



All-Bond Newsletter

November 18, 2010

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Dear Hildy,

Yield hungry investors search stocks for abundant dividends, or purchase a dividend paying fund to secure a plentiful cashflow. The hope is that the investor will get capital appreciation in addition to dividends, but the stocks may disappoint on both counts. As dividend yields on stocks have increased, some commentators suggest high-dividend paying stocks are a better investment than bonds. Are they?

Best wishes for a wonderful Thanksgiving holiday,

Hildy Richelson, Ph.D.
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Please let us address your questions by asking [here](#).

Cash Flow: Stock dividends versus Bond Interest

Stock investors can usually tell you how their stocks have been performing. However, they cannot tell you what kind of dividends those stocks pay. This is what SmartMoney's contributing editor Glen Ruffenach describes as "what's wrong with retirement finances today." [i] He exhorts: "once we start living off our portfolios, depending on capital gains and liquidating assets to meet [retirement] expenses is a game of luck."

In October, 2010, Barron's commentators Peter Brimilow and Edwin S. Rubenstein from MarketWatch have pointed to the fact that dividend yields on stocks have increased, and therefore high-dividend paying stocks are a better investment than bonds. [ii] They reach this conclusion by subtracting the short-term certificates of deposit from high-yield stocks held for the long run. Since stocks are considered as long-term holdings why not subtract the stock dividend from the longer-term bond interest rate? Then the stock return does not look so attractive. This is particularly true because interest payments on bonds are not optional, while stock dividends may be reduced or eliminated. For example, University of California Build America Bonds rated strong double-A with a 5.946 percent coupon due 5/15/2045 yield about 6 percent. Another alternative might be Lubbock Texas Build America Bonds rated double-A with a 6.032 percent coupon due February 15, 2030 yielding 5.72 percent to maturity. Would you rather lock-in a guaranteed return on a high-quality bond, or would you rather hope and pray

that when you need the money there will be another investor who will buy your stock at the high price at which you hope to sell?

The problem with the strategy of stocks for the long run is that it doesn't take into account the basic difference between stocks and bonds: bonds come due at their maturity date which gets closer with every passing year. Stocks never come due. Stocks can and do crash periodically with recovery taking many years or sometimes never. Bonds pay a consistent stream of income that can be reinvested to provide growth and will return your principal at the bonds due date. The fact that dividends as a percentage of stock prices has increased either means that certain companies have increased their dividends or that the price of stocks has fallen, both of which have happened frequently between 2000 and 2010.

In the 1950s stock investors counted on their dividend payments to remain stable or increase. Company managements knew that their stock price would suffer dramatically if they reduced the dividend. Today management has found a dividend alternative. It is called the stock buyback. It is intended to increase the stock price, and hence management's bonuses, without encumbering the company with continuing dividends.

If you don't want to contemplate moving in with your kids when you retire, keep in mind that we have gone a decade or more without any capital gains. If a flat or down market occurs at the beginning of your retirement, you might have enough assets to sustain you, but if it occurs at the beginning of your retirement and you are counting on capital gains, then your entire retirement plan is at risk. Retirement is all about cash flow. Bonds provide predictable cash flow, whereas stock dividends payments are iffy. The fact that dividends as compared to stock prices have increased is not a reason to run out and buy stocks. It is a reason to reconsider the bond alternative.

Keep in mind that there are possible tax consequences when you purchase dividend paying stock. Currently dividends are taxed at the federal rate of 15 percent. If Congress does not act, that rate will expire by the end of the year, replaced by the ordinary income rate which may be as high as 39.6 percent.

[i] Glen Ruffenach, "How to Keep Cash Coming," [SmartMoney](#), November 2010.

[ii] Peter Brimelow and Edwin S. Rubenstein, "Is there a bond bubble?" [MarketWatch](#), October 14, 2010.

Our philosophy has always been to seek out highly rated general obligation bonds, and bonds backed by revenue streams from essential services like water or sewer that generally carry the lowest risk of default. These are examples of what we call "plain vanilla" bonds in our bestselling book [Bonds: The Unbeaten Path to Secure Investment Growth](#), (Bloomberg Press, 2007).

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