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Turning Wealth Into Income

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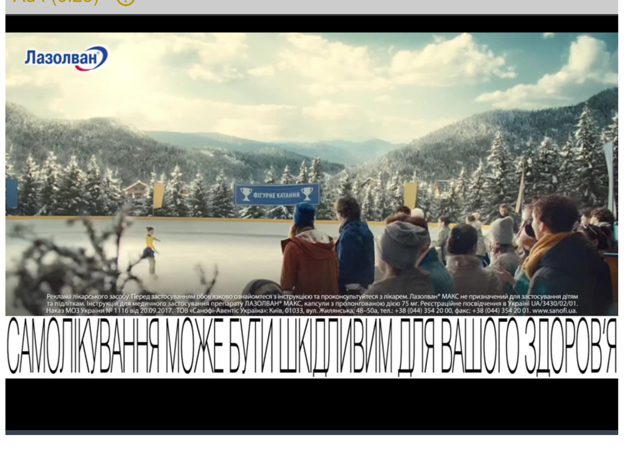
Markets
I write about investments, retirement and related financial topics.



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No retiree ever wants to run out of money. Creating a reliable and sustainable stream of income from their accumulated wealth is their first and most important objective.

But, generating income from your wealth is much harder than simply growing it in the first place. It takes a much different investment policy. In terms of strategy, the accumulation phase is the easy part.

Think about it. With a reasonably diversified portfolio as long as you are adding to the account you would never expect to zero out the balance. But, as soon as you begin to withdraw funds, you introduce the risk of self liquidating the portfolio. And as any retiree will tell you, that's the nightmare scenario.

Here are some points you might use as a guideline to form your strategy for reliable and sustainable withdrawals to fund your retirement income needs:

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- Past experience over long periods of time show us that with withdrawals above 4% of capital per year have an unacceptably high probability of failure. Failures increase dramatically as withdrawal rates increase above 4%.There are literally thousands of articles in professional journals that discuss sustainable withdrawal rates. Some of them torture the data to justify a marginally higher rate, but without the gift of perfect foresight you would be wise to keep a very conservative withdrawal rate. The worst that happens is that later you can distribute more as your funds grow. That sure beats depleting the account.
- Of course it's always a good idea to keep expenses to a bare minimum. Even if you don't believe that markets are efficient, the low cost of index funds and ETF make compelling sense. The dominance of passive strategies has been established beyond a reasonable doubt and you will want to make them a key part of your investment strategy.

- Manage risk as aggressively as possible. Maximum return without regard to risk is not a valid strategy for any withdrawal program because portfolio volatility is the big killer for withdrawal programs. At any given level of withdrawals, portfolio failures increase exponentially as volatility increases. A big swing in a down market coupled with withdrawals could deplete the portfolio to a position from which it can never recover. So, as you evaluate potential investment strategies one with a somewhat lower return associated with a lower risk may have a higher probability of surviving your lifetime than a higher return, higher risk portfolio. Aim for the sweet spot where expected return is somewhat above your withdrawal rate but with the lowest possible risk necessary to generate that return.
- Diversifying between fixed income and equity is the first step to manage your risk and control volatility. The fixed income allocation serves two purposes: it provides a store of value to fund future withdrawals and mitigates the risk at the portfolio level. As you add fixed income to an equity portfolio, risk falls a lot faster than expected return which in turn translates to a much higher probability that you won't outlive your nest egg.
- Keep enough in very safe income securities to fund several years known cash flow in advance. That way you don't have to sweat the short term market fluctuations in your equity portfolio. For instance, if you planned on withdrawing 4% of your nest egg each year, and wanted to have a ten year cushion for withdrawals, 40% of the total portfolio might reasonably be committed to high quality short term bonds. The balance can be committed to long term growth. In today's almost zero return short term bond market, it's tempting to stretch of yield, but the slight increase in yield you might generate by increasing duration increases the risk far in excess of any added benefit.
- You will need a healthy allocation to equities to provide the necessary growth of capital and inflation hedge over your lifetime. But, avoid any kind of concentrated risk in your equity portfolio. You are paid handsomely over time to accept risk in the world's equity markets. However, an appropriate equity strategy of global diversification into multiple asset classes will reduce risk to its lowest possible denominator while generating an optimum level of return for the risk you accept. Remember, you won't be compensated for any risk that you could have diversified away. Index funds and ETFs offer an economical path to widest possible diversification at the lowest possible price.
- Rebalancing your portfolio when parts of it grow out of predetermined tolerances from their allocation will both contain risk and enhance returns. It's counter intuitive to sell assets that have been going up to buy assets that are going down. But, all asset classes have their day and they move in different cycles. I can't remember a rebalancing trade between fixed income and equities or between equity asset classes that wasn't profitable when we looked back at it two years later.

Converting your accumulated wealth to a reliable and sustainable income requires careful planning and discipline. A common sense investment strategy with low cost, the right amount of risk, and wide diversification can make the difference between a bountiful retirement and outliving your portfolio in retirement.

Frank Armstrong is the founder and principal of Investor Solutions, a Miami-based NAPFA fee-only registered investment adviser with more than $650 million of assets under management. He has more than 38 years' experience in the securities and financial services industry and has published four books and hundreds of articles on investments and retirement planning. Visit him atwww.investorsolutions.com.

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