

*By Christopher E. Grant*

## **Can Retirees Really Retire?**

### **The Hunt for Income**

While the issue of retirement income is hardly a new topic, the challenges faced today are very different from those confronted by past generations. The number of older Americans is growing as people live longer and healthier lives. **According to the U.S. Census Bureau, by 2030, Americans aged 65 and over are expected to represent one-fifth of the U.S. population,** up from 12% in 2000. In fact, for a 65 year-old married couple today, there is a 72% chance that at least one spouse will live to age 85, a 45% chance that one will live to age 90, and an 18% chance that one will reach age 95. Accumulating sufficient assets to generate a continuing "life style" income for this extended life expectancy won't be easy.

### **Do It Yourself Planning**

Compounding the problem is the monumental change in America's corporate pension structure, which has seen the virtual demise of Defined Benefit (DB) plans which often provided lifetime retirement and healthcare benefits. Instead, corporations have substituted defined contribution plans (for example 401(k)s), so that **those leaving the workforce today receive a lump sum payment along with the responsibility and the anxiety of turning this pool of money into a lasting stream of retirement income.**

Our twofold objective in this quarter's newsletter is first, to assess the retirement savings status of the Baby Boomer generation and second, to offer a helping hand as retirees face a particularly daunting task given the current investment climate. For those prone to depression, you may want to skip directly to the solutions.

### **Retirement Going Boom**

For the 78.2 million Americans labeled as the "Baby Boom" generation (having been born from 1946 through 1964), **2011 will be a hallmark year, as roughly 8,000 of the club's oldest members will reach the magic retirement age of 65 every day.** Unfortunately, the statistics on retirement savings for Boomers gathered by the mutual fund giant, Fidelity, paint a bleak picture.

Consider the following statistics: Boomers have \$35,000 in median total household personal retirement savings and typically save only \$2,750 annually for retirement. This means that, on average, **Boomers are on track to replace just 59% of their pre-retirement income.** Even boomers who save in a 401(k) have an average account balance of \$80,000, hardly sufficient to fund retirement. Thus, 69% of Boomers say they will rely on working at least part-time for income in retirement, with 68% of that group working to cover basic expenses and just over half working in order to receive health benefits. Not a pretty picture.

### **Retirement Income, Where Oh Where?**

What, then, are the biggest sources of expected retirement income?

To no one's surprise, a recent Gallup survey found that **one-third of current workers expect Social Security to largely fund their retirement,** the highest Gallup has recorded in this decade-long annual survey, and up 7 percentage points since 2007. Over half of the 1,020 survey participants expect Social Security to be a "major" source of income.

The shift away from pensions is clear as only 23% of respondents are anticipating pension income vs. the 37% receiving pensions

today. However, given the paltry savings statistics quoted above, there seems to be a major disconnect between perception and reality as almost half of respondents still expected to fund their retirement with a 401(k), IRA, Keogh, etc., while less than one fourth of current retirees consider these accounts to be a major source of retirement income.

Where rational interest rates once provided a safe haven for savings account and CD investors, only 13% of current retirees are now using these vehicles to fund retirement. Similarly, the roller coaster ride in stocks and stock funds which has netted virtually no return over the past decade has obviously disappointed investors as **only 1 in 5 current workers think equities will play a significant part of their retirement income**, still higher than the 14% of current retirees who are using stocks or equity funds to pay for part of their living expenses.

The leveraging of home equity via HELOCs (Home Equity Lines of Credit), combined with sinking home values, has eliminated this traditional source of retirement “savings” for many. Today, only 20% of retirees are using their home to fund retirement.

Finally, part-time work is anticipated by many who haven’t saved enough to meet their retirement expenses. As a sign of the times, today, **one in five employees think they will work part time in retirement, double the number in 2001**. Given the employment landscape, however, finding and holding a job may be difficult.

Our status check on baby boomers heading toward retirement is obviously less than heartening. Borrowing and spending have clearly outpaced saving, and the last ten years of alternating market booms and busts has, at best, left investors where they were, heading into the 21<sup>st</sup> century. To top it off, whatever equity had been built up on primary

residences has been substantially eroded by the housing market collapse. Given this current savings gap combined with depressed asset values, knowledgeable and prudent investing will be critical to the oncoming wave of baby boomer retirees.

### The Free Ride is Over

For retirees who have historically relied on CDs, Treasuries, or bonds for safe and inflation-beating cash flow, the free ride is over. From a peak rate of 15.8% in September of 1981, the 10-year Treasury yield has steadily declined to today’s 2.5% level. And, while coupon returns have gradually fallen during this nearly thirty-year timeframe, offsetting increases in principal values have actually boosted total returns for fixed income investors. (We’ll detail more on the inverse relationship between shifts in interest rates and bond principal values below.)

But first, let’s take a look at the dearth of fixed income opportunities now available. The “riskless” benchmark U.S. Treasury market offers .15% for one month, .19% for six months and a whopping .26% for one year. For those who would like to lock in for longer periods in order to capture higher coupons, the 5-year, 10-year, and 30-year Treasury yields are 1.125%, 2.5% and 4%, respectively. Money markets (1.25% best rate) and bank CDs (37-month, 1.01%; 45-month, 1.25%; 58-month, 1.76% at Wells Fargo) are no better. And, **even though the official September, 2010 12-month CPI was 1.1%, the food, energy and medical care services components (obviously highly important to retirees) ran at 1.4%, 3.8% and 3.7%, respectively.**

Clearly, these miniscule risk-free yields will generate almost no cash flow and are even at risk for suffering negative after-inflation real returns. To add insult to injury, there will be no Cost of Living Increase for Social Security recipients for the second year in a

row. Unfortunately for bond investors, the near-term outlook gets even tougher.

### Are Bonds the Next Bubble?

After experiencing the bursting of the technology and credit-fueled bubbles in 2000 and 2008, many money managers are warning that a third balloon is about to pop – in bonds. Paradoxically, this latest bubble isn't forming because of a rush into risky assets; but rather because anxious investors have stampeded into bonds in an effort to minimize risk and dodge a repeat of their equity losses. With interest rates almost certain to rise in coming years from today's near zero base, bond values are about to get slammed. This vulnerability to rising rates will surprise many investors, since holding a bond to maturity guarantees the return of the full principal value. Not so with bond mutual funds. For the first time in roughly 30 years, bond fund investors are about to be confronted with what is known as duration risk, a term used to measure the relationship between interest rate movements and bond principal values.

### Rates Up, Bonds Down

Without going into the complex calculation methodology, suffice to say that the "modified duration" of a bond is a measure of its price sensitivity to interest rate movements, based on the average time to maturity of its interest and principal cash flows. Duration enables the investor to more easily compare bonds with different maturities and coupon rates by creating a simple rule: with every percentage change in interest rates, the bond's value will decline by its modified duration, stated as a percentage. For example, **at the current 4% yield, the 10-year Treasury has a duration of 8.44 years, meaning that if the 10-year rate went up 1% from 4% to 5%, the 10-year Treasury would be expected to decline in price by 8.44%.** Not a problem if you like your bond and won't have to liquidate it prior to maturity; but potentially a major issue if the security is inside a bond

fund that suffers the price decline with no date-certain maturity protection. If we are truly at an inflection point with rates about to reverse their long-term downward trend, understanding the risk tradeoff between current yield and duration exposure is vital.

Having at least hoisted the cautionary flag for bond investors, we now shift to a description of some of the alternatives that can be used to build a retirement income portfolio. While identifying and understanding these many options can only improve the opportunities for success, the selection process will necessarily be a matter of risk appetite and individual circumstance.

### Bonds That Won't Go Bye-Bye

Even with the potential hazards associated with a cyclical reversal in interest rates, abandoning the entire bond category would be a mistake. A number of niche opportunities are available that provide variations on individual Treasuries or investment grade corporate bonds. These include Treasury Inflation Protected Securities (TIPS), floating-rate bond funds, high-yield ("junk bond") funds, convertible bond funds and foreign or emerging market bond funds.

### Riding Rates and Inflation

Treasure Inflation Protected Securities or TIPS are issued by the U.S. government and are designed to protect investors from inflation which, theoretically, would be reflected in rising interest rates. Every six months, TIPS pay a fixed interest rate and adjust the underlying principal value based on increases (or decreases) in the CPI index. TIPS are available in 5, 10, and 30 year maturities.

Second, floating rate or "bank loan" funds offer a solution to the duration risk outlined above, since the rate on the loans resets between every 30 and 90 days based on the London Interbank Offering Rate, or LIBOR.

This means their payment rates will climb along with increases in market interest rates. **What is introduced into the equation is credit risk since these loans, even though they are generally collateralized, garner an average credit rating of just BB, well below the definition of “junk.”** Managers of these funds argue that their holdings shouldn't be equated with high-yield credit risk since they are senior and secured, with recoveries from default twice as high as high-yield bonds. Still, the category lost an average of 27% during the 2008 credit meltdown while high-yield bond funds fell 26%. Although both categories recovered in '09 gaining 41% and 47%, respectively, reaching for the 2.5% yield premium over comparable investment grade floaters carries substantial risk.

### There's Junk and There's JUNK

Next are fixed-rate, high-yield bonds, which require individual fund analysis since each fund will be a unique combination of duration, credit rating, and yield. For example, among the nearly 600 high-yield bond funds tracked by Morningstar, the effective duration ranges from 1.5 to 6.6 years, while the percentage of sub-investment grade holdings ranges from 35% up to 100%. Accordingly, the 12-month yield ranges from under 4% up to 13.5%. While past performance is no guarantee for the future, picking an experienced management team that has demonstrated strong underwriting capability is a good place to start.

### Part Bond, Part Stock

Convertible bonds, our fourth sector (convertible preferred stocks have similar characteristics), are a hybrid of stocks and bonds as they are income-producing investments that can be converted into shares of the company's stock. Here, too, there are different management strategies ranging from pure income for “burned out

converts” where the conversion price is judged to be unachievable, to a combination of income and appreciation for those securities where the conversion option is still in play. As with the high-yield sector, experienced management specializing in convertibles is a must.

### Dodging the Dollar

Finally, **foreign and emerging market bond funds present similar duration and credit risks while also introducing currency fluctuation as an additional consideration.** For investors concerned with a long-term depreciation in the U.S. dollar, diversification into foreign sovereign debt is a logical solution.

### Finding A Place for Stocks

Shifting from the fixed income to the equity markets, there is another diversified menu of income-oriented approaches. Since it would be impossible to cover every variation on a theme, we will focus on the major categories of high-dividend stocks, preferred stocks, Master Limited Partnerships (MLPs), utilities, and real estate investment trusts (REITs).

### Core Dividend Payers

Before investing in high dividend-paying stocks, one needs to understand that these companies are openly choosing not to reinvest profits to fuel future growth. Instead, they are likely to be mature companies with limited or regulated growth potential and less opportunity for expansion. For those uncomfortable doing their own “stock picking,” dividend strategies are available via both mutual funds and exchange traded funds.

Two important points: First, **unless you are focused entirely on income, maintaining at least some allocation to non-dividend paying stocks will help capture the gains from tomorrow's high flyers.** Second, even if you want only income generators,

stay diversified by sector. Remember how the big payouts from financial institutions disappeared during the credit meltdown. Caveat: Continuation of the favorable 15% tax treatment afforded Qualified Dividends is currently in limbo until Congress acts on the January 2011 expiration of the current law.

### Preferred Treatment

Preferred (and Trust preferred) stocks get their name because the shares get preference when a company pays out dividends. As recent history has shown, preferred shares may continue to receive dividends, even when payments to common shareholders are suspended. In the case of cumulative preferred stock, any suspended preferred dividends must be paid in full before common shareholders begin receiving dividends. Within the corporate capital structure, preferred shareholders stand between the debt holders and common stock holders.

Given these priorities, what is the cost of this preferential treatment? Generally, investors buy preferreds primarily for income rather than capital appreciation. Thus, **preferred stock holders will receive a higher payout than their big brother bondholders while sacrificing potential price appreciation compared to the common shareholders.** Though it is possible to buy preferred stocks individually, utilizing a mutual fund or ETF will provide diversification of company risk and leave the navigating of complex provisions to specialists in this market.

### Pipeline Income

Since Master Limited Partnerships (MLPs) have garnered so much recent attention due to their higher payouts, we want to at least acquaint those who are not familiar with this asset class. Although traded like stocks, MLPs are structured as partnerships for tax purposes with investors owning partnership units rather than shares. MLPs are limited to the energy sector (due to the preferential tax treatment) and include natural gas pipeline

operators, crude oil or refined petroleum product pipelines, propane distributors as well as some in the exploration and production side of the business.

The partnership structure allows MLPs not to pay federal income taxes, since they must distribute their earnings to shareholders. Due to depreciation and other tax deductions, investors are taxed currently on only 10-20% of the cash distribution with the balance deferred until the units are sold. Although this tax treatment can complicate filing, the hassle may be worth it. **Most popular among MLPs are the pipeline and storage companies whose performances have historically been more stable.** Simply picking a high distribution partnership can be disastrous, while learning the terminology and performing in-depth due diligence can provide comfort in selecting a long-term cash flow generator.

### Utilities: Power and Income Generators

Two specialty equity categories often targeted for income investing have been utilities and real estate investment trusts (REITs). In both cases, the choices are diverse, again making careful selection for a portfolio "fit" a must. Within the utility sector, well-managed electric utilities have historically been excellent candidates for a dividend-oriented portfolio. As a regulated category with somewhat targeted profit levels both restricted and protected by rate regulation, electric utilities have been slow growth cash machines that have paid out a high percentage of profits as dividends to shareholders.

Some of the basic ground rules for selection include the following: **Look for consistent earnings growth, a long history of rising dividends and a reasonable payout ratio,** the ratio of dividends to earnings. A low payout ratio (less than 70%) may indicate the possibility of future dividend increases where a very high payout ratio (greater than

90%) may be a warning that the company is struggling and that the dividend is not sustainable. For those not into individual stock selection, diversified utility funds and ETFs are plentiful. Still, a quick look inside the wrapper will confirm if the underlying strategy meets your individual objectives.

### **REITS: Real Estate Ownership without Being a Landlord**

Real estate investment trusts (REITs) are companies that own and most often actively manage income-producing commercial real estate. Because of the unique non-taxpaying trust structure, REITs are required to distribute at least 90% of their taxable income to shareholders annually in the form of dividends. As a result, REIT dividends are taxable as ordinary income and do not receive the preferential tax treatment of qualified dividends. REIT investing offers as many flavors as there are sectors in the real estate market; apartment, healthcare, hotel industrial, office retail, and storage just to name a few.

Somewhat akin to MLP investing, it is important to learn the language of the industry and understand the basic metrics. For example, because net income takes the non-cash deductions for depreciation and amortization into account, a more accurate measurement of performance common in the industry is Funds From Operations (FFO). **Unless an investor possesses individual expertise in real estate, utilizing a fund of**

**REITs managed by a team of professionals is probably the preferred methodology for portfolio inclusion.** Just like utilities, a little homework on both the management and holdings will confirm an appropriate match.

Our tour of retirement income alternatives is obviously not all-inclusive. In particular, we have deliberately left the topic of annuities for another day. **While an annuity may be an appropriate component of a retirement income portfolio, today's offerings can be highly complex and should be fully explained and understood before purchase.**

### **Retirement: Difficult But Doable**

The Baby Boomer generation is, at best, under-prepared for the economic trials and tribulations they will face in their fast approaching retirement. **Not only will many boomers have the newfound responsibility of managing their own retirement finances, the investment climate of all-time low interest rates and a grudgingly slow economic recovery will only add to this challenge.** Greater investment knowledge coupled with on-going diligence will be keys to success. Grant/GrossMendelsohn stands ready to help guide clients through the maze of choices and provide solutions that will meet each individual's needs and objectives.

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