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Capital Analysts of New England: Stock dividends and today's retiree

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The goal of many retirees is to invest their money to generate a rising inflation adjusted income stream for life. One of the best ways to help accomplish this is through an allocation to dividend paying companies. Dividend paying stocks can be purchased individually, through a mutual fund or an index fund.

First a little background, historically retirees were advised to invest in CD's and or bonds. Today, two things have changed. The first is retirees are living longer and need to develop an investment portfolio designed to last as long as 20 to 30 years. CD's and bonds tend to lose value over the long term due to inflation, taxes and low returns. The second change is interest rates have declined to historical lows. This has resulted in CD rates in the 1% range (if you are lucky) and very low yields on bonds. When you factor in inflation - especially health care inflation - retirees will be losing money over time with these seemingly safe investments. In our opinion, every retiree should still have an allocation to these safer investments although a lessor amount. In the past, the allocation might have been 100%, today this allocation might be in the 50% range or less depending on the risk tolerance and specific situation of each investor.

In our practice, we are recommending our retired clients have a larger allocation (55% to 60%) to stocks and specifically to dividend paying and dividend growing stocks (through mutual funds and Index funds) for the following reasons:

1. Our goal is inflation adjusted rising income. Historically, stocks within the S&P 500 Index have increased dividend payments greater than the rate of inflation.

2. From 1983 to 2012 dividends represented 53% of the total return of companies in the S&P 500. In other words, more than half of the return came from reinvested dividends.

3. Dividend paying companies tend to be more conservative as the dividend represents a net profit to shareholders after all expenses have been paid. There is a saying, "you can't fake a dividend." It is a cash payment.

4. According to Ned Davis research, companies that regularly grow their dividends saw the highest increase in share price from 1972 to 2012. In fact the highest returns with the least amount of volatility historically have been the dividend growing companies - not necessarily the highest dividend today - but the potential for growing dividends in the future.

Research has indicated retiree's should re-characterize their stock investments from growth to growth and income or dividend investing. This will lead to more conservative stock investments with an income stream (Source: Capital Group)For retirees, a portion of your expected return is being paid to you as spendable income and many times a growing income. These rising cash payments help fund increasing living expenses.

Many companies have paid dividends and raised their dividends for past 25 years - even through stock market corrections and the great recession of 2008/2009. There are mutual funds and index funds available with a focus on these investments.

Dividends are not guaranteed but tend to be paid by financially strong companies with a management team focused on the shareholder. These companies tend to have high profits, stable earnings, low debt and good payout ratios.

As a reminder, stocks fluctuate in price and can decline significantly in poorly performing stock markets. This is the reason we recommend an allocation to dividend paying companies yet also recommend an allocation to bonds and cash. Many retirees will have 50% on the stock side and 50% on the bond/cash side again depending on their unique situation. An allocation to dividend paying companies- both US and abroad - should be considered as part of a well-diversified portfolio.

If your goal in retirement is to replace your paycheck with a rising income stream from your investments - consider an allocation to dividend paying stocks either individually, through an actively managed mutual fund or an index fund.

Mutual funds and Index funds are not FDIC insured, principal is subject to market fluctuations, and value at redemption may be worth more or less than the original cost. There is a higher degree of risk to capital associated with equity mutual funds. Although fixed income or bond funds may pay higher rates than CDs, their net asset values are sensitive to interest-rate movement and a rise in interest rates can result in a decline in value of the investment.

Inflation is the rise in the prices of goods and services, as happens when spending increases relative to the supply of goods on the market. Moderate inflation is a common result of economic growth. Hyperinflation, with prices rising at 100% a year or more, causes people to lose confidence in the currency and put their assets in hard assets like real estate or gold, which usually retain their value in inflationary times.

S&P 500 Index is an index of 500 of the largest exchange-traded stocks in the US from a broad range of industries whose collective performance mirrors the overall stock market. Investors cannot invest directly in an index.

Diversification does not guarantee a profit or protect against a loss.

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