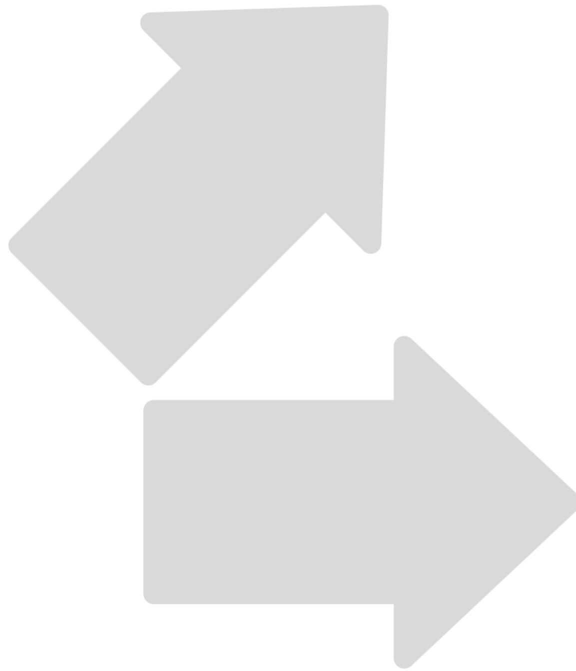
First Ascent Asset Management

TOTAL RETURN VS. INCOME INVESTING

Understanding the Trade-Offs



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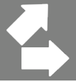


TOTAL RETURN VS. INCOME INVESTING

There are two approaches to building a portfolio that individuals commonly take in preparing for retirement. One is the “income” approach and the other is the “total return” approach.

Using the income approach, an individual builds a portfolio so that interest and dividend income are sufficient to fund periodic withdrawals in retirement. The idea is to avoid ever having to “dip into principal” or sell securities to fund distributions.

The total return approach is not focused on the source of the distributions. The idea is to produce a greater and steadier stream of distributions regardless of whether those distributions are funded by interest, dividends, or capital gains.

Total return investors and income investors both recognize the psychological benefits of not dipping into principal, if possible. However, total return investors believe that there are practical considerations that justify doing so.

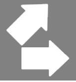
The Changing Investment Environment: Yields Are Much Lower Than They Used to Be

For decades, the income approach was a perfectly workable way to build retirement portfolios. It was possible for many retirees to live comfortably off the interest and dividends generated by a relatively conservative portfolio. But the investment environment has changed.

Interest rates have declined significantly over the past 40 years. In 1981, the interest rate on a 10-year Treasury bond peaked at 15.84%. In 2020, the interest rate had fallen to 1.01%.

Source: Macrotrends

Over that same period, dividend yields have also declined significantly. The dividend yield on the S&P 500 in 1981 was 5.35%. In 2020, it was 1.52%.



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Exploring the Alternatives: Reaching for Yield Can Add Risk

There are three primary ways an investor may seek out investments that generate more income. Each results in increasing portfolio risk.

First, an investor can extend the duration of their bond portfolio. Bonds with longer durations tend to have a greater yield. But they are also more sensitive to changes in interest rates. The increase in yield achieved by extending duration may be more than offset by the loss in principal value caused by even a modest increase in interest rates.

Second, an investor can move away from Treasury bonds and other safe government securities and seek out higher yielding bonds. These may include corporate bonds, high-yield junk bonds, or emerging market bonds.

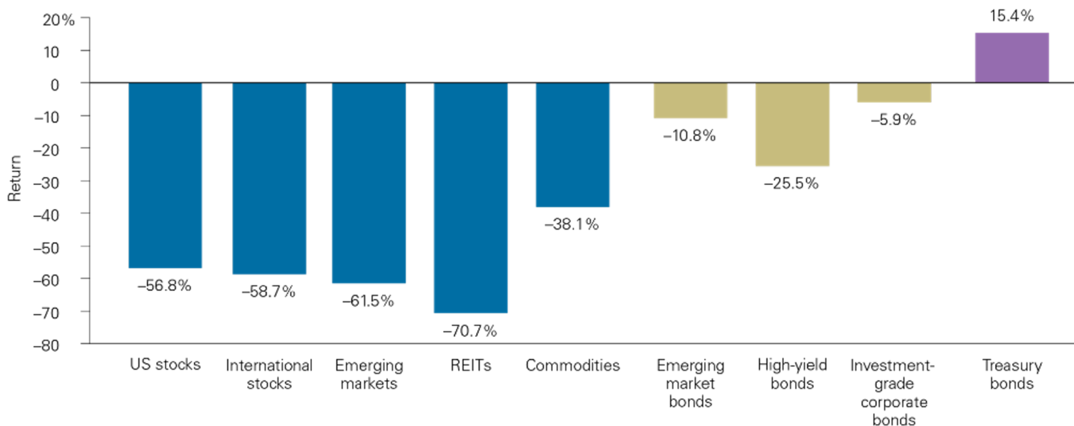
Doing so can have two negative effects on a portfolio. First, higher yields are correlated with increased credit risk. The higher the yield, the greater the risk of defaults.

In addition, Treasury bonds are a proven diversifier—they provide protection when stock markets decline in value. Higher yielding bonds tend to be more positively correlated with stock markets and, thus, provide less downside protection in the event of a market decline.

An example of this problem is shown in the graphic below. You can see that during the financial crisis of 2007-2009 higher yielding fixed income instruments failed to provide the downside protection offered by Treasury bonds.

Cumulative Performance of Selected Asset Classes

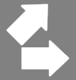
9 October 2007 – 9 March 2009



Notes: Returns for US stocks, international and emerging market stocks and REITs represent price returns; returns for commodities and bonds represent total returns. US stocks are represented by the MSCI US Broad Market Index; international stocks, the MSCI World Index ex US; emerging market stocks, the MSCI Emerging Markets Index; REITs, the FTSE NAREIT US Real Estate Index; commodities, the Dow Jones-UBS Commodity Index; emerging market bonds, the JPMorgan Emerging Markets Bond Index; high-yield bonds, the Barclays U.S. Corporate High-Yield Bond Index; investment-grade corporate bonds, the Barclays U.S. Corporate Bond Index; and Treasury bonds, the Barclays U.S. Treasury Bond Index.

Sources: Vanguard and Thomson Reuters Datastream.

Finally, investors stretching for more income may shift a greater portion of either the fixed income or the equity portions of their portfolios to dividend paying stocks. But doing so will increase portfolio volatility and decrease portfolio diversification.



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Dividend paying stocks are still stocks and will experience greater swings in value than bonds. They also tend to be larger "value" stocks that are concentrated in certain market sectors. Allocating more to them will underweight smaller growth stocks and certain market sectors.

It will also greatly reduce the universe of stocks available for inclusion in the portfolio. A February 2020 study by Dimensional Fund Advisors (DFA) found that from 1963 through 2019 an average of only 52% of US companies paid a dividend.

Economic Equivalents: Taking Distributions from Principal Does Not Create a Worse Outcome

Although it may feel better to take distributions from dividends rather than selling a stock to fund a distribution, both are roughly equivalent from an economic perspective.

When a company pays a dividend, its share price drops by approximately the amount of the dividend, all else being equal. You can take your dividend or sell shares of the same value and your portfolio value will be the same. (This does not take taxes or commissions into account.)

This point is illustrated below.

Portfolio A: Income Via Dividends

Portfolio Ahead of Dividend Payout			
Asset	Quantity	Price	Portfolio Value
Stock ABC	100	$20	$2,000
Total			$2,000

Portfolio After Dividend Payout			
Asset	Quantity	Price	Portfolio Value
Stock ABC	100	$19	$1,900
Cash			$100
Total			$2,000

Portfolio B: Income Via Stock Sale

Portfolio Ahead of Stock Sale			
Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$20	$2,000
Total			$2,000

Portfolio After Stock Sale			
Asset	Quantity	Price	Portfolio Value
Stock XYZ	95	$20	$1,900
Cash			$100
Total			$2,000

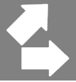
Data source: Dimensional Fund Advisors.

The owner of Portfolio A holds 100 shares of ABC company. Each share is worth $20. The total portfolio value is $2,000. The owner of Portfolio B holds 100 shares of XYZ company. Each share is worth $20. The total portfolio value is $2,000.

ABC company declares a $1 per share dividend providing the owner of Portfolio A with $100. This investor still owns 100 shares of ABC company, but the share price drops to $19 per share to reflect the payment of the $1 dividend. Portfolio A is now worth $1,900.

The owner of Portfolio B sells 5 shares of XYZ company at $20 per share and receives $100. This investor now holds 95 shares of XYZ company. The share price is still $20 because no dividend was paid. Portfolio B is now worth $1,900.

Both the owner of Portfolio A and Portfolio B received $100 and now have a portfolio worth $1,900. The two transactions were economically equivalent.



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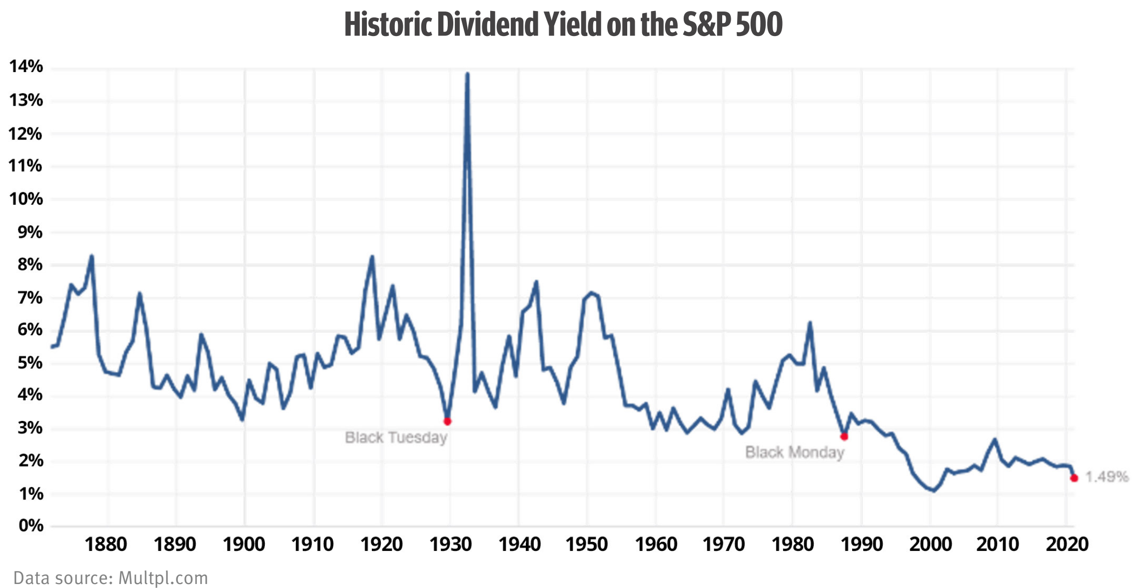
Steadiness of Distributions

Income investors have less control of the steadiness of their distributions than total return investors. Interest rates and dividend payments rise and fall over time based on many factors. This can dramatically affect the funds available to an income investor for distribution.

As we saw earlier, interest rates have risen and fallen quite dramatically over time. This is also true of dividends as we can see below.



In the wake of the 2008 financial crisis, 57% of dividend-paying firms cut or eliminated their dividends[1]. In the first three quarters of 2020, dividends paid by US companies decreased 22%[2]. Such developments make it difficult to ensure a steady income stream.

Total return investors can smooth out disruptions to their income stream by selling portfolio holdings, if necessary. This gives them more control to deal with unforeseen events.

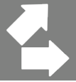
Taxes

Because income investors want easy access to their income stream, they often hold their income producing stocks and bonds in a taxable account. If so, they pay taxes each year on the interest and dividends received even if those amounts are not distributed.

By contrast, total return investors may hold income producing securities in a tax-advantaged account to gain more control over when taxes are paid on the income received, which may be taxed at a higher rate than capital gains. They would hold more tax-efficient assets, like equity ETFs, in taxable accounts and selectively realize gains, or even losses, to fund distributions.

Minimizing taxes in this way may extend portfolio longevity for the total return investor.

1. Global Dividend-Paying Stocks: A Recent History, Dimensional Fund Advisors (March 2013)
2. Dividends in the Time of COVID-19, Dimensional Fund Advisors (November 2020)



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Conclusion

The income approach to portfolio design is intuitive to many investors and has worked for several generations. However, changes in interest rates and dividend payment levels over the last 20 years mean that investors should revisit their approach to drawing income from their portfolios. Adopting a total return approach can help investors create stable income streams while avoiding unnecessary risks and better manage taxes.