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FINANCIAL PLANNING

Cash Flow Stability

These strategies will help you create a steady cash flow for your clients.

For your clients approaching retirement, the most important IRA attribute is a reliable income stream. The ability to generate consistent and satisfactory annual cash flow takes precedence over all other considerations, including capital growth.

That's a major shift from just a couple of years ago. In light of increased market volatility, those in or nearing retirement have become acutely aware that while they can't spend appreciation, they can spend cash flow. As advisors and managers, how can we help produce steady cash flow for these clients?

An approach that works

One approach that has worked for our firm in recent years is an asset allocation for IRA and other retirement accounts composed of dividend stocks, bonds and REITs. The equity component of this allocation took a beating earlier in the decade when value investing fell out of favor, and investors abandoned dividend stocks in favor of growth issues.

Not many investors cared to hear about single-digit dividends when growth stocks were delivering 25 percent to 35 percent annual total returns. But the market upheaval of the past few years helped change that viewpoint. Today, those reliable dividend payouts look pretty good, especially for retirees dependent upon the income. Should the market reverse itself, their cash flow remains intact.

Strong earnings from dividend-paying stocks provide the opportunity to capture companies' net cash flow while waiting for the market to once again offer a higher multiple on earnings. Investors are paid to wait. For example, a stock with a reliable dividend before the market correction may have been at \$70 a share, but then dropped to \$40, at which point it could be paying close to a 9 percent yield. By now the stock may have rebounded to \$55 to \$60 per share, but the yield is still about 6.5 percent. The stock price has yo-yoed, but the dividend remains in place.

When the Dow was at 14,000, not many dividend stocks paid a yield worth noting, but at 10,000, many more of these stocks are worth exploring for retirement portfolios. Currently, dividend yields of 4 percent to 6.5 percent are generally available.

For taxable accounts, we've utilized a combination of dividend stocks and municipal bonds purchased at a discount. We use primarily individual issues because if interest rates rise as expected and even if the bond value declines as interest rates rise, the bonds can simply be held to maturity where they are paid off at par.

Selecting munis

Naturally, municipals must be evaluated for their source of repayment, insurance and rating. Not every muni is worthwhile. There are fewer good values available today than a year ago, so there's more research necessary. But the effort can still pay dividends, if you'll excuse the pun. Moreover, should tax rates rise, which seems likely, munis may be the only tax haven remaining.

Another-fixed income component that is often overlooked is Build America Bonds, which offer taxable returns like a corporate bond but with the risk profile of municipals. They represent an opportunity to move fearful investors back into the market while reaping returns that are much higher than what they get from CDs.

REITs have been beaten down lately as a result of the sagging commercial real estate market, but there are some with the money to scoop up bargains in the depressed real estate market.

Private REITs with cash to deploy now focus on specific niches, such as health care, triple net leases to stronger companies and distressed but performing properties offering opportunities for stable income streams. They have current yields that can compete favorably with both bonds and higher-yielding stocks, appear to be able to keep up with inflation and generate capital appreciation for the long term.

As with the bond issues mentioned earlier, rigorous research into both the program and the sponsor is critical. Private REITs must be considered illiquid, typically have specific and higher investor qualifications and are subject to more restrictive suitability considerations. Public REITs offer opportunities for strong cash flow but can be more susceptible to market volatility; so it's a good idea to consider a mix of both private and public issues to help ensure consistency.

The strategy has helped us gain market share during a challenging period. Many investors express disappointment after falling far below what they remember as their old high water mark. As you know, portfolio shrinkage of 50 percent or more is not uncommon in recent times, and for those in or approaching retirement, the prospect of severely reduced income is worrisome, to say the least.

In these instances, we've discovered that investors are more concerned about the security of their lifestyle than their total wealth. When we can focus them on income vs. appreciation and demonstrate a lower volatility method of helping secure reliable cash flow, we are able to restore their confidence in the future. □

Laila Pence is a registered representative with and securities offered through LPL Financial. Member FINRA/SIPC. Visit us at Pencewealthmanagement.com.