Building A Strong Retirement Income Portfolio - Part 1

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Summary

This first article in a series discusses switching from growth to income.

Strategies, risk, and resources are discussed.

Some specific high-yield vehicles and strategies also are discussed.

Are you trying to build your retirement portfolio? If so, chances are good that you're engaged in that often difficult transition between trading growth stocks and moving onto income vehicles.

Here are some strategies and resources we've used through the years as part of this same journey.

1. Risk:

Determine a realistic annual income target for your portfolio - hint - if it depends upon an overall yield of 10% or more, you're probably stretching too far for yield. A big part of this determination is how much risk you're willing to take - are you an old "horse trader," who can deal with the ups and downs of the market, or can you only tolerate shallow bumps in the road?

If you ask most investment professionals what they spend the most time on, many will answer, "managing risk."

One thing to be aware of is that not all of your ideas will work out - that's the way it is for all investors, from the smallest to the biggest. The examples you'll find from a simple web search for "Buffett's biggest misses" can be quite enlightening. You also can insert other well-known, successful investors' names into that search - they've all made blunders, and so will you. That much is guaranteed. Of course, the goal is that your good ideas overcome your mistakes and give you a positive total return.

And, guess what? An idea that looks like it will never pan out today may start to work in one, maybe two, or maybe three years or more. That's one reason you want to get paid to wait, i.e. collect some income along the way.

2. Which industries are you most familiar with? Look for income vehicles within those industries first. As Mr. Buffett once said, "Invest in what you know."

In the market, individual industries are part of sectors, which move in or out of favor. However, sectors which are supported by macro trends seem to weather the storms better than most.

Healthcare comes to mind. Since it's supported by the geezering of the huge baby boom generation, healthcare has had quite a nice ride over the past few years.

Tech is another well-supported sector, but, like healthcare, it has had its troughs, i.e. pullbacks, along the way, such as in Q4 '18, when the market fell 20%.

But look at how both sectors bounced back in 2019. Healthcare took until ~October to hit its stride, but it's up 15.6% so far in 2019. Tech, on the other hand, is up ~41%, vs. the S&P 500's 25% gain:

"But if healthcare's lagging the market in 2019, why would I want invest in it?" If you set your sights on a longer outlook, it gives your ideas more time to work. A longer view is one of the tools that retail investors have that most institutional traders don't have.

The other issue here is performance vs. income. If you're designing your retirement portfolio primarily for income, vs. growth, you'll need to get used to the idea of not always outperforming the market.

Here's an example from 2019, using BlackRock Health Sciences Trust (BME), a closed-end fund which invest at least 80% if its total assets in equity securities of companies engaged in the health sciences and related industries.

At first blush, we see that BME's total return of 17.91% lags the SPDR S&P 500 ETF's 27.98% total return by ~10%. That's quite a spread, but there's more to this story.

	Ticker	12/11/19 Price	Forward Distribution Yield As of 12/31/18	2019 Price Gains	Total Return
BlackRock Health Sciences Trust	**BME**	$40.58	6.58%	11.33%	17.91%
SPDR S&P 500 ETF Trust	SPY	$314.35	2.20%	25.78%	27.98%

Example: One investor bought 100 shares of BME for a total of $3,645.00, while a second investor used the same amount, $3,645.00, to buy 14.58 shares of SPY.

The BME investor ended up receiving $240.00 in dividends, 3X the $80.07 that the SPY investor received in dividends. So, suddenly, that disparity between the two total returns doesn't seem to tilt in favor of SPY, if you're looking to maximize your portfolio income and you're not interested in trading.

Ticker	12/31/18 Price	Cash to Invest	Share Amount Bought	Annual Dividends/ Share	Total Dividend $ Received
BME	$36.45	$3,645.00	100	$2.40	**$240.00**
SPY	$249.92	$3,645.00	14.584667	$5.49	$80.07

In a scenario where both investors collected their dividends and then sold their shares, the SPY investor would've taken in more total money, but it's clearly two styles of investing, which require differing amounts of skill, interest and amount of time available.

Ticker	12/31/18 Price	12/11/19 Price	Share Amount Bought	$ Cap Gain If All Shares Sold	Total Dividend $ Received	Total $ Return
BME	$36.45	$40.58	100	$413.00	**$240.00**	$653.00
SPY	$249.92	$314.35	14.58	$939.69	$80.07	$1,019.76

2. Watchlist:

Assemble a watchlist of income vehicles you'd like to own within your target sectors.

Where do you begin? There are many public and brokerage financial websites which have screeners - they vary in complexity and depth of data.

Here's something to watch out for - *dividend payout ratios are sometimes wrong on these sites*, due to automation errors, among other things.

Moreover, the dividend payout ratios listed for REITs and most LPs are usually wrong.

Why? Because they use the wrong data. When you're researching REITs, look for Funds From Operations, FFO, or Adjusted Funds From Operations, AFFO, or Funds Available for Distribution, FAD. REITs use these metrics in order to strip out non-cash expenses, such as depreciation and amortization, and fair value derivative revaluations.

LPs/MLPs use distributable cash flow, which is a similar metric that strips out non-cash charges, but deducts maintenance capex - picture ship-owning companies or midstream pipeline LPs - they own a lot of assets, which generate a great deal of non-cash depreciation and amortization.

A tip o' the hat to *Seeking Alpha*, which just upgraded its data coverage of REITs, in order to include FFO and other appropriate metrics. There are a host of other metrics via which you can research your target vehicles on the site as well.

We use sub-industry screeners in order to get an apples-to-apples comparison of income vehicles which we're interested in. We look at comparative valuations, such as P/E, price/book, price/sales, and EV/EBITDA. We also look at how these metrics compare to the target company's past valuations.

No discussion of a watchlist would be complete without mentioning portfolio cash levels. After all, what good is a watchlist if you haven't any dry powder to deploy?

In a perfect world, we'd all be in 100% cash just before the market pulls back by 20% or more, but that's not reality, since we need to deploy a lot of our cash in order to earn some income.

However, if you can keep some cash aside for those dark periods in the market, you may find that you'll be rewarded with some of your most lucrative income investments.

3. Stay Calm During The Storm:

The trick during those deep market pullbacks is to keep breathing and to not panic, even though you may be reading very negative headlines which suggest that mankind's imminent fate is all of us living in tents soon.

It's easy to look back at a deep valley in a stock's chart and say, "I shoulda, woulda, coulda," but the thing is, at the time the market is crashing, all you can see is a downward line, with no upward bounce in sight.

So what do you do, when other investors are abandoning the market, en masse? *Zero in on your target stocks* - How do their suddenly lower valuations compare to the past, and to their peers? How much higher has their dividend yield gone?

Moreover, is there anything in this market or individual stock's pullback which suggests that they won't be able to sustain their dividends in the future? If you believed the stock was competitively valued at $20.00, for example, and now it's at $15.00, are you still a believer?

4. Stay Calm When Riding The Bull:

Calmness also has another enemy - euphoria. It's much sneakier than panic, because it's a feel-good emotion, and it causes even great investors to blunder.

Don't be in a hurry to join the crowd that's chasing a particular income stock - a good dose of pessimism can battle FOMO - the Fear of Missing Out.

Unless we're in a full-scale pullback, we usually don't take full positions in any income vehicle on our initial purchase. This can be advantageous, in that you may get a chance to average down in the near term future.

One way of averaging down, while getting paid to wait, is via selling cash secured put options below your target stock's current price/share. We've often combined this with our initial buys, or in lieu of a purchase, in order to get a lower breakeven cost. If the stock takes off, and you missed out on it for the time being, at least you got paid something for waiting.

Many of our articles have details for many different put-selling and covered call option trades, which explain those techniques. Those are shorter-term strategies, i.e. running from ~2-3 months to ~5-6 months.

For example, AT&T (T), has an average target price of $39.67 from analysts. Selling the March $38.00 put option would earn you a bid premium of $1.72. That gives you a breakeven of $36.28, which is 8.5% below T's $39.67 average price target. If you do have the T shares assigned to you, your $36.28 breakeven cost would have a forward dividend yield of 5.62%.

You can see more details for this trade and a covered call trade for T on our free Covered Call and Cash Secured Puts Tables.

TICKER	12/11/19 Price	DIVIDEND PER SHARE $ EX-DATES BEFORE PUT EXPIRATION	ANNUAL'D DIVIDEND YIELD %	PUT OPTION EXPIRATION DATE & STRIKE PRICE	PUT BID PREMIUM	**ANNUAL'D PUT YIELD**	100% CASH RESERVE AMOUNT	BREAK-EVEN PRICE
T	$38.17	$0.5100	4.88%	3/21/2020 $38.00	$1.72	**16.52%**	$3,800.00	$36.28

5. Diversify:

Although you may be more familiar with one or more sectors, they're not all going to offer you the same type of dividend yields. So, what typically can happen in retirement is that DIY investors will gravitate to the higher yield sectors, such as energy/basic materials, real estate, financials and utilities. These sectors blow the doors off of tech when it comes to paying dividends, but, sadly for income investors, tech companies are usually in favor, even if they are run by a bunch of tightwads.

Meanwhile, your favorite sectors, and the stocks within them, may go in and out of favor, depending upon the direction of interest rates, or the price of crude oil, or where we are in the economic cycle, for example. This is why it's usually prudent to not be overly concentrated in one sector.

Size also matters - do you own mostly large caps, mid caps, or small caps in your portfolio?

We've found that there's better stability in our income portfolio when it's diversified by sector and size. In general, we also don't put any more than 2.5%-3% into any one income vehicle.

An interesting feature of some small- and micro-cap dividend stocks is that they're sleepy - they may not always trade every day, so they ride out the bumps in the market better than the big name dividend stocks.

We'll delve more into that, and different types of income vehicles, in Part 2 of this series.

All tables furnished by DoubleDividendStocks.com, unless otherwise noted.

Hidden Dividend Stocks Plus, covers undercovered, undervalued income vehicles, with dividend yields from 5% to 10%+.

Our latest success story a 51% total return from inception for one of our core holdings, a little-known 124-year old US microcap dividend stock, which is getting bought out at a 34% premium. In addition to the buyout premium, HDS+ subscribers received 2 years of fat dividends, yielding over 8%.

We publish exclusive research articles weekly for the HDS+ site that you won't see anywhere else. **Find out now** how our portfolio is beating the market since inception. There's a 20% discount for new members.

Disclosure: I am/we are long T, BME. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

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