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Turning Your Investment Into a Paycheque

A balanced approach to drawing down a portfolio in retirement

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Countless books and articles explain how Canadians can build wealth during the working years. But when it comes to drawing on that wealth in retirement, things become murkier. Instead of using their income to build a portfolio, retirees must switch gears and use their portfolio to generate income. For those who have spent decades saving and investing for the future, this can be difficult.

Many investors believe this transition requires a new investing strategy in retirement. They may feel they need to move all of their money into conservative income-generating assets such as GICs and bonds.

There is a more sophisticated approach. With professional guidance, Canadians can preserve and grow their capital using the same balanced strategy they used to accumulate it. At the same time, they can meet all of their income needs by drawing down their portfolios in the most tax-efficient way possible.

IT STARTS WITH A PLAN

The first step in managing a retirement portfolio is to carefully consider how much income you'll need to meet your monthly expenses. Surprisingly few people get even this far: a survey of pre-retirees by Richard Day Research (RDR) revealed that two-thirds had not completed a budget of anticipated income and expenses. Only 28% said they understood how much they would be able to spend each month without outliving their savings.[1]

A comprehensive retirement plan will consider all sources of income, including any employer-sponsored pensions, the Canada Pension Plan, and Old Age Security. Professional planning can determine the optimal start date of CPP payments, and help seniors minimize OAS clawbacks.

[1] The Fidelity Investments Retirement Transition Study was conducted by Richard Day Research, Inc. (RDR) in November and December 2004. RDR surveyed 749 pre-retirees within one year of retiring, and 755 retirees within three years of having retired.

WHICH ASSETS DO YOU DRAW FIRST?

In most cases, government benefits will not be sufficient for Canadians who want to enjoy a comfortable lifestyle in retirement. The additional income will have to come from the investor's personal accounts—but which assets should be tapped first? This is not straightforward. The RDR survey found that less than 23%of retirees and pre-retirees understood which income sources to draw first to minimize taxes.

A popular rule of thumb is that non-registered funds should be spent before making withdrawals from an RRSP or RRIF. But this may not be the best long-term strategy. Registered accounts are fully taxed in the year of death, which can result in an enormous tax bill paid by the estate. With careful planning, an adviser can manage the withdrawal of registered funds so that taxes are paid sooner at lower rates, rather than all at once at the highest rate.

Professional planning can also determine whether it would be more tax-efficient to take money out of corporate or holding company accounts rather than drawing from personal funds.

YOU'RE YOUNGER THAN YOU THINK

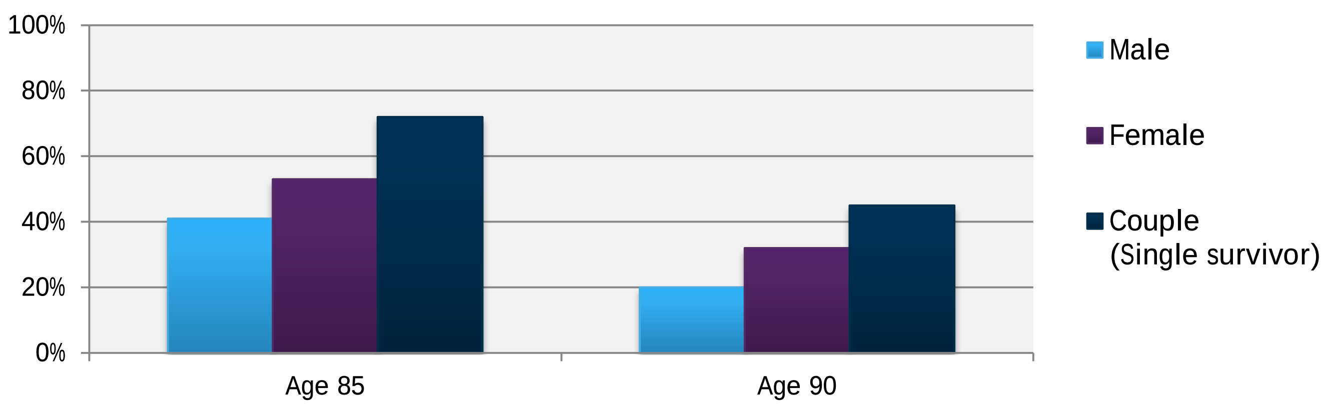
For many retirees, nothing is more palpable than the fear they will outlive their money. Even high-net-worth investors may need to be concerned about this possibility.

Life expectancy in Canada today is about 79 years for men and 83 years for women. But these averages are misleading, because they include all of those who die long before they reach retirement age. Life expectancy in Canada when calculated at the age of 65 puts the average male's life at 83.3 years and at the average female's life at 86.5. In fact, if we measure life expectancy of at least one spouse of married couples and both partners are currently 65, the probability that at least one spouse will reach the age of 90 is close to 50%. In almost one out of five couples who reach age 65, one spouse will live to be 100.[2]

This means that a retirement portfolio must be able to withstand the stress of consumption and inflation for 30 years or more. In many cases, bonds and GICs will not provide the rate of return necessary to accomplish that.

LIFE EXPECTANCY*

Probabilities of 65-year olds living until age 85 and 90



[2] Statistics Canada, CANSIM, Table 102-0512, and Catalogue no. 84-537-XIE. Undated 2011-09-27

*Calculations are based on U.S. mortality data from the Society of Actuaries Retirement Participant 2000 Table (www.Vanguard.com)

MANAGING RISK

Stocks have historically delivered returns that are both greater than bond and GIC returns and higher than inflation, and they should make up a portion of most retirement portfolios. Unfortunately, the higher long-term returns of equities come at a price: stocks are highly volatile in the short to medium term, and we have witnessed many periods where they have underperformed more secure investments.

A properly designed portfolio must capture an investor's required rate of return while keeping volatility to a minimum. Using the principles of Modern Portfolio Theory, an investment manager can accomplish this by determining an appropriate blend of stocks and bonds. All of the equity positions must be broadly diversified across sectors and geography: these positions may include thousands of stocks in dozens of countries.

Finally, the investment manager will ensure that the portfolio maintains a constant level of risk by occasionally rebalancing back to the target mix of equities and fixed income. In a retirement portfolio, this rebalancing can be done when the investor needs to draw from the account for current income. For example, if the portfolio is currently overweight in equities, the required funds can be taken from those positions in order to get the account back to its target.

Retirees who rely on their investments for monthly income face some daunting tasks, and a professional adviser can be a valuable resource. With professional insight, a portfolio can be designed to fend off the ravages of inflation and taxes, minimize volatility, and help retirees maintain a comfortable lifestyle for decades to come.