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WEALTH MANAGEMENT

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THE RETIREMENT INCOME PARADOX

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Consider for a moment that there may be two psychological phenomena that lead most investors and financial advisors to approach retirement income planning incorrectly.

The first phenomenon stems from careers. Working Americans generally spend 40+ years paying their living expenses by having a job that spins off income. Fairly straightforward - ensure the job stays intact and live off the income. Drawing an analogy to investing, it is as though the job is a bond that stays intact, and the job income is the bond interest.

As a result of this 40+ year paradigm, most believe that the way to pay for retirement is to emulate those working years; have something that stays intact, and live off the income it generates. This is frequently referred to as "passive income." It comes in different forms, but most commonly fixed income (bonds), annuities, or rental real estate. For instance, an investor may have a $5 million portfolio of bonds earning 3% interest, or $150,000 of income, which they know they can spend each year without dipping into principal. Psychologically, this approach provides a lot of comfort, but we will explain shortly how it can be flawed.

The second phenomenon is a mindset that once retired and in the latter half of life that portfolios need to be more conservative because there is less time to make up for losses. This mindset dovetails nicely with the first phenomenon, because it leads an investor to the same investments of fixed income (bonds), annuities, or rental real estate.

Let us see how these mindsets play out for our friend, Rick, who decides to use bonds in his portfolio. Assume Rick retires at 65, lives to 90, has annual expenses of $90,000, has $5 million in savings, buys 30-year treasury bonds because they pay the most (3% among treasuries), which means he receives $150,000 per year in interest income, and that Rick's effective tax rate is 23%.

Rick's Age	Portfolio Value	Portfolio Income	Taxes	Living Expenses Adjusted for Inflation	Surplus
65	$5,000,000	$150,000	$34,500	$90,000	$25,500
66	$5,025,500	$150,765	$34,676	$92,700	$23,389
67	$5,048,889	$151,467	$34,837	$95,481	$21,148
68	$5,070,037	$152,101	$34,983	$98,345	$18,772
69	$5,088,810	$152,664	$35,113	$101,296	$16,256
70	$5,105,066	$153,152	$35,225	$104,335	$13,592
75	$5,143,245	$154,297	$35,488	$120,952	($2,144)
80	$5,093,769	$152,813	$35,147	$140,217	($22,551)
85	$4,931,339	$147,940	$34,026	$162,550	($48,636)
90	$4,625,254	$138,758	$31,914	$188,440	($81,597)

You can probably spot the flaws in Rick's approach.

1) Though Treasury bonds avoid state income tax, they are federally taxed as income, so Uncle Sam takes a lot off the top.
2) While the interest income remains as a nice and predictable 3%, it does not take long before this income fails to cover living expenses that increase with inflation.
3) Because inflation takes Rick's expenses beyond his interest income, he needs to start selling bonds, which compounds the issue by reducing his interest income. This also means Rick leaves an estimated $4,625,254 ($2,159,876 adjusted for inflation) instead of the originally expected $5,000,000 to his heirs.

The types of annuities typically used for retirement have similar characteristics as Rick's bond portfolio. You receive predictable income, but it can be heavily taxed and the income remains static while your expenses continue to increase with inflation.

So if these common ways of generating retirement income are flawed, what is the best approach? We argue that the best approach is to focus on *total return (investment income + investment growth)*, not simply interest income. Doing so has the following advantages:

1) More tax efficient
2) Increases the chances of keeping up with or staying ahead of inflation
3) Increases the chances of greater wealth over time

Let us see how this plays out for our friend, Stephanie, who decides to use both bonds and stocks in her portfolio. Assume Stephanie also retires at 65, lives to 90, has annual expenses of $90,000, has $5 million in savings, but buys a balanced portfolio expected to have a 7% average annual return, most of which is stock appreciation, and that Stephanie's effective tax rate is 20%.

Stephanie's Age	Portfolio Value	Portfolio Income & Growth	Taxes	Living Expenses Adjusted for Inflation	Surplus
65	$5,000,000	$350,000	$70,000	$90,000	$190,000
66	$5,190,000	$363,300	$72,660	$92,700	$197,940
67	$5,387,940	$377,156	$75,431	$95,481	$206,244
68	$5,594,184	$391,593	$78,319	$98,345	$214,929
69	$5,809,112	$406,638	$81,328	$101,296	$224,015
70	$6,033,127	$422,319	$84,464	$104,335	$233,520
75	$7,304,948	$511,346	$102,269	$120,952	$288,125
80	$8,876,702	$621,369	$124,274	$140,217	$356,878
85	$10,826,649	$757,865	$151,573	$162,550	$443,742
90	$13,255,066	$927,855	$185,571	$188,440	$553,844

So how does Stephanie get her money? She gets it from two sources: one, from interest and dividend income, and two, from selling stocks as needed. It took Stephanie some time to get used to the paradigm shift of taking some money from the principal instead of only spun off income, but she is reaping the rewards.

1) Her taxes are less than Rick's because she is paying mostly capital gain tax rates instead of income tax rates
2) Her earnings of 7% instead of Rick's 3% are easily covering her expenses as they increase with inflation
3) She is able to leave an estimated $13,255,066 ($6,189,780 adjusted for inflation) to her heirs, OR she could have spent much more than she was throughout her lifetime

Of course portfolio returns are not consistent from year to year as in this example. For instance, there is the risk of bear markets, however below are some reasons why this is a palatable risk.

1) We (and any advisor worth their salt) account for return variability and bear markets in modeling for clients, and even when this is done the story is the same
2) Although Stephanie's portfolio will not return 7% each year, she can reasonably expect to average 7% over her 25-year time frame
3) Although her portfolio could drop, say 30%, in a bear market, she would be withdrawing a very small portion of it each year when it is down, so most of the portfolio is intact to recover
4) Most bear markets recover fairly quickly; for instance, coming through the 2008-2009 bear market, a well-diversified portfolio fully recovered in 23 months
5) Over timeframes like those of Rick and Stephanie's, stocks begin to look much safer. For instance, there is not one 20-year period in history that stocks have been down, and there is not one 30-year period in which bonds have beaten stocks.

Rental real estate offers similar benefits to those found in Stephanie's portfolio. It can be tax efficient due to such aspects as depreciation, the property value is expected to increase, and the rents are expected to increase over time, which enables the income to keep pace with increasing living expenses. While passive income from real estate can work, the investor who chooses to invest in real estate should be prepared for three primary drawbacks: real estate is not diversified, as a colleague put it, “you cannot eat the porch” if the income is insufficient, and if you do need to sell, real estate can be illiquid.

In summary, we encourage you to do your best to escape the mindset that you must live solely off of interest and dividend income in retirement. Instead, focus on total return, which can provide the money you need to fund your retirement. Doing so should increase your chances for financial security due to greater returns and lower taxes, and you are also likely to leave a larger estate to your heirs.

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Footnotes

- Inflation: 3%
- Reference: Chapter 1 of The Little Book of Market Myths by Ken Fisher

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