

SILICON VALLEY



Through the 1990s, most people became involved in appreciation-based investment strategies. This made sense given the economic climate, particularly in the latter half of the decade when one could reasonably expect to buy a stock for "X" and sell it later for "Y." However, as lucrative as this may have been at the time, it was not a true income producing strategy.

Income represents the means to perpetuate one's lifestyle and standard of living. And cash flow determines one's income. Dividing the cash flow generated by a stock portfolio by one's income needs is useful in measuring the percentage of income coming solely from dividends and interest.

A retiree will use this income to replicate his lifestyle. As he matures, the need to rely on additional cash-flow items will increase. For this investor through the '90s, the total-return mentality dictated striking a balance between appreciation and income from interest and dividends. However, in the past two to three years, there has been a more intensive focus on cash flow generated through dividends and interest. The issue of declared dividends is hotly debated, thanks to media coverage surrounding the proposal to eliminate taxes on dividends. Stocks paying a 3.5 to 4 percent dividend in a 7 percent money market environment were somewhat attractive in the 1990s. However, in today's 1 percent money market environment, a 3.5 to 4 percent dividend-paying stock has become paramount to the success of an investment portfolio. If the proposed tax cuts pass, dividend-paying stocks become 100 percent more attractive (based on an estimated combined federal and state tax of 50 percent). As the herd begins to grasp this fact, more money is beginning to flow into dividend-paying investments. We expect to see this trend continue with a magnitude unseen since Tulip Mania, a speculative frenzy in 17th century Holland over the sale of tulip bulbs. In that case, fortunes were made as the price of tulips climbed, but for many unfortunate investors, prices plummeted as there were more sellers than buyers. When monitoring performance and valuations from a cash flow orientation, we obviously need to look at dividends. But we also need to explore the other facet of cash-flow investing -- interest-bearing investments, such as bonds. There is, however, an added risk inherent in these kinds of investments that didn't exist three years ago. Interest rates are so low today that if they move sideways or upward, bond investments could lose principal value. As a result, the stock market has made the dynamic shift from an appreciation vehicle to a total-return vehicle. The types of items one should hold in a portfolio have changed to reflect the added risks to bond investments.

AS PRINTED IN SILICON VALLEY BIZ INK

Finance: viewpoint

Cash-flow investing strategy goes mainstream

Even more important, one should resist the old temptation to calculate performance by measuring one's portfolio growth against the S&P 500 index. The new calculation: What amount of cash flow does my portfolio produce through dividends and interest?

The point is, cash flow investing is no longer a simple investment decision. Rather, it has become a performance evaluation metric, focused less on appreciation versus the S&P and more on the underlying cash flow. After all, this is how an investor gets paid.

There is a new way to achieve total return and evaluate performance. It requires that we stop measuring performance against the indexes alone. It requires that we instead measure the level of cash flow that each portfolio generates. In days past, whether or not your portfolio generated cash flow was inconsequential in light of the great appreciation of most investments. But today, a portfolio without cash flow is in serious trouble.

Shifting from straight "appreciation stocks" to dividend paying stocks and shifting from long-term corporate bonds to short-term convertible bonds helps create cash flow. It helps to reduce risk and provides exposure to some potentially impressive upside gains.

John Valentine is the principal investment adviser at San Ramon-based Valentine Capital Retirement Planning Group Inc. and a branch manager with Securities America Inc., a registered broker/dealer member of NASD/SIPC. You can reach him at jvalentine@vcrpg.com. To send a letter to the editor, e-mail jmaragoni@svbizink.com.



John Valentine, VCRPG