January 2011 – Finding Income in a Low-Rate Environment

One of the stories my family likes to tell is that as my mother aged she let her family do more things for her financially. As I was a CPA, my brother was a lawyer, and my sister was married to a banker, this was not expected to be difficult. My mother became a widow in 1976 when she was sixty years old, but she felt financially secure (it was the Jimmy Carter era) and for a number of years she was earning high interest rates on FDIC insured bank CD's. In August 1981 such rates averaged over 18% for a six month certificate. The rates then began to fall, and she couldn't understand why her children kept getting her lower rates as these CD's matured. Earning today's average rate of 0.69% was just as unimaginable to her as those 18% rates are to us today.

We always thought that as we became older or more financially well off we would be able to rely more on high-quality, safe, fixed income investments. But in this economy this is not the case, nor will it likely be for years to come. In 1981 my mother only needed $280,000 to earn $50,000 in interest on those CD's. Today, she would need $7,250,000 to earn that amount. (Adjusting for inflation Mom would need earnings from $17,400,000 to have the same buying power). Circumstances, such as we have now, make traditional financial planning almost meaningless.

As we have stated many times in these quarterly letters, we believe that in the long run stocks will provide the greatest returns; yet we also know that being invested 100% in stocks is not likely to be appropriate for retirees. However, if a person cannot get a relatively riskless normal return with fixed income, what can a person do? (When we refer to a normal return we mean around 6%-7% for long-term bonds and a 3%-4% inflation rate).

A guideline many people use to determine the allocation of fixed income to equities is to use their age as the percentage that should be allocated to fixed income with the remainder to equities. Thus, a sixty year old would be 60% fixed income and 40% equities while a seventy-five year old would be 75% fixed income and 25% equities. However, this guideline doesn't work in today's markets because the fixed income allocation returns virtually no income without taking an inordinate amount of risk. So what is a person to do?

One way some people are solving this dilemma is by emphasizing stocks which have good current yields, a good cash flow to pay for the dividend, and a good history of increasing the amount of the dividend. Consider the information in Table 1. Ten stocks are included in the table. Each represents one of the sectors of S&P 500 stocks. The time period covered is from August, 1981 until the end of 2010. This is the same period in which we saw CD rates decline from 18% to less than 1% today. While all have done better than inflation, some like McDonald's (MCD) have done spectacularly. MCD's current dividend is over 3% - an amount which is almost 100 times greater than it was in August, 1981 and the stock price is 54 times larger!

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Of course, we don't know what MCD's or the other equities are going to do in the future, but their management have demonstrated over a long period of time that the results of their companies have out-performed inflation and have produced satisfactory returns for investors. Accordingly, such stocks could be substituted for some of a person's fixed income allocation until interest rates go up high enough to provide satisfactory income within reasonable risk guidelines. Today, we believe investors must consider increasing stock allocation to such stocks until rates rise to more satisfactory levels. Such an allocation should emphasize stocks with yields that compare favorably to bonds. For example, Johnson and Johnson's (JNJ) current dividend yield is 3.49% while a November 2019 maturity JNJ bond has a current yield of 2.83%. Further, JNJ has a 47 consecutive year record of dividend increases while its bond will never pay more than its stated interest rate. Even a very conservative investor should be willing to substitute the stock for the bond.

Table 1

Selected Stock Information

Name	12/31/2010 Price	Current Annual Dividend	Current Yield	8/31/1981* Split Adjusted Price	8/31/1981 Annual Dividend	8/31/1981 Yield	Percentage Dividend Increase	Percentage Price Increase
Exxon	73.12	1.76	2.41%	9.15	0.3750	4.10%	469.33%	799.13%
Dupont	49.88	1.64	3.29%	6.77	0.4000	5.91%	410.00%	736.78%
General Electric	18.29	0.56	3.06%	1.16	0.0670	5.78%	835.82%	1576.72%
McDonald's	76.76	2.44	3.18%	1.42	0.0250	1.76%	9760.00%	5405.63%
Pepsi	65.33	1.92	2.94%	1.83	0.0811	4.43%	2366.86%	3564.10%
Johnson & Johnson	61.85	2.16	3.49%	18.67	0.0550	0.29%	3927.27%	331.28%
American Express	42.92	0.72	1.68%	3.56	0.1670	4.69%	431.14%	1205.62%
IBM	146.76	2.60	1.77%	13.78	0.8600	6.24%	302.33%	1065.02%
AT&T *	29.38	1.72	5.85%	5.28	0.4670	8.84%	368.31%	556.44%
NewEra Energy *	51.99	2.00	3.85%	9.13	0.9000	9.86%	222.22%	569.75%
Inflation Percentage	240.00%	Thus $1.00 in August 1981 is worth $2.40 today.						

*AT&T's data is from July, 1984, and NewEra is from June, 1983

My mother lived for 26 years after my father passed away. Had she kept her liquid assets solely in fixed income she would not have done as well as she did by keeping a good portion of her funds in stocks. Consequently, she was able to see her income increase, and she was able to see substantial increases in the value of her holdings.

We don't know what the future holds, but until interest rates give better returns we believe a diversified portfolio of stocks with a heavy weighting of good dividend payers should provide satisfactory results for all three investment objectives: preservation of capital, income and growth.

We hope everyone had an enjoyable Christmas, and we all will have a happy and prosperous New Year.