PATRICK H. YANKE, CFP® | Financial

Creating Retirement Income with Common Securities

One of the challenges of investing during retirement is providing for annual income while balancing other considerations like liquidity needs, longevity of funds, risk tolerance, and anticipated rates of return for various types of investments. A well thought out asset allocation in retirement is essential. This article discusses some common retirement income vehicles. I will tackle some less-common vehicles in my next article.

BONDS: RETIREMENT'S TRADITIONAL BACKBONE

Buying individual bonds (which are essentially IOUs) at face value and holding them to maturity can provide a predictable income stream and the assurance of principal when the bond matures (unless a bond issuer defaults). It sounds good on paper … but there are risks.

Bonds pay a set amount of simple interest to the bond-holder for the duration of the bond. The amount of interest paid is determined by the open markets through the forces of supply and demand. Bonds traded in the markets adjust their price to account for the interest paid—they are worth more if they pay a rate higher than other similar bonds. This means bonds can lose value as interest rates rise. This shouldn't be a problem for investors who hold bonds to maturity but it can be a significant problem for investors seeking liquidity prior to maturity. Even if held to maturity, the principal amount may lose purchasing power over time due to inflation.

Bonds are a way for an entity to take out a loan. In exchange for investment funds, the entity pays interest until the bond matures. There are two main issues to factor when considering a bond issuer – financial strength and potential tax advantages. The first confirms the ability of the entity to pay interest and return principal at maturity. The second determines how much of the interest paid is taxed. In general, bonds issued by the federal government are exempt from state and local taxes but not federal taxes. Bonds issued by state and local governments are usually (but not always) exempt from federal taxes but may be subject to state, local, and even the alternative minimum tax. Corporate bonds are normally fully taxed. "Tax-free" munis typically yield less than treasuries and corporates due to their tax advantage.

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EQUITIES: GROWTH AND INCOME

Dividend-paying stocks—and managed portfolios that invest in them—can also provide income. Dividends on common stock are subject to the company's earnings—which are influenced by economic, market, and political events as well as decisions by boards of directors each quarter—and are not guaranteed. Dividends can be changed or eliminated. In addition to dividends, equity investors may benefit from compound annual growth rates that should help them keep up with inflation.

Dividends on preferred stocks are different. The rate is fixed and they're paid before any dividend is available for common stockholders. Prices of preferred stocks tend to behave somewhat like bonds. Preferred shares usually pay a higher dividend rate than common shares. Although most preferred stockholders do not have voting rights nor do they participate in company growth, their claims on the company's assets will be satisfied before those of common stockholders, if the company has financial difficulties.

ANNUITIES

The definition of an annuity is "a stream of income you can't outlive." Whereas life insurance protects beneficiaries against an untimely demise, annuities are longevity insurance against outliving income. As with bonds, there are many types of annuity contracts (some with market participation and some without) and the financial strength of issuing insurance companies makes a big difference in benefits. Annuities are not appropriate for everyone nor for every retirement, but they are the only way to create an insured, private pension.

MANY CHOICES

New ways to translate savings into income are constantly being created. These are only a few of the many possibilities and there are many combinations. Consult appropriate tax, legal, and investment professionals to determine which are appropriate for your financial situation.

Patrick Yanke is a Raleigh-based financial advisor. Opinions expressed here are mine and not necessarily those of Raymond James. The information is not a complete summary or statement of all data necessary for making an investment decision and does not constitute a recommendation. This article is not meant to provide tax or legal advice. Please consult the appropriate professionals. www.yankefinancial.com.

Recommended pull quote: "A well thought out asset allocation in retirement is essential."

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