Investing for Income in Retirement

MARCH 27, 2019

Finally, after a number of years of record-low interest rates following the 2008-09 Great Recession, interest rates are slowly rising. The Fed has been increasing short-term interest rates, the rate that drives returns on short-term bonds and cash investments. But still, higher yields from income-oriented investments can be tough to come by.

So if you're nearing retirement, what steps can you take to build a portfolio to generate liquidity, income, and potential growth to support you? And how will you continue investing after retirement?

The answer doesn't have to involve a lot of fancy footwork, says Rob Williams, vice president of financial planning and retirement income at the Schwab Center for Financial Research. With the right perspective, a combination of familiar strategies and investments can be an effective way to maximize your portfolio's income potential.

"You can use a lot of building blocks," Rob says. "Some to help secure your income, some to help provide growth. In today's market, building a diversified portfolio, in our view, is the best approach."

Step 1: Build in downside protection

Given the volatility in the markets, a smart income strategy in retirement planning should include cash reserves for liquidity—and downside protection, Rob says. When investing after retirement, set up "buckets" within your portfolio. You can have cash available when you need it, reduce potential losses and still keep part of your portfolio focused on longer-term growth. One approach to create this "foundation" to build on is as follows:

- Set aside 12 months' worth of expenses, after accounting for other non-portfolio income sources, in a liquid cash account. This reserve is the money you need to supplement your regular income sources, such as Social Security or a pension.
- Keep an additional two to four years' worth of expenses in short-term bonds or bond funds in case of a market downturn. With this cushion, you'll be less likely to have to sell more volatile investments at a loss. (On average, over the last 50 years, it took the S&P 500 about three years and eight months to recover from a downturn).

Having these reserves in place may also help protect you from sequence-of-returns risk. If the market dips early in your retirement when you're first taking withdrawals, it can be more difficult for your portfolio to recover from those losses, increasing the chance that you will run out of money. Having sufficient short-term reserves can help save you from having to deplete your core portfolio.

Another way to add downside protection is to purchase an annuity. An annuity can provide a steady income stream. But the terms, quality and cost of annuities vary widely. Annuity guarantees depend on the financial strength and claims-paying ability of the issuing insurer. It's best to consult with a financial professional to select an annuity that will suit your specific needs.

Step 2: Focus on income and potential for growth

With some protection in place, you can now consider investing the remainder of your portfolio in assets that have greater potential for investment income and growth, depending on your time horizon and risk tolerance.

Dividend-paying stocks are one option worth looking into, says Brad Sorensen, managing director of market and sector analysis at the Schwab Center for Financial Research.

"Just remember, these stocks are not a substitute for bonds, also known as 'fixed income' investments," Brad cautions. If you're aiming for a portfolio for income, you may want to integrate more dividend payers into your stock allocation.

When choosing which stocks to invest in for income, "look at more than just the current dividend rate," Brad advises. It pays to examine a company's cash flow to see if it can continue to cover its dividend. Other factors to consider before buying an income stock include whether the company is selling any assets and how consistently it has offered its current yield over the past five years.

Also be sure to account for broader economic issues, Brad adds. For example, energy stocks could trim their historically impressive dividends because of depressed oil prices. By contrast, financial services and many established tech companies have been increasing their dividends in recent years.

Investors seeking yield may be tempted to consider real estate investment trusts (REITs) for a portion of their stock allocation. These securities invest in income-producing properties and are required by law to pay out at least 90% of their taxable income to shareholders in the form of dividends.[1]

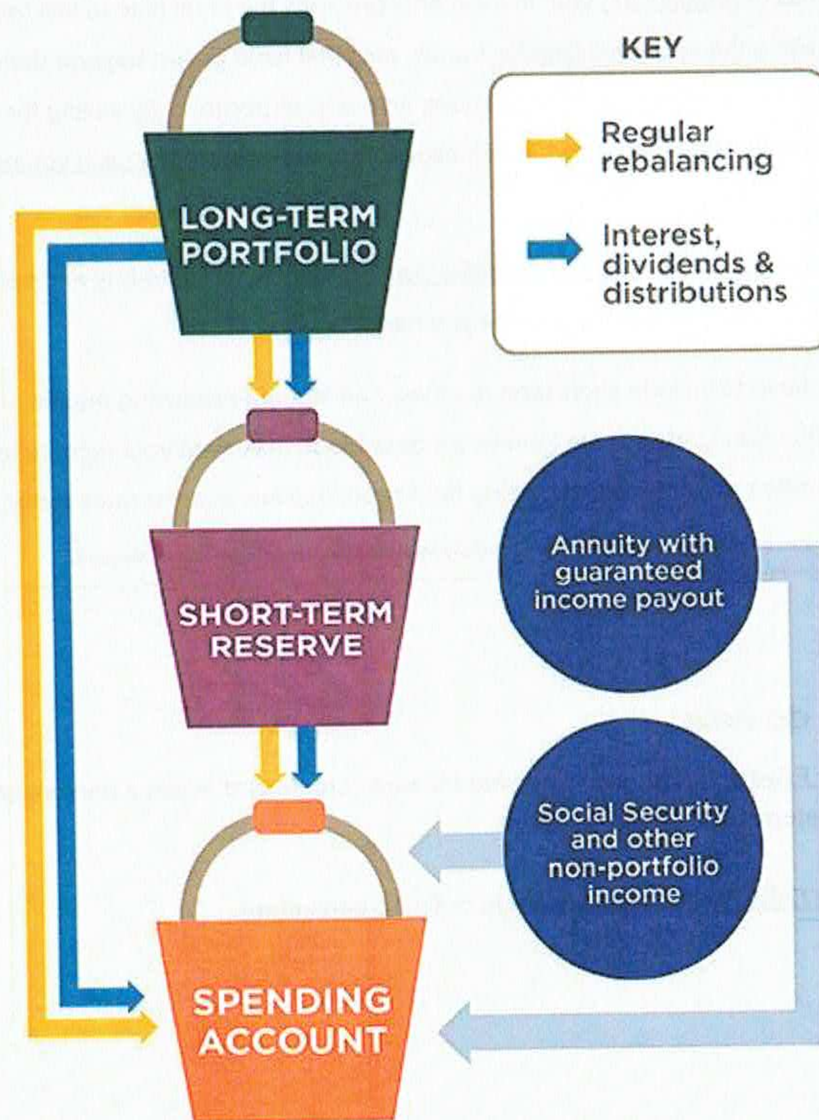
But Brad warns that many REITs are sensitive to interest rates, with the asset class as a whole tending to underperform in rising-rate environments.

Step 3: Consider a "total return" approach

Think of the methods above as a way of structuring your portfolio for retirement. When it comes to distribution, a "total return" retirement income strategy may help you meet your income needs.

A 'TOTAL RETURN' APPROACH TO RETIREMENT INCOME

Using the short- and long-term buckets within your portfolio, you can combine regular income sources with periodic rebalancing to generate the income you need.



Source: The Schwab Center for Financial Research

Given today's low-rate environment, it may not be practical or optimal for many investors to depend on dividends and interest alone, Rob notes. Nor is it necessary, given the other potential sources of return in your portfolio. Consider generating income by selling assets as well.

This approach doesn't necessarily mean "tapping principal" or "drawing down your portfolio," says Rob, which both might sound taboo to some investors. Ideally, a total return approach allows you to harvest some of your portfolio's gains—including price appreciation—for income as needed. Depending on how much you withdraw, your portfolio may continue to grow.

Often, the routine process of rebalancing your investments presents the ideal time to sell assets and harvest gains. Rebalancing involves selling the securities (stocks, bonds, etc.) that have grown beyond their percentages in your asset allocation plan due to the relative gains and losses across your portfolio. By selling the outsize positions, you can reallocate to your targets, help manage your risk exposure and generate the cash you need in addition to investment income.

You may want to enlist the help of an investment professional to decide which to buy and sell to bring your portfolio back in line with your plan and generate the income you need.

If you structure your portfolio to include short-term reserves and income-producing equities—as well as considering total returns in your distribution strategy—we believe it's possible to maximize your income by increasing your portfolio's income-generation potential without being held captive to low interest rates today.

[1] REIT dividends typically aren't treated as qualified dividends and will generally be taxed at higher ordinary income tax rates.

What you can do next

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