How Do I Re-Create a Paycheck in Retirement?

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You have accumulated assets, your retirement date is rapidly approaching, now you ponder the appropriate steps to transition your investment portfolio into a predictable retirement income stream. How do you coordinate various investment accounts to effectively recreate a paycheck in retirement? Where do you generate income in a low yield environment? Are your dollars in qualified retirement accounts or do you have after tax savings and what are the tax implications for accessing the dollars in each account? Albeit benign by historic standards, inflation will creep back into the picture; is your retirement income strategy designed to protect purchasing power?

Common Approaches

Retirees are commonly advised to purchase annuities, sell assets as they need income, or the ubiquitous rule of thumb, simply withdrawal 4% of your assets each year.

Not only are annuities extremely expensive, they provide you little, if any, flexibility to access additional funds beyond your monthly payment. Lacking the ability to utilize your wealth during unexpected circumstances – without adding costly riders to the policy – can be detrimental to your financial security. Unforeseen hospitalizations, financially supporting children, and housing maintenance are a few unplanned events that could require an off-cycle distribution. Additionally, without adding costly riders, typically, annuity payments are not adjusted for inflation.

If you are like most people, neither a haphazard, nor a regimented distribution strategy will make sense. At the one extreme, liquidating shares of an investment as distributions are required is not prudent nor is it a sustainable strategy. Life moves independent of the financial markets and expenditures such as mortgage payments, do not decrease during market downturns; why subject yourself to the volatility? At the other end of the spectrum, a set withdrawal rate of 4% could make sense, as long as your investments are returning a minimum of 4% per year; unfortunately, the investment markets are neither consistent nor linear. Based on Morningstar data, the S&P 500 increased 10.61% in the first quarter of 2013; the impact of drawing 4% during this time frame is far less impactful compared to accessing money in the 4th quarter of 2008 when the S&P 500 plummeted -28.90%. A disciplined and well executed strategy to create a regular cash-flow from a prudently managed portfolio of individual bonds and dividend paying stocks can provide consistent income and limit the need to sell investments at inopportune times.

The Quest for Predictable Income

The current low interest rate environment is advantageous for anyone looking to refinance a mortgage, but it is problematic for investors seeking yield without incurring too much credit risk or duration risk. Investors typically view the fixed income market, or bonds, as safer than the stock market; however, with the pending rising interest rate environment, bond valuations are poised to decrease at some point. Though your portfolio will need a growth component, a main focus of a retirement portfolio should be towards generating income; and many of the defensive sectors within the market are currently producing high dividend yields. Be mindful that not all yield is created equally. Income generated from bond positions are taxed as ordinary income whereas dividend from stocks are taxed at capital gains rates, a much lower bracket in many cases.

A Coordinated Strategy

Before determining the best methodology for generating income, take a step back to quantify your income needs, after all, how can you devise an appropriate income strategy if you do not know the end objective? Constructing an independent and objective financial plan allows you to create a suitable Investment Policy – a clearly defined investment approach based on your income needs, your time horizon and your risk tolerance.

The challenge is determining the appropriate balance of growth to income, equities to fixed income and selection of the appropriate underlying investments. A common mistake we see when discussing these concerns with new clients is the amount of risk they are taking – often unknowingly – to reach their goals. At the other extreme, holding large amounts in cash in an attempt to protect yourself from market volatility, results in guaranteed losses from a steady reduction of purchasing power.

Be Mindful of Risk

Chasing yield often leads investors to a higher exposure to risk than is prudent. Unlike your 30's and 40's, now is not the stage in your life to take excess risk in your portfolio. The amount of time to recover is reduced substantially as you are either currently, or will shortly, be living off your investments in the near future. You cannot control the market, but you can control your strategy to fit the current economic conditions.

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