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The Dollar that Stays in Your Pocket, and the Portfolio It Leaves Behind

You may have heard me say that it's not how much money your portfolio pours into your pocket that matters, but how much stays there after fees, commissions, and most of all, taxes.

For each dollar that "stays there" though, does it really matter what its origin was, whether from the perspective of risk (say, a long shot speculation that paid off vs. a plodding agency note) or sentimentality (income from shares bequeathed by a favorite aunt, or gains from the first stock you ever purchased)? And for that matter, should we judge it by its accounting origin (interest vs. dividends vs. capital gains)? In your pocket, does one dollar differ from another?

As for risk and sentimentality, I'll be brief: Once you pocket the dollars, they don't care how they got there, whether on a speculative rocket ride or a humdrum interest coupon. Likewise, they don't care where they came from; your securities are legal claims – abstractions lacking the capacity to care about you – so why imbue them or their dollar offspring with character they're devoid of? Net-net, dollars are dollars, economically indistinguishable and memory-less, unencumbered by history.

Now, some people are adamant that accounting origins matter, hence the old saws "Only spend income," and its obverse "Don't invade principal," not to mention Grandmother's favorite "Don't eat your seed corn." Like many rules of thumb, these sayings simplify complex matters to help us behave consistently and avoid dithering.

But the relevant issue for cash flow planning and portfolio management is not the dollar you've already received, it's the assets your portfolio retains to satisfy your future cash needs. Indeed, the wisdom of these old saws lies not in their literal meaning, but rather in the principle they suggest: that today's withdrawals must leave enough behind to sustain the future withdrawals required.

Let me contrast two over-simple portfolios which both follow the "Only spend income" mandate. The first invests in high coupon Treasuries bought at a big premium to par value, and stocks of mature companies whose growth prospects are meager but whose

dividend yields are above average. The second invests in inflation-protected Treasuries (TIPS) at par value, and stocks that pay market-level dividends but whose track record and prospects indicate they'll be able to raise payouts at a rate approximating inflation going forward.

In the early years, the first portfolio will pour out a lot more accounting income, but as its bonds approach maturity their values will pull downward toward par, and the mature companies' stock prices won't appreciate much; the market value of the portfolio will languish, and the relevance of its static income stream will erode with inflation. Meanwhile, the initially lower-yielding portfolio will do a better job of maintaining its economic relevance both in the income it throws off and the principal value it retains. At some point, the second portfolio should be distributing more dollars than the first *and* likely have a higher market value. The first portfolio is an exercise in mathematical decay, the second an engine for sustainable distribution.

My purpose here is to illustrate that we can get dramatically different results though relying on the same accounting convention to decide what's distributed. While the first portfolio may not have invaded accounting principal, it actually consumed seed corn just the same – over-distribution early on condemned the portfolio "left behind" to dwindle in inflation-adjusted terms, sacrificing future distributions for the sake of current distributions. This happened because the heuristic was improperly applied, favoring the literal over the substantive interpretation. Accountancy doesn't excuse our defying economic good sense.

Now, I should emphasize that consuming seed corn can be a necessary virtue, depending on one's asset base, cash needs and time horizon. Retirees in particular may want or need to spend down their portfolios. The key is this: any intent to accelerate capital consumption should be acknowledged from the outset, and planned for, lest a naïve reliance on accounting distinctions fool anyone into exhausting their portfolio before they expect it, or outliving that last dollar in their pocket.

As for the rest of us who want a distribution engine that keeps chugging along, we're no better able to afford preoccupation with where the dollars come from. We must structure portfolios to optimize net after-tax total returns at a level of risk that suits us, and pace our withdrawals accordingly, mindful that projecting empty distinctions onto our cash and investments can't secure our future nearly so well as discipline and deliberate planning. Now, surely Grandmother would approve of *that*.