Yield vs. Total Return

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Many investors, including retirees, rely on their investment portfolio to fund their cash needs. This need can be approached in one of two ways.

The first approach looks primarily to interest and/or dividends from securities to fund cash flow needs. The amount of dividend and interest income generated by a portfolio is largely determined by dividend policies of the firms and prevailing market interest rates—two variables outside an investor's control. Investors may also allow their preference for yield to influence their asset allocation by focusing on securities with higher yields.

An alternative approach, focused on total return, involves selling assets in the portfolio to create cash flow. This method reflects the idea that, from an investment standpoint, it makes little difference whether returns are delivered as dividends or capital gains. Selling assets also allows greater control over the amount of cash flow generated.

Traditionally, income-oriented investors have chosen the first approach, resulting in a bias for securities that pay interest and dividends. However, investors should carefully consider the investment tradeoffs in pursuing an income-based strategy, as their income bias may affect diversification and expected returns.

Before pursuing a yield bias, investors should understand the potential effect on portfolio diversification and expected returns.

In this brief, we explore the yield vs. total return approaches to generating income in a portfolio and address misconceptions about the benefits of emphasizing dividend and interest income at the expense of other portfolio issues.

DIVIDEND APPEAL

The traditional appeal of dividends stems from a long-held belief that stocks paying high dividends are less risky because they offer a regular stream of payments to investors. But dividend payments are not created out of thin air. They flow from a company's earnings or assets, which are reflected in the current stock price. As illustrated in **Exhibit 1**, when a company pays a dividend, its stock price is reduced by an

Exhibit 1: Ex-Dividend Price Change Illustration

Before Dividend Payment

Scenario 1: Dividends

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

Scenario 2: No Dividends

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

After Dividend Payment

Scenario 1: Dividends

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$19	$1,900
Cash			$100
Total			$2,000

Scenario 2: No Dividends

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$20	$2,000
Cash			0
Total			$2,000

For illustrative purposes only. Assumes no nondividend-related price movements.

amount approximately equal to the dividend (Scenario 1). When accounting for this cash dividend, the portfolio value may be unchanged.[1]

Part of the conventional wisdom about dividends is that a high dividend yield may help a retiree avoid encroaching on capital to generate cash flow. Yet, **Exhibit 1** shows that a dividend distribution does encroach on capital unless it is reinvested rather than spent. Although no stock may have been liquidated, the economic impact is essentially the same.

Exhibit 2: Stock Decline Illustration

Initial Portfolio

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

Portfolio Value Drops 25% Before Dividend Payment

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$15	$1,500
Total			$1,500

After Dividend Payment

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$14	$1,400
Cash			$100
Total			$1,500

For illustrative purposes only. Assumes no nondividend-related price movements.

Another common misconception is that dividends offer downside protection by mitigating the impact of a falling stock price on the portfolio. For example, a stock that yields a 5% dividend can decline by up to 5% before the investor experiences a negative total return. However, since a dividend paid reduces the stock price by the same amount, any additional non-dividend related price decline would result in a negative total return.

Exhibit 2 illustrates that a dividend-paying stock may not offer special downside protection. Consider a stock that loses 25% of its value before the dividend payment. After the dividend payment, the share price further drops by the amount of the dividend, but the investor also has cash from the dividend. Overall, the investor has still suffered a 25% loss.

OTHER TRADEOFFS

Holding a portfolio that emphasizes dividend-paying stocks may also force significant tradeoffs related to diversification and expected returns (Black, 2013).[2] The research concluded that:

- A global portfolio of dividend-paying stocks would have similar average returns to a portfolio of nondividend-paying stocks. However, a dividend-focused portfolio would exclude 35%–40% of stocks globally, resulting in lower diversification. Also, the number of US and international firms that pay dividends is shrinking—from 71% of the market in 1991 to 61% in 2012.

- The proportion of dividend-paying firms varies considerably across countries. For example, 92% of Japanese stocks paid

1. Certain studies show the price drop on the ex-dividend date is, on average, lower than but close to the amount of the dividend when controlling for market movement.

2. Black, Stanley. March 2013. "Global Dividend-Paying Stocks: A Recent History." Dimensional Fund Advisors white paper.

dividends in 2012, compared to only 38% of Australian stocks. Dividend payout levels also have high cross-country variation. For example, an average 31% of corporate earnings were distributed in Switzerland vs. 73% in New Zealand.

- Holding only dividend-paying stocks may impact investors' ability to pursue higher expected returns. The research shows that global portfolios holding only dividend-paying stocks exclude about 47% of the available small cap stock universe, which historically has offered higher average returns than large cap stocks.

- Dividends are not certain or guaranteed. Although dividends may be less volatile than the capital gains component of stock returns, the aggregate stream of dividend payments is subject to the same broad, macroeconomic risks that affect capital gains. As demonstrated in the 2008–2009 financial crisis, companies have reduced dividends after large market declines.

TOTAL RETURN: CREATING CASH FLOW

The alternative to meeting a cash flow need through dividend and interest payments is to create cash flow by selling securities in the portfolio. By selling assets, investors have greater control over the level and timing of cash flows. Investors can also reduce their reliance on dividend yields and market interest rates, both of which are variable through time and outside their control.

Investors in taxable accounts should consider any tax implications that may arise from differences in capital gains and dividend tax rates.[3] For example, if capital gains are taxed at lower rates than dividends, a stock sale may be more tax efficient. Furthermore, the lower tax rate is only applied to the portion of the cash flow that represents the stock's capital gain, whereas the higher tax rate for dividends is applied to the full amount of the dividend. Tax treatment of dividends from domestic companies vs. foreign companies may also play a role in the outcome.

Exhibit 3 illustrates the impact of earning dividends vs. selling assets to create cash flow from a portfolio. In Scenario 1, the stock's price per share is reduced by the dividend, whereas in Scenario 2 the share price stays the same but the number of shares is reduced. After the respective dividends are received, the portfolio balance sheets for Scenarios 1 and 2 have the same value and asset composition. Thus, an investor's approach to generating cash flow may not affect total portfolio value on a pretax basis.

A final consideration in structuring portfolio income is the implication for rebalancing. Generating cash flow from securities sales may create an opportunity to strategically rebalance by selling assets that are overweighted relative to the target allocation.

FIXED INCOME AS A CASH SOURCE

Investors must also consider their goals for fixed income when determining an appropriate asset allocation. Investors seeking yield in fixed income may consider incorporating term or credit premiums. However, market interest rates can be volatile, so the cash flows generated by interest income will vary over time. Investors seeking greater control over their cash flows should also consider selling assets rather than relying heavily on interest income.

Exhibit 3: Creating Cash Flow Illustration

Before Dividend Payment

Scenario 1: Dividends

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

Scenario 2: No Dividends

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

After Dividend Payment

Scenario 1: Dividends

Asset	Quantity	Price	Portfolio Value
Stock XYZ	100	$19	$1,900
Cash			$100
Total			$2,000

Scenario 2: No Dividends (Sell Assets)

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

For illustrative purposes only. Does not include transaction costs from asset sale. Assumes no nondividend-related price movements.

3. As of this writing, tax rates for long-term capital gains and qualified dividends are the same in the US (15% or 20%, based on a taxpayer's income bracket). But tax rate differences have occurred in the past and may occur again in the future.

CONCLUSION

Investors can have much greater control in generating cash flows by selling securities rather than relying on dividend and interest income. Firms' payout policies evolve over time, as do market interest rates. Rather than letting portfolio yields determine spending rates, investors can develop a sustainable withdrawal strategy with their advisors.