STELLAR CAPITAL MANAGEMENT, LLC

Stocks are the "New" Bonds

or Stocks as an Income Tool

Conventional wisdom has been that common stocks are bought for growth and bonds for income. In practice, buy stocks during your earlier working years and shift your asset allocation toward bonds as you approach retirement age to supplement your pension and social security income, providing for a good life in the golden years.

For most of my career this strategy has generally worked well. Investors tended to buy growth oriented stocks when they had the prospect of annual earnings increases, a long time horizon and little need for current investment income. As one matured in age and career, and the prospective years of salary income diminished, the time horizon shortened and the focus turned to retirement income. As long as stocks maintained their growth trajectory and bonds generated more income than stocks, things went according to plan.

Until 2000, the stock market fulfilled its historic role. Since then, we've experienced a disconcerting series of peaks and valleys with a consequence that the overall stock market has provided no overall appreciation over the last 12 years. Starting even earlier, the bond market has not cooperated either. Using the 10 Year Treasury as a benchmark, interest rates peaked in 1981, reversed their historical upward course, and have generally trended down ever since. Today interest rates are at their lowest level in history. While some sectors of the bond market still have higher yields than the stock market, the differential is lower than it was historically and the associated risks are correspondingly higher. With a weak economy, high unemployment and underemployment, retirement accounts and current income have become more important, if not crucial, much sooner than previously anticipated.

In the search for more current income, the timing of record low interest rates on traditional income oriented securities such as bonds and certificates of deposit could not have come at a worse time. The 10 Year Treasury Bond currently yields less than 2% and the Federal Reserve (the "Fed") has stated its intention to maintain low interest rates at least until late 2014. If the Fed follows through on its stated intentions, interest rates may well continue to be substantially less than what many need to provide the required income, particularly in retirement. Some may disagree with these expectations and prefer to hold cash or equivalents in the expectation of higher rates sooner, but there is an opportunity cost. At the current money market rate, cash will double in 3,466 years! While interest rates may not remain this low for that long, a more meaningful comparison may be that if inflation continues to increase at its historical average of 3% annually as it has for the last eight decades, investment in 10 Year and even 30 Year Treasury Bonds will lose actual purchasing power.

The dilemma, therefore, is how best to achieve and grow income when the traditional sources of a high and secure income are now insufficient. While the declining interest rates over the last 30 years have provided bond investors with capital gains, at the current level of interest rates it seems reasonable that further rate declines, and capital gains, are substantially less probable. The alternatives to declining rates are rates remaining at current levels which continue the problem of insufficient income, or rates could increase which results in the worst situation for current bondholders in that income remains insufficient and is compounded by losses in the value of existing bonds.

In this environment an alternative to traditional fixed income securities are common stocks. The overall stock market, using the Standard & Poor's 500 Stock Index as a benchmark, currently yields almost 2%, which is more than the 10 Year Treasury Bond. And, other than during a few months during the 2008/09 Global Financial Crisis, the stocks of many high quality companies yield well in excess of bonds issued by those very same companies for the first time since 1958. As an added enticement, at least through the end of 2012, the tax on dividends receive favored tax treatment at 15% versus bond interest which is taxed at ordinary income tax rates up to 35%.

Consideration of stocks with generous dividends as a substitute for high quality bonds raises the issue of quality. Are the companies providing dividends likely to remain in business and be sufficiently successful to reasonably assure favorable prospects to continue paying dividends at the current rate? While nothing short of US Treasury securities may be considered guaranteed, there are four companies which still have AAA credit ratings, one notch higher than Treasuries at AA+. These are Automatic Data Processing, ExxonMobil, Johnson & Johnson and Microsoft. All four have current dividend yields higher than the 10 Year Treasury, ranging from 2.6% to 3.8%, with an average of 3.1%. Additionally, all have a history of increasing their dividends on an annual basis which, if continued, will provide an increasing income going forward, quite unlike bond interest payments which remain constant until maturity. While other companies may have lesser credit ratings, there are many which are considered "blue chip." There is a group referred to as “Dividend Aristocrats,” which is defined as companies that have increased their dividend for at least 25 consecutive years. These include such well known names as 3M, Clorox, Coca Cola, Kimberly Clark, McDonalds, Pepsico, Proctor & Gamble, Wal-Mart and Walgreens, to name a few. While each dividend is subject to approval of the respective company's Board of Directors, they take great care to preserve and increase the dividend because a reduction or suspension can, and historically does, devastate the stock price requiring years to regain the confidence of investors, not to mention reflecting poorly on company management and Directors.

Many years ago, stocks were purchased for income purposes as stock dividends were generally higher than bond yields. Following the Second World War, the US experienced an economic boom with stock prices rising accordingly. This led to a greater emphasis on capital gains which then became the primary reason for stock ownership. With substantially less growth in recent years, there has been considerable disappointment in stocks and relatively little attention to the consistency and growth of the dividend. It is widely known that, despite the performance of recent years, stocks have provided a compound annual return of 10% since 1926. What is less well known is that the dividend and growth of the dividend has accounted for 42% of the overall 10% stock return!

Other factors which make a case for dividends have to do with the current economic status of corporations relative to their history. First, the recent economic experience notwithstanding, corporate balance sheets hold record high levels of cash. Following the financial crisis, corporations have returned to fiscal discipline and again have the capacity to not only continue but increase their dividends. This is also reflected in the stock market’s current yield of about 1.9%, which is well below its 50 year average yield of 2.8%. Second, the payout ratio (the amount of earnings paid out in dividends) is at a historic low of 35%. Returning to historical norms (reversion to the mean), reflects a capacity and likelihood for higher dividends going forward. As a final point, there is overwhelming data demonstrating that over the long term, dividend paying stocks not only have better performance than non-dividend payers but actually have done so with less volatility.

For all these reasons, the potential price volatility notwithstanding, I believe that the income from a portfolio of high quality, dividend paying stocks will not only exceed the income from a comparable quality bond portfolio but, unlike bonds, will provide growth of that income well into the foreseeable future. Investments of this type can augment a portfolio structured to meet a multitude of investment objectives.

Philip A. LaMell
June 7, 2012