Tips, Tricks and Strategies for Making IRIS Work for You
While generating income is obviously an important part of income investing, it’s not the only part. Income investors should actually be pursuing some combination of four goals simultaneously. The first is capital preservation, or safety. The second and most obvious is current income. The third is capital appreciation, or growth. And the fourth, and possibly most overlooked, is future income.

When we surveyed a large group of income investors earlier this year, 49% ranked Safety (protection of capital) as their number one priority, above Income and Growth (capital appreciation).

However, 65% of the same group of respondents classified their risk tolerance as “Medium,” defined as being “OK with occasional 10%-20% losses.”

Knowing your risk tolerance, your income expectations, and your priorities are the first steps to creating an income portfolio that works for you.

I can’t tell you what those are; you have to figure it out for yourself. Some of the answers will be defined by your gut feeling: how do you feel when you lose 20% on a position that makes up 1% of your portfolio? What if you lose 5%?

Other answers will be defined by your circumstances. How old are you? How many other sources of income do you have or expect to have when you retire? What are your living expenses like? Do you expect them to increase or decrease in the future?

I want you to consider the answers to these questions, and any other circumstances, needs or preferences that might affect your priorities, and then try to rank the four goals of income investing in the box at right.

These might change over time: if you’re not retired yet, you’re probably going to rank future income above current income now, but you might switch them once you are retired. Preservation of capital may also become more or less important to you as you age.

Once you’ve thought about your priorities, you can start trying to craft a portfolio that meets your goals.

If future income is important to you, either because you’re anticipating retirement or simply because you expect your demands on your investment income to be higher in the future, then you should focus on securing a growing income stream now, by buying investments with excellent dividend growth potential.
If you're very risk averse, and have every penny of your savings earmarked for a future expense, your first priority will be **safety**—preserving the capital you have by buying very safe income investments. You may be able to become more aggressive once you've grown your nest egg a bit.

If you're already into your retirement, your top priority might be **current income**. If that's the case, there's nothing wrong with stretching for some yield now, when you can use it.

And if your top priority right now is **growth**, you're probably planning to invest only part of your portfolio in income-generating investments, and focusing on dividend payers that also have growth potential.

Most likely, you're in some mix of these scenarios, and you want to create a portfolio with a little of each ability. That's what **IRIS**, our Individualized Retirement Income System, and this report are designed to help you do.

**What to Buy for Safety**

If your primary goal is capital preservation, you should focus on conservative fixed income vehicles designed not to lose value, and possibly establishing some long-term positions in high-quality, low-volatility dividend stocks.

**Bonds** have historically been recommended for investors who wanted to preserve their capital above all else. However, bond prices are likely to decline sharply in the years ahead, as interest rates rise. Standard bond funds will not be a good store of value, because they're particularly susceptible to yield curve risk in a rising rate environment (they're forced to regularly unload bonds at the shorter end of the yield curve while buying bonds at the longer end of the curve—for example, a bond ETF that tracks a three-to-seven-year bond index will constantly be selling bonds once they fall below three years to maturity and replacing them with bonds that don't mature for seven years.)

If you're going to hold bonds, be sure you are investing in them in a way that preserves your principal guarantee—which refers to the fact that, regardless of what happens to the bond price, you always get your principal back when the bond matures. For this to work, you have to hold individual bonds with a principal date you'll be around for. If you're holding a 30-year bond, you **will** be able to redeem it for full value in 30 years, but a lot can happen in the interim, including the bond losing much of its value for a time. If something unexpected happens, you or your heirs may be forced to sell it at a disadvantageous price.

The principal guarantee also only works if you buy the bond at or below face value. If you buy the bond for above redemption value, you'll lose some of your investment when you redeem it. (This might be worth it for the yield in the meantime; use a calculator like the one at **www.moneychimp.com/calculator/bond_yield_calculator.htm** to decide.)
Also, if safety is important to you, you should only invest in investment-grade bonds.

If you decide to hold some of your portfolio in bonds, you can either buy individual bonds (I suggest bonds with maturities no further than 10 years out; you can also try laddering them), or a bond fund with a maturity date, like one of the Guggenheim BulletShares ETFs.

**Preferred Shares** are another type of fixed income investment that can be a good store of value, if used correctly. You can read about the nuts and bolts of preferred shares in my *Complete Retirement Income Guide*. Preferreds have a par value like bonds, but they don’t always have a maturity date, so you can’t always count on getting your principal back. Also carefully consider how interest rate changes will affect the issue, how likely it is to be called, and how creditworthy the issuer is before buying preferreds for capital preservation.

Some **Dividend-Paying Stocks** can also be used in the “safe income” portion of your portfolio. **Utilities** are usually very reliable dividend payers with very low volatility, for reasons explained in my *Complete Retirement Income Guide*. In addition, blue-chip holdings that you’ve owned for years can be good “core holdings” for your safe income portfolio, especially if you already have a good profit cushion.

You should also ensure your portfolio is very well diversified, so that adverse market events that disproportionately affect certain asset classes, industries or types of investments will have a minimal impact on your overall portfolio. Also ensure you are only invested in very liquid securities, and that your positions aren’t so large that they might be difficult to liquidate if necessary.

**What to Buy for Growth**

Many of the income investors we surveyed said they were interested in dividend-paying stocks that also have growth potential. This is not a contradiction! Many still-growing companies choose to pay some of their earnings out as dividends, while retaining plenty of cash for reinvesting in and growing their business.

You’ll want to consider **Dividend-Paying Stocks** that show earnings growth and have low payout ratios (showing the company is retaining enough cash to keep its business growing). You may also want to focus on stocks whose charts are in uptrends, or on stocks that are undervalued, leaving room for price appreciation.

One more factor to consider is when the company began paying a dividend. Companies that started paying dividends more recently, like Apple (AAPL), are usually still in an earlier stage of growth than companies that have been paying dividends for decades.
What to Buy for Current Income

If your current priority is to generate as much income from your portfolio as possible, there’s nothing wrong with reaching for yield from High-Yield Investments. These can include Master Limited Partnerships (MLPs), Real Estate Investment Trusts (REITs), and high-yield Dividend-Paying Stocks. You might also find some high yield Closed End Funds (CEFs) you like, which can invest in fixed income and equities, or use strategies like covered calls to boost income. See my Complete Retirement Income Guide for more information on all these investment types.

For investors focused on current income, an investment’s yield is the most important piece of information. However, you’ll probably also want to know that the investment will keep paying that dividend for the foreseeable future. IRIS’ Dividend Safety Ratings and Dividend Growth Ratings can help you there.

What to Buy for Future Income

Lastly, we get to my favorite topic. If you’re getting into income investing early enough that you can focus more on future income than current income, you’re both smart and lucky. Young people are always being told how much impact their money can have if they start saving it early; investments in dividend-paying stocks work kind of the same way.

In my Complete Retirement Income Guide, you’ll find a full explanation of why dividend growth is so powerful. In short, low-yielding stocks that you buy today can turn into some of your highest yielders over time, thanks to the power of dividend growth.

If setting your portfolio up to generate future income is one of your priorities (and I really think it should be, unless you have a very short investment timeline), then you need to be buying stocks with excellent dividend growth potential.

IRIS finds these stocks by assigning every stock in our universe a proprietary Dividend Growth Rating. This rating is based on both the stock’s dividend growth history and its potential to keep up its rate of dividend growth. Looking backward, we take into consideration the stock’s past dividend growth rate and history of dividend increases. Looking forward, we focus on the company’s expected earnings growth, since cash is the number one factor that determines a company’s ability to pay its dividend.

These factors contribute to the stock’s Dividend Growth Rating, which is a number between 0 and 10.

Stocks that rank high on our Dividend Growth Rating have shown a commitment to dividend growth, and also look likely to be able to maintain this commitment going forward.
If you are primarily concerned with future income, you should load your portfolio up with the highest-ranking Dividend Growth stocks we recommend. These are companies that are still growing fast enough to reward investors more handsomely every year. If you also select high-quality companies with the financial strength to thrive in varied market conditions, you should be able to let your dividend growth portfolio sit untouched until you need it, and then enjoy a strong, consistent income stream when you want it.

If future income is your primary goal and current income does not rank high among your priorities, you may also want to consider reinvesting your dividends in some of your dividend growth stocks for now. These reinvested dividends will gradually increase your position in the stock, so when you start opting for those dividend checks, they’ll be even larger.

**Putting It All Together**

As I noted above, most investors are going to aim for some combination of the above goals. Thinking about your rankings from earlier, and the types of investments that are best for achieving each goal, try filling out this simple table of target asset allocations:

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<thead>
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<th>% of Portfolio</th>
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<tbody>
<tr>
<td>Safe Income</td>
<td></td>
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<tr>
<td>Dividend Growth</td>
<td></td>
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<tr>
<td>High Yield</td>
<td>100%</td>
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If your primary goal is capital preservation, Safe Income investments should make up most of your portfolio. If you’re eager to secure a growing income stream for the future, Dividend Growth stocks will be your bread and butter. If current income is your number one priority, you’ll dedicate more of your portfolio to the High-Yield tier. And if all three are important to you, your portfolio may be close to evenly divided.

Congratulations! You’re ready to start investing for income.

In the coming weeks, I’ll be sending you a guide to getting started with *Cabot Dividend Investor*, which will show how you can use our recommendations to fill out the perfect portfolio you just created. Then, it’s time to get down to business with the recommendations themselves—I know you’re probably eager to get started. But remember, defining your goals today will help you be a much more successful investor tomorrow.
About the Expert

Tom Hutchinson is the Chief Analyst of Cabot Dividend Investor, Cabot Income Advisor and Cabot Retirement Club. He is a Wall Street veteran with extensive experience in multiple areas within the financial world. His experience includes specialized work in mortgage banking, commodity trading and as a financial advisor at several of the nation's largest investment banks.

For more than a decade Tom created and actively managed investment portfolios for private investors, corporate clients, pension plans and 401Ks. He has a long track record of successfully building wealth as well as providing a high income while maintaining and growing principal. With Cabot Dividend Investor, Tom combines a scientific, quantitative approach to stock analysis with the practical, personal and honest advice that have characterized Cabot’s services since 1970.