Retired Investor

A series devoted to the issues that face investors in retirement.

Advocating the Paycheck Strategy for Lifetime Investing

The Paycheck Strategy for Lifetime Investing is outside of the current investment paradigm of professional investment advisers, but we believe it can be the basis for a strategy to ensure a flow of income.

Instead of focusing on periodic investment gains and losses, our strategy focuses on buying individual bonds that pay current interest for a retiree's cash flow. We also suggest buying deferred-interest (zero-coupon) bonds to provide a lump sum of cash at some specific time in the future. Creating a predictable cash flow will enable you to focus on the important activities or people in your life without worrying that the markets are moving against you and you have to take action. If you have enough income from other sources (e.g., pensions) to live on and you do not need the current cash flow from your individual bonds, then the cash flow from your bonds can be reinvested for growth at a compound rate of interest.

Unlike institutions and corporations that may live for centuries, an individual has a finite life. An individual investor needs to know how much cash he or she will have to live on in order to tailor his or her lifestyle accordingly. We believe that you should match the due date of your bonds to payment of your known obligations. In addition, you should have enough cash flow to sustain yourself currently or be able to set aside some of your cash flow to increase your principal at a predictable compound rate of return.

Your bonds can come due over the course of years, thereby returning your principal in a laddered succession. Your bond ladder should be custom made for you to meet your financial and life objectives. As we write this, a ladder of longer-term bonds maturing between 15 and 25 years provides the most return. Though you may worry that you might not outlive long-term bonds, we counter that they will ideally be short-term bonds by the time your heirs inherit them.

Our strategy focuses on creating a predictable cash flow from a portfolio of high-quality individual bonds that have a very low credit risk profile. Our strategy is simple, straightforward and easy to understand. However, being outside the accepted paradigm of the diversified portfolio, it may be difficult to accept. Here are the principles:

- *Financial independence is the goal*. The method is to generate predictable cash flow from a portfolio of high-quality individual bonds that you can draw upon if and when needed to provide a supplement if you are working part-time, and to replace your paycheck if you are no longer working. The custom bond ladder is used to create a sufficient cash flow to underpin retirement investing.
- *Paycheck creation is the method*. Semiannual interest payments from your portfolio of individual bonds provide comfort. This is a paycheck you can count on regardless of what your other sources of income are. Accordingly, we believe that you should let your cash flow needs drive your investment strategy, not hoped-for gains from a diversified portfolio. This is the guiding principal of our strategy.
- *This is a strategy for individuals*. Institutions can live indefinitely. However, unlike institutions, individuals have finite lives and may not be able to ride out market volatility. The timing of market highs may not coincide with your need to withdraw funds. If you are dependent on investment gains for income and there is a timing mismatch, your ability to have enough cash to fund a successful retirement may be compromised.

Trading Versus Buy-and-Hold Bond Investing

Mark-to-market accounting is for institutions, not individuals. Institutions must "mark to market," which means they must record gains and losses on their portfolio periodically. We believe that individual investors need not and should not be distracted by mark-to-market accounting when they are building a bond portfolio.

The financial industry focuses on trading strategies, hoping for asset growth that may or may not materialize when you need to draw upon your assets for living expenses. Anticipation of high returns often justifies high annual fees. The reality may be different. For example, you may incur difficult equity markets during your retirement, reducing the size of withdrawals you can make.

Financial Independence

The important goal of a reliable paycheck for individual investors is obscured by the focus on gains and losses inherent in all trading strategies. Paycheck creation can provide financial independence, which we define as the ability to live on your interest income from a portfolio of bonds. You need merely look at your yearly predictable interest paycheck rather than the current value of your portfolio.

Those who invested in high-quality individual bonds saw no reduction in their investment paycheck or in the value of their bonds after the stock market crashes in 1987, 2000 and 2008. We know that bonds will fluctuate in value; however, the cash flow from individual bonds will remain the same. Some pundits will say the failing of bonds is that rising interest rates will result in losses. We respond by saying that if you are able to reinvest some or, if your other sources of income allow, all of the income and also the principal when bonds are called or come due, that rising interest rates are the upside case. Would you rather reinvest at higher or lower yields? And remember, unlike any other asset class, individual bonds are self-liquidating, meaning they come due at a specified date.

Bond investors often achieve their financial independence by being portfolio people. We define that as people who draw cash flow from a number of sources. For example, you might have income coming in from a pension, bonds, Social Security or even part-time work. Investing in bonds may enable you to delay taking Social Security at an early date if you have not already claimed it. The cash flow from the bonds would substitute for the Social Security income. It is well-known that if you can delay taking Social Security until your normal retirement age of 66—or 67 if you were born in 1960 or later—your benefit increase would be a predictable 8% per year, much more than any other conservative investment.

Bond Ladder

A bond ladder of high-quality individual bonds customized for your specific situation is the foundation of the paycheck strategy because there is a predictable cash flow and a predictable return of principal. Every year you could have a bond coming due, returning its face value to you, as well as regular interest payments. For example, if you owned $10,000 Oklahoma State Water Resources Board Revolving Fund bonds due April 1, 2025, the $10,000 would be returned to you on the due date. Meanwhile, every year you would be paid the interest on the bonds semiannually. You need not incur any fees or trading costs once the bonds are purchased.

This paycheck earned from your bond portfolio will supplement your Social Security and other sources of income and bring you within a foreseeable range of financial independence. If not, you should consider the possibility of generating some earned income and/or a reduction of your cost of living to a place of equilibrium, predictability and comfort. As The Economist quoted investment adviser William Bernstein saying, "The purpose of investing is not simply to optimize returns and make yourself rich. The purpose is not to die poor." ➤

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