Brounes & Associates

2319A WORDSWORTH ▪ HOUSTON, TEXAS 77030 ▪ 713.962.9986 ▪ ron@ronbrounes.com

RETIREMENT PLANNING: INVESTING FOR INCOME

For many long-term investors, retirement planning means socking dollars away in growth oriented portfolios and sitting back while they increase in value (hopefully) over time. Investment income needs may not be very significant during those prime working years when paychecks are more than enough to cover monthly budgets. But what about those folks in their 50's and 60's who are looking forward to that day when the alarm clock rings and they realize they no longer have to make that morning commute to the office? (Or those unfortunate employees whose companies made that retirement decision for them?) How will they be able to replace that steady stream of cashflow and maintain a similar lifestyle?

While many investors choose to include income oriented securities within their well-diversified portfolios earlier in life, such products begin to make even more sense as retirement approaches. Dividend paying stocks and income earning bonds provide periodic cashflow that may be needed to supplement other sources of income. Sure, the government will pay (that paltry sum known as) social security and some companies still provide pensions that will prove helpful (at least, those that are not under-funded). However, by and large, individuals are on their own when it comes to generating the needed income to live comfortably in their twilight years. And income oriented portfolios can prove quite beneficial in helping investors meet these needs.

Some Early Considerations

As retirement approaches, individuals may choose to sit down with their financial advisors and map out a "new and improved" strategy to accommodate this transition in life. In certain cases, investment portfolios should be reallocated from a more growth oriented "wealth accumulation" strategy to the more conservative "wealth preservation" and "income" strategies. Many a former Enron or Worldcom employee wish they would have taken this proactive step prior to witnessing portfolio values disintegrate overnight. Because retirement will often last 20 to 30 (or more) years, investors may wish to include a certain smaller percentage of growth products within the well-diversified portfolios; however, this more conservative approach may help ensure that no major "financial" lifestyle changes will be needed in the upcoming years.

While everyone cringes at the thought of the dreaded "B" word, creating a retirement budget can go a long way to ensuring a successful transition. The financial advisor can help clients determine just how everyday expenses will change in retirement. While long daily commutes, expensive parking, and business attire will be diminished, they may be replaced with hobbies, vacations, shopping, and other new expenses. Once a decent picture of monthly costs is determined, the retirement income sources should be analyzed. Will the income derived from social security, a monthly pension, and perhaps that temporary consulting gig be enough to cover the newly determined cost of living? If not, how can that investment portfolio best be structured to help replace that old reliable paycheck?

Getting Started

Income oriented portfolios can be designed to provide steady streams of cashflow, while still maintaining some capital appreciation potential. The transition into such portfolios should begin a few years prior to retirement (if possible) so that investors are not forced to make dramatic reallocations overnight. Should an employee receive a severance package as a result of a termination or early retirement, a percentage of those assets should be invested in income paying securities.

Since most new retirees are accustomed to that routine paycheck, they may choose to set up a periodic (monthly) distribution schedule where dollars are moved from the investment accounts to their separate checking accounts on the same day each month. As income is paid (from dividends or interest), it can accumulate in a cash account until the predetermined distribution date. In selecting suitable securities for income replacement, the advisor should be conscious of those with associated redemption fees to avoid any additional costs of adhering to distribution schedules and periodic rebalancing.

Allocation is Always Important

Income oriented portfolios can be structured as equity focused (with greater expected total return), an equity/fixed income blend, or a fixed income only portfolio. As always, the risk tolerance of the investor should always remain a primary consideration. Just because a portfolio is fixed income focused does not mean it is without risk. High yield bonds or even mortgage-related or asset-backed securities maintain certain levels of risk that may not be suitable for some investors. Further, just because a portfolio is equity focused does not mean it possesses excessive risk for retired people. Dividend paying “value” stocks can be quite consistent with the preservation and income goals of retirement.

Income portfolios can be structured within either qualified or non-qualified accounts, though the tax-efficiency of the underlying securities within each may vary. They can be comprised of more actively managed mutual funds which often offer greater opportunities for capital appreciation. Likewise, ETFs make for suitable income-oriented investments and are often more tax efficient and cost effective. A combination of asset types and asset classes helps provide additional diversification. Investors can take advantage of changing economic environments without making any interest rate calls by structuring portfolios with fixed income securities with maturities across the yield curve. They can benefit from various changing market cycles by incorporating sector funds comprised of underlying dividend paying stocks.

As time passes, the advisor and investor should monitor the underlying performances and systematic distribution schedules to ensure the portfolio is accomplishing its initial intent. If additional cashflow is generated (more than needed as an income source), they may choose to limit certain distributions and reinvest dividends and interest to help grow the existing portfolio through the effects of compounding. Then again, while the overall goal may be to supplement the income sources without tapping into the underlying principal, remember that those investment dollars have accumulated throughout a working career to be used in retirement (if needed). The advisor’s role is to help individuals 1) adjust to the retirement transition; 2) ensure they have adequate dollars to maintain an appropriate lifestyle; and 3) not run out of money during their lifetimes. A well-structured income portfolio can prove helpful in accomplishing these goals.

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