Scarsdale Investment Group, Ltd.

All Bond Portfolios

Planning for Cash Flow in Retirement

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How do you plan for your cash flow needs in retirement? It is often recommended that you create designated pools or pots of money from which to draw, called investment buckets. The recommended order is to spend down cash first, short-term bonds second, and lastly stocks, which are supposed to increase in value in the long run. We suggest that a high quality, laddered, individual bond portfolio is a more reliable way to support your cash flow needs.

Recommended Current Investment Practices

Individual investors have looked like geniuses for the past eight years because stocks and bonds have gone up together. Increased correlation has made a 60/40 portfolio look like magic beans.

Now stocks and bonds may be correlated the other way, with both stocks and bonds declining in value. Investors are going to be pretty frustrated if they put all that thought into asset allocation, and asset allocation doesn't help.

The traditional 60/40 asset allocation may prove to be undesirable because the inputs about inflation, interest rates, and market movements are all unknowns. In reality we do not know what will happen today, much less than tomorrow.

However, in order to make our world orderly, which is what we need for our own sanity, we buy into the belief that if we know what happened in the past we can predict the future. We hold to the idea that there are predictors which presage the future. We say we are ‘right’ in our call of a recession, for example, even if it comes two years after we said there would be one. If we wait long enough, the inevitable eventually happens. Then we can say: See! I told you it would happen.

What can we say about what will happen today? What we know is that recessions generally happen every four to five years. It has been nine years since the last one, so we may be due for one – if not tomorrow then a two year window is a safer bet.

We know that stock market valuations are near an all-time high and that volatility has picked up. This may be a bad time to retire because of what is called “sequence of return risk.” This is the risk of withdrawing an expected rate of return based on current holdings and performance at the onset of retirement, but the stock market either tumbles or makes only mediocre gains for a prolonged period of time. This is what many analysts currently project as the present market situation. If the expected withdrawal rates based on high stock market returns after inflation do not materialize, the new retiree will withdraw too much at the beginning of retirement in anticipation of market gains that may never come. In this case, the retiree would experience an unsustainable rate of withdrawal – using up unreplaceable assets too quickly. With the nest egg depleted, the new retiree would not have enough assets to recoup and would therefore suffer a financial shortfall toward the end of life.

We can tap recent memory for an example of stock market predictability by looking at the S&P500 in the year 2000. In that year the S&P 500 hovered around 1400 points. It fell to 815 by September 2002. It rebounded about 1,550 points by October 2007 before crashing again. It did not recover to pre-crisis levels until March 2013. If this was your situation, you made zero percent for 13 years. With the recent run up of the stock market, people are feeling much more affluent. However, if you do not close your stock market positions you have not locked in the gains you believe you have made.

Suggested Alternatives for Retirement Planning

What alternatives are suggested if you suffer losses from your diversified portfolio? You can take out a reverse mortgage to draw down the value of home. This is an expensive alternative, but it will provide additional cash flow. You could draw down the cash in a cash–value life insurance policy. You may view these moves as temporary, but more likely they will be permanent and expensive. If you chose these options make sure that you get good impartial advice.

Fixed annuities are a possibility, but you give up your principal for a fixed cash flow. You may need to access a lump sum which may not be available to you. Also, if you lock in a low distribution rate at the time of purchase, you will not be able to take advantage of rising interest rates, unless you purchase an inflation rider which is very expensive. Surprise! Some annuities reserve the right to lower the interest rate they pay to a one percent floor if interest rates fall. All annuities are very complicated. You should have your lawyer review a specimen policy before you sign anything. In addition, consider the possibility that the high quality company selling the annuity may not still own your annuity when you are ready to cash out.

The High Quality Individual Bond Ladder

Bonds are rarely suggested as an alternative because the rates are considered either too low, or about to rise. They get a bad rap because many brokers and advisors consider an investment in bonds to be “dead money.” There is no turnover from which to make fees unless the bonds are traded. A high quality bond portfolio does not need to be traded to produce annual income, but your account may still have to pay annual fees.

However, if you create a laddered portfolio of high quality individual bonds, you can tailor the ladder to your needs. If you ladder your bonds, you will always have some of your principal predictably returned. You will have a known cash flow to complement your social security and any pension benefits. You can plan your retirement in a reasonable way. If your account were not 'managed' by a professional advisor, you would not incur any more fees on your bonds unless you chose to sell.

There are many ways to structure a bond portfolio depending upon how you want to live and what you hope to accomplish. This is really where retirement planning comes in. How can you tailor your lifestyle to your cash flow? What accommodations have to be made to enable you to live a life free of financial worry?

Conclusion

Creating a laddered, high quality portfolio of individual bonds can help you to achieve your lifetime aspirations by creating a predictable cash flow and return of principal. You just need some creative curiosity to realize your dreams.

Do you see the logic in what we have outlined here today? If so, you may call us to discuss whether this strategy is right for you.