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For the Intelligent Investor
Answers to questions you may not even know you have.

Problems with Investing for Income

This essay was originally published in Muhlenkamp Memorandum *Issue 36, October 1996, and has been updated to 2007. It is the second in a three-part series on estate planning.*
In this essay, Ron shows how investing for "income" is flawed. What investors should do is invest to grow their assets. Though it may seem like semantics to some, it is a fundamentally different approach to investing and will lead to better investments and lower taxes.

In the last essay, "Estate Planning for Generations," we began a discussion on the effective integration of good investing and good estate planning. The following continues that discussion.

To the extent that any of us received instructions from our parents on the preservation of family assets, it was probably the maxim, "Protect the principal—spend only the income." For most people, it is the cardinal rule; it goes unquestioned. But if you are going to preserve your principal for any period of time, you need to understand why this rule is/was useful, when it works, and how things may have changed since your parents or grandparents found this to be a useful maxim.

The first major problem with the rule is one of definition. The investing public and their paid advisers have allowed the IRS to set the definitions of "principal" and "income." We find the IRS definition to be worse than useless for investment purposes. In essence, the IRS defines principal as those assets on which you've already paid taxes. Investors define principal as the assets they started with. Any increase in assets the IRS defines as either "income" or "capital gains."

Consider the following example. (The numbers are real, but approximate.) Mr. Jones had a pension plan funded with pretax dollars. When he retired at age 62, he rolled it over into an IRA; the value was $100,000. We view the $100,000 as "assets." Mr. Jones views the $100,000 as "principal." The IRS doesn't define it.

In the next eight years, the IRA grew to $250,000. Question: Is the additional $150,000 classified as principal, income, capital gains, or assets? Since the money is in an IRA and not taxed, the IRS doesn't define it. Therefore, it doesn't matter.

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At age 70½, Mr. Jones begins withdrawing funds from his IRA. Is he withdrawing principal, income, capital gains, or assets? For tax purposes, the IRS says the money he withdraws from his IRA is all income. The point is that the IRS defines principal, income, and capital gains only to determine your tax bill. Their definitions have no other function, and there is no reason for the investor to be governed by the IRS definitions.

Preserving Purchasing Power

For most people, "Protect the Principal" means to preserve the number of dollars you started with. We believe "Protect the Principal" means to preserve the value (or purchasing power) of the assets you started with. When inflation is zero, the two are the same. But when inflation cuts the purchasing power of the dollar in half (as it did from 1968 to 1978 and again from 1978 to 1993), the number of dollars must double (and double again) to preserve the purchasing power of the principal.

The "spend only the income" part of the rule is so ingrained that when people need spending money, they don't say, "I need spending money"; instead they say, "I need income." This wouldn't matter except that their accountants, their stockbrokers, and their financial planners use the IRS definition of income, and the IRS often taxes income at a higher rate than capital gains or principal.

When we ask our clients whether they are allowed to spend capital gains, we often get a blank look. The rule doesn't say. But they are certain that they aren't "allowed" to spend principal. By following the rule as they understand it, people end up paying the maximum tax rates on their returns.

The following is a summary of tax rates (updated to 2007):

1. Estate taxes at 45% on assets over $2 million.
2. Income taxes = 10%–35% on income and interest.
3. Income Taxes = 15% maximum on dividends.
4. Capital gains taxes = 15% (maximum) on long-term capital gains; but:
    - You pay no capital gains taxes until you sell an asset;
    - You pay no capital gains taxes when you give an appreciated asset to charity;
    - You assign a stepped-up basis to assets you inherit. [1]

[1] In 2010, the cost basis step-up will be limited.

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As an investor, it profits you to lower your tax bill by earning returns in ways that the IRS taxes at a lower rate. An 8% return in capital gains will often cost you less in taxes than an 8% return as "ordinary income." In addition, the capital gains tax can be deferred until you sell the asset; ordinary income will be taxed in the year you receive it. When capital gains tax rates were significantly lower than ordinary income tax rates, legitimate tax shelters benefited investors by converting ordinary income into capital gains.

The Problem with Investing for Income

In order to get more spending money, we now see people demanding more income and demanding that corporate management convert capital gains or principal into income by paying higher dividends. This does nothing to raise investors' returns; it merely raises their tax bills.[2] But paying the higher tax rates on income is the smaller part of the problem.

The greater problem occurs because the focus on income causes investors to choose the wrong investment vehicles. "Income" vehicles— whether short-term debt, long-term debt, or preferred stocks— are not designed to protect the purchasing power of your principal. They are merely designed to pay you an interest or dividend stream for the use of your assets. While the level of these interest and dividend streams (on new issues) normally rise (and fall) to adjust for the level of inflation plus a rate of interest, both the IRS and the public view the returns as income. In 1980, when inflation was 10% and interest rates were 14%, the IRS taxed the full 14%, and people spent the full after-tax returns. They did this even though their principal needed to grow by 10% to offset inflation if they were to keep the purchasing power of their assets intact. In effect, the IRS taxed 10% of their principal, and investors spent 10% of their principal.

Common stocks are designed to protect the purchasing power of your assets. Common stocks represent company ownership. One of the obligations of the company's board of directors is to (profitably) reinvest funds back into the company. Dividends to shareholders should be paid from the income remaining after this reinvestment. However, in many cases, the shareholders' demands for

[2] In 2007, dividend income is taxed at a maximum rate of 15% (the same as capital gains). Interest income continues to be taxed at the ordinary income rate of 35% (maximum).

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Increased dividend income have been so great that directors raise dividends to levels that bleed the company of necessary capital. This either stunts the company's growth or results in the company issuing more stock to fund the company's needs. Such actions have been particularly common among electric utilities.

"Protect the principal—spend only the income" is a useful discipline only when:

- Inflation is near zero, or
- You are invested in the common stocks of companies in which the boards of directors view it as their primary responsibility to preserve the real value of the company (and thus, the value of the shareholder's stock) in an inflationary environment.

We have consistently maintained that normal market valuations (pretax) are:

- Short-term interest rates roughly equal to inflation, for a 0%-1% real return;
- Long-term interest rates exceeding inflation by 3%; and
- Stocks priced to provide returns over inflation of 5%–6%.

Many of you are familiar with the chart published by Ibbotson Associates that shows compounded returns of stocks, bonds, Treasury bills, and inflation since 1925. Ibbotson recently adjusted these returns for taxes and inflation. The results are listed in the table below.[3]

Figure 6.16 Compounded Annual Rate of Return, 1926–2006

	Before Taxes & Inflation	After Taxes & Inflation
Stocks	10.4	5.1
Bonds	5.4	0.4
T-Bills	3.7	-0.7
Inflation	3.0	N/A

Hypothetical value of $1 invested at the beginning of 1926, with taxes paid monthly. No capital gains taxes are assumed for municipal bonds. Assumes reinvestment of income and no transaction costs. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. © 2007 Morningstar, Inc. All rights reserved. 3/1/2007. Used with permission.

[3.] This information is now published by Morningstar, Inc. Used with permission.

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Figure 6.16 indicates that bond returns have been below our estimates, while stock returns have been a bit above our estimate. Specifically, neither bonds nor T-Bills provided a significantly positive return.

During the 80-year period, which included a lot of good years, as well as a depression, several wars, and most of the disasters that people worry about, the only time you could have made decent money investing for income was during the depression and during the period of 1981 to 1993. Both periods are now over! The rest of the time, if you invested for "income," you were unable to protect (the purchasing power of) your principal. We believe this is also true today. If you invest for income, you will lose (part of) your assets.

Redefining the Maxim

It's almost poetic—the public adopts a rule of thumb based on one time period and one set of circumstances, but it continues to use this rule of thumb after the circumstances have changed. Wall Street creates products that promise to generate returns in the form the public wants, but it doesn't tell the public what they are giving up to generate returns in this form. The media trumpets those strategies that would have worked well over the recent past. Meanwhile, the government is happy to increase the tax load on the favored forms of investments.

This was the pattern in real estate and other tax shelters; this is currently the pattern in variable annuities (which convert capital gains into income). This is also the net effect of paying Social Security benefits to wealthy retirees; many of these benefits will eventually be taxed at estate tax rates.

We believe that an investor's only recourse is to invest his or her assets to grow more assets (on an after-tax basis). Spend whatever portion of those assets is needed or desired to maintain a given lifestyle. Move the remaining assets to heirs or charities in concert with your goals and priorities. Periodically review and adjust to reflect changing markets, changing tax laws, and changing personal goals and priorities.

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