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How to create and manage retirement income: The different types of income producing investments

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If you are at the stage of your life where you will stop working or you have a desire to work less you will need to develop a plan to create an income stream from your investments. When I work with clients I emphasize our goal is to create an increasing and growing future income stream to at least keep pace with the cost of living in the future and ideally exceed the cost of living or inflation.

Gather the information

The first step is to prepare a retirement budget or a listing of your estimated expenses in retirement. Many times clients will ask me if they have enough investment assets to retire and I always tell them it depends on how much you plan on spending in retirement. Some of my clients need $50,000 annually and others need $250,000 annually. The amount they need many times has nothing to do with their accumulated assets. The second step is to prepare a complete inventory of all of your investment assets including your home. The third step is to determine guaranteed sources of income such as social security and or pension and annuities. You or your financial advisor would then need to prepare a spreadsheet projecting your expenses into the future and showing your income from guaranteed sources and your projected income from your investments. This is where a financial advisor/planner can really come in helpful.

Different Types of Income Producing investments

The following are the investment options you have to create an income stream:

1. Bonds: Bonds are basically loans to corporations, the U.S. government or municipalities. Bonds generate interest payments in the 5% range. They are typically very safe and throw off a good income stream. They can help to offset losses within a stock portfolio and provide some stability. The disadvantage of bonds is the income stream does not increase with the cost of living and in the long term your income may not exceed the inflation rate thereby lowering your future purchasing power. Treasury inflation protected bonds have been created to provide an inflation adjusted income, however the current yield- in the 2% range - is very low.

2. Money market/ CDs: Money market funds and CDs are ideal for short term savings and may make sense in a rising interest rate environment. As I write this article, money market rates are in the 2% range and CDs are in the 2% to 4% range depending on the duration of the CD. One of the biggest problems I see with our new clients' portfolios is an over reliance on these so called safe investments. They are safe in the short term (as long as your money is with multiple banks), however they are risky to a long term retirement income plan. Why? Because if the inflation rate is 4% and a CD is yielding 3% - 2.1% net after tax, then your future purchasing power is declining not rising.

3. Dividend Paying Stocks: Dividend paying stocks can be a very good investment for a retiree because they offer current income and the best chance for a growing future income stream. If the

dividend paying stocks appreciate by 7% annually and throw off a 2% dividend the income stream will double in about 11 years. In addition you will have an account value growing much greater than the cost of living. The obvious disadvantage is stocks decline on average one out of every four years and are subject to annual corrections in the 5% to 10% range. For this reason, 50% - more or less depending on the investor - seems to be the ideal allocation to stocks for the average retiree.

4. Real Estate Investment Trusts: REITs are publicly traded entities owning properties such as apartment, office, and industrial buildings. These investments typically produce about 5% annually in dividend income and over the longer term offer some upside growth potential. REITS are stocks and are subject to the same risks. These are best held in a tax deferred account such as an IRA. A small allocation - typically 5% to 10% - is usually recommended.

5. Annuity/Pension/ Social security: Lifetime guaranteed annuities; company pensions and social security are guaranteed sources of income, for the most part. Pensions are only guaranteed as long as the employer stands behind the promises. These sources of income are very desirable to a retiree because typically the income is paid for as long as you live and you do not have to control or monitor the investment allocation. These sources of income make up the starting foundation of your retirement income plan.

6. Yourself: Many retirees will work because they want to, others will work because they have to. Consider this, if you generate $25,000 annually in part time enjoyable work it is the equivalent of having $500,000 earning 5%. So if you are $500,000 short of your retirement goal this may be a good solution. If you don't need the money it still helps your overall portfolio by tapping into less each year or delaying social security payments.

Combine the Income Producing Investments Into a Portfolio

A retirement income portfolio should ideally have an allocation to all of the above referenced investment options. Each retiree has a unique situation and therefore each portfolio would be designed differently depending on the investor's risk tolerance and guaranteed sources of income. In general, I find a balanced portfolio evenly split between dividend paying stocks and bonds with a small - 5% to 10% - allocation to real estate on the stock side works very well. I could go into much more detail on how we develop a well diversified balanced portfolio but for purposes of this article the important point is that 50% of the portfolio is very stable with high current income and 50% is in dividend paying stocks and real estate with the best opportunity for growth and an increasing future income. Again, the percentages would be adjusted based on the investor's overall objectives.

In the long run, the dividend paying stocks and real estate should provide a growing income stream exceeding the inflation rate. In the short term, the bonds will provide stability, high current income, and be used for income during corrections and bear markets in stocks.

How to Manage Withdrawals

Many financial advisors consider a 4% withdrawal rate to be a conservative withdrawal rate to allow your money to last for your lifetime. This could be anywhere from 4% to 6% annually depending on your particular situation. Another issue to consider is which account to withdraw from to generate an income stream. When we develop a retirement income plan for a client we will typically withdraw from the taxable account first, followed by tax deferred accounts such as IRA's, 401k's and annuities and then lastly tax free accounts such as Roth IRA's/Roth401k's. Many of our clients have trust accounts set up that are not subject to estate taxes. In these situations, we allow the trust to accumulate and only withdraw funds if it is absolutely necessary.

One of the biggest mistakes I see in the retirement income planning area is withdrawing from stocks or stock funds in a correction or bear market. Your retirement income plan needs to be managed so when we have the inevitable down years in the stock market, on average one out of four years, your stocks are left alone and your income stream needs to come from the safe side of your portfolio - bond funds and money market accounts. Selling stock funds when the market is temporarily down 15% will ruin your retirement income plan. I have met a few perspective clients who had been receiving IRA withdrawals on a monthly basis with the income coming out of each of their funds proportionally. When we make them aware that they are selling stock funds in a depressed market they typically will transfer the accounts to us and have us manage their withdrawals. We like to tell our clients we cannot predict the market but we can manage the market and make it work for your benefit.

Develop a Retirement Income Plan

Consider a financial advisor who can help you develop a well thought out retirement income plan. A good plan will address your lifetime income needs, protect you from the high costs of long term health care and smoothly transition your remaining assets to your family. You will be able to sleep well at night- through good and bad markets- knowing you can rely on a solid plan. Most importantly, you can reap the rewards of all of your working years and develop new interests, volunteer, travel, play golf, publish a book as my father has done or anything else you always wanted to do. It's your plan!

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