Steward Advisors

In Brief

A Brief Review of Financial Best Practices.

What is a Total Return Approach to Investing?

You may be wondering what we mean by a *Total Return Approach to Investing.* This approach starts with building a diversified investment portfolio matched to an investors risk tolerance. The portfolio may include stocks, bonds, real estate, commodities and other asset classes.

When choosing the asset classes we focus on how the investment interacts with the rest of the portfolio to get the best combination of risk and return. We do not choose the investment based on whether it pays a dividend or interest. We are more concerned about the total return of the investment including capital gains, dividends and interest. In order to fund cash needs, if there is not enough cash from interest or dividends, we will sell the appropriate investment to bring the portfolio back into its target allocation.

In contrast, many investors use a *Cash Flow* approach, focusing on dividends and interest generated by the portfolio investments. This approach ignores capital gains and the opportunity provided by growth oriented investments.

Reasons a total return portfolio is generally more successful than a cash flow portfolio

1) A total return portfolio allows you to take advantage of the best possible mix of investments for a given level of risk, while a cash flow portfolio will limit you to high interest or high dividend investments. As an example, if you could only buy 2 investments; a stock that is expected to grow at 15% per year but doesn't pay a dividend and a bond that pays 5% per year in interest, the cash flow approach would require you to forego the higher expected return of the stock and only invest in the bond.

2) A cash flow oriented portfolio is likely not tax efficient. Interest is generally taxed at ordinary income tax rates (as high as a 39.6% federal rate) while dividends and capital gains are taxed at 15% or 20% (with a surtax on top of that for high earners). If your portfolio generates $50 of interest income and $50 of dividends, you could owe $29.80 in tax. On the other hand, if you sold $100 of stock that was originally purchased for $50, and were in the same tax bracket, you would only owe $10.00 in tax.

While this doesn't take into account trading fees, you can see how the tax savings could be significant (much more than the cost of trading) for larger cash withdrawals.

3) A cash flow portfolio does not allow you to take advantage of mixing which investments are in taxable versus tax deferred accounts. With a cash flow portfolio you would need as much income generated in the taxable account (or IRA's subject to required minimum distributions) as possible, as that is where you are able to access cash from your portfolio without adverse tax consequences. This is just the opposite of efficient tax management: generally income generating assets are best held in tax deferred accounts.

Portfolio Yields and Expected Returns at Various Asset Allocations

Asset Allocation	Yield [1]	Expected Total Return [2]
100% bonds	1.68%	3.68%
80% bonds/20% stocks	1.74%	4.33%
60% bonds/40% stocks	1.80%	4.98%
40% bonds/60% stocks	1.86%	5.64%
20% bonds/80% stocks	1.92%	6.29%
100% stocks	1.98%	6.94%

[1] Bonds, 1.68%, 2/28/20, wsj.com/market-data/bonds/benchmarksps

[2] Stock, 1.98%, 2/29/20, ftserussell.com/products/indices/russell-us

4) Cash flow portfolios lock you into a pre-determined split between lifetime spending and leaving assets to your heirs. By the nature of a cash flow portfolio, your principal balance is the amount that you will leave to heirs. On the other hand, a total return portfolio will allow you to determine how much you want spend today versus leave to heirs.

5) A cash flow portfolio will quickly become out of balance. For instance, if you invest 50% in bonds and 50% in stocks, your bond portion of the portfolio will stay close to the original value while the stock portion of your portfolio will fluctuate based on market fluctuations. A total return portfolio allows you to easily rebalance by selling appreciated assets to fund cash flow needs.

6) The cash flow generated on a cash flow portfolio is not consistent. For the 50 year period ending in 2013, yields on 10 year treasury notes ranged from under 2% to over 15%. If you were counting on a 15% interest payout, you would not be able to support your spending needs when rates dropped to 2%.

In general, we believe that a diversified total return portfolio will generate more consistent returns over time that can support your spending with confidence.