

Return

Investors seek real (in excess of inflation), after-tax return. How return is measured, however, can affect strategy and, therefore, potential outcome. For example, seeking a level of annual cash flow could lead to a focus on income return. But such a focus could reduce diversification and raise exposures to certain risks beyond reasonable levels. Whether investing for income or growth, a focus on total return – income return + price return – is most appropriate. A perspective of the components of return for different assets over time can provide investment implications.

Q PERSPECTIVE

Goals of preservation, income and growth generally are accomplished through money market investments, bonds and stocks respectively. These matchups reflect the underlying mix of income return and price return of each asset. With a general expectation that money market investments have no price return, the income return is 100% of the total return. The return mix is quite different for both bonds and stocks. **Chart I** displays the mix over the last 90 calendar years for the overall stock market as measured by the S&P 500 index. It is clear that price return has driven the variability of stock market return each year. Over time, annual averages were as follows:

$$4.1\% \text{ Income Return} + 7.6\% \text{ Price Return} = 11.8\% \text{ Total Return}$$

Return and risk comparisons among three assets are shown in **Table I**. The return components for bonds and broad U.S. stocks are as expected. It is notable that due to generally declining dividend rates, only 21% of stock returns on average came from income over the past 30 years versus 35% over the past 90 years. This resulted in potentially higher total return volatility as price return risk became a higher source of total return risk. As utility stocks often are sought for their income potential, it is useful to see the return and risk comparisons. Over this time period, income return has competed with that of bonds but with a much lower level of income return risk. At the same time, utility stock price return risk was closer to that of stocks in general.

The impact of taxes and inflation on return components is shown in **Table II**. While quite simplified, the analysis does provide a sense of how outcomes can vary with return components and with differing tax rates on income return versus price return. Effective tax rates can vary for each investor according to individual circumstances such as asset situs, i.e., taxable versus tax-deferred. However, general “rules-of-thumb” provide guidance not certainty with respect to strategy.

INVESTMENT IMPLICATIONS

Goals for most investors often are a blend of preservation, income and growth. To accommodate and coordinate all goals, total return and total risk are the measures of choice both for planning and implementing strategy and for assessing outcomes. To start, goals, horizons and risk tolerance must be clear. Falling short of goals is the risk that matters most, and real, after-tax return is a helpful measure of success.

CHART I

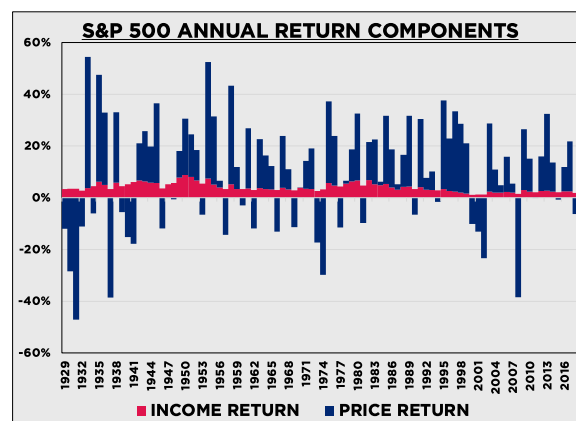


TABLE I

COMPARATIVE RETURN STATISTICS Rolling 12-Months July 1988 to February 2019			
	U.S. Taxable Bonds	Broad U.S. Stocks	U.S. Utility Stocks
Average Return			
Income Return	5.7%	2.4%	5.0%
+ Price Return	0.6%	9.1%	5.8%
= Total Return	6.3%	11.5%	10.8%
Average Risk			
Sources of Risk			
Income Return	90%	6%	12%
Price Return	10%	94%	88%

TABLE II

AFTER TAX AND INFLATION RETURNS Rolling 12-Months July 1988 to February 2019			
	U.S. Taxable Bonds	Broad U.S. Stocks	U.S. Utility Stocks
Average After Tax Returns*			
Income Return	3.4%	1.4%	3.0%
+ Price Return	0.5%	7.3%	4.6%
= Total Return	3.9%	8.7%	7.6%
After Inflation Returns**			
Total Return	1.9%	6.6%	5.5%

*Assumed Tax Rates: Income 40%; Price 20%
**Assumed Inflation Rate: 2.0%