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BOOMERS NEED DIVIDENDS

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I recently had the pleasure of moderating a couple of sessions with various experts for the Bank of Montreal on the "New Retirement", which is the term the bank has chosen to describe the developments which retiring baby boomers will find themselves facing when they begin to retire over the next decade. The discussions were wide ranging and produced some thought provoking statistics and issues which I wanted to share with subscribers to the Income Investor. After all, the reason for subscribing to a publication with this title indicates that you have a keen interest in the subject which dominated a lot of the discussions of retirement and how to fund it.

As part of the sessions, I had the opportunity to interview Professor Moshe Milevsky of York University, who has spent a lot of time investigating the issues that surround retirement. One of the more surprising but though provoking insights that he provided was that spending is more difficult than saving, or, to use his phrasing, de-accumulation is more difficult than accumulation. While at first sight this might seem counter-intuitive (after all most of us would say that our experience was exactly the opposite!), when explained it makes perfect sense. We all know about "paying yourself first", by saving a certain percentage of your income to provide for retirement, whether the percentage is 3%, 5% or 10%. In effect, we save, or should save, whatever we can afford to after taking account of the day to day expenses, such as mortgage payments, taxes, education, vacations etc. But how much should you withdraw from your retirement fund annually?

Prof. Milevsky's point is that most of us have no idea how much is a reasonable amount to withdraw each year from our nest-egg, and even what is a safe maximum, to ensure that we do not end up running out of money. You will not doubtless be surprised to hear that the answer is "less than you hoped" and that anything more than 4% p.a. is likely to result in erosion of your capital. Given that the real long term return from equities over the last century has been around 7-8% p.a., and that half of that return comes from dividends, the title of this article may begin to become clearer. There are several other points to consider as a baby boomer approaching retirement.

Firstly, there are a lot of us. Statistics Canada has estimated that the percentage of the Canadian population over 65, which was 13% in 2006, will rise to 15% in 2011, 17% in 2016 and 21% by 2026. In other words, the percentage of retirees in the population will almost double over the next 17 years. Secondly, this population of seniors is growing much faster than the general population. While annual population growth in Canada and the USA is estimated at 0.6% and 1% p.a. respectively over the period from 2000-2030, the respective growth rates for those aged 65+ and 85+ are 3.5-4% p.a., three to four times as fast as the population as a whole. This will inevitably put strain on the facilities available to handle the aging population and the resources needed to provide for them. Prof. Milevsky made the point that inflation for items in demand by this aging population, such as drugs, medical services and assisted living facilities would be different and higher than the inflation rate for traded goods such as TVs and cell phones.

Lastly, and perhaps stating the obvious, we are all living a lot longer than our parents' generation. When Franklin Roosevelt introduced social security and old age pensions in 1936, with a state pension for life for everyone over the age of 65, he was not being especially generous. The average life expectancy of Americans in that decade was 62.7 years! Thanks to the advances of modern medicine, better diets and an awareness of the importance of physical exercise, despite the widely held concerns over obesity and diabetes, the average life expectancy of men in Canada and the US has increased by 14 and 18 years respectively between 1921 and 2001 (60 to 74 and 59 to 77). Women, of course, as they take better care of themselves, have seen their life expectancies increase by more and live longer (Canada 18 years, from 62 to 80 and USA by 21, 61 to 82). I have not seen any explanation of why US life expectancy has grown by more than that of Canadians, and why it is higher, except to note that Canada has a much higher number of people employed in higher risk occupations such as fishing, forestry and mining. Incidentally, increased life expectancy means that one spouse of a couple has a 90% chance of living to at least 80, and a 50% chance to living until they are 90! When making plans for your retirement, you should, assuming that you are in a long term relationship, plan on needing income for at least 15 years.

Another point that arose in the discussions was the importance of self reliance for the boomers. The gradual disappearance of the traditional defined benefit pension plan, where your employer provided you with a pension dependent upon how many years you had worked for them and what your final salary was, now virtually extinct except for government employees and the chartered banks, meant that retirees were now responsible for their own pensions, through the defined contribution route. The investment risk was now entirely borne by the retiree, and as Prof. Milevsky pointed out, this introduced a very serious issue. It was the "sequence of returns", which meant that it became vitally important whether the stock market had a bear market at the beginning of your retirement as opposed to the end of the period. While most people would think that this would be equally important during the savings or accumulation phase of your career, if one does the maths assuming that the bear market occurs at the beginning, the middle or the end of your working career, it turns out that the total amount at the end of the period is exactly the same! This is because you are not withdrawing money during the market's decline; in fact, if you are in your twenties or thirties, you actually should welcome a big bear market because it will allow you to invest money at better valuations.

The case is very different if you are retired and having to withdraw money from your RRSP or defined contribution pension plan. Once you turn 71, you are required to withdraw a set and increasing amount from your RRIF, a recipe for investment woes if there is a bear market going on. You bear all of the investment risk, and if the bear market occurs at the beginning of your retirement you run a major risk of outliving your capital. The government has recognized this by permitting a holiday from withdrawals for RRIFs in 2008, but this is one-off exemption. What is the retiree to do to combat this invidious state of affairs?

The potential solutions that the New Retirement sessions examined were varied but ended up agreeing with Prof. Milevsky's overall analysis which recognized three different types of assets that are available to retirees. The first is the guaranteed income stream provided by the government in the form of CPP and OAS, and also from a defined benefit pension plan. This is a set amount with some inflation protection, and even if the employer providing the defined benefit runs into financial difficulty, such as has happened with the Big 3 auto companies, underfunded pension plans will still provide a percentage of the final pension, even if it is not as high as the original amount. Secondly, there are the various "guaranteed" or "protected" products, which take away some of the exposure to downside risk in exchange for giving up some of the upside. These would include the various guaranteed minimum withdrawal benefit plans sold by the life insurance companies, or the "target date" life cycle products which gradually move the asset mix towards a more conservative setting as the fund gets closer to its maturity date. In both cases, the retiree receives the guarantee that his or her nominal capital investment will be repaid at the end of the product's life, less any withdrawals during the life of the fund.

Finally there is the traditional equity, cash and bond asset allocation, which is what most investors think of when they look at RRSPs and pension plans. The difficulty, as noted, is that these portfolios are volatile and can be negatively affected by bear markets at the wrong stage in one's retirement. One way of avoiding this is to liquidate one's RRSP and buy an annuity, which gives one a guaranteed nominal income for life. However, one is hostage to what the level of interest rates is when one is retiring. If as now, they are near 60 year lows with the 10 year Govt. of Canada and US Treasury bonds yielding 3.5% and 3.75% before tax, then the nominal income produced is both too low and subject to erosion through inflation. Inflation protected real return or TIPs govt. bonds preserve the real value of capital but the tax treatment of their low yielding income is very unfavourable.

In the end, the most effective approach that a retiree can adopt is some combination of the three asset classes. Putting together the amounts one receives from CPP and OAS (if applicable) with some form of guaranteed or protected product to ensure that regardless of what the equity markets did, one had a reasonable amount of capital available in a decade or fifteen years and having the remainder invested in less volatile dividend paying stocks would be the preferred option. Tax effective income vehicles such as dividend paying stocks will have a built in investment constituency in the decades ahead with the wave of retiring baby boomers, and a limited and shrinking supply of tax effective vehicles with the tax changes to the income trust market. Research by RBC Capital Markets in Canada has shown that dividend growing stocks, i.e. the banks, life insurers, pipelines, utilities and selected consumer and industrial issues, have produced a total return of 9.8 times the initial investment (with dividends reinvested) over the last 22 years, dividend payers 6 times, the S&P/TSX Composite 2.4 times and non dividend payers 0.5 times. Even if, as a retiree, one is taking the dividends rather than reinvesting them, the ability to pay and increase dividends indicates a profitable and growing company. It also delivers some protection against inflation.