETF category, having amassed $126 billion in assets as of the third quarter of 2016.

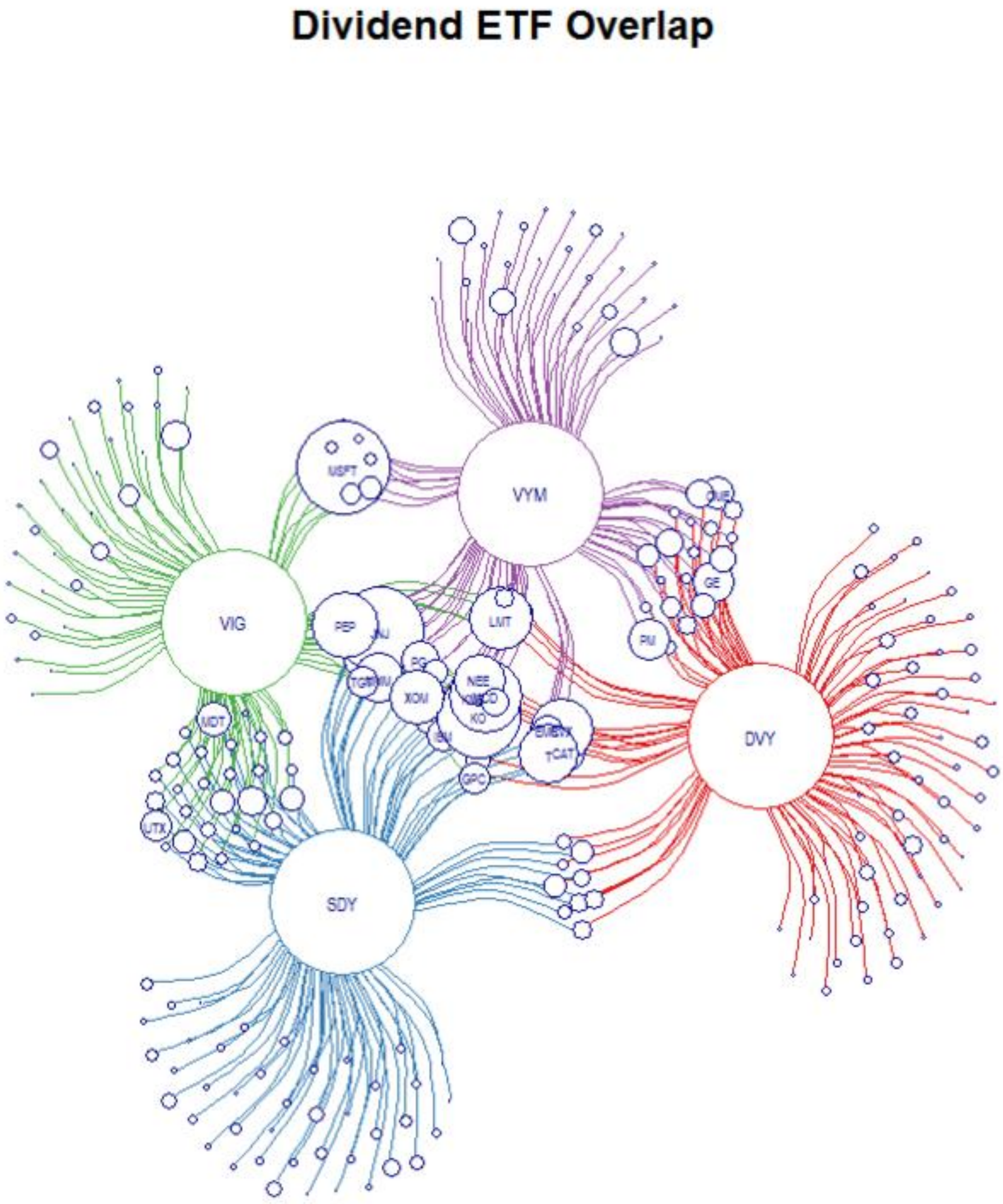


The challenge with dividends as an investment factor, as opposed to Value, Momentum, or Quality, is that only so many companies pay dividends. As buybacks have become more popular in the U.S., the share of stocks paying high dividend yields has declined. ... While the share of companies paying small yields of less than 1% has decreased, the share of companies paying greater than 4% has also declined. Historically, about 12% of S&P 500 stocks offer a yield of 4% or greater. As of the third quarter, the tally is half that at 6%.

So, as a generation of Baby Boomers seeks alternative solutions for income generation in the face of low fixed income yields, the dividend opportunity set is also shrinking. Even still, with average dividend yields in excess of most fixed income, you can bet dividend ETF's will continue to be recipients of investment dollars.

Circling back on the point of overlap, let's take for example, four of the most popular dividend ETF's by assets:

- Vanguard Dividend Appreciation ETF (VIG)
- iShares Select Dividend (DVY)
- Vanguard High Dividend Yield ETF (VYM)
- SPDR S&P Dividend ETF (SDY)



After pulling the holdings as of 1Q 2016, I used some fancy programming pyrotechnics to generate a map of their holdings. The graphic above illustrates the overlap between these ETF's. The large circles represent an ETF ticker. Each of the spokes is an individual stock holding and is scaled to its weight across the ETF's. The spokes connect each stock to the ETFs in which it is held. For the sake of simplification, only underlying holdings with a greater than 3% weight receive a label.

A few observations. The largest names tend to be those that are held in common between all of the ETF's--those stocks in the middle of the map. The stocks that are unique to an ETF tend to be the smallest weights and line the periphery. *It's surprising how similar the ETF's are; only 20% of the total weight across the 4 ETF's is* *unique*. 80% of the assets have at least one holding in common with the other three ETF's. 30% have two holdings in common. And 9% of the assets are held in common across all four ETF's.

Self-perpetuating momentum

Here's why this matters. I mentioned earlier that $126 billion resides in dividend ETF's. If the stocks occupying the largest weights are the ones that are most commonly held across dividend ETF's, then the massive flows we have seen over the last few years have disproportionately gone into these stocks.

The characteristics of the most highly-weighted names across these popular ETF's betray exactly this point. Flows have pushed up valuations of the stocks holding the greatest weights, and those with the greatest weights have substantially better momentum (momentum being the average of 12 month trailing total return).

The table below takes all of the stocks held in the four popular dividend ETF's and treats them as one super portfolio. It then segregates the super portfolio into stocks that occupy weights greater than and less than 1%. I then calculate average characteristics on the two groups of stocks.

Characteristics of Holdings Across Most Popular Dividend ETF's

Weight	Proportion of ETF Market Value	Price to Sales	Price to Earnings	Price to Cash Flow	Price to Book	Dividend Yield	12-month Momentum
<1%	19%	1.0	16.5	7.6	1.9	3.2	-2.9
>1%	81%	1.6	19.9	10.5	2.8	3.0	5.6
	Relative Advantage	-37%	-17%	-28%	-32%	10%	291%

The <1% group is cheaper by 37%, 17%, 28%, and 32% relative to sales, earnings, cash flows and book value than the >1% group, and their dividend yield is 10% higher. Given the choice between these two groups of stocks, any competent investor would choose the <1% group! Unfortunately, the <1% group represents a disproportionately small amount of the ETF's holdings, just 19%. The more expensive and lower-yielding group represents a whopping 81% share.

Why?

In a word...scale. ETF's prefer stocks with large market capitalizations because they are designed to accommodate large amounts of assets that are not limited by capacity constraints. Some of the highest yields are offered by lower capitalization stocks that are beyond the reach of the Vanguards, iShares and SPDR's of the world. This creates opportunities for smart investors willing to go against the grain.

Our thoughts continued:

HCM's first use for clients of the Insider Buying Theme we term Reaching For Yield resulted from May 2013's "Taper Tantrum" which began over concerns that the Fed would precipitously raise interest rates. To a lesser extent a repeat occurred last year, again providing opportunities to buy dividend paying stocks. Those opportunities are gone, at least for now, even in the "<1%" stocks, as we shared in our 10/3/16 **The New Real Estate Sector** post.

Unlike "Value, Momentum, or Quality" Dividends is not a Factor we recommend. While most Value stocks pay a dividend, it is the Value Factor that matters. This from Meb Faber's May 2, 2016 **How Much Are Those Dividends Costing You?**

1974 - 2015	S&P 500	2000 Stocks Equal Weight	2000 Stocks Mkt Cap Weight
Returns	10.77%	12.80%	10.94%
Volatility	15.36%	18.94%	15.90%
Max DD	-50.95%	-51.44%	-50.72%

Top 100 stocks	Top Quartile Dividend Yield Equal Weight	Top Quartile Dividend Yield Mkt Cap Weight
Returns	13.87%	13.20%
Volatility	15.10%	15.48%
Max DD	-55.05%	-65.29%

Top 100 stocks	Value Comp Equal Weight	Value Comp Mkt Cap Weight
Returns	17.38%	15.37%
Volatility	19.03%	18.70%
Max DD	-56.52%	-54.59%

"The first row shows the S&P500, and the equal weight and market cap weight of the top 2000 stocks. Notice that the market cap is near identical to the S&P500, and also that the equal weight is about two percentage points higher than both (one reason we always say to avoid market cap weighting).

The next row is taking the top 25% of the universe by dividend yield. Notice this adds about a percentage point over buy and hold.

The next row is weighting stocks by valuation. One can define "value" any number of ways. For our purposes ... we constructed our value composite by taking the top stocks by a combined rank of price-to-earnings, price-to-sales, price-to-book, and EBITDA-to-EV (the last, along with the closely related EV/EBIT, being HCM's preferred valuation metric when PEG isn't available).

Notice the massive outperformance over the broad market and the dividend portfolio. ... Focusing on value is a much better value strategy than dividend yield!"