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RETIREMENT INCOME INVESTING
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MONEY!

During times of stock market turmoil, I keep seeing headlines that say something like: "How to protect your money..."

Those headlines drive me crazy. Your money? To be a great investor you must learn to differentiate "money" from "assets." Money is something you spend, or possibly store away to spend in the future. An asset is something that endures and produces "money."

An asset's value can be measured by its current market value or by the value of the "money" it produces. The current market value is whatever a buyer would pay for the asset at a particular time. And, quite naturally, when there is panic in the financial air, it is very likely that most buyers are not anxious to buy, thus the market value will decline, sometimes dramatically. But, that doesn't mean the asset has less value as a potential money producer.

[To a dairy farmer his cows are assets that provide milk, or money. If the market value of cows goes down it has no impact of his herd's production of milk. In fact, it has no economic impact on our farmer's life, unless he is in the market to add more cows to his herd.]

RETIREMENT CASH FLOW

For this *Report* we are going to talk about investing, the purpose of which is to provide a retirement income, either a current retirement income or a future retirement income.

Let's keep in mind what our primary focus is and that is the <u>creation of a dependable *cash flow* for our retirement years.</u> If we are currently retired, then the *cash flow* is there to provide a monthly income. If retirement is in the future, then the *cash flow* needs to *compound* to provide a future monthly income.

This Retirement Income Investing is focused on the *cash flows* of an investment account and not the account values. If you need or want a stable account value, I doubt that common stocks will ever be the answer.

COMPOUNDING...

Most of us have heard the word "compounding" all our lives, but some of us haven't taken the time to really absorb what it can do for our financial future.

The concept of "compounding" is a major law of life. If we are in debt, the debts keep "compounding" making us poorer by the day. If we have good friends, life seems to "compound" by providing us more good friends. If we are sick our body seems to "compound" downward.

"Compounding" does not have to be a big number to have big results, positively or negatively, over time. If we graduate from high school weighing 140 pounds and let our weight grow at a mere 2% per year, by the time we are forty we have "compounded" into a less than svelte 215 pounds.

Let's get back to investing. If I have $100,000 invested in a ten-year bond that earns 5%, then I earn $5,000 per year. If I withdraw the earnings, then next year the 5% earns me another $5,000. If I continue doing this for ten years, my earnings for the tenth year are still $5,000.

However, if I <u>reinvest</u> the $5,000 each year, then I also earn 5% on the re-invested earnings. Thus, by the tenth year, my annual earnings are $7,700. Compounding is earning interest on previous re-invested earnings.

"But where can I earn 5% today?" This example is for education, we will address the earnings rate later.

INFLATION

If the cost of things we want/need to live increases at 4% per year, then we need to increase our retirement income by 4% each year, or we are going to have to cut-back on something. Thus if we need $10,000 this year to live the good life, by the tenth year we will need almost $15,000 and by the twentieth year about $22,000.

We must work to create a retirement income strategy that has the potential to keep our monthly *cash flow* growing to off-set inflation.

ASSETS FOR RETIREMENT INCOME… must provide cash flow

A reminder that "money" is to spend…either today or in the future. A retirement income "asset" produces "money" during our non-working years.

A good retirement income plan must focus on decades, not days. Thus, you want to focus on owning assets that can remain viable for the very long term. Think of a good retirement income strategy as an orchard that produces fruit for years and years.

You will want almost every asset in your retirement income account to produce *cash flow*. We need this *cash flow* to live on or to compound for the future. An asset that provides no *cash flow* means you are speculating that it will appreciate significantly in market value and you may be right, but this is not usually a sound retirement income strategy.

In our world we use primarily stocks and bonds to produce the retirement income *cash flow*.

Some people are more comfortable relying on savings that do not fluctuate in market value, such as certificates of deposit or some fixed value annuities, but in today's low interest rate world, these financial instruments produce very limited *cash flow*.

Others are relying on real estate investments to provide for themselves in retirement. This can be a valid retirement income strategy if the real estate produces a good *cash flow*, which usually means there is no debt on the property. Most people we see who are using real estate to provide for their retirement are speculating that the market price for the property will appreciate substantially and then they can sell it and use the proceeds as "money."

A sound retirement income strategy is one in which almost all the assets produce a *cash flow*. We are not interested in speculating on our retirement.

INTEREST RATES

As I write this you could invest your retirement income account in a ten year U.S. Treasury bond and you will earn about 2.0% each year for ten years. A $100,000 investment will give you $2,000 per year or $166 per month. The average certificate of deposit will hardly earn you 1.00%, which is $83 per month.

CHEAPEST ASSET CLASS

In a world of investing everything is relative. That is the value almost everything is relative to something else. If the Treasury Bond is paying 2.0% other bonds will probably have to pay a little more, because Treasury bonds are still considered *safer*. If the rate on the Treasury bond rises to 6.0%, then the rate on other bonds will also rise…everything is relative and this concept is difficult for most people to understand and it makes the world of investing rather difficult to understand.

You've heard this from us before, but we believe that large, dividend paying corporations, especially those that have a lot of global revenue, are currently probably the cheapest asset class.

Let's look at some examples:

- I'm looking at an industry dominating computer networking company that is currently selling for about $16 per share and it has over $7 per share in cash. Get it…this company has revenues of over $42 billion and profits of over $7 billion and yet you can buy its shares for a little over twice what cash they have sitting around waiting for deployment.

- Oh look, here is the world's largest software company and it is selling for 9 times it free cash flow and it pays a dividend greater than that of the 10-year Treasury Bond and last year increased its dividend by 23%.

- On this other shelf is a retail company with stores all over the world. It reported that its profits increased 12% last quarter. This company raised its dividend by 20% earlier this year, which is their 38th straight year of dividend increases.

- Here's a company that is a giant consumer marketing firm. Its annual dividend is currently 3.4% and it has raised its dividend every year for the last 55 years.

- How about this soft drink and snack company that pays a 3.2% dividend and has increased their dividend every year since 1972?

- And here is a boring old electric utility company that is currently paying a dividend $3.32 which is a yield of about 5.3%. Back in 2007 the dividend was $2.58. Way back in 1995 the dividend was $1.80.

- Lastly, let's look at this consumer and health-care giant that has increased it dividend an average of 13% per year over the last twenty-five years.

[**Note:** figures from Morningstar]

PHIL NOTE:

The opportunity to own globally dominating companies, in many cases, for less than 10 times their *free cash flow* (money left over after paying for everything) which also have huge amounts of idle cash sitting waiting for opportunities is something I haven't seen for over thirty years. BUT, I lived through the 1970's when stocks seemed to stay perennially "cheap" for years.

There you have it folks, would you rather count on a ten-year Treasury bond or a diversified group of these dividend paying companies to provide your retirement income?

Right now more than 160 publicly traded companies have a dividend yield that is greater than the ten year Treasury bond. (Source: Bloomberg BusinessWeek)

I'm well aware that if you are planning on spending your *money* in the reasonable future, then the Treasury bond or an even shorter certificate of deposit is a very appropriate savings vehicle. However, if your goal is to create a decade's long retirement income strategy, then you may want to think differently.

But, what if you know a big market drop is coming, wouldn't it make sense to sell and re-buy at the bottom? We do know there will be a big market drop in our future, we just don't know if it will be in weeks, months or years. We also don't know if the "drop" will be from today's level or a level much higher. We don't think a solid retirement income strategy is to speculate on the level of the stock market. We want to own solid companies that are well managed and well positioned to potentially thrive in the future. Stock market price declines do not impact the operation of a company. And, history has pretty much shown us that when the market improves, these solid companies will likely increase in share price far more than they declined. By the way, how do you determine the market "bottom" ahead of time?

I don't know how you can just sit there and watch an account decline in value? One more time. For retirement income investing, account values are not important. What is important is the "cash flow" to provide the monthly retirement income. We own "assets" and not "money." We will not sell something that is paying us a good dividend and that we believe will recover from any stock price decline unless we feel we have a better opportunity somewhere else. Too much "trading" or "moving to the sidelines" destroys the power of "compounding."

Retirement income investing is not about looking for some perfect timing strategy it's about the production and compounding of "cash flow."

We are not talking about stocks and bonds; we are talking about cash generating strategies.

WHAT ABOUT RISK?

There are so many different risks, but the one thing most people associate as a *RISK* is the decline in market value of an investment or their investment account.

Sometimes we must try to remember there is a difference between the decline in market value of an asset and the *risk* of the asset becoming worthless. If a good asset declines in market value, it will probably increase in market value sometime in the future. If an asset becomes worthless, it will remain worthless.

Stocks of strong businesses will go up and down, but should generally trend higher as the rising stream of dividends supports a higher share price.

[Think of our dairy farmer. If the overall prices of dairy cows go down in value, his herd will bring him less money if he sells his cows. That is a risk, but only a financial risk if he is planning to sell his herd. (It may be an emotional risk even if he doesn't plan on selling.) However, if one or some of his herd contracts some life-threatening disease, then that is a different type of risk…a very serious risk and not just a psychological risk.]

Let's REVISIT our Compound Interest section

We illustrated compound interest as our original $5,000 of annual earnings increased to $7,700 after ten years of *compounding* assuming we earned 5% each year.

But what if we started out earning 5% and our rate of return increased at the rate of 6% per year. (That would mean the earnings rate for year one is 5.0%, for year two 5.3%, for year three 5.6%, etc.) For example, let's assume we could find an electric utility company that pays a 5% dividend and it increases that dividend at the rate of 6% each year.

In this case, our income for the tenth year will be about $14,750.

Get it? We start out earning 5% and we re-invest our earnings and next year our earnings rate goes up a little. And the year after that, and the year after that, the earnings rate continues to increase.

Nothing is guaranteed in the world of investing, but if we could find such a scenario, in the eleventh year we are earning about 15% on our original investment.

Question: But I'm already seventy-seven years old. What do I care about 2022?
Response: First of all you may not ask me that if you are still living in 2021. But, in any case, we are talking "assets" here. These assets are living, breathing, revenue generating, profit making companies that are very experienced at surviving the demons the world throws in their path. What would your heirs rather inherit, money earning literally nothing sitting in a savings account that is losing purchasing power by the day, or shares of a diversified group of these globally dominating companies? Of course, the answer is that if they plan to spend the inheritance before the grass starts to sprout over your grave, then they will want "money," because the BMW dealer doesn't accept shares of stock.

THE "RIGHT" RETIREMENT Income STRATEGY

QUESTION: You are saying that everyone, even old people, should use your dividend paying stocks?
Response: I'm saying that everyone who has a decent size account that is to provide a retirement income should consider having have at least a foundation of dividend paying stocks, some of which have a considerable global presence.

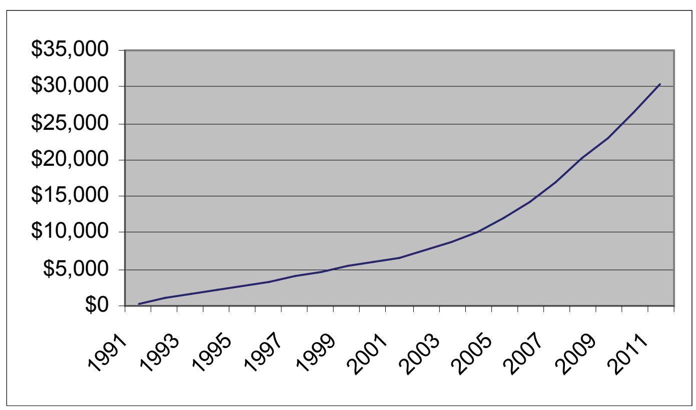
QUESTION: What is a decent sized account?
Response: An account which has the potential to produce an amount of income that is meaningful for your retirement.

QUESTION: I'm fifty years old and have been totally disillusioned by the stock market. I keep putting money into my 401(k) at work and then watch as it seems to almost disappear. I don't know how you can tell me to invest in stocks for a reliable retirement income?
Response: Unfortunately, most 401(k) plan investment options are totally wrong for the market cycle we are experiencing, which seems to be a very volatile, sideways market. But, I don't see that changing. I suggest that you invest in your 401(k) plan only up to the amount that your employer matches. With the remainder of your savings, follow the strategy in this next section.

TWENTY YEARS TO FINANCIAL HAPPY DAYS

Here's the assumed scenario: We chose five companies: we will use a large oil and gas company, a large pharmaceutical company, a large communications company, a large consumer products company and a payroll process company in our example. We will invest $5,000 in each one twenty years ago, in good old July 1991. To that we will add $200 per month to each company.

If you would have done this, here is what your retirement income chart would look like:



[Source: Morningstar]

In case you haven't figured it out, this is NOT a chart of the market values of the five companies. It is a chart of the annual DIVIDENDS of the combined companies.

Get it? After the initial investment of $5,000, each month $200 was added to each stock. he results are after twenty years is an annual income of about $30,000 that is still growing. Of course, not every five stocks will produce the same results but there is great financial magic in investing in companies that pay dividends that hopefully increase most years. (Remember: past performance is not a guarantee of future results.)

Would you invest $1,000 per month if you thought it might give you a retirement income of $30,000 per year? We chose companies that have a history of solid dividend payments, but, of course, future results may vary considerably.

What do you watch?

I see him only at an occasional reunion, so I was happy when he came by the table at the restaurant and pulled up a chair. The first thing he asked was: "Phil, what do you guys watch to keep up with the market, CNBC?"

I offered that we do not have a television set at the office, so we do not watch any television business news station.

"Then you must study the Wall Street Journal, don't you?" "No, actually we don't"

How do we keep up with the world of finance? (And remember our focus is on years and decades, not days and weeks.)

We work hard at it. After taxes, salaries and rents, research is about our next biggest expense. So let's take a minute to see where we spend these dollars.

We do have daily subscriptions to the *Wall Street Journal, Investors Business Daily* and *Financial Times*. We rely on the digital versions primarily, however, I still get one delivered to the house each morning that I have to walk to the end of the driveway and pick up and throw on the front porch. Of course, we are also hooked into the Internet on a continual basis during the day and we occasionally glance on one of the investment sites. However, despite all of this, the daily news is not a very important part of our research.

On the general financial news front, I think most of us are more likely to read articles in one or more of the weekly or bi-weekly financial publications. Our subscriptions include the print or digital versions of: *Barron's, Bloomberg BusinessWeek, Fortune, The Economist* and *Forbes.* But, quite frankly, this is more for entertainment than to help us make investment decisions.

All the above subscriptions contribute to our total research cost, but the real cost is for the research we purchase from independent sources. (By independent we mean not affiliated with a large sales organization We learned many years ago to NOT rely on a sales organization to look out for our benefit.)

It varies from time to time, but we subscribe to about twenty-five different sources of research. Several specialize in dividend paying stocks, some cover all areas of energy and natural resources, one on the utility industry, one on Canadian stocks, a couple on smaller company stocks, a couple of bonds, another on master limited partnerships, one that focuses mostly on banks and insurance company stocks, one that tracks corporation insider actions and several that are more general in nature.

Add to this several more sources that provide us information on income taxes relating to investing and estate taxes and planning strategies.

In today's wired world, most of these reference sources provide information on a weekly basis, almost all of which comes to us digitally. The day of the postal carrier carrying a big load of research reports to our doorstep is long gone. (Actually, we do get one report that is only available by mail....you'll like this...it is "The High-Tech Strategist" written by Fred Hickey.)

In case you haven't figured it out, those of us here in the office that focus on investments are basically in the reading business. We don't want the emotion of the television financial news, we are too busy reading!

This is also what differentiates us from about 95% of the financial planners and stock brokers (or investment consultants or whatever they call themselves). Most people in our industry spend almost all their time *gathering assets* (selling) and the management of those assets is farmed out to someone else, no matter what their literature says. We spend most of our time *managing* investment accounts because we are lucky in that we don't need to spend our time selling. And for that we thank each of you.

SUMMARY

Retirement Income Investing is not about "beating" the market nor is it about being able to accurately predict the market's future and move to the *sidelines* to avoid the major market declines. The truth is most people do not have enough retirement income assets to have the luxury of being on the sidelines.

We believe Retirement Income Investing is about building an account around the ownership of high quality, dividend-paying companies that have modest debt and an experienced management team that has a history of treating shareholders well.

Disclaimer: Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price. Stock investing involves risk including loss of principle. Government bonds are guaranteed by the full faith and credit of the United State government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds. Dividends are not guaranteed.

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