The Value of Dividends in Retirement

February 2019

Executive Summary

- Longstanding “all growth” or “all income” schools of thought about funding retirement need to shift to approaches that combine the two.
- An investment strategy generating attractive current income and which provides an opportunity for dividends to grow over time can generate both long-term savings and fund current income needs for retirees.
- The most effective dividend growth portfolios tend to widen their net to include companies outside the U.S., where companies prefer to return cash to shareholders through dividends, rather than U.S.-style buybacks.

Since 1900, dividends have accounted for approximately 45% of the total return for the S&P 500 Index. The importance of dividends is an often overlooked part of investing, but should be top of mind as baby boomers prepare for retirement and look for high and growing income-generating investments.

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There are generally two schools of thought regarding how best to fund expenses in retirement. There are many who believe a total return approach is optimal, whereby an asset allocation and total return is targeted for the portfolio and a portion of the retirement assets is sold periodically to cover expenses. While this approach attempts to provide the growth that retirees need to outpace the effects of inflation, they may also be forced to sell assets at an inopportune time.

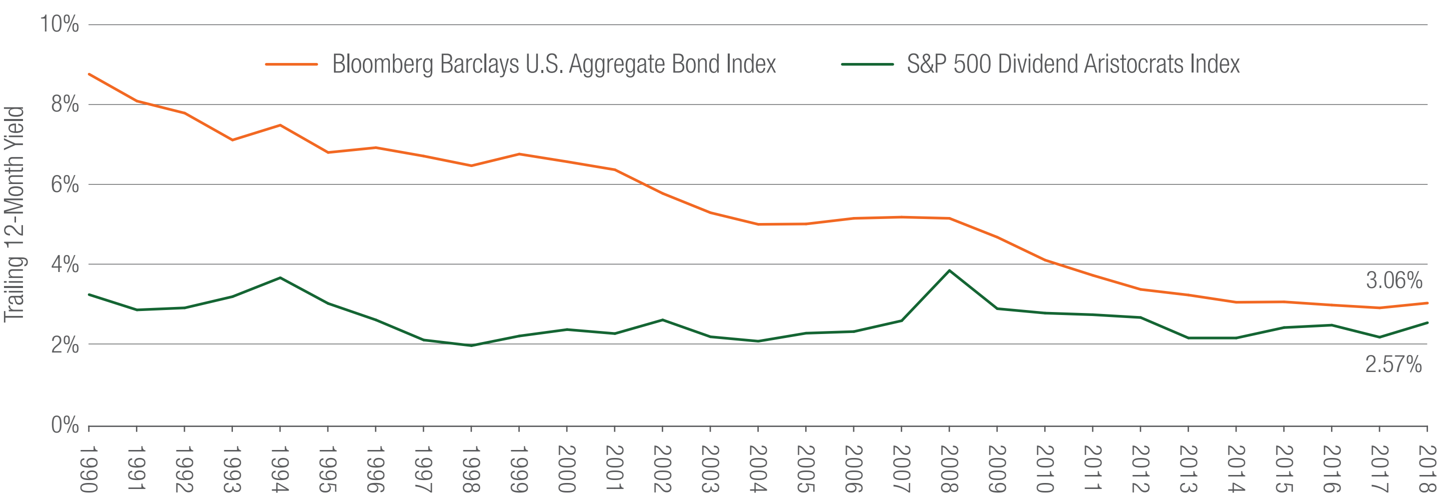
The second school of thought follows a high-income approach, whereby the portfolio is comprised of high-yielding income investments in an attempt to generate sufficient current income to cover expenses. This approach can leave a retiree with limited opportunities to grow spending power and at risk from the ravages of inflation.

In this paper, we will examine a third approach, which is a hybrid of the total return and high-income approaches. We will explore how investing in stocks of companies that provide both high and growing dividend income can benefit a retirement portfolio undergoing the duress of withdrawals. This type of investment strategy has the potential to generate a growing income stream as well as capital appreciation needed by retirees.

Understanding Yield

When reviewing income-generating alternatives, retirees often focus on current yield (the current income divided by the current price). This works well for fixed income investments, which are contracts that pay a certain level of income to the bond holder each year and then return the principal amount at maturity. However, for equity investments,

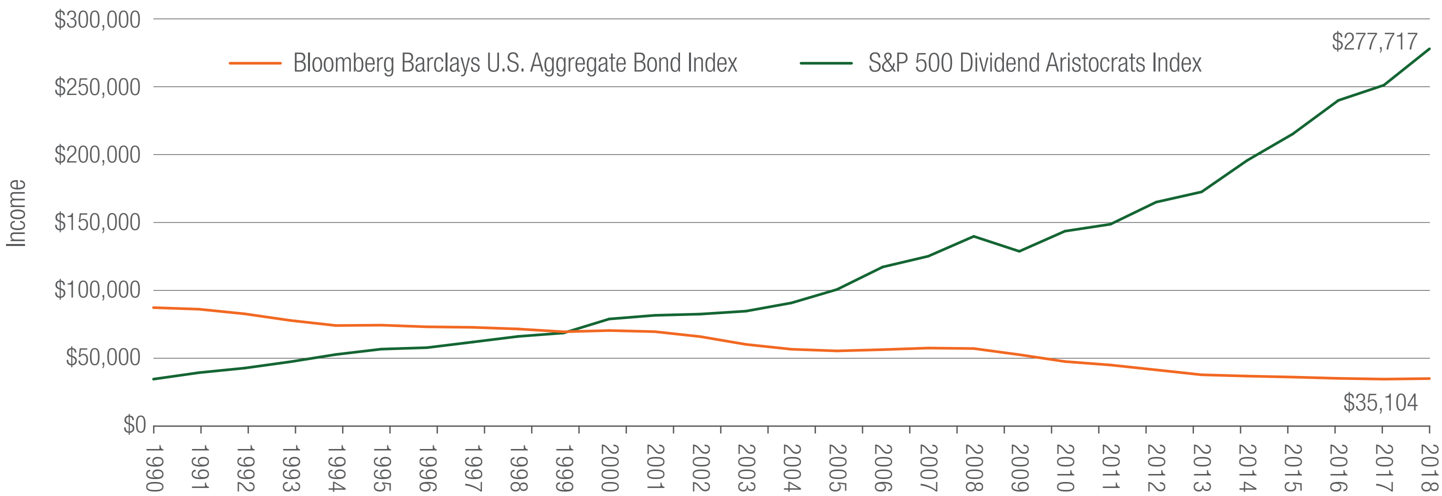
Figure 1 | Bond Yields versus Dividend Yields
Calendar Year Yields



Dividends were not reinvested.
Data through December 31, 2018
You may not invest directly in an index.
Past performance does not guarantee future results.

Source: Bloomberg and Standard & Poor's

Figure 2 | Bond Income Versus Dividend Income
Annual Income from a Hypothetical $1 Million Investment Made in January 1990



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where both the income and stock price may appreciate, looking solely at current yield can disguise the growth in the actual dollar amount of the income generated.

To illustrate this point, ***figure 1*** on the prior page shows a comparison of bond yields versus equity yields over calendar years. At first glance, it is obvious that current yields on bonds are higher, but this higher yield comes with little to no potential for growth.

To show the difference between the growth of income provided from bonds versus a dividend-paying equity investment, in ***figure 2***, we calculated the amount of income generated annually on a hypothetical $1 million investment made in 1990. While the income from the bond investment steadily declined from 1990 to 2018, the amount of dividend income derived from the dividend-focused equity allocation grew fairly steadily. Although beginning at a relatively modest level compared to the bond investment, the dollar amount of dividend income generated surpassed the bond income in approximately 10 years and ended at 791% of the bond income by 2018. For this example, it was assumed that the bond interest and stock dividends were being used to support expenses and not being reinvested.

Figure 3 | Dividend Aristocrats Index versus S&P 500 Index

	Aristocrats	S&P 500
Income	3.03%	2.29%
Price	8.54%	6.98%
Total	11.57%	9.28%

Dividends were reinvested.
Data from January 1, 1990, through December 31, 2018, annualized.
Past performance does not guarantee future results.

Total Return for Dividend Growers

Our analysis uses the S&P 500 Dividend Aristocrats Index, a subset of the S&P 500 Index. It is comprised of U.S. companies that have consistently increased their dividends for the past 28 years. Since the Dividend Aristocrats Index began in January 1990, we can compare its returns versus the S&P 500 Index for the period beginning January 1, 1990, to December 31, 2018, to determine its performance in a dividend-focused retirement portfolio, from a total return perspective. For the results, see ***figure 3***.

The total return for the Dividend Aristocrats Index of 11.57%, compared to the 9.28% return for the S&P 500 Index, is very attractive for investors of any age, not just retirees.

This test period included some very different investment environments, including the banking and real estate crisis of the early 1990s, the "internet bubble" in the mid- to late-1990s, that culminated with the 2000–02 bear market, and the maelstrom in the financial markets that began in late 2007. ***Figure 4*** illustrates how dividend paying stocks performed during these difficult market scenarios, the 25-year period is segmented into five-year periods, the three-year period 2015-2018, and finally the 28-year period is shown in its entirety.

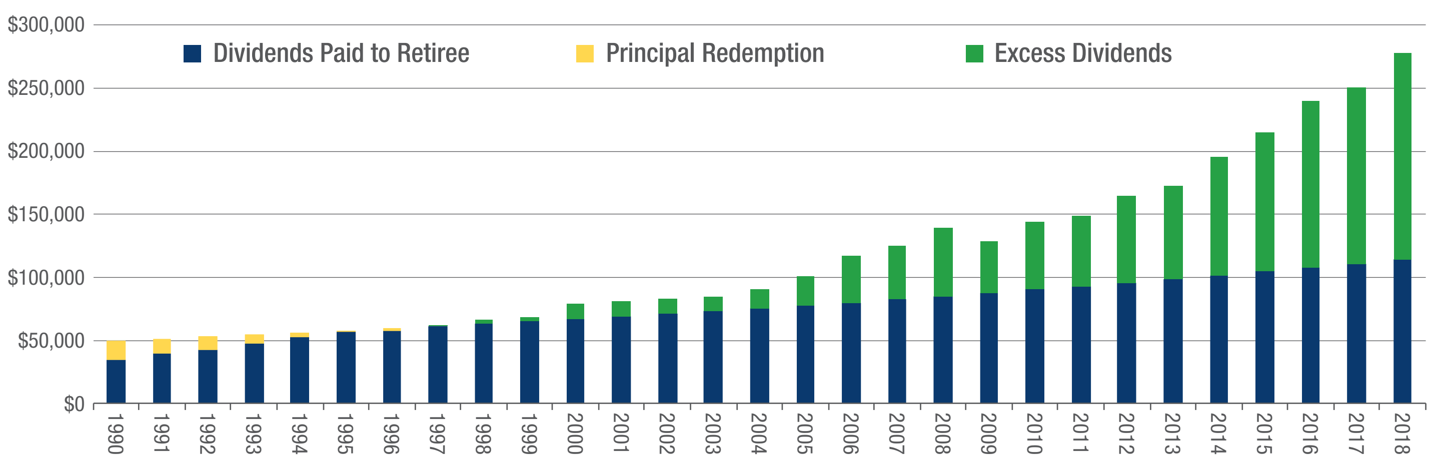
Figure 4 | Dividend Aristocrats Index versus S&P 500 Index

	Aristocrats	S&P 500
1990–94	11.13%	8.69%
1995–99	19.49%	28.54%
2000–04	9.74%	-2.29%
2005–09	3.32%	0.41%
2010–14	18.27%	15.44%
2015–2018	8.25%	8.04%
1990–2018	11.57%	9.28%

Reflects reinvestment of dividends.
Data through December 31, 2018, annualized.
Past performance does not guarantee future results.

As the analysis in ***figure 4*** illustrates, the Dividend Aristocrats Index outperformed in four of the five five-year periods. It only underperformed during 1995–1999, when investors were infatuated with high-growth stocks that fueled the internet bubble and led to the 2000–02 bear market. While the Dividend Aristocrats Index didn't keep pace during this period of "irrational exuberance," they produced an attractive total return of 19.49%

Figure 5 | Dividends for Retirement Income from S&P 500 Dividend Aristocrats Index

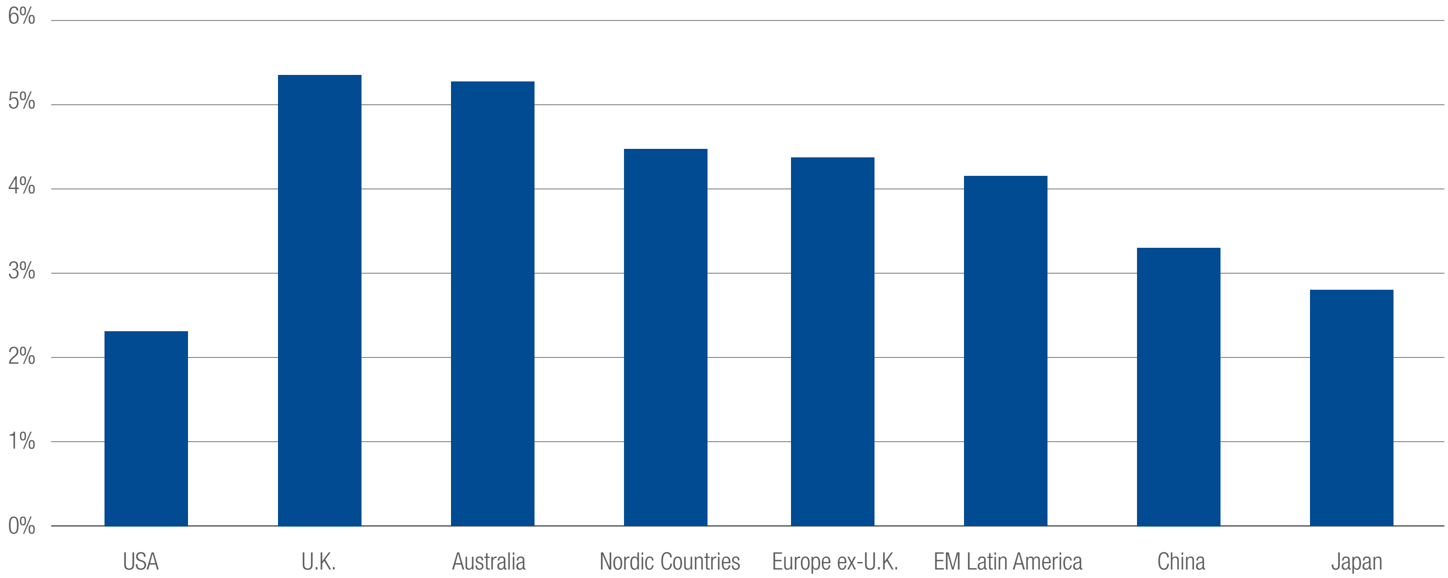


Dividends Earned	Amount Spent	Net Reinvested	Ending Portfolio Value
$3,367,134	$2,260,943	$1,106,191	$11,398,196

You may not invest directly in an index.
Past performance does not guarantee future results.

Source: Bloomberg and Morningstar.

Figure 6 | Dividend Yield by Country (2019 Estimates)



Past performance does not guarantee future results.

Source: MSCI indices sourced via Bloomberg as of December 31, 2018.

and proved far more resilient when the bubble popped.

Dividend Income in Retirement

To illustrate how a dividend-grower strategy can be used to fund a retiree's expenses, ***figure 5*** assumes a hypothetical $1 million in the S&P 500 Dividend Aristocrats Index beginning in January 1990. To calculate the retiree's spending, we assume that 5% or $50,000 will be needed to cover pretax expenses in the first year of retirement and then increase that amount annually by a 3% cost-of-living adjustment to cover inflation. For the early years in retirement, when dividends don't fully support the spending, the retiree will redeem a portion of the investment to cover the shortfall. For the later years, dividend income, beyond what is needed for spending, was reinvested in the portfolio.

In this hypothetical, the Dividend Growers Portfolio generated sufficient dividend income to cover 100% of the retiree's spending after seven years. Once this 100% coverage was achieved, it never fell below that level and generated excess dividends that could be reinvested into the portfolio. As summarized in the table below the graph in ***figure 5***, the initial $1 million investment produced $3.37 million in dividends of which $2.26 million was spent and $1.11 million reinvested. The portfolio value, as of December 31, 2018, was $11.40 million.

For most retirees, developing a growing dividend income stream should be an attractive alternative to the total return or high-income approaches described earlier. Having the retirement portfolio generate sufficient income to cover expenses while the portfolio is poised with an opportunity for continued growth should be a goal for every retiree.

Developing a growing dividend income stream should be an attractive alternative to the total return or high-income approaches.

Best Practices

Before implementing a dividend-grower strategy, there are two improvements that should enhance the portfolio's diversification and selection of attractive dividend opportunities. First, it may improve results to look for companies around the globe that

Figure 7 | Global Dividend Yield by Sector (2019 Dividend Yield Estimates)

SECTOR	USA	UK	AUSTRALIA	NORDIC COUNTRIES	EUROPE EX-UK	EM LATIN AMERICA	CHINA	JAPAN
Energy	3.91%	6.48%	5.25%	4.84%	5.51%	4.60%	6.43%	3.90%
Utilities	3.64%	6.82%	5.88%	3.95%	5.76%	5.15%	4.32%	2.36%
Consumer Staples	3.43	4.69%	4.01%	4.05%	3.18%	3.26%	2.71%	2.03%
Financials	2.74%	5.84%	6.66%	7.19%	6.81%	4.65%	5.59%	4.21%
Materials	2.47%	5.33%	4.75%	4.47%	3.96%	4.71%	5.52%	3.22%
Industrials	2.23%	3.11%	4.66%	3.45%	3.74%	3.42%	3.78%	2.52%
Information Technology	1.88%	4.60%	3.15%	3.16%	1.99%	11.10%	7.13%	2.56%
Health Care	1.85%	4.32%	2.03%	2.84%	3.40%	4.16%	2.03%	2.28%
Communication Services	1.62%	6.82%	4.42%	5.07%	4.92%	3.21%	1.14%	2.82%
Consumer Discretionary	1.53%	5.05%	4.69%	6.15%	3.99%	2.19%	0.81%	2.92%
Index Average	**2.31%**	**5.35%**	**5.27%**	**4.47%**	**4.37%**	**4.15%**	**3.30%**	**2.80%**

= Attractive Yield above 3%

Past performance does not guarantee future results.

Sources: MSCI indices sources via Bloomberg as of December 31, 2018.

offer both a high and growing dividend, rather than limiting the investment universe to just domestic stocks. As seen in ***figure 6***, dividend yields outside the United States, are higher across more sectors. Allowing the construction of a more diversified income portfolio. Internationally, there is an equity culture where dividend growth is seen as a sign of financial strength and the tax structure does not incentivize returning capital to shareholders through buybacks.

Another benefit of using a global approach is the opportunity to improve the portfolio diversification by industry sector. In the United States, attractive dividends are typically concentrated in real estate and utilities. Outside the United States, dividend opportunities exist in a multitude of sectors, as shown in ***figure 7***.

The second improvement when implementing this dividend-growers strategy would be to use an active investment management team that chooses investment opportunities based upon fundamental research. The decline of dividends for U.S. companies in the S&P 500 Index since 2008 has made for a difficult environment, and even the Dividend Growers were not immune. It is important to use an active manager who can analyze both a company's willingness and ability to pay a high and growing dividend as a way to try and navigate around some of the dividend declines seen in the broader market.

As the baby-boomer generation progresses on the road of retirement, a dividend-grower strategy may be a prudent addition to their equity portfolios as part of a core investment strategy. Not only can growing dividends help contribute to the retiree's distributions, but the portfolio value may also have the ability to outpace inflation through price appreciation.

Following this strategy does not guarantee sustainability of a retirement portfolio or better performance, nor does it protect against investment losses.

Bonds are debt investments in which an investor loans money to an entity (corporate or governmental) which borrows the funds for a defined period of time at a fixed interest rate. Bonds are subject to certain risks, including interest-rate risk, credit risk, and inflation risk. The principal value of bonds will fluctuate relative to changes in interest rates, decreasing when interest rates rise.

A stock (equity) is a share in the ownership of a company. As an owner, investors have a claim on the assets and earnings of a company, and in some cases, voting rights with the shares. Historically, stock investors have been subject to a greater risk of loss of principal compared to bond investors. However, both stock and bond prices will fluctuate, and there is no guarantee against losses. There is no guarantee a dividend-paying stock will continue to pay dividends.

Dividends and gains on investments in either stocks or bonds may be subject to federal, state, or local income taxes as well as the alternative minimum tax. Investments in stocks and bonds are not FDIC insured, nor are they deposits of or guaranteed by a bank or any other entity. Dividends are not guaranteed.

Investing outside the United States, especially in emerging markets, entails special risks, such as currency fluctuations, illiquidity, and volatility.

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Diversification does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

The S&P 500 Dividend Aristocrats Index is equally weighted and measures the performance of large cap, blue chip companies within the S&P 500 Index that have followed a policy of increasing dividends every year for at least 25 consecutive years.

The S&P 500 Index is an unmanaged broad measure of the U.S. stock market.

The Bloomberg Barclays U.S. Aggregate Bond Index is composed of approximately 8,000 publicly traded bonds including U.S. government, mortgage-backed, corporate and Yankee bonds. The index is weighted by the market value of the bonds included in the index.

The MSCI country indices are free float-adjusted market capitalization indices that are designed to measure equity market performance in that specific country in U.S. dollars.

The MSCI Europe ex-U.K. Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the developed markets in Europe. The MSCI Europe ex-U.K. Index consists of the following 15 developed market country indices: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Israel, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, and Switzerland.

The MSCI EM (Emerging Markets) Latin America Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of emerging markets in Latin America. The index consists of the following 5 emerging market country indices: Brazil, Chile, Colombia, Mexico, and Peru.

The MSCI Nordic Countries Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of the Nordic region. The index consists of the following 4 developed market country indices: Denmark, Finland, Norway, Sweden.

The performance of any index is not indicative of the performance of any particular investment. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments into any index.

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