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# INDEPENDENCE TRUST COMPANY

## *The role of dividend-paying stocks in trust fund portfolios* *as seen in ...*

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How heavily should you invest your trust fund portfolio in dividend-paying stocks? As in all investment questions, the answer starts with "it depends."

# The role of dividend-paying stocks in trust fund portfolios

Would you like to buy a stock earning an 8 percent dividend? A dividend that can be expected to grow each year? If you are willing to plant a seed and let it grow for a few years, you can do just that. The key is to buy a good company paying a dividend which will grow in the coming years and then to measure that yield on your investment, rather than on the market.

Most cemeterians and funeral directors would agree their goal for endowment care trusts is to maximize income. The important question to ask is over what time period are you trying to achieve this goal: this quarter, this year or over the life of the trust?

The answer to that question has a large impact on how the trust should be invested. In this article, we explore one particular choice, the role of dividend-paying stocks. The income, growth of income and growth characteristics of dividen-paying stocks also make them appealing choices for preneed and merchandise trusts.

## A case study

Let's say you have the choice of placing $100,000 in one of two investments, expected to generate the following amounts of income:

| | A | B |
|---|---|---|
| Year one | $ 3,000 | $ 5,000 |
| First 5 years | $19,000 | $25,000 |
| First 10 years | $53,000 | $50,000 |

If your focus is on this year's income, clearly investment B is preferable. Even over a five-year time horizon, you will get more income with investment B. However, over 10 years, you would expect to receive more income from investment A.

Would your decision be easier if you knew that the expected market value (separate from income generated) of your $100,000 investment would be:

| | A | B |
|---|---|---|
| Year 1 | $112,000 | $100,000 |
| Year 5 | $175,000 | $100,000 |
| Year 10 | $310,000 | $100,000 |

So, after adding the projected income and expected market value of the investments after one, five and 10 years you have:

| | A | B |
|---|---|---|
| Year 1 | $115,000 | $105,000 |
| Year 5 | $194,000 | $125,000 |
| Year 10 | $363,000 | $150,000 |

Investment A is looking better and better.

## Background on stocks and bonds

Let's go back to basics for a moment before we explain what investments A and B represent. Traditionally, bonds are used to provide income and stocks are used to provide potential for growth.

Over the 81 years from 1926 through 2006, the U.S. stock market (as measured by the S&P 500 total return index) had a total annualized return of 10.5 percent, the bulk of which came from growth rather than dividend income. During that same time, long-term government bonds had a total return of 5.3 percent, the bulk of which came from interest income rather than growth. (Source: 2006 AndexChart).

**Dividend paying stocks.** Now consider a subset of stocks, those which pay a dividend. Within this sector there are a number of varieties, including those that provide maximum current yield with greater risk that a dividend will be cut and those that provide a good dividend with expectations for growth.

We will focus on the latter, those with a good dividend yield—say 3 percent—and expectations for good growth of that dividend, say 12 percent.

You have probably figured out by now that investment A represents a portfolio of such dividend-paying companies while investment B represents a 10-year bond earning a 5 percent yield and maturing at its same $100,000 face value.

**Why use dividend stocks in an endowment care trust?** Now you can see why dividend-paying stocks are attractive for an endowment care trust: Over time, the income they generate can grow, protecting the purchasing power of the income stream. In other words, through the dividends, the trust can provide the cemetery with a growing income stream.

Another advantage is that as the value of the dividend-paying stocks grows, the portfolio can be re-allocated, with more placed in investments which generate a greater current income.

To see this secondary advantage, consider a simplified example of a portfolio with $200,000, half invested in dividend-paying stocks and half in bonds. Suppose the dividend yield is 3 percent, dividends grow at 12 percent and bonds yield 5 percent. Assume that all income is paid out.

| | Stocks | Bonds | Income that year |
|---|---|---|---|
| Year 1 | $100,000 | $100,000 | $8,000 |
| Year 5 | $176,000 | $100,000 | $9,700 |

At this point, due to the growth of the stocks, the trust is 64 percent in stocks. If we rebalance it back to half and half, it looks like this:

| | Stocks | Bonds | Income that year |
|---|---|---|---|
| Year 6 | $138,000 | $138,000 | $11,000 |

You have increased income by 13 percent simply by rebalancing back to the target allocation of half stocks and half bonds.

## Risks

There is of course no free lunch. With any investment choice there are benefits as well as risks. The risk/benefit trade-offs for bonds and dividend-paying stocks are outlined in the chart on this page and explained in more detail below.

***Bond risks***

• Purchasing power risk. Income stream does not increase, so purchasing power decreases if there is any inflation at all. (Over the past 81 years, inflation has been running at 3 percent annually.)

• Reinvestment risk. At maturity, you would buy another bond, but your income from the new bond will be limited to current interest rates. For instance, in late 1993, 10-year government bonds were yielding 8 percent. If you bought $100,000 worth of those bonds, you would be receiving $8,000 of income annually.

But in late 2003, when those bonds matured and you reinvested the $100,000, yields had dropped to about 4.2 percent, so your annual income would now be $4,200, a decrease of over 47 percent.

• Lack of growth of principal. Generally in a stable interest rate environment, bonds do not grow in principal. If you invest $100,000 now, you will receive about that amount at maturity.

***Bond benefits***

• Generally higher current income.

• Can purchase high-quality (government, agency or highly-rated corporate) bonds where the default risk (i.e., the risk of not getting back your investment) is low.

• At maturity, you know how much money you will get back from your investment.

• Usually their market price varies less than that of stocks.

***Dividend-paying stock risks***

• No guarantees. A stock does not have a maturity date at which time you know its value; you are fully subject to the market fluctuation of prices. Reality may not match the assumptions which underlie the investment decision.

• Volatility of stock price. This means the price bounces around. The upward bounces are a benefit, but the fact that stock prices are set by the market means that if you are forced to sell at a weak time in the market, you may receive less than expected for the stock. (There is a similar risk for bonds, though usually their prices are not as volatile.)

• Dividend cut. Dividends are declared by a company's board of directors and can be cut as well as raised; note that a cut will not only reduce the income from the investment but also likely reduce the market price of the stock.

The risk of a cut can be diminished by how you invest in these stocks, for instance by choosing those which have a reasonable dividend supported by good earnings. If the dividend becomes too great a portion of the stock's earnings, the stock can be sold from the portfolio before the dividend is actually cut.

***Dividend-paying stock benefits***

• Opportunity for income to grow.

• Opportunity for principal to grow.

## Portfolio structure

If some is good, wouldn't more be better? For the reasons discussed above, we believe that dividend-paying stocks have a role in many endowment care, merchandise and preneed fund portfolios. We do not believe they, or any other investment class, should constitute 100 percent of the portfolio.

**Disclaimer**

Throughout this article we have provided illustrations based on simplifying assumptions. We have attempted to make reasonable assumptions and to state them clearly. Please be aware that in the markets, there are no guarantees and reality may vary from the stated assumptions or results.

**Conclusion**

Dividend-paying stocks create the possibility of both a growing income stream and growth of market value. For these reasons, they are a valuable part of the portfolio for an endowment care trust, which in most states is still subject to strict principal and income accounting. ❑

## Glossary of terms

**Dividend:** Income on a stock investment. For common stocks, the dividends are declared by the board of directors and are generally paid on a quarterly basis. A company is under no contractual obligation to continue to pay a dividend.

**Interest:** Income on a bond investment, generally paid twice a year. The entity issuing the bond is under a contractual obligation to pay interest.

**Total return:** The return from an investment, including both income (dividends or interest) and price change. Compare this to "yield."

**Volatility:** For an investment, how much the market price bounces around. Downside volatility is a euphemism for a declining price. Many consider volatility to be a measure of risk of an investment.

**Yield:** The annual income from an investment divided by its current market price.



| | STOCKS | BONDS |
|---|---|---|
| **Benefits** | • Growth of income<br>• Growth of principal | • Higher current income<br>• Little default risk (with high quality bonds)<br>• Known value at maturity<br>• Lower price volatility |
| **Risks** | • No guarantees<br>• Loss of principal (downside volatility)<br>• Possibility of dividend cut | • Purchasing power decline<br>• Reinvestment risk<br>• Lack of principal growth |