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Retirement Income Investing: Beyond Annuities

One of the challenges of investing during retirement is providing for annual income while balancing that need with other considerations, such as liquidity, how long you need your funds to last, your risk tolerance, and anticipated rates of return for various types of investments. Annuities may be seen as a full or partial solution, since they can offer stable income or guaranteed lifetime payments (subject to the claims-paying ability of the issuer). However, they're not right for everyone.

A well-thought-out asset allocation in retirement is essential. While income investments alone are unlikely to meet all your needs, it's important to understand some of the most common non-annuity investments that can provide income as part of your overall investment strategy.

Bonds: retirement's traditional backbone

A bond portfolio can help you address investment goals in multiple ways. Buying individual bonds (which are essentially IOUs) at their face values and holding them to maturity can provide a predictable income stream and the assurance that unless a bond issuer defaults, you'll receive the principal when the bond matures. (Bear in mind that if a bond is callable, it may be redeemed early, and you would have to replace that income.) You also can buy bonds through mutual funds or exchange-traded funds (ETFs). Depending on your circumstances, funds may provide greater diversification at a lower cost than individual bonds. However, a bond fund has no specific maturity date and therefore behaves differently from an individual bond, though like an individual bond, its price typically moves in the opposite direction from interest rates.

Before investing in a mutual fund, carefully consider the investment objectives, risks, charges, and expenses of the fund, which are contained in the prospectus available from the fund. Read the prospectus carefully before investing.

Consider the issuer

Bonds are available from many types of issuers, including corporations, the U.S. Treasury, local and state governments, governmental agencies, and foreign governments. Each type is taxed differently. For example, the income from Treasury securities (unlike corporate bonds) is exempt from state and local taxes but not from federal taxes.

Bonds issued by state and local governments, commonly called municipal bonds or munis, are just the opposite. Often a staple for retirees in a high tax bracket, munis generally are exempt from federal income tax (though specific issues may be taxable), but may be subject to state or local taxes. Largely because of that tax advantage, a tax-free bond typically yields less than a corporate bond with the same maturity. You'll need to compare a muni's tax-equivalent yield to know whether it makes sense on an after-tax basis.

Think about bond maturities

Bond prices can drop when interest rates and/or inflation rise, because their fixed income will buy less over time. Inflation affects prices of long-term bonds--those with maturities of 10 or more years--the most. One way to keep a bond portfolio flexible is to use so-called laddering: buying bonds with various maturities. As each matures, its proceeds can be reinvested. If bond yields are up, you benefit from higher rates; if yields are down, you have the option of choosing a different maturity or investment.

Certificates of deposit/savings accounts

Certificates of deposit (CDs), which offer a fixed interest rate for a specific time period, usually pay higher interest than a regular savings account, and you typically can have interest paid at regularly scheduled intervals. A CD can be rolled over to a new CD or another investment when it matures, though you may not get the same interest rate, and you'll pay a penalty if you cash it in early. A high-yield savings account also pays interest, and, like a CD, is FDIC-insured up to $250,000 (though that amount is scheduled to revert to the earlier $100,000 standard guarantee as of Jan. 1, 2014).

Stocks offering dividends

Dividend-paying stocks, as well as mutual funds and ETFs that invest in them, also can provide income. Because dividends on common stock are subject to the company's performance and a decision by its board of directors each quarter, they may not be as predictable as income from a bond.

However, dividends on preferred stock are different; the rate is fixed and they're paid before any dividend is available for common stockholders. That fixed payment means that prices of

preferred stocks tend to behave somewhat like bonds. Preferred shares usually pay a higher dividend rate than common shares, and though most preferred stockholders do not have voting rights, their claims on the company's assets will be satisfied before those of common stockholders if the company has financial difficulties. However, a company is often permitted to call in preferred shares at a predetermined future date, and preferred stockholders do not participate in a company's growth as fully as common shareholders would.

Pass-through securities/REITs

Some investments are designed to act as a conduit for income from underlying assets. For example, mortgage-related securities represent an ownership interest in mortgage loans made by financial institutions. The most basic of these, known as pass-throughs, represent a direct ownership interest in a trust that consists of a pool of mortgages. Examples of pass-throughs include securities issued by the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association.

Certain types of investment trusts--for example, REITs that buy, develop, manage, or sell real estate--don't owe taxes as long as they pay out at least 90% of their net income to investors. That payout has traditionally made them popular as an income vehicle and portfolio diversifier (though diversification alone does not guarantee a profit or ensure against a loss). There are many types of REITs, so be sure you understand how the one you choose functions before investing.

Automated inflation fighting

Some investments are designed to fight inflation for you. Treasury Inflation-Protected Securities (TIPS) pay a slightly lower fixed interest rate than regular Treasuries. However, your principal is automatically adjusted twice a year to match changes in the Consumer Price Index (CPI). Those adjusted amounts are used to calculate your interest payments.

That inflation adjustment means that if you hold a TIPS until it matures, your repaid principal will likely be higher than when you bought it (the government guarantees it will not be less). However, you can still lose money if you sell a TIPS before maturity. Inflation rates change, and other interest rates can affect the value of a TIPS. If inflation is lower than expected, the total return on a TIPS could actually be less than that of a comparable non-indexed Treasury. Also, federal taxes on the interest and increases in your principal are owed yearly even though additions to principal aren't paid until a TIPS matures. Inflation-linked CDs function much like TIPS, but you'll generally owe federal, state, and local taxes each year.

Some retirees put all their money into bonds, only to suffer from the impact of years of inflation. If you get a 4% return and inflation is 3% annually, your real return is only about 1%--not counting any fees or taxes. Retiring is no reason to turn your back on growth-oriented investments, though they may involve greater volatility and past performance doesn't guarantee future results.

Some mutual funds are managed with an eye toward inflation. A mutual fund that invests in inflation-protected securities pays out not only the interest but also any annual inflation adjustments, which are taxable each year as short-term capital gains. Some funds target inflation by mixing TIPS with floating-rate loans, commodity-linked notes, real estate-related investments, stocks, and bonds.

Distribution funds

Some mutual funds are designed to provide an income stream from year to year. Available as part of a series, each fund designates a percentage of your assets to be distributed each year as scheduled payments, usually monthly or quarterly. Some funds are designed to last over a specific time period and plan to distribute all your assets by the end of that time; others focus on capital preservation, make payments only from earnings, and have no end date. You may withdraw money at any time from a distribution fund; however, that may reduce future returns. Also, payments may vary, and there is no guarantee a fund will achieve the desired return.

Many choices

New ways to help you translate savings into income are constantly being created. These are only a few of the possibilities and there's more to understand about each of them.

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