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Advisors Are Chasing Dividends Instead of Buying Bonds. Is This a Mistake?

One of the biggest challenges facing retirees is trying to find the "right" amount of money to receive on a monthly basis. Many equate this to the difficulties of climbing Mount Everest. As challenging and taxing as it is to scale the mountain (building wealth over a lifetime), history has shown that descending the treacherous peak is far more deadly (taking monthly distributions). Retirees concern themselves with the sequence of returns, fearing what happens if they begin withdrawing in a bear market. It can also be a complicated problem to understand how much to withdraw and if or when principal should be used to maintain their living expenses. Some retirees turn towards the age old saying of withdrawing 4% of your portfolio each year, as many financial advisors have preached over the years. Another popular option, particularly in vogue of late, is using dividend paying stocks. The idea is that a retiree can receive monthly income simply from owning companies that pay a dividend. But is this a wise strategy? In particular, if a recession were to happen, what would happen to your monthly income? We will examine these important questions and see how dividend investing has held up during times of distress.

A good place to begin with dividend investing is with volatility versus stock prices. Historically speaking, stock prices have generally displayed greater levels of unpredictability than dividends. That said, dividend yields can still exhibit volatility, not to mention the change in the stock values that impacts the investor as well. By way of reference, over the last seven bear markets, the S&P 500 dividend yield decreased on average by over -6%. This is in addition to the average price decline of over 38%.

Generally, management teams avoid cutting dividends as it signals to investors that the company is struggling or not doing well financially. However, during a recession all bets are off. During the financial crisis between 2008 and 2009, almost all of the major banks and S&P 500 stalwarts, such as Wells Fargo, AT&T and Chevron, either cut or **eliminated their dividend**. In total, 41 companies within the S&P 500 slashed their dividend payout in 2009, for a total reduction of approximately $41 billion. This was in addition to the 61 cuts by S&P 500 companies totaling $40 billion in 2008. While companies hope to avoid these measures, dividends are not guaranteed by any means; it is simply a way for companies to provide payouts to their shareholders. In troubled times, companies will often cut dividends by necessity. Unfortunately for shareholders, these dividends are typically cut or completely eliminated at the worst possible time, the period of a bear market. This forces the dividend paying stock investor to pull income out of their declining principal … making a challenging situation that much worse.

As we have just seen, during a recession, dividends can change quickly. This can present serious concerns for a retiree with a dividend-oriented portfolio. One of the primary reasons for owning dividend stocks, specifically for retirees, is offsetting inflation. Even a slight decline in the dividend payout of companies within a portfolio can potentially represent a significant hit to a retiree's lifestyle. As an example, using the Vanguard High Dividend Yield ETF, we find that dividend payouts were hit particularly hard between 2008 and 2010. Over this period, the fund's dividend payments peaked in 2008 at $1.44 per share, before declining to $1.17 in 2009 and $1.09 in 2010, representing a decline of about 25%.

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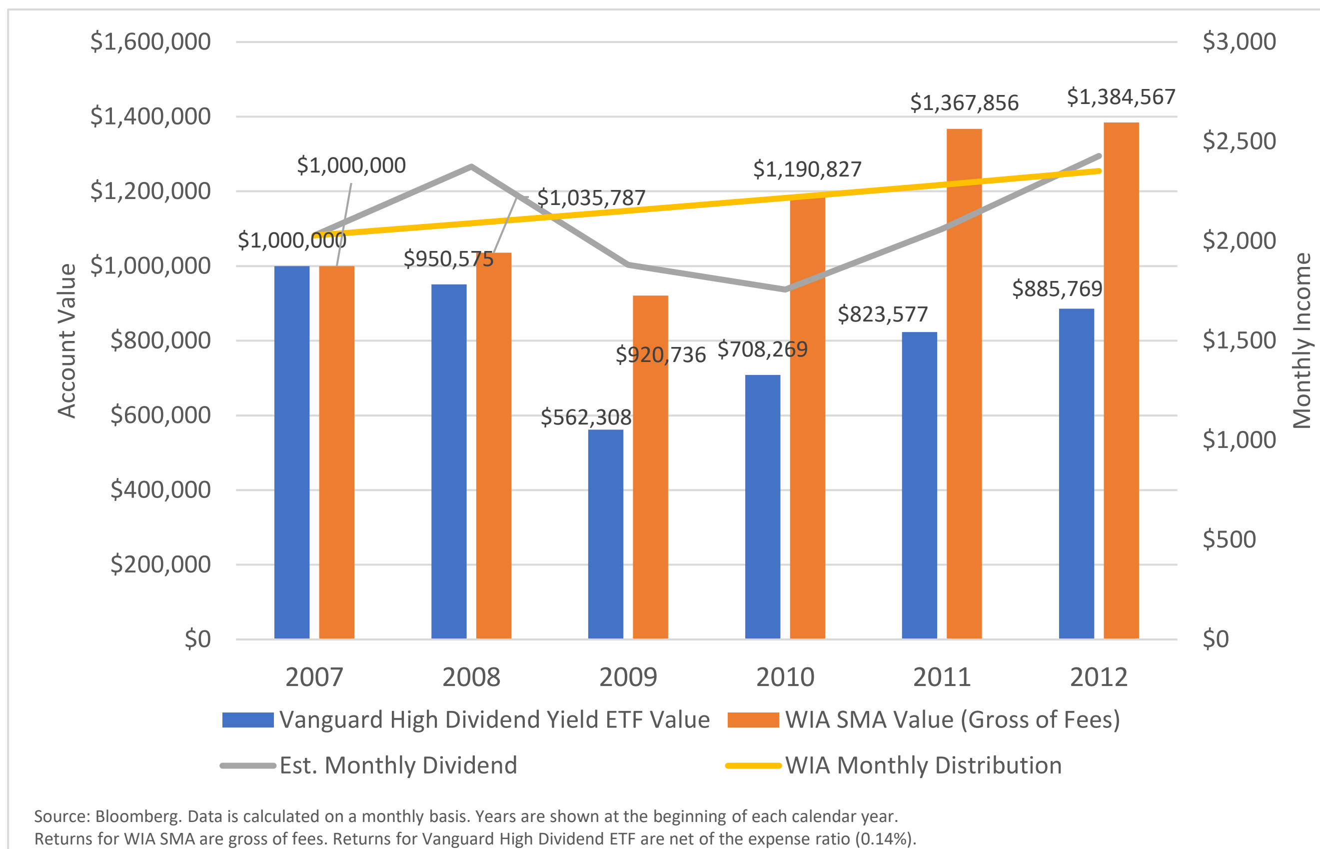

The graph above illustrates this in greater detail. If a retiree had $1 million invested in the Vanguard High Dividend ETF in 2007, they saw their account value drop to $562,000 by 2009. To make matters worse for this retiree living off the monthly dividends, their estimated monthly payments decreased from ~$2,000 in 2007 to ~$1,750 by 2010. Seeing your monthly income decline by almost 15% can be very challenging for an investor who is dependent on income. This does not even account for the loss in purchasing power as prices increased during that time. In the illustration above, we compare this to investing in our WIA SMA convertible bond strategy and receiving a monthly distribution of $2,000 (with a 3% inflation increase). Over that time frame, a retiree's monthly payments continued to increase and their account value did as well – increasing from $1,000,000 in 2007 to $1,190,827 in 2010. By 2012, the retiree would have had close to $500,000 in additional value and did not sacrifice a cost of living haircut during that time frame.

We all know that bear markets are a part of our financial lives. The ability to predict the timing of a market correction or bear market is incredibly challenging, but we can prepare for them. For retirees, limiting losses is particularly important. Here at Wellesley Asset Management, we focus on investing in convertible bonds with predictable and stable coupon payments. During the financial crisis, our WIA SMA strategy worked very well for our investors capturing only 17% of the market downside versus the S&P 500 and gained over 36% in 2009, beating the S&P 500. When companies cut dividends, they still must pay the coupon payments to their bondholders, assuming they continue to stay in business. Convertible bonds provide the benefits of investing in stocks with the additional layer of security that a bond provides. Additionally, stocks do not offer a timeline or guarantee for when the investor would see their principal returned. Our convertible bond portfolios keep a short to middle term duration that does not only keep coupons constant, but also gives investors some security that, barring default, the convertible bonds' principal will be repaid. We believe our active management adds even more protection for our clients. Our investment team is always searching for companies with high quality earnings, strong balance sheets and upside stock potential. That is why we believe that convertible bonds compared to dividend paying companies provide retirees with a winning strategy, as they descend down the mountain of retirement.

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Past Performance is not indicative of future results.

No representation is made that the investor will obtain similar results to those shown. The performance presented may not be representative of investments held in any one client account or performance realized in any one client account. An investor's actual performance may differ from the performance presented due to timing of investment, contributions and withdrawals. Performance does not reflect the effects of taxation, which may result in lower after-tax returns.

The reader should not rely on this information for investment purposes. This presentation is meant for broad discussion purposes only and is not intended as a recommendation to buy or sell any security.

An investment in convertible securities involves a risk of loss. The value of an investment in convertible securities may decrease as well as increase.

Returns reflect the reinvestment of interest and dividend income. Gross returns are presented before management fees and include any transaction costs and custodial fees, if applicable. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. Standard WAM management fees are set forth in WAM's Form ADV Part 2A. If expenses were reflected, the performance shown would be lower. For example, if $100,000 were invested and experienced a 10% annual return compounded monthly for 3 years, its ending value without giving effect to the deduction of management fees would be $134,818 with a compound return of 10.47%. If a management fee of 1.75% of the average market value of the account were deducted monthly for the 3-year period, the annualized compounded return would be 8.57% and the ending dollar value would be $127,974.

The S&P 500 Total Return Index, a registered trademark of McGraw-Hill Co., Inc., is a market capitalization-weighted index of 500 widely held common stocks. The S&P 500 Total Return Index is a free-float capitalization-weighted index published since 1957 of the prices of 500 large-cap common stocks actively traded in the United States. The stocks included in the S&P 500 are those of large publicly held companies that trade on either of the two largest American stock market exchanges; the New York Stock Exchange and the NASDAQ. The S&P 500 Total Return Index calculates the performance of a group of stocks assuming that all dividends and distributions are reinvested.

The Vanguard High Dividend Yield ETF Seeks to track the performance of the FTSE High Dividend Yield Index, which is derived from the U.S. component of the FTSE Global Equity Index Series and measures the investment return of common stocks of companies characterized by high dividend yields.

WIA Disclosures

The investment approach of the Wellesley Investment Advisors ("WIA") composite is to seek capital preservation in combination with positive annual returns over full market cycles. Client funds are typically invested in a majority of short to medium term convertible bonds. Many of the convertible bonds in the portfolio have short term put options that are intended to limit the bond's downside potential. The selection criteria used by WIA for the convertible bonds in the portfolio include the upside potential of the underlying equity, the quality of the bond, its liquidity and its yield to put or maturity.

Footnotes Pertaining to Years Up to and Including 2009: The performance presented reflects model performance an investor may have obtained had it invested in the manner shown and does not represent performance any investor actually attained. Model returns have many limitations and may not reflect the impact that material economic and market factors may have had on the decision-making process if client funds were actually managed in the manner shown. The performance presented reflects the convertible securities portion of WAM's client accounts. Actual client accounts may include positions other than convertible securities and such other positions are excluded from the performance calculation. Accordingly, the actual return of WAM client accounts is different, in some cases substantially, from the performance presented for convertible securities. WAM's convertible returns have been calculated using the methodology set forth below. Such methodology includes several assumptions that result from systems limitations on aggregating the convertible security portion of multiple client accounts. Although information has been obtained from and is based on sources WAM believes to be reliable, WAM does not guarantee the accuracy of the information, and it may be incomplete or condensed. Listed the market value of all convertible securities held on the last day of each month. Determined the weight of each security holding in the portfolio (individual security value / total security value). Determined each security's return for the month (monthly interest earned plus / minus monthly price change). Assumed that a security entered the portfolio on the first day of the month in which it was first purchased. When a security was completely sold out of the portfolio, its prior month ending value was adjusted to reflect the final sales price. Weighted each security's return for the month by the security's weight in the portfolio. Summed each security's weighted return for the month to get the portfolio's return for the month. Compounded monthly returns to calculate annual return.

Footnotes Pertaining to Years After 2009: Beginning on January 1, 2010, monthly returns are size-weighted average returns and have been compounded to calculate annual returns. The WIA Composite includes all client accounts consisting only of cash and convertible bonds. Effective January 1, 2015 the composite was redefined to include client accounts that hold unregistered 144A bonds. Accounts are included in the composite for the first full month under management and are removed from the composite at the end of its last full month under management.

Footnotes Pertaining to Years 2016 and after: Beginning January 1, 2016, the composite was redefined to add client accounts which may invest in WAM's proprietary mutual funds and excludes institutional client accounts and wrap accounts in the Wellesley Convertibles and Wellesley Institutional Capital divisions from the performance calculation. Wellesley Convertibles includes accounts which are fully discretionary wrap portfolios. Wellesley Institutional Capital accounts consist of institutional investors, including pensions, profit-sharing plans, defined benefit plans, defined contribution plans, hospitals and not-for-profit organizations.

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