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FUNDING RETIREMENT

The right prescription for your future

THE INCOME YOUR PORTFOLIO CAN GENERATE IS KEY FOR POST-CAREER COMFORT, SECURITY

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Few outsiders understand the pressures most physicians face. For many years, being a doctor was considered the ultimate profession and physicians' compensation reflected this high standing. But with the growing influence of insurance companies, the government, and attorneys, it is not uncommon for physicians today to be working harder and earning less. In addition, changes to pension contribution rules have made it much more costly to accumulate large retirement balances. These factors, combined with a decade of disappointing stock market returns, have led many doctors to reconsider their plans for retirement.

POWER POINTS

- Focus retirement planning on the income a portfolio can generate, rather than the size of the portfolio.
- Value appreciation and distributions are the only ways to earn a return on investments.
- The income potential of dividend-growth stocks compares favorably with that of fixed-income investments.

WHAT'S YOUR NUMBER?

Whether you are nearly retired or just beginning your professional career, a question physicians consistently ask is, "How much money will I need to retire?" An insurance company recently ran a series of commercials asking investors, "What's your number?" The commercials show people walking around with "their numbers" wedged under their arms like folded newspapers. One person's number was $1.2 million, another was $2.3 million and yet another man's said "gazillion." The point this company is trying to make is that we all have a portfolio "number" we must accumulate to retire—and the man with "gazillion" was approaching retirement without a clear plan.

If you are like most physicians, chances are you

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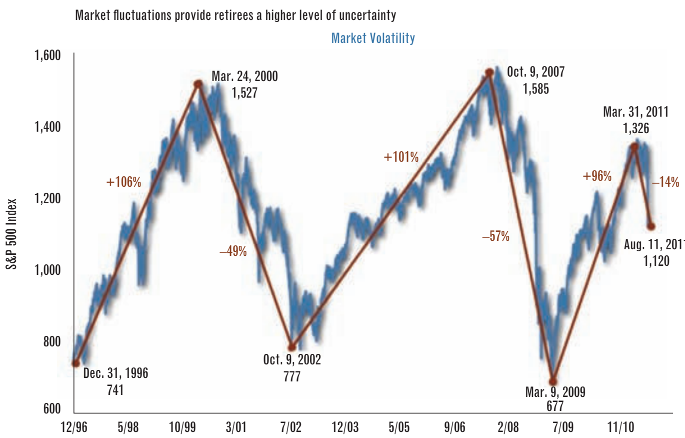
have thought about your number. We believe it is a great question for everyone to ask himself or herself. The answer, however, should not be the *value* of your portfolio at retirement, it should be the *amount of income* your portfolio can generate at retirement. The people in this commercial should be carrying around numbers closer to $100,000,

FIGURE 1

Success=Attaining your number



Source: Yahoo Finance S&P 500 Historical Prices

$150,000, or even $200,000—the number representing the amount of income they will need to supplement Social Security, pensions, and other sources of retirement income.

Generating the income necessary to fund retirement has become far more challenging as interest rates have declined. In the past, investors could transition the bulk of their portfolios to fixed-income investments and live off the interest. With short-term rates at record low levels (as of September 30, 2011, a 5-year U.S. Treasury bond paid 0.95% interest annually), a retiree with $1 million invested in a 5-year U.S. Treasury bond would generate only $9,500 of income per year. As a result, as rates have declined, the option of living off the income generated by a bond portfolio has all but disappeared. When it comes to funding retirement, therefore, financial advisers almost universally recommend the total return approach.

SHORTCOMINGS OF THE TOTAL RETURN APPROACH

Under the total return approach, investors sell a portion of their portfolio each year to generate the cash they need to live. This approach arose out of academic studies that focused on determining the mix of stocks and bonds that would give an investor the best chance of not outliving his or her money.[1, 2]

The general consensus of the research was that investors who maintained a portfolio that was 50% invested in stocks and 50% in bonds could withdraw 4% of their initial retirement portfolio value (with 3% increases to account for inflation) with a minimal chance of running out of money.

At first glance, this approach is very appealing. It makes determining "your number" a simple mathematical equation. If you will need $80,000 of portfolio income to live, then you must accumulate $2 million by the time you retire.

The mathematical certainty behind the total return approach, however, is grossly oversimplified. As is evident in figure 1, an investor who met his or her "number" in March 2000 or October 2007 may have celebrated his or her retirement. Unfortunately, the market declines following each of these peaks likely would have caused him or her to throw a "welcome back to the workforce" party shortly thereafter. The total return approach can provide a false sense of comfort for investors who are strictly focused on accumulating a "number."

The foundation of the total return approach is the planned liquidation of a fixed dollar amount of the portfolio each year. Although selling principal in good years typically is not a problem, relying on the sale of assets in down years can be extremely detrimental.

The reason is that whenever investors regularly sell a fixed dollar amount of their portfolio, they must sell more shares at depressed prices to generate the same dollar amount of cash flow. We refer to this systematic liquidation strategy as "dollar loss averaging."

In addition, most studies supporting the total return approach are premised on 30 years of generally declining interest rates. As interest rates declined, bond prices rallied. (The opposite occurs when interest rates rise.)

Given today's exceptionally low rates, it is highly unlikely that the 50% of the portfolio normally allocated to bonds under the total return approach will have anywhere near the positive impact on overall portfolio performance. If bond returns are lower in the future, then the safe withdrawal rate of 4% also will need to be adjusted downward.

FIGURE 2

Company	Current yield 9-30-11*	Closing price 9-30-11	Dividends paid since	Consecutive years of dividend increases**	10-year dividend growth rate
Procter & Gamble (PG)	3.16%	$63.18	1891	55	10.9%
Johnson & Johnson (JNJ)	3.47%	$63.69	1944	49	13.0%
Altria (MO)	5.86%	$26.81	1928	43	11.7%
Kimberly Clark (KMB)	3.87%	$71.01	1935	39	9.2%
Sysco (SYY)	3.94 %	$25.90	1970	41	15.3%

Dividends are not guaranteed and must be authorized by a company's board of directors
*Trailing 12 month
**Source: U.S. Dividend Champions, www.drpinvesting.org, David Fish

Finally, studies supporting the total return approach assume investors don't panic during market downturns but instead maintain their target asset allocation. Although we would all like to believe this to be true, studies have demonstrated over the years that investors overwhelmingly sell stocks during market bottoms and buy stocks near market peaks.

EARNING RETURNS ON INVESTMENTS

The only ways to earn returns on investments are through appreciation in the value of the investments or by receiving a distribution from the investments. For owners of stock, the growth is considered capital appreciation and the distribution is called a dividend. Historically, dividends have accounted for almost half of shareholder returns.

In the past, it was common for companies to distribute more than 50% of their income as dividends. With the start of the bull market in the 1980s, however, investors became increasingly comfort-

FIGURE 3

Power of dividend growth

Assumptions: initial investment: $1 million, original annual dividend: 4% dividend growth: 6%	Income without dividend reinvest-ment*	Income with dividend reinvestment		
		4% Stock growth	No stock growth	4% Stock decline
Year 1	$40,000	$40,000	$40,000	$40,000
Year 5	$53,529	$65,117	$66,735	$68,734
Year 10	$71,633	$108,055	$119,704	$137,756
Year 15	$95,862	$183,113	$236,181	$351,877
Year 20	$128,285	$317,524	$527,904	$1,306,337

*Assumptions are based on a hypothetical stock. You may not invest in this hypothetical stock. Beginning dividend yield and annual dividend growth are presented for illustrative purposes only. Illustration assumes fixed stock price. Reinvestment consitutes purchase of additional shares of hypothetical stock with all dividends and occurs at the end of each year.

able receiving their return through price appreciation. During this period of double-digit returns many companies drastically reduced the portion of their income paid out as dividends.

During the technology boom, the prevailing investor mindset shifted to the notion that dividend-paying stocks were only for conservative investors who needed the income. Surprisingly, even after the bursting of the tech bubble and a decade of poor stock market performance, investors still significantly underestimate the long-term benefit that dividend-paying stocks can provide.

Throughout this period, several high-quality companies maintained their long established corporate policy of annual dividend increases. Although stock prices may vary from year to year, boards of directors usually are very reluctant to compromise a track record of dividend increases and even less likely to institute a dividend cut. Even during the market meltdown in 2008-2009, dividend cuts outside of the banking sector were minimal.

Many investors are surprised to learn that several of the world's most famous companies have raised their dividends for 25 consecutive years or more. Figure 2 highlights some of the 42 companies that are part of the S&P 500 "Dividend Aristocrats," an index of companies in the S&P 500 that have raised their dividends for at least 25 consecutive years. In fact, according to David Fish, publisher of *The Moneypaper,* 101 publicly traded companies have raised their dividends for more than 25 consecutive years, and 147 companies have raised their dividends for more than 10 years but fewer than 25 years.

THE VALUE OF A STEADY DIVIDEND STREAM

Investors accumulating funds for retirement often overlook the value that an annually increasing dividend stream can have on retirement cash flow. Equally important, a portfolio of dividend-growing stocks can reduce the challenge for retirees of generating income from a portfolio that they have spent their working careers accumulating.

Figure 3 shows the effect that dividend growth rates have over time. The table assumes $1 million is invested in a fictional company that pays a 4% dividend and increases its dividend 6% each year. The table also shows the impact of compounding dividends, assuming that all dividends were reinvested and the stock price of the company appreciated by 4% per year, remained flat, and declined by 4% per year.

One other notable point from figure 3: Although it may appear counterintuitive, investors reinvesting dividends (thereby accumulating more shares) receive greater future income from their portfolio when stock prices do not appreciate. In fact, investors receive the most income when the underlying stock prices decline over time, because reinvested dividends purchase more shares at the same or lower prices (rather than fewer shares at a higher price). This process is similar to buying more house for your money during a period of falling real estate prices.

The income potential of dividend growth stocks compares favorably with that of fixed-income investments. Whereas figure 3 represents hypothetical dividend growth, figure 4 illustrates the actual income generated by the S&P 500 Dividend Aristocrat index over the last 20 years. During this period the annual income from the Dividend Aristocrats index more than tripled and the income generated by the Barclay's U.S. Aggregate Bond Index declined by more than 40%.

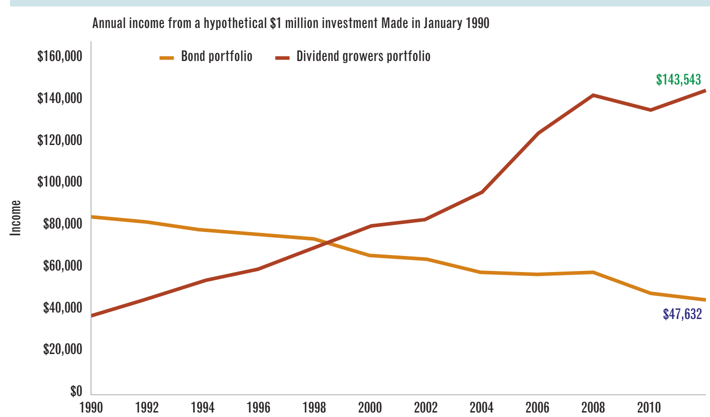
"WHAT ABOUT THE GROWTH OF MY PRINCIPAL?"

Whenever we introduce the benefits of dividend growth, especially with non-retirees, the conversation eventually takes this track: "Dividends are great, but what about growth of my principal?" Investors often overlook the fact that for a company to increase its dividend continually, its earnings must grow over time. Many of the most recognized dividend growth companies are benefiting from rapid growth in the emerging markets. In addition, many of these companies are the dominant brands in their industries and have significant pricing power.

The long-term performance of dividend-growth stocks is illustrated by the fable of the tortoise and the hare. It seems investors remain focused on trying to find a hare that won't rest, instead of

FIGURE 4

Bond income versus dividend income



Data through December 31, 2010 Dividends were not reinvested. We've assumed that the hypothetical Dividend Growers Portfolio performed similarly to the S&P 500 Dividend Aristocrats Index and the Bond Portfolio performed similarly to the Barclays Capital Aggregate Bond Index. You may not invest directly in an index. Past performance does not guarantee future results.

Source: Thornburg Investment Management

FIGURE 5

S&P 500 Dividend Aristocrats Index versus S&P 500 Index

Period	Dividend Aristocrats Index	S&P 500 index
1990-1994	11.3%	8.70%
1995-1999	19.48%	28.56%
2000-2004	9.74%	–2.30%
2005-2009	3.32%	0.42%
2010	19.35%	15.06%
1990-2010	11.17%	8.52%

Reflects reinvestment of dividends. Data through December 31, 2010, annualized. Past performance does not guarantee future results.

Source: Thornburg Investment Management

recognizing the value created by the consistent effort of the tortoise. Like the tortoise, "slow and steady" dividend growing stocks historically have won the performance race over time. The biggest challenge most investors will face is staying loyal to this disciplined strategy during periods of short-lived, hare-like investment returns.

As noted earlier, the Dividend Aristocrats index tracks the performance of large capitalization, blue chip companies in the S&P 500 that have increased their dividend for at least 25 consecutive years. When analyzing 5-year performance figures over the past 20 years, you can see in figure 5 that the dividend aristocrats underperformed the S&P 500 only during the late 1990s—a period of significantly above-average market returns.

A portfolio of dividend growth stocks is the prescription for helping you reach your retirement goals. The earlier you start accumulating shares of dividend growth stocks, the greater your income stream can be in retirement—especially if you take advantage of dividend reinvestment.

So when you're asked, "What is your number?"; think in terms of retirement income, not portfolio value. Focus on an investment strategy that will enable you to live off the income from your investments. Investors who follow a dividend growth strategy can produce a rising income stream throughout retirement, regardless of interest rates and stock market performance. ME

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