

NEWSLETTER – SAVING FOR RETIREMENT

FEBRUARY 2013

WHITEHEAD DINGLEY & BETAR

You as an investor saving for retirement may be thinking, “What do I invest in? Growth Stocks or Dividend Paying Stocks or Both?”

The conventional wisdom has always been, as you get older you switch from growth to yield plays, however, this conventional wisdom was based on you dying around 10 to 15 years after retirement – this is simply not the case now.

Many people will live for 20 to 30 years into retirement and switching too early, and by too much may mean you will run out of money before you die. We have all read plenty of articles about this and I think it's a real problem for people over their late 40's.

If you fall into the 5 to 20 years away from retirement or even just recently retired, the chances are you have been given a good dose of “conventional wisdom” which has you thinking that cash, bonds and pure dividend plays are the way to go in retirement.

In my opinion, this is mistake and may see you run out of capital well before you die (no other nice way to put it). You should continue to include growth in your investment portfolio. Inflation munches into your capital at the rate of 3-4% each year and that's the headline rate, you know as well as I do, prices for electricity, rates, food, fuel, housing and medical care all rise at sometimes double or three times this rate – in retirement, you may find yourself, well, in trouble.

So, what I suggest is to stop worrying about the stock market going down for a year here or there, as you will live longer than you think and there are only two asset classes that protect you from the evils of inflation – property and equities. Property is great but not the easiest thing to get rid of in a hurry and it's hard to free up say \$30k for an overseas trip – whereas equities are a breeze in this regard. Over the long term, the share market will be just fine, as we are now seeing after what was a once in a lifetime event in 2008-9.

To my mind, having part of your portfolio in growth stocks to maintain a hedge against “real” inflation is almost a necessity, as you simply have no idea how long you'll live and have to protect capital. However, we all understand that you need income to live on, so you will need yield from “somewhere”.

There are two ways to approach this dilemma:

1. Sell down a few shares of your “growth” portfolio from time to time and use the proceeds to live on while still maintaining your overall value of your investment. This has advantages, as your tax will be cheaper than fully franked shares if you have held the shares longer than one year – and cheaper still if held within a self-managed super fund.
2. Invest some of your portfolio in shares that pay an excellent dividend. However, you have to be sure that the company in question can maintain the dividend long term. Many investors make the mistake of “buying dividend”, which is to say they see the yield and invest on that basis only. Telstra is a perfect example. They give little consideration of whether the dividend is sustainable or not in the long term. This ends up being a disaster. The dividend is cut due to profits falling, the yield falls and so does the share price – **you lose your prized yield and your capital.** You need to think differently.

On point 2, the best way to approach your “value, yield paying stocks” is to make sure they have “growth”. Yield is fabulous as long as it can be maintained and increased!

How many “yield seeking investors” blindly buy Telstra and the big banks without considering for one second the state of their business not just in the next year, but in 3 to 5 or even 10 years? How many spot a dividend yield in the paper and invest to get the yield only to find the yield being cut the next year due to poor business conditions.

The best way to build a good yield portfolio is to look for business growth, sales growth, earnings growth and finally Dividend Growth . You don't consider a yield portfolio any different from a growth one – the important thing is a good business model that is sustainable through the years and has a distinct business advantage over its competitors. These businesses will either pay you via capital appreciation (point 1) or they will pay you in ever increasing dividends (as well as a little capital appreciation, point 2).



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How Do You Choose a Good Dividend Paying Stock?

The post GFC era has brought major problems for investors seeking a steady income from their investments. Interest rates have fallen to historic lows and bonds are yielding equally low rates. In many cases, fixed deposits and cash are yielding negative real returns when tax and inflation are taken into account. It would appear there are few investment alternatives available to retail investors that don't carry greater risk than they are prepared to accept.

While some corporate bonds carry high yields they often carry high risk and very high minimum levels of investment – often \$500k. This leaves shares being the logical choice for better returns, but even there, dividends can be cut or unreliable if the company has cash flow problems or profits dip. That's why it's imperative to ensure you understand the investment and its underlying business model, its economic position, its levels of debt, levels of capital expenditure needed and most importantly – its level of free **cash flow**.

Free cash flow is the amount of money the company actually receives after allowing for non-cash items in the profit and loss and payment for capital expenditure. This is very different from profit.

Profits are all very good, but they are meaningless to shareholders if that money is not available to them for cash dividends, reducing debt or buying back shares. Mining companies like BHP make enormous profits on paper, but much less is actually cash available to shareholders. Most of it is used for capital expenditure to produce another giant "paper" profit next year.

The secret for a good dividend that increases each year is to invest in companies that have all the usual requirements like a good and durable business model, good return on equity, solid balance sheet with low debt, committed and excellent management, but most of all – strong cash flow resulting in high levels of free cash flow, which is money available to you as an investor.

Ideally this company will have steady sales, earnings and free cash flow increases each year allowing the dividend to increase. This is not easy to find as many companies have "lumpy" earnings and cash flows, which means regular dividend increases may not occur.

This is all-important but capital growth is important as well, as this will mean that the overall "real value" of your investment will at least, and possibly exceed that of inflation.

Investing in investments that continuously increase their payout to investors is vital. Let me give you an example of an investor that invests this way – Warren Buffet.

It's well documented that he started buying Coca Cola from 1988 and constantly added to his holdings for many years. His average price for each share sits at \$5.46 (after splits); they now trade for around \$38 – a very nice appreciation in price of approximately 600%.

However, Buffett will tell you that is not the whole story - in that time Coca Cola have increased the dividend every single year and currently pays \$1.02c each year in dividends. Buffett's yield per annum on just the dividend is 19%! This from a company with an official dividend yield of 2.6%.

Since buying Coca Cola, the company have paid him \$25.61 in dividends for his \$5.46 investment, which has now increased in value to \$38. You'd have to say, that's one of the best investments you'd ever heard of – correct? All he bought was boring old Coca Cola shares, but he understood the investment thoroughly and this is all-important to a long-term investor.

While you should be looking for investments, equities and other asset classes that pay much higher yields than 2.6%, the long term goal is the same – increase capital in a risk averse way, seek companies with all the fundamental attributes I have talked about in this commentary and then allow increasing income over the long term to push actual real yields to levels very few other investments are capable of, while at all times keeping an eye on risk, which means steering clear of any investment where substantial risk to capital or income is higher than we deem prudent.

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