Building Portfolios to Last

"Having More Income than Months or Years"

By line: Doug Horn, CFP®

Those who retired recently, currently facing retirement, or nearing the monumental date, all face the same question, "Will their assets last their lifetime and provide the income required?"

During the last 30 years, the answer to this question has become more difficult to determine. In 1960, planning for retirement income was manageable. The life expectancy for men was 66.6 and 73.1 for females. Those retiring in 1960 at the typical age of 65 needed to plan for about eight years, only 84 months. Most could easily get their arms around this and were not severely impacted by inflation or investment returns. An inflation rate of 2% only reduces the purchasing power of $1,000 to $850 by the end of the period. And, investments earning 5% require a little less than $79,000 to provide $1,000 per month lasting eight years. Of the $84,000 of income consumed, only $5,000 (5.95% of all distributions) came from appreciation or growth with the balance being met from principle.

Today, the retirement period can be up to 30 years, a far cry from the 1960's. Today's inflation impact on retirees can be significant. Additionally, over a thirty-year period the number of unexpected demands upon cash can be extensive. In the 60's, a retiree might purchase one vehicle during their retirement. Today, it is not unheard of for a couple to purchase four to six vehicles. Another expense facing today's retirees is the care of their home. These costs range from improvements to keep the home up-to-date to the required maintenance, which can often reach into the thousands.

For today's retirees, the same 2% inflation will reduce the purchase power to $545 over the 30 years. Should inflation be closer to 3%, the impact becomes $401. Naturally, retirees facing this type of reduction in purchasing power must counteract it in some way. If the investment accounts permit, it will be an increase in the monthly distributions to keep pace with inflation. And when it doesn't, changes in lifestyle must take place to offset the reduction in buying power.

For decades, investors have always heard their portfolio must become conservative once they retire, as they no longer have the time for the portfolio to recover from losses which may be created from owning stocks. This may create conflicts for investors. They must decide whether to purchase conservative investments, those which generally produce income rather than growth, which they have always heard they should do versus purchasing growth assets such as stocks. For those investors seeking assistance from professional advisors, the question becomes do they listen to those recommending what they have always heard, or follow recommendations which may be contrary to the rule of thumb. As discussed above, the timeframe, needs, and demands have changed significantly; and, if the investment strategies do not change as well, I believe many investors will be disappointed with their financial security during retirement.

To meet the income needs throughout retirement, the portfolio must produce more income and value than what is consumed initially, which can be achieved either through size or performance. To produce the base needs of $1,000 a month for 30 years, $186,281 is needed if the earnings remain at 5%. For retirees today, 48.26% of the income they require comes from the growth of their portfolio versus the principle, increasing the importance of the returns. Earlier, only 5.95% of the distributions over the entire period came from earnings. To reduce this importance on earnings and to provide for the impact of inflation and onetime expenditures, investors could create a portfolio much larger than the $186,000 for each $1,000 of monthly income they are seeking. To achieve this, most likely more of their income throughout their life must be put aside for their retirement which could alter some of their lifestyle decisions and benefits.

Another concern for the traditional retirement portfolio design is the impact rising interest rates could have. It has been many years since we have been in an increasing interest rate environment, and investors may have forgotten how increasing rates causes the value of fixed income type investments to drop in value. Interest rates can also be driven lower by the Federal Reserve when they determine there is a need to stimulate the economy. Most investors have seen the impact of this over the last decade or so. An option used by many is the use of equities in the portfolio, even for retirees. Equities often create increasing income through dividend rate increases. Another benefit equities provide is the tax rate on dividend income is lower than the rate on interest income.

With each investor's needs being unique as well as their life expectancy and size of their portfolio, there is no one solution fits all. But, most advisors and professional investors like Warren Buffett agree equities should be a part of everyone's portfolio and will provide long-term growth.

About the author:
Founded Quality Financial Concepts in 1983 and serves investors locally and across the country.

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