Your Complete Guide to Investing for Retirement

How to Invest Smarter and Enjoy Retirement More
By Tom Hutchinson, Chief Analyst, Cabot Dividend Investor, Cabot Income Advisor, and Cabot Retirement Club

Retirement is an exciting goal: time to pursue your passions, relax, and enjoy everything you’ve worked for your whole life. But it also brings new challenges—not the least of which is figuring out how to fund your new lifestyle when you’re no longer receiving paychecks every month. Most retirees rely on investments to fund at least part of their retirement and investing success can mean the difference between scraping by and living it up in your golden years. This handbook is designed to help you secure a better, longer, richer retirement for yourself by making the most of your savings both before and during retirement.
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STEP 1: GETTING STARTED

How Will Your Goals Change In Retirement?

Often, people first become interested in investing as they approach retirement, or after retiring, when they have more free time and a more direct interest in how their investments are faring. Even people who have been saving for retirement their whole lives often leave the investing up to their 401(k) or IRA manager during their working years. If you’re one of these investors, you’re in good company and can get up to speed quickly.

On the other hand, if you’ve been an investor your whole life, you might be wondering what will change once you retire, or how you should adapt your strategies to retirement. This guide can help you there too.

How Is Investing For Retirement Different?

If you’ve been investing for a long time already, you’ve probably pursued capital appreciation as your primary goal. That means buying investments that you believe will go up in price, then selling at some point, once your initial investment has increased in value.

Capital appreciation is still important for retirees, but most will also have an additional goal: income.

You may have used an investment account to save and earn money for a big purchase in the past, like a house or college education. Once you had enough—or it was time to send your kids to college—you withdrew a big chunk of money. But most of the time, investing when you’re still earning is more about making money than taking money out.

In retirement, you still want to make money, but you also probably want to cash in some of your investments to pay for things. That can mean selling a chunk of stock so you can afford a luxury cruise, or just withdrawing a little bit every month to pay the bills. Or both.

For investors who’ve spent all their lives adding to their nest egg every month, helping it grow by carefully choosing the best investments, it can be stressful, disorienting and even a little scary to suddenly start doing the opposite. Even with the money there, you might not be sure how much you can use, and that might keep you from going on that cruise, or make you anxious about paying your bills every month.

Especially if you’ve invested for a long time, and are used to having capital appreciation as your number one goal, actually using the money you’re earning can be difficult to reconcile with your investing strategy.

That’s why this guide presents investments and strategies that are just for retirees and those planning for their retirement. It can help you be as comfortable using your savings as you are investing them. I’ve included detailed information on a variety of investments that make it easy to fund your post-paycheck life by generating passive income every month or quarter. I’ll also introduce strategies for adapting your portfolio to your life situation, so it can meet your needs at every stage of pre-retirement and retirement.

With the right strategy and the right investments, your retirement can be richer, less stressful, and more fun.
**How Much Income Do You Need?**

Before we get to the nuts and bolts of creating that income-generating portfolio, you’ll want to set some goals for your investments. There are many different ways to approach this, each with their strengths and weaknesses. We’ll begin with an approach you’ve probably seen before: the “retirement calculator.”

Many advisors think these calculators have more weaknesses than strengths, and we won’t argue. Most use an average annual return on investment to calculate investment returns, which can create unrealistic projections. They also assume that you can roughly estimate your annual spending for the next 30-plus years. But even using generous assumptions, it’s hard to account for unanticipated expenses, like medical bills. It also oversimplifies retirees’ spending habits—many retirees can and do adjust their spending when their circumstances change, which the calculators don’t account for.

But despite their drawbacks, running some numbers through a retirement calculator can give you a good starting point for deeper planning.

If you’ve already used one of these calculators, feel free to plug in those numbers in this exercise. If not, the retirement calculator below accounts for more variables than most, including “modern” retirements where you’re still earning some income. Give it a try here:


Some of these numbers are almost guaranteed to change, but filling out the worksheet will give you a starting place for your income investing.

**How Much Income Can You Expect?**

While retirement spending calculators can give you an idea of how much income you’ll need to generate in retirement, they also make a lot of assumptions. Expenses are very difficult to predict—especially health-related expenses—and these calculators usually don’t take into account retirees’ ability to adjust for changes in life circumstances. If you have higher medical expenses one year, for example, you may choose to cut back elsewhere rather than dip into your savings.

Another thing you can’t control is the market. Over a long enough period of time, the stock market’s trend is up, but it’s impossible to predict what it will do from year to year. Even expected equity returns based on historical averages are just guesses.

Bond yields introduce more uncertainty: many calculators still assume today’s “unusually” low bond yields will return to their historical averages sooner or later, but there’s no reason to believe that will be the case. Many analysts forget that until the mid-1950s, the dividend yield on the S&P 500 exceeded the yield on 10-year treasury bonds for decades. It’s easy to assume the next 50 years will look more like the 1960-2010 period than the 1900-1950 period, but there’s no inherent reason that should be the case.
All these uncertainties can make planning for retirement seem futile. But don’t despair. You don’t have to know exactly what’s going to happen in the future to make a solid plan.

When you pack for a vacation, you don’t know exactly what the weather will be like, but you can still plan fairly well based on forecasts. If you’re going to San Francisco in June, you can find out that the average high that month is 66º and the average low is 53º, and be reasonably sure you don’t need a heavy coat, but you’ll probably want a jacket. If the weather turns out to be unseasonably warm during your trip, at worst, you’ll regret the wasted space the jacket took up in your luggage. You can also look at the average number of rainy days in June and decide whether to bring a raincoat or umbrella. In San Francisco, it rains about 13% of the time in June. If you decide not to bring a raincoat, and it rains one day of your trip, you’ll probably think you made the right call. If it rains every day of your trip, you’ll wish you’d brought a raincoat and umbrella! But the odds of that happening are so small, the possibility of it happening doesn’t necessarily make it worth packing the extra items.

Retirement planning is, believe it or not, similar. It’s impossible to know exactly how your portfolio will perform over the next 10, 20, 30 or more years, but you can predict a range of likely situations, and position yourself accordingly.

Vanguard has made a valuable tool available on its website that runs a Monte Carlo simulation on your current retirement savings to generate a range of possible outcomes and probabilities for each. A Monte Carlo simulation approximates the probability of certain outcomes by running multiple simulations on your inputs and measuring the frequency of each. You can access the tool at the address below:


Tools like this avoid predicting exactly what will happen but can give you an idea of a reasonable expectation for your investments.
Required Minimum Distributions (RMDs)

Another useful prediction tool is the IRS’s own regulations governing RMDs, or Required Minimum Distributions. The IRS requires holders of most retirement accounts to withdraw a certain amount of the balance each year. The RMD rules apply to all employer-sponsored retirement plans including traditional IRAs, profit-sharing plans, 401(k) plans, Roth 401(k) plans, 403(b) plans and 457(b) plans. However, the RMD rules do not apply to Roth IRAs while the owner is alive. The IRS requires holders of these accounts to start taking RMDs in the year they turn 70½ (unless you’re still working).

Even if your plan isn’t subject to RMDs, the IRS’s guidance can be useful in determining how much you can spend each year without depleting your principal. That’s because the IRS calculates RMDs by dividing the year-end balance by a life expectancy factor (listed in IRS Pub 590) so they’re responsive to the changes in your account balance each year.

For example, a 75-year-old retiree with $400,000 in her IRA at the beginning of the year would be required to withdraw $17,467.25 this year. After the withdrawal, she’d have to achieve a 4.57% return on her investments that year in order to maintain her account balance. Of course, some investors will want or need to withdraw more than the RMD each year, which will change the rate of return needed to maintain the account balance.

Most investors won’t generate exactly the target rate of return every year—in some years your returns may be better, and in some they may be worse. But if your returns average close to the target rate over time, the RMD calculator can help make sure you don’t run out of money partway through retirement.

Calculating this rate can also help you target an annual yield for your portfolio. Many retirees, unsure how much income they actually need, buy the highest-yielding investments they can find, often taking on more risk than they’re comfortable with in the process. If you know how much yield you need from your portfolio, it can help you choose investments that will fulfill that quota.

Do note that some sources say the IRS’s calculations are on the conservative side for younger retirees.

Determining Your Risk Tolerance

Running simulations like the one above can give you some idea of how much risk you’re willing to introduce into your portfolio. We often hear from retirees who assume that because of their age, they should be investing very conservatively, in the lowest-volatility investments they can find. But we’ve also talked to retirees in their 80s who love fast-growing, hit-or-miss momentum stocks. And the fact is, if you’re already retired but know you still need to be focused on growing your nest egg, the safest, lowest-volatility investments are simply not going to meet your needs.
The most important consideration when choosing what type of investments you will buy is your personal investing style. Some investors love buying cheap stocks and waiting patiently for them to go up. Others get bored waiting around for value stocks to get moving and would much rather buy an “expensive” but fast-moving stock and sell it after a few months.

Financial advisors will try to tell you that you have to invest a certain way based on your age or your portfolio size... or whatever products they’re selling. But knowing what type of investing you’re best at and most comfortable with is invaluable knowledge. If you’re a round peg, trying to force yourself into a square hole is going to be both counterproductive and costly.

A Monte Carlo simulation like the one run by Vanguard gives you a different way to look at risk. Rather than assuming you should only be investing in conservative, low-risk investments because of your age, running such a simulation can help you quantify actual risks of various investment strategies.

The lowest-risk strategy, of course, is keeping your savings 100% in cash. The only variable in this simulation is inflation (putting aside variables on the cost side like unanticipated expenses and how long you live), so there are few risks to account for. If you’ve saved $2 million, for example, Vanguard’s calculator assures you that you can spend $50,000 per year and still have 100% confidence that your savings will last 30 years in cash. On the other hand, if you start with only $1 million in cash, you’re guaranteed to run out before 30 years are up.

Both these situations minimize risks, technically, but only one is a viable retirement strategy. It’s important to wrap your head around the concept of risk as more than the concept of the unknown.

Risk can be quantified, and sometimes you will choose to take risks. The investor who has saved $1 million and wants to spend $50,000 a year for 30 years would be much wiser to take some risks with his money than to try and eliminate risk altogether. Using this situation again but allocating 60% of the $1 million to stocks, 30% to bonds and 10% to cash, the Vanguard simulator calculates a 79% chance that his money lasts 30 years. That’s not a low-risk situation—his money ran out in 21% of simulations—but it’s certainly preferable to guaranteed poverty. (As a side note, even with 100% of the money in stocks—what most investors would consider a “higher-risk” allocation—the Vanguard simulator still finds that the money lasts in 78% of simulations. But with 100% in “low-risk” bonds, the money lasts in only 32% of simulations. So risk doesn’t always work how you’d expect.)

**Set Goals for Growth**

As discussed in the previous section, the “safest” course isn’t always the most desirable. Most investors will be more like the man who has saved $1 million than the one who has saved $2 million. In other words, you’ll need and want to keep your nest egg growing in retirement, even while you’re simultaneously using it for expenses.

The Monte Carlo simulation we ran above uses historical returns to approximate the growth of your portfolio every year. Rather than using an average historical return like many retirement calculators, the simulation chooses a random year’s stock, bond and cash returns to use for each year of each simulation. So each simulation includes the returns from 30 random but historical years. Some
simulations will include bumper years like 1995 when the stock portion of your portfolio grows by 30% or more, and others will include years like 2008, where it shrinks by over 30%.

While that’s a sophisticated way to model possible returns in a variety of market conditions, it’s not a constructive way to think about your own investing. Unless you plan to invest exclusively through broad market indexes, you can target much more nuanced returns in your own portfolio.

Below is a graphic based on allocation models created by Fidelity, which offers some useful retirement planning tools on their website. Although the allocation models are simply suggestions, considering the average historical returns of the range of asset allocations is a very good idea.

<table>
<thead>
<tr>
<th>US stock</th>
<th>Foreign stock</th>
<th>Bond</th>
<th>Short-term investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>30%</td>
<td>14%</td>
<td>6%</td>
<td>5%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Conservative</th>
<th>Balanced</th>
<th>Growth</th>
<th>Aggressive growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>6%</td>
<td>15%</td>
<td>21%</td>
<td>25%</td>
</tr>
<tr>
<td>14%</td>
<td>35%</td>
<td>49%</td>
<td>60%</td>
</tr>
<tr>
<td>30%</td>
<td>25%</td>
<td>5%</td>
<td>15%</td>
</tr>
<tr>
<td>50%</td>
<td>25%</td>
<td>25%</td>
<td>25%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Annual return %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average annual return</td>
</tr>
<tr>
<td>Best 12-month return</td>
</tr>
<tr>
<td>Worst 12-month return</td>
</tr>
<tr>
<td>Best 20-year return (annualized)</td>
</tr>
<tr>
<td>Worst 20-year return (annualized)</td>
</tr>
</tbody>
</table>

The average returns, visible in the top row of the bottom table, range from 5.89% to 9.47%. This is a fairly realistic range of target returns for the average investor.

Of course, the higher the return you target, the more variability you’re likely to see from year to year. No one achieves a 10% return consistently, year after year. But you can average more than 10% over time if you make 136% in your best year and -61% in your worst year, as the table shows for the “most aggressive” allocation.
Based on the numbers you generated using the retirement calculators above (or your actual spending and income, if you’re already retired), you should have an idea of what kind of return your investments need to be generating. Now take a look at the best and worst annual returns in that column, to get an idea of the kind of volatility that comes with targeting that annual return. Most investors well into their retirement can’t afford to lose 41% a year (the worst annual return for the “balanced” mix), even if it will eventually be offset by a good year (the worst 30-year return for that strategy is still 3%). That’s why older investors invest heavily in conservative securities with lower volatility, which generate more predictable returns, even if they are lower overall.

In the next section, we’ll help you combine this knowledge with what you know about yourself to figure out what strategy you should follow and what kind of investments you should own, now and in the future.

**Allocation and Diversification**

Now that you have some idea of your goals for retirement, it’s time to get down to the nuts and bolts of accomplishing those goals.

In all likelihood, you will use a variety of investments and strategies, and you’ll probably change and adapt your strategy and allocations several times. Most investors want to invest more aggressively in pre-retirement, so they can build up as large a nest egg as possible, and then gradually become more conservative over time as their margin for error decreases. But not all investors will follow this pattern: You might have begun retirement in a very conservative position, concerned about living on your savings, but maybe you’ve done well and are now ready to get more aggressive.

Wherever you are, there’s an investing system that can help you accomplish your goals. The next section will help you find it.

**Find The Right Investing System For Your Goals**

Your goals are likely to change over time, but, beginning in the present, let’s try to match the goals you determined above to the right investing system. Note that you may wind up mixing and matching investing systems to prioritize different goals in different parts of your portfolio. The following table is simplified but will give you an idea of which systems are most appropriate for which goals.

First, find your primary goal on the left, then follow the rows across to see which systems can help you accomplish it over the short, medium and long term. (For our purposes, short-term strategies focus on returns in the next 12 months or less, medium-term investors invest for roughly the next six months to three years, and long-term investors focus on returns over multiple years or even decades.)
If you’re surprised by your result, don’t worry, in all likelihood, you’ll want to mix and match these strategies to some extent. Though the 60/40 model of equities and bonds is largely—and rightly—discredited, the concept of allocating a portion of your portfolio to a lower-risk, more predictable system and a portion to a more growth-oriented and often more active system is still popular. And it makes sense for many investors.

But if you got a result you weren’t expecting, you might want to consider learning more about that investing style and making it a larger portion of your portfolio. It might make it easier for you to reach your goals that the system you’re currently using.

### Overview of Investing Systems

Here are brief explanations of each of the investing styles in the chart:

**Growth Investing**

Growth investors buy stocks that are rising and that they believe are likely to keep rising. Growth investing involves a greater degree of volatility than dividend or value investing. But it also has the potential for much bigger rewards.

Growth investors usually invest in companies that are growing—or projected to grow—earnings at a faster rate than the overall market. Their goal is to discover these companies as they’re becoming more popular, and then benefit as large investors pile into the stock, driving it up.

Of course, the risk in growth investing is that you’re buying less mature companies that usually don’t pay a dividend. If the share price declines, you don’t have a quarterly dividend payment to cushion the fall. And these stocks can very volatile, especially during earnings season.

While fast-growing companies have a good chance to outpace the market—sometimes by a considerable amount—they also have the potential to fall flat. Most growth stocks will also go through cycles of popularity, so they’re usually not great long-term holdings.

**Value Investing**

The objective of value investing is to find stocks priced incorrectly by the market. Specifically, value investors seek companies that are worth substantially more than their current stock prices.

After finding stocks that are underpriced, value investors typically hold for a fairly long time, usually one to three years.

Value investors believe you should sell a stock when it becomes overvalued, that is, when the stock price is significantly more than its true worth. Many investors have made fortunes using a value-based approach—Warren Buffett is the most well-known value investor.

Perhaps more than any other type of investing, value investing is focused on the fundamentals of a company’s balance sheet and income statement. Fundamentals include current assets, long-term debt, earnings, dividends, cash flow and book value.

Value investing does not entail following earnings and stock price momentum, reading stock charts or timing the market.

**High Yield Investing**

High yield investors’ top priority is current income, so they buy securities primarily for their high current yields. When fishing in the high-yield pool, you will always have to sacrifice some security, growth potential or simplicity for the big payout. However, some high yield investments can payout double-digit returns each year—before price appreciation.

**Dividend Growth Investing**

Dividend growth investors want income now, but also want higher income in the future. They buy investments with rising payouts that will create a robust future income stream.

Dividend growth investors can choose from a wide variety of investments, with a wide
Just as in Fidelity’s allocation models, you can generally expect that the higher the returns you target, the more volatility and risk you can expect. For most retirees or pre-retirees, I recommend that you have at least a portion of your portfolio in low- or medium-risk dividend paying stocks or income investments, to create a reliable foundation for your portfolio. This base will generate regular income and hold its value better in downturns than more speculative investments, but you can still have some fun and shoot for the moon with the rest of your portfolio.

Of course, if you just want to be able “set it and forget it,” you might want to dedicate your whole portfolio to high-quality income-generating investments.

Either way, take the time to fill out the following target allocation worksheet for your portfolio, jotting down what percentage you’d like to dedicate to each investing style. Remember to take into account your income needs, growth goals, tolerance for risk and volatility, and how your goals might change in the future.

<table>
<thead>
<tr>
<th>Investing Strategy</th>
<th>Percent of Portfolio</th>
<th>Primary Goal</th>
<th>Secondary Goals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Growth</td>
<td>____%</td>
<td>Capital Appreciation</td>
<td>Income</td>
</tr>
<tr>
<td>Value</td>
<td>____%</td>
<td>Long-Term Capital Appreciation</td>
<td>Income, Capital Appreciation</td>
</tr>
<tr>
<td>High Yield</td>
<td>____%</td>
<td>Income</td>
<td>Capital Appreciation</td>
</tr>
<tr>
<td>Dividend Growth</td>
<td>____%</td>
<td>Future Income</td>
<td>Capital Appreciation, Current Income</td>
</tr>
<tr>
<td>Safe Income</td>
<td>____%</td>
<td>Income</td>
<td>Long-Term Appreciation</td>
</tr>
<tr>
<td>Fixed Income</td>
<td>____%</td>
<td>Income</td>
<td>Capital Preservation</td>
</tr>
<tr>
<td>Cash/Short-Term</td>
<td>____%</td>
<td>Capital Preservation</td>
<td></td>
</tr>
</tbody>
</table>

Learn more about investing systems at https://cabotwealth.com/category/daily/how-to-invest/
STEP 2: TIME TO INVEST

Now that you know what kind of investments are most appropriate for you, it’s time to start getting down to the brass tacks of identifying the ones worth buying. What qualities should you look for in a dividend-paying stock, bond fund or high yield investment? What are MLPs, BDCs and REITs? How do you know when to sell these investments? This section will cover the answers to these questions and more.

Equities

Retirement investing is most commonly associated with buying safe dividend-paying stocks. Those income-generating stocks are certainly a major part of investing for retirement and should be well represented in any long-term portfolio. But many investors will want to add some variety and diversity to their portfolios with other types of equities. Most frequently, we hear from investors combining dividend-paying stocks with growth or value investments.

The latter are great retirement stocks, since they’re low risk and value investing is a long-term, low-activity strategy. Plus, many high quality value stocks pay regular dividends.

On the other hand, adding a handful of more aggressive, high-risk/high-reward growth stocks to your retirement portfolio can juice your returns without raising your overall risk level too much. It can also keep your mind sharp and your investing fun if that’s something that’s important to you (and maybe keep you from being tempted to play with your longer-term investments too much, a common danger for investors not used to retirement investing.) If sacrificing a chance at investing in the next Apple or Tesla makes you wince, adding a handful of growth stocks to your portfolio is a great way to keep yourself and your portfolio happy. At the same time, you’ll be steadily building wealth over years and decades even if none of those swings for the fences pan out.

The following is a breakdown of how different types of equities can fit into a retirement-focused portfolio.

Growth Stocks

There are a lot of reasons to keep building wealth after you reach your 50s or beyond. You’ve been accumulating wealth in the form of stocks, bonds, CDs, your home and other investments all your life and want to continue. Your portfolio might have taken a hit during the tech wreck or housing crisis. You want to build more wealth to weather any unforeseen storms. Or maybe you enjoy investing and want to use your investment skills to continue fortifying your nest egg.

Whatever your reason for investing somewhat aggressively, you’re not alone. In a recent survey conducted by Cabot, we found that most investors in their 50s, 60s, and 70s are investing in moderate risk growth stocks to add to their wealth. It’s OK to invest in moderate risk stocks while approaching retirement age, or after retirement. You are older and wiser now, and after making a few investing mistakes in the past, you are confident in your ability to consistently grow your investment portfolio.
However, some growth stocks are appropriate for older investors and some are not. In order to limit your risk pursuing capital appreciation, we advise investing in companies that are growing and performing well but also have sound fundamentals.

• **First, look for companies with good sales and earnings track records.** Past, present and future growth prospects are all important. At the *Cabot Retirement Club*, we look for a track record of increasing operating cash flow, and higher analyst estimates for earnings in each of the next two to five years. We also consider the growth ratings assigned by IBD (Investor’s Business Daily). IBD’s “EPS Rating” measures earnings growth and extends from 1 (low) to 99 (high) with 85 considered very good.

• **Screen for high quality companies.** Growth is fine, but retirees should also screen for quality, which means the company has longevity, a sound balance sheet, good management and institutional investors. You can investigate all these factors individually, or do what some analysts do and use Standard & Poor’s “Quality Ratings,” which range from A+ down to C-, with B+ or higher considered more than adequate.

• **Buy stocks that are outperforming the market.** Growth investors have a secret weapon on their side: the best growth stocks select themselves. *Cabot Growth Investor* uses Relative Performance (RP) lines to identify stocks that are outperforming the market, which usually means they’re under accumulation by big institutional investors. Growth investors believe that the best investing tips come from the performance of the stocks themselves.

• **Use market timing.** Never underestimate the power of the market to move stocks. You don’t want to invest in a growth stock just as the market is topping out, as three out of four growth stocks will follow the trend of the overall market. If you’re in a bull market, you can afford to be aggressive in buying stocks that are more speculative. Unlike with long-term value or dividend investments, you’ll want to sell many of your growth stocks when the market turns against you.

• **Be patient.** Even though growth stock investing is shorter-term than dividend or value investing, you’ll still need to be patient with your growth stocks. Not every growth stock will advance exactly when you want it to. Very few will, in fact. Even Apple had plenty of fits and starts on its way to becoming the most valuable company in the U.S. In the investment world, time is your friend. If you get out of a stock too early, you may miss out on some big gains months down the road.

• **Know When to Sell.** When investing in growth stocks, it’s important to cut losses short, and to sell winners once they lose positive momentum. Cutting losses short is the key to ensuring that you retain enough capital to stay in the game. *Cabot Growth Investor* Chief Analyst Mike Cintolo recommends keeping losses (of your original money invested) below 20%, although *Cabot Growth Investor* usually cuts losses sooner, at between 10% and 15%. Our growth system also calls for selling once positive momentum disappears, no matter how successful your investment has been until then. *Cabot Growth Investor* usually sells former winners after a RP line correction of 8 to 13 weeks, but sometimes sooner.

By sticking to these general guidelines, you can reduce the risk of growth investing without sacrificing the potential rewards that can transform your retirement portfolio for the better.
**Value Stocks**

Notice any stocks that are getting pummeled as a result of embarrassing headlines or negative rumors? They might be the next great value stocks.

Value investing isn’t as simple as that, but that’s sort of the mentality.

“Be greedy when others are fearful,” legendary value investor Warren Buffett once said. Those six words are the basis of the value investor’s creed.

Sometimes good companies get wrongly punished by the stock market, often to the point that they become undervalued. But not just any company receiving a bit of bad news qualifies as a good value play. Instead, value stocks typically share a couple of key characteristics. Those are:

- **Cheap multiples.** There are ways to actually measure how under or overvalued a stock is. And it’s not as simple as looking at the price-to-earnings (P/E) ratio, as some analysts might have you believe. Price to earnings is just one of six valuation benchmarks we use to select stocks for *Cabot Retirement Club*. The others are price-to-book value, price-to-cash flow, price-to-dividends, price-to-sales and the PEG ratio, which is calculated by dividing the current stock price by the last four quarters of earnings per share growth. For a company to be considered a strong value stock candidate, at least one of those ratios needs to be low. If several of those valuation multiples are low, and earnings are projected to grow, then you may have found a stock that is trading well below its intrinsic value.

  Some will also compare the first five ratios to their 10-year historic means and forecasts them for the next two years using analyst and computer-generated estimates for sales, cash flow, earnings, dividends and book value.

- **Strong earnings growth.** Every stock takes it on the chin at one point or another. The companies whose sales and earnings continue to grow through it all are the ones that consistently bounce back. It doesn’t take much for a stock to get knocked down—a disappointing new product, a scandal involving one of its executives, a bad Super Bowl ad. Those are temporary problems. For savvy value investors, they’re also prime buying opportunities.

  We analyze growth potential by looking directly at earnings and estimates. Our requirements vary based on which value model we’re using when analyzing a stock, however, the metrics Roy considers include estimated one-year forward EPS growth (8% or above for Modern Value stocks), five-year estimated EPS growth (over 1% for Classic Value stocks, 10% or above for Modern Value stocks) and earnings growth over the past five years. He also considers free cash flow (over $20 million for Graham-Buffett stocks), net profit margin (over 15% for Graham-Buffett stocks) and the ratio of discounted cash flow to the current price (higher represents a good value).

- **Low Debt.** Looking at debt helps ensure that you’re buying quality companies, not just cheap ones. For our Classic Value analysis we look for companies whose long-term debt to current assets ratio is 1.10 or less and whose ratio of current assets to current liabilities (also called the current ratio) is 1.50 or more.
Even with those characteristics in place, successful value investing still depends a lot on timing. You don’t want to invest in a strong value candidate while it’s still in free fall. You want to buy value stocks right around the time they’ve hit rock bottom—or at least close to it.

Finding that bottom isn’t an exact science. Rarely, if ever, are you going to get in at the exact right time. A simple rule of thumb is to adhere to Benjamin Graham’s “Margin of Safety.” Graham, universally recognized as the father of value investing, said the Margin of Safety is achieved by buying a stock only when it’s trading below its maximum buy price, thus minimizing potential losses.

Buying a good company at a depressed price improves your chances of landing a winner. Buy enough of them and hold onto them for the long term, and it can really add to your post-retirement return.

**Dividend-Paying Stocks**

Dividend-paying stocks are retirees’ best friends, because they pay you to own them, automatically creating a regular income stream from your portfolio. Plus, companies that have the cash flow to pay regular dividends typically make safer, more reliable investments. The best dividend-paying stocks are high-quality, long-lived companies with predictable business models—they aren’t going to suddenly crash due to a lousy quarter or a bad news event.

Not all dividend-paying stocks are created equal, however. More than 400 of the 500 companies that comprise the S&P 500 now pay a dividend, but many of those dividends are either unreliable or too paltry to make it worth buying the stock. What you want is a combination of consistent dividend payers and better-than-average yields.

The wide variety available in the world of dividend stocks means there’s truly a dividend-paying stock for everyone: there are even small caps that pay dividends! In my advisory service, *Cabot Dividend Investor*, I recommend dividend-paying stocks for investors with a wide variety of goals, as long as income is one of them. Our portfolio is divided into High Yield, Dividend Growth and Safe Income tiers to help subscribers find the investments that best fit their personal goals. Not every investment is right for every subscriber, but every subscriber can find an investment that’s right for them.

**High Yield Stocks**

High yield investments are chosen primarily for their high current yields and are most appropriate for investors whose top priority is current income. When fishing in the high yield pool, you will always have to sacrifice some security, growth potential or simplicity for the big payout. And since these companies tend to be less well established that our other recommendations, they often shouldn’t be held for as long.

However, for investors whose number-one priority is getting fat dividend checks or deposits every quarter or month, high yield investments can be just the ticket. Just be sure to do your homework before taking the plunge: a double-digit yield is often a sign of big problems beneath the surface. To select the highest quality high yield investments for our members, I consider the following metrics:
• **High Yields.** The first requirement for high yield investments is simplest: their current yield must be significantly above average. However, abnormally high yields can be a red flag. Typically yields only rise above the low teens temporarily. Even if the last 12 months of dividends divided by the current price works out to a 30% yield, there’s a good chance the next 12 months of dividends won’t keep that going. If the dividend is halved this year, the yield will be too. Expectation of a dividend cut is usually part of the reason the stock is trading where it is and “offering” an abnormally high yield.

• **Dividend History.** If you’re looking for sustainable high yields—companies that will keep sending those fat dividend checks—you want to make sure the investment has a good track record of doing just that. I like to see at least five years of high and rising dividend payments in the high yield tier, although more is even better.

• **Cash Flow.** Like dividend history, looking at cash flow tells you if this company’s dividend payments are likely to be sustainable. Dividends are paid from cash flow, so if it’s declining or inconsistent, the company may have trouble covering future dividend payments. (In some special cases, like MLPs and REITs, cash flow goes by another name—we’ll discuss all of them in the relevant sections.)

• **Debt.** A lot of high yield investments are also highly leveraged companies. While some companies can and do thrive even with high levels of debt, other times, debt is a red flag. Avoid companies that are borrowing to pay their dividends, and be wary of companies that have taken on lots of new debt recently, or have a lot of debt maturities coming in the near future. Also think twice about investing in companies with rising interest expenses, which can be a sign that creditors believe the company is becoming less creditworthy.

• **Tax Issues.** Many high yielding investments come with tax consequences. It’s not necessarily a reason to avoid them, but you should make sure you understand what your responsibilities are before buying.

**Dividend Growth**

For investors whose tastes lean more toward growth investing, it’s easy to find stocks that deliver both capital appreciation and income: just look for stocks that increase their dividends every year. I call these dividend growth stocks. For a company to consistently increase their dividends year after year, they have to be earning more every year, which is also a hallmark of great growth stocks. Sometimes the capital returns in dividend growth stocks wind up dwarfing their dividend yields, but we’ll always appreciate the dividends too for their consistency—plus, as they grow over time, so does your yield-on-cost.

Yield-on-cost refers to the annual yield you’re receiving on your original investments, and is equal to the current annual dividend amount divided by your purchase price. The sidebar on this page has an example of how powerful dividend growth can be in securing you an exceptional yield-on-cost over time.

Thanks to the beauty of dividend growth, your investment portfolio can actually become less work as you get older. If you choose the best, highest-quality dividend growth stocks today, you can sit back, relax and watch the dividend checks roll in tomorrow.

So how do you choose the best dividend growth stocks? Here’s what I look for in candidates for *Cabot Dividend Investor*: 
• **Dividend History.** If you want to own stocks that increase their dividends every year, there’s no better way to find them than by looking back in time. Companies with a good track record of raising dividends every year have proven both that dividend growth is a priority for them and that their business has the cash flow to support regular dividend increases.

• **Cash Flow.** While dividends are a good sign of consistent cash flow, looking at income itself is equally important. For most businesses, I use free cash flow, or FCF, as the best indicator of available funds. Free cash flow simply equals operating cash flow minus capital expenditures. In other words, it’s what’s left of income after the company spends what is has to. That number is important because, when all is going well, it’s where the money for dividends comes from. (Companies that can’t afford to pay their dividends out of free cash flow are forced to either cut them or find the money elsewhere, which is usually only a temporary solution. You can tell this is happening by comparing free cash flow to dividends paid.)

• **Earnings Growth.** Dividend growth means a company will require more cash for dividends every year, so I require a company to demonstrate strong and reliable earnings growth, and I also like to see company-specific or industry-wide catalysts for more growth in both price and the dividend. I consider both management’s projections and analyst estimates of future earnings growth.

• **Payout Ratio.** The payout ratio links dividends to earnings, telling you how much of its earnings a company is giving to its investors. Most websites report the payout ratio as the stock’s annual dividend payment divided by its earnings per share (EPS), but I also calculate payout ratios based on free cash flow, mentioned above.

For example, a company that reported EPS of $3.00 per share and made four quarterly dividend payments of twenty cents each (for a total yearly dividend of $1) would have a payout ratio of 33%.

Ratios in the range of 20% to 50% are usually considered good, although higher or lower payout ratios can be acceptable depending on what business the company is in, how mature the company is, and other factors. In addition to looking at the payout ratio on its own, I also compare the current payout ratio to the company’s historical payout ratio, to see if the company’s earnings and dividends are growing at the same rate or if one is outpacing the other. It is worth noting that companies that started prioritizing dividend growth recently will sometimes have rising payout ratios, as the company enters a more mature stage where it chooses to direct more of its cash to investors. Often

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**How Does Yield-On-Cost Work?**

Let’s say you bought Target (TGT) when it was trading at 35. At the time, TGT paid a quarterly dividend of $0.16, for a total annual payout of $0.64. So when you bought the stock, the yield was:

\[
\frac{0.64}{35.00} = 0.018 = 1.8\%
\]

Over next six years, TGT rose from 35 to 78. But TGT also increased its dividend every year over this time period, from 64 cents per year to $2.08 per year. So the stock’s current yield changed to:

\[
\frac{2.08}{78.00} = 2.7\%
\]

But you bought at a lower price, so your yield on cost is even better. It’s equal to the current annual dividend amount, divided by your purchase price. That works out to:

\[
\frac{2.08}{35.00} = 5.9\%
\]

In essence, you’re now getting a nearly 6% yield from a 2.7% yielding stock.

Over longer time periods, this effect becomes even more powerful. It’s estimated that Warren Buffett’s Berkshire Hathaway now earns more in dividends from Coca-Cola (KO) every year than it originally paid for the stock... that’s a yield of more than 100%.
management will have mentioned on earnings calls that they’re now intending to return a larger percentage of revenue to investors, and sometimes they even provide a target percentage they’re working toward.

The primary red flag to watch out for when looking at payout ratios is a number that’s too high. With some exceptions for MLPs, utilities and other entities created specifically to pass along cash to investors, the payout ratio should generally show that the company has some cash left over to put back into the business, buy back shares and create a cushion for leaner times ahead. A company handing over 90% of its earnings to shareholders, in other words, may have a hard time affording that same payment down the road. Younger, faster-growing companies generally hold on to more of their income for growth and stability than older, slower-growing companies that may feel the best use for the money is paying back shareholders.

• **Story.** The factors above give me the most direct, unfiltered look at an investment’s ability to continue rewarding investors through dividends and long-term growth. But I also consider less quantitative factors to pick the best of the qualifying investments for our dividend growth tier. Catalysts for growth at the company or in the industry can give one stock an edge over another, as can macroeconomic factors that are likely to act as tailwinds.

Companies can also be eliminated from consideration based on “story” factors, even if they have strong earnings numbers and promising dividend histories. For example, a company that bought up a lot of distressed real estate after the market crash and gradually sold it off might have been able to deliver stellar dividend growth over the past several years, as the properties in its portfolio became more valuable. But as similarly advantageous investment opportunities dry up going forward, dividend growth is likely to slow.

Companies that expand their dividend payouts year after year can leave you with a return even if the share price doesn’t budge. 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.

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**What Is An Ex-Dividend Date?**
The ex-dividend date is the first day the stock trades without its dividend, thus ex-dividend. You have to buy before the end of the day on the day before ex-dividend date to get the next dividend.

**What Does It Mean When A Stock Is Trading Ex-Dividend?**
When a stock is trading ex-dividend that means its ex-dividend date has already passed but the dividend payment has not been made yet.

**So When Should I Buy?**
In theory, the stock falls by the amount of the dividend on the ex-dividend date.

*If XYZ stock pays a $0.10 per share dividend, it should theoretically open ten cents lower on its ex-dividend date.*

In practice though, this dividend capture effect doesn’t always occur, or isn’t always equal to the exact amount of the dividend, because the stock price may be up or down for different reasons.

So if you buy before the ex-dividend date, the stock might drop by the amount of the dividend, but you will receive the dividend payment a few weeks later.

*If you buy on or after the ex-dividend date, you might get a slightly lower price, but you won’t receive the next dividend payment.*

There isn’t a time when you can buy that would mean you participate in the price drop but not the dividend, so you don’t have to worry about that.
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.

**Safe Income**

Safe income stocks are perfect for investors who want to “set it and forget it.” In other words, these are high-quality stocks that will be good long-term holdings, that you can plan to hold for decades and pass onto your kids—all while sitting back and watching the dividend checks roll in. The key is to find stocks generating steady income with minimal volatility and low risk. They’re usually appropriate for all investors but are meant to be held for the long term, primarily for income—they’re not going to double your money in a year.

- **Dividend History.** The first requirement for any safe income stock is an impressive dividend history. A long and consistent history of paying dividends tells me both that the company consistently generates enough cash to reward shareholders, and that management is committed to prioritizing shareholder returns. It indicates that the company’s business model can sustainably support regular dividend payments during a variety of economic conditions. In addition, no dividend cuts or skipped dividends shows both that the company’s business is stable and that management is realistic when declaring dividends; the company doesn’t stretch to pay dividends it can’t afford.

While a five-year history might be enough for the High Yield or Dividend Growth tier, in the Safe Income tier, we like to see decades of dividends. Some of our safe income stocks have paid dividends for over 100 years.

You don’t want to see any dividend cuts, especially recently. Cuts suggest that either the company’s cash flow isn’t reliable or predictable, or that the company distributes dividends it can’t afford.

- **Low Volatility and Longevity.** For investments I’m considering for the Safe Income tier, relatively low volatility is important. To assess volatility, I look at stock charts, consider the stock’s beta (< 1 means less volatile than the benchmark, > 1 means more volatile) and research industry factors. Established businesses in growing or stable industries are much less volatile than smaller companies and those in more cyclical industries. Longevity is also a concern—the company and its industry must both be viable long term, and stocks in faddish industries, like 3D printing or social media, are simply inappropriate.

**Utilities**

*Utilities have long been considered “widow and orphan stocks” for their slow, steady returns and low volatility. While they’re never going to grow fast enough to be hot stocks, utility companies usually operate legal monopolies in their market area and don’t have to worry about losing customers. Utilities in faster-growing regions may grow faster than average, while utilities in slower-growing regions may struggle. And economic conditions can temporarily affect demand levels for electricity and other utilities. But long term, utilities usually manage to achieve annual earnings and revenue growth in the mid-single digit range.*

*This reliability makes utilities good safe income stocks. They have predictable cash flows, so they can easily predict how much they’ll be able to afford to make in dividend payments. And they rarely cut their dividends during tough times, because utility demand will usually rebound long-term. The average utility’s yield is good too, around 4% per year.*
• **Payout Ratio.** The payout ratio is the percentage of earnings paid out as dividends, calculated by dividing the stock’s dividend per share by EPS (earnings per share). A low payout ratio is good: it shows that the company’s dividend payments are well covered by its earnings, so they’re not in danger. In addition, it means the company is holding plenty of cash back to reinvest in the business, ensuring the security of future dividend payments. On the flip side, a high payout ratio can be a red flag that a company is having a hard time affording its dividend payments, especially if the payout ratio is historically high for that company.

**Specialized High Yield Investments**

As the number of investors in and approaching retirement has ballooned, so too have the number of specialized investments targeted at investors who want high regular income. Some of these investments are risky or evolving, and some come with tax complications, but they can be a good complement to a portfolio of dividend paying stocks or more traditional income securities.

**REITs**

Real estate investment trusts, or REITs, are special-purpose entities, with special tax status, that own real estate and pass along most of the income from that real estate (rents or mortgage payments) to shareholders. A REIT can own any type of real estate, and many specialize in one type, like apartment buildings, malls, office buildings, self-storage facilities or hotels. A REIT that owns property directly and gets most of its income from its tenants’ rents is called an equity REIT.

A mortgage REIT, on the other hand, is a REIT that doesn’t own property directly. Instead, it owns property mortgages and mortgage-backed securities. Their income comes from the interest they’re paid on the mortgages. They’re sometimes called mREITs. There are also hybrid REITs that own assets both ways.

Both types of REITs are exempt from taxation at the trust level as long as they pay out at least 90% of their income to investors. That means that while any retained income will be subject to regular corporate-rate taxes, the REIT doesn’t have to pay taxes on current income (rents or interest payments from the current period) that is distributed to unitholders (the trust version of shareholders). Essentially, the REIT is treated as a “pass-through” entity, collecting the rents or interest payments and then passing them onto investors. It’s as if you own a sliver of the properties or mortgages themselves.

But that doesn’t mean REITs have zero growth potential. While they don’t retain much money to reinvest in their business, REITs often borrow money to make new acquisitions or improve properties. They can also earn more by raising rents or improving occupancy rates.

REIT performance tends to be more correlated to the real estate market and interest rates than the overall stock market (and mortgage REITs are strongly affected by credit conditions), so keep this in mind when deciding how much of your portfolio to allocate to them.

Owning REITs does have some tax consequences. Most of your REIT distributions will be classified as ordinary income, because you are treated as a part owner of the assets the REIT owns, and thus income from those assets is treated as your income. However, when some portion of a REIT’s distribution did not come directly from that quarter’s real estate ownership activities—for example, if it sold a building and distributed part of the proceeds to investors—you may be taxed differently on that portion of the distribution.
The REIT will tell you after the year-end how that year’s dividends should be treated. Options include ordinary income, qualified dividend income, long-term capital gains and return of capital. Any portion of the distribution that is treated as return of capital will reduce your cost basis in the REIT, and then you’ll be taxed on the difference between your purchase price and your adjusted cost basis when you sell the REIT.

On average though, about 70% of REIT distributions are taxable as ordinary income. This can be a good reason to own REITs in a tax-advantaged account like an IRA. Some REITs can be very high risk, but others are very well established and can be a valuable addition to an income portfolio. Here’s what to look for in a high-quality REIT investment:

• **Funds From Operations.** As income investors, we don’t really care about the REIT’s retained income or EPS. The important number to us is how much cash the REIT generates and can distribute to investors. You can get an idea of this by looking at a REIT’s Net Income, a GAAP number reported with quarterly earnings that equals revenues minus expenses. However, NAREIT (the National Association of REITs) has developed an industry-standard but non-GAAP measure that can give us an even better idea of how the REIT is really doing.

That number is Funds From Operations, or FFO. FFO is calculated by adding real estate depreciation back to net income (see box), and then subtracting gains from the sale of real estate (which generate non-recurring revenue). The result is a good indication of how much cash the REIT’s regular income sources—leases or mortgages—generate on an ongoing basis.

Most REITs also report Adjusted Funds From Operations, or AFFO, which is not industry-standard (it varies from company to company) but can be an even purer measure of distributable cash flow. Usually REITs calculate AFFO by subtracting certain recurring capital expenses, like repairs and maintenance, from FFO. AFFO will generally give you the best idea of how easily a REIT can afford its distributions. Investors who want a margin of safety in their REIT investments should focus on REITs whose AFFO per share consistently covers their distribution per share.

The remainder of the REIT’s revenue can be used to improve its properties, acquire new properties, or for operating expenses.

• **Debt.** Most REITs borrow heavily to make new acquisitions or improve properties. REITs are usually highly leveraged as a result, so high debt is not in itself a reason to stay away from a REIT, but you do want to make sure your REIT’s debt is manageable.

You can do this by looking at a measure like the debt-to-equity ratio and comparing it to the industry average and the REIT’s typical historical level, or by looking directly at the REIT’s outstanding debt obligations and maturities.

• **Credit Quality.** REITs can hold real estate assets with a wide variety of credit qualities, from Manhattan office buildings to run-down strip malls or foreclosed-upon mortgages. The average credit quality of your REIT’s assets will determine both how stable its income stream is—rents are more
reliable at higher-quality properties—and how susceptible the REIT is to credit market conditions. I also recommend limiting your investing to REITs with a demonstrated history in their market, not those trying to generate yield by branching out into every real estate opportunity that presents itself.

- **Interest Rate Exposure.** Both equity and mortgage REITs can be affected by changes in interest rates and credit conditions. Better-capitalized REITs should be more insulated from rising interest rates, but all REITs are susceptible to interest rate-related shocks. REITs that own adjustable rate mortgages can actually benefit from rising rates, although new investments will become more expensive (as will debt service).

**Business Development Companies**

Business Development Companies, or BDCs, are kind of like venture capital funds, but they’re publicly traded on stock exchanges so that anyone—not just millionaires—can invest in them. They provide financing to small- and mid-size companies that are often underserved by banks and other traditional lenders. Often this financing includes “mezzanine loans” that pay high interest rates and come with or can be converted into equity in the target company. BDCs typically borrow funds at much lower interest rates than those paid by the smaller companies, so investors reap the rewards of the spread—although it does make these investments fairly interest rate-sensitive.

BDCs can have very high yields—frequently in the double-digits—but those payouts often reflect the high risk of lending to speculative, development-stage companies. BDCs that make loans primarily to more mature businesses with positive cash flows will be safer, while BDCs that make more speculative loans to smaller businesses will be riskier—but they may also have more growth potential, especially if they take equity positions in their portfolio companies.

Looking at a BDC’s filings should give you a sense of how risky or safe their loan portfolio is. Some BDCs mostly make higher quality loans that have a better chance of getting paid back, while others will make more speculative loans that have higher interest rates but also carry a greater chance of default. You can check the interest rates on the loans for a sense of the borrower’s creditworthiness. If the BDC is able to charge higher interest rates than its peers, it’s probably making riskier investments.

BDCs also have to take on a lot of debt themselves, so they can then lend that capital at higher rates. Luckily for you, that means bankers have already looked at this company’s balance sheet and assessed its financial health, so you can take a shortcut by looking at what kind of interest rates the BDC is paying on its own debt. That will give you a general idea of how risky bankers think this company is. Also, find out if the rates are fixed at that level or if they’re floating rate, which can expose the BDC to more interest-rate risk. You may also want to compare the BDC’s debt-to-equity ratio to the industry average to see if this BDC has more or less financial flexibility than its peers. Some BDCs may even be rated by the big ratings agencies.
Master Limited Partnerships

As also mentioned earlier, Master Limited Partnerships are another unique kind of tax-advantaged investment designed primarily to pass income along to investors. MLPs are popular among income-seeking investors because they offer very high yields.

MLPs are publicly traded, by definition. The limited partners are public shareholders—called unitholders. The unitholders are entitled to a share of the MLP’s cash flow, which is paid to them as distributions. From an investor’s point of view, these distributions are similar to common stock dividends: their amount is usually declared (announced) at the beginning of the fiscal year, and the distributions are then paid to the unitholders quarterly or monthly.

There are some differences though, and most of the differences are related to the taxes you pay on those distributions.

That’s because the primary benefit of organizing a business as an MLP is that MLPs don’t pay corporate taxes on their revenue. Instead, the company’s cash flow is distributed, almost in its entirety, to its unitholders ... who are then responsible for taxes.

That makes MLPs a very efficient way to pass along the cash flow of an income-generating enterprise to public shareholders. And that’s what accounts for their large distributions and very high yields. Not just any business can be organized as an MLP though. The tax code requires MLPs to derive about 90% of their revenue from natural resources, commodities or real estate. In practice, many own energy transportation or processing facilities, like oil or gas pipelines, although there are also MLPs that own unique assets like cemeteries. Any business in one of the above industries that generates high regular cash flow, whether from rent, fees, or simply selling goods, can make a good MLP.

Evaluating a Master Limited Partnership is a little different from evaluating an ordinary stock. While your questions will be similar—like, “can the MLP keep paying its distribution?”—you’ll find the answers differently.

• Distributable Cash Flow. Cash is an important consideration, but for MLPs, traditional measures like earnings per share (EPS) and profits don’t tell us much, in part because of the companies’ massive depreciation of assets. Instead, we look at Distributable Cash Flow (DCF), which is calculated by subtracting interest and capital-spendings costs (cash expenses) from earnings before interest, taxes, depreciation and amortization (EBITDA).

\[
\text{Distributable Cash Flow (DCF) = EBITDA – interest – capital spending}
\]

DCF gives us a better picture of an MLP’s income situation than earnings or net income because they usually keep their depreciation, interest and capital spending deductions as high as possible to lower their tax liability. Most MLPs own significant physical assets, like pipelines, and they claim significant depreciation of these assets every year. Sometimes, EPS are actually negative because depreciation and other non-cash “expenditures” are larger than cash flow. But it’s cash we care about, not the non-cash stuff.

DCF is also important because that’s the number the MLP uses to determine its payout to unitholders (usually distributing a specified percentage).
• **Distribution Coverage Ratio.** Likewise, because MLPs are designed to pass almost all of their income on to unitholders, the usual payout ratio is not a useful measure of whether an MLP can “afford” its distributions. Instead, look at the percentage of DCF that is being paid out as distributions, sometimes called the Distribution Coverage Ratio. If the ratio is less than 100%, the MLP should be able to pay its distributions going forward. If it’s over 100%, find out why, and decide if the MLP is likely to continue overextending itself, or if the situation will be resolved in the next quarter or so.

• **Reliability of Income.** One reason MLPs are prized by income investors is their consistency. Most MLPs are structured as simple pipelines (sometimes literal pipelines), earning lots of cash and passing it onto their unitholders. The more reliable an MLP’s revenues, the more reliable your distribution will be.

  To find the most reliable cash generators, look for MLPs with primarily fee-based income. Those MLPs are getting most of their cash from fees for things like using pipelines or storage facilities.

  By contrast, MLPs that get most of their revenue from commodity-price dependent sources, like propane production or mining royalties, are more likely to experience fluctuations in revenue.

  You can also look at what industry the MLP is in: cemeteries are pretty much as non-cyclical as it gets, while energy demand can change significantly.

• **Distribution History.** Just as with common stocks, you want your income from your MLP holdings to keep rising. Frequent or recent distribution increases are a sure sign that the MLP is confident it can continue to afford its payout. Distribution increases are also a great indication of a growing business with increasing cash flow.

• **The General Partner.** Another important factor to consider before buying an MLP is the partnership’s relationship with its General Partner (GP). As mentioned above, investors like you are an MLP’s limited partners. But MLPs also have a General Partner, which is a person or another company (sometimes also public) that’s responsible for running the MLP.

  The General Partner has a direct stake in the MLP, like you, but usually also has incentive distribution rights, which entitle the GP to extra payments from the MLP. The amount of these incentive distributions is based on how much cash the MLP handed out to unitholders—so the more money unitholders get, the more money the GP gets. It’s the GP’s job to run the MLP, so it makes sense that the more cash it generates, the better they’re paid.

  But some incentive distribution formulas are more unitholder-friendly than others. A good formula incentivizes distribution growth by rewarding the GP for increases in distributable cash flow, particularly early on, without ever becoming too generous to the GP. If the formula becomes too generous toward the GP at high distribution levels, unitholders may not see much additional cash when their MLPs start earning more. Always be sure you understand the incentive distribution formula, and how it’s likely to affect your payouts going forward, before buying an MLP. You can find the formula in the MLP’s registration statement.

  So how does a good GP help their MLP grow DCF and distributions? One important tool is the dropdown acquisition. In a dropdown acquisition, the GP sells an asset it already owns—like a refinery, a shipping terminal or just land—to its MLP. Since the GP is a part owner of the MLP, and
what’s good for the MLP is good for the GP, the GP usually sells the asset at a very advantageous price, usually described as “immediately accretive to distributable cash flow” in industry parlance.

Previous dropdown acquisitions made at advantageous prices and integrated successfully are a good sign for MLP investors. They mean that the MLP has good support from its General Partner and may be able to grow its DCF and distributions with future dropdown acquisitions.

Funds

Exchange-Traded Funds (ETFs)

Income-oriented exchange-traded funds come in all sorts of flavors, from high-risk high-yield funds to funds that invest in the market’s most reliable dividend payers. Your most important consideration when adding an ETF to your income portfolio will probably be how the ETF generates its income. ETFs that hold mostly fixed-income assets, like bonds or preferred stocks, will be very sensitive to interest rate changes and have lower upside potential than equity ETFs. But equity ETFs will be highly correlated to the stock market, or whatever sector of it they focus on.

Many income ETFs also pay less predictable dividends than individual dividend-paying stocks. Look at the ETF’s distribution policy, if it has one, and distribution history to get an idea of its distribution schedule and how much its distributions vary. Many ETFs will pay variable quarterly dividends from their regular income plus an extra dividend at the end of the year made up of capital gains.

You should also check the fees you’ll incur before buying any ETF. Warren Buffett has suggested that most investors should forego trying to pick stocks and time the market, and just invest in low-cost index funds instead. “The goal of the non-professional should not be to pick winners,” he’s written, “but should rather be to own a cross-section of businesses that in aggregate are bound to do well. A low-cost S&P 500 index fund will achieve this goal.”

He backed up his words by sharing that his will instructs his trustees to do just that with his wife’s inheritance, putting 10% of the cash in short-term government bonds and 90% in a “very low-cost” S&P 500 index fund. While I don’t agree with Buffett about the futility of picking individual winners, I do think that for investors who don’t want to try to pick winners, his endorsement of low-fee index funds is spot on.

How Are ETF Distributions Taxed?

ETF distributions are taxed based on their original source—i.e., how the fund earned them. When ETF dividends come from common stock dividends, they’re taxed just as they would be if you owned the stock yourself. They can be eligible for the lower dividend tax rate if they’re paid by a qualified corporation.

Dividends from businesses organized in some structure other than a corporation—like REITs—will usually not be qualified.

However, just as when you own an individual stock, you need to have held the ETF for over 60 days, including the ex-dividend date, in order to qualify for the lower dividend tax rate. In addition, the fund needs to have held the stock long enough for them to qualify for the lower rate too. So even if a fund only holds stocks of companies that pay qualified dividends, you may receive some non-qualified dividend income.

Any portion of a fund’s distribution that comes from interest on fixed income investments will be taxed as ordinary income, just like interest paid by individual bonds. (Income from municipal bonds will be exempt from federal income taxes and income from Treasury bonds will be exempt from state and local income taxes.)

And capital gains distributions, which are often made at the end of the year (but include any portion of a distribution generated by price appreciation and sale of assets), will be taxed at either long-term or short-term capital gains rates, depending on how long you held the ETF and how long the ETF held the assets.
If you don’t want to or don’t have time to buy individual stocks yourself, there are hundreds of ETFs that track every conceivable type of index for fees of less than 1% per year. The largest S&P 500 tracking funds have expense ratios of less than a tenth of a percent.

But you don’t just have to track the overall market—there are low-fee ETFs that cater to every kind of investor and market. ETFs that own the best dividend payers in the market are a good bet for most retirees over the long term. You can also use ETFs to get exposure to high-yield investments that are too complex for you to analyze individually. For example, REITs are hard to analyze because of their high levels of debt and unusual accounting practices (unfamiliar investors frequently email me to ask how a REIT’s distributions can be greater than its EPS, for example) so buying a REIT ETF can give you broad exposure to the sector and its high yields.

**Closed-End Funds**

Closed-end funds, or CEFs, are exchange-traded funds that offer a limited number of shares (hence the word “closed”). The size of the fund doesn’t change when new investors buy in. That actually makes them resemble ordinary publicly-listed companies more than other funds: when a new investor buys into a CEF, they have to buy from someone else who is selling their shares, as with a stock.

ETFs and mutual funds, by contrast, regularly issue new shares and buy back old ones (through bank intermediaries). That means they’re sometimes forced to buy more assets just because the fund is getting bigger, and sometimes they get too big to maintain their performance.

Many CEFs are designed to generate income, either by owning income-generating investments like bonds, dividend stocks or preferred stocks, or by employing leverage, covered calls (more on these later) or other strategies to extract a consistent income stream from their holdings. It’s important to know how a CEF generates its income before buying it, so you know what kind of market conditions would affect its performance (the source of your distributions can also change what kind of taxes you owe on them).

CEF’s trade at a market-determined price like common stocks, not at their net asset value (NAV) like mutual funds. This makes trading easier and should impact your decision to buy a CEF. The gap between the current share price and the NAV is referred to as the CEF’s discount or premium.

If a CEF is currently trading at $19.00, but its NAV is $20.00, then the CEF’s discount is -5.0%. You can find a CEF’s discount or premium with this equation:

\[
\text{Discount or Premium} = (\text{Share price} \div \text{NAV}) - 1
\]

Here’s one more example:

\[
\text{Share price} = 12.00
\]

\[
\text{NAV} = 10.00
\]

\[
\text{Premium} = (12.00 ÷ 10.00) - 1 = 1.20 - 1 = +0.20 = +20.0\%
\]

You can also look up a CEF’s current discount or premium on the fund manager’s website or on Morningstar. Usually, premiums are denoted with a plus sign, as above, and discounts with a minus sign.
The fact that discounts and premiums exist gives CEF investors one more piece of information when considering their investment. However, it’s not as easy as buying any CEF that’s trading at a discount. Some investors think so, and will argue that by buying at, say, a 10% discount, they’re “getting $1 worth of assets for 90 cents.” But that’s an oversimplification.

For one thing, you can’t assume that a CEF’s price will always return to its NAV. CEFs can trade at a discount or premium to their NAV for years.

Second, there may be a reason a particular CEF is trading at a discount to its NAV. It may have made negative changes in its distribution policy, or may own assets that are out of favor.

Third, and most important: a CEF’s NAV is not fixed. The NAV can change just as easily as the fund’s price. If you buy a CEF at a 10% discount to its NAV, but then the value of the fund’s assets declines by 10%, the discount will have been erased, but you won’t have made any money. (In fact, you’ll probably lose money as the price declines to reflect the loss of worth.)

So while it’s important to check a CEF’s discount or premium prior to purchasing it, a big discount is not in itself a reason to buy the fund.

That said, it’s important to be careful when buying shares at too high a premium. While shares currently trading at a premium can certainly stay at a premium for a long time, their upside may be limited. Unless the NAV increases commensurately, any increase in the share price will also widen the premium gap, which may limit how far the share price can rise.

You can also compare a CEF’s current discount or premium to its average historic discount or premium, as you might compare a stocks’ current P/E to its average historical P/E, a common strategy among value investors.

To find a CEF’s relative discount or relative premium in a historical range, use this equation:

\[
(\text{Current Discount} - \text{Average Discount}) / \text{Standard Deviation of the Discount} = z
\]

If \( z \) is negative, the CEF’s current discount is lower than its average, and this might be a good time to buy the fund. If \( z \) is positive, the current premium is higher than average, and the fund might be somewhat overvalued right now.

So, the important things to remember when investing in closed-end funds are:

- Check the discount or premium of any CEF you are considering buying.
- Premiums add risk to a CEF investment because unless the NAV rises to meet your purchase price, you will likely lose money on your investment in the long run. Avoid premiums above 10%.
- While buying a CEF at a discount can increase your chances of making money, always check to see if there is a reason why the fund is trading at a discount, and remember that the NAV can also decline.
- A fund’s relative discount is more important than its discount to the current NAV, because CEFs are more likely to return to their average historical discount than to their NAV.
**Mutual Funds**

Mutual funds give individual investors access to the active management of money managers by pooling their funds.

The appeal of mutual funds is their diversity. They give an individual investor access to wide array of investments—often between 50 and 200 securities—that they might not be able to afford on their own. That diversification reduces risk and exposure to one field or another. They also trade only once per day at closing, thus avoiding wild price fluctuations throughout a trading session.

However, the active management of mutual funds can be more of a downside than an advantage. You can never predict exactly what a fund manager will do, so in addition to sacrificing control, you won’t always know what you’re getting—or agree with the manager’s decisions. In addition, fund managers tend to hew closely to the indexes their funds are benchmarked against, and often try to beat the index by only a few percentage points per year, so their fund gains a reputation for reliability and predictability with institutional investors like pension funds. That’s fine, but when their index is underperforming the market, it can also mean sacrificing potential for better performance in the name of consistency.

As a result, mutual funds rarely beat the market; historically, less than 1% of them have beaten the market over time. If beating the market is one of your objectives in retirement, those odds aren’t worth the management fee you’ll pay.

Perhaps worst of all, mutual funds aren’t cheap; most of them come with expense ratios, sales charges and management fees. Those add up much quicker than the $10 or less fees you pay on your own every time you buy or sell a stock in your own brokerage account.

Given some of the cheaper alternatives we’ve already covered, mutual funds should be limited to a small part of your portfolio—or ignored entirely if you feel comfortable making your own investment decisions in your retirement years.

**Target-Date Funds**

For investors with retirement accounts that limit the types of investments they can buy, or who just want to keep some of their portfolio in index funds, target-date funds are popular. Assets in target date funds grew to $1.4 trillion in 2019, up 27% from 2018.

These funds are so-called because they have a specified “target date” that is close to your planned retirement time. The funds automatically adjust their asset mix to a be more conservative as the target date grows nearer—and you grow older.

While this “set it and forget it” approach is appealing to some investors, it has some drawbacks. The most obvious is the lack of personalization—not all investors become more conservative as they age, or want to start transitioning into fixed income at the same time. Target-date funds are likely to leave many investors feeling like their money is in the wrong place at the wrong time.

Target-date funds also have drawbacks for skittish or active investors, because they truly target long-term returns. Many investors will want to sell at the first sign of trouble in the fund, potentially destroying their chances of benefiting from this retirement vehicle over the long-term. Target-date funds are for the long-term investor who wants put his money somewhere and walk away, not jump in and out of investments.
Lastly, target-date funds usually determine their asset allocations based primarily on the target date, not on market conditions. That means some target date fund investors will inevitably wind up in the wrong place at the wrong time. Target-date funds for young investors are usually 80% to 90% invested in the stock market, for example, and have no provision for going to cash or switching to a different asset class if the market begins a serious correction. Likewise, target-date fund investors in or close to retirement will see most of their investment channeled to fixed income, regardless of the interest rate situation or bond market health.

It’s also hard to compare performance of the “customized” target-date plans offered by many 401(k)s, which often don’t have a ticker symbol.

Having said all that, it’s clear that target-date funds are enticing to individual investors. So if you do decide to invest in one, there are a couple of important considerations:

• **Check The Expense Ratio.** The lower, the better, and under 0.50% is best. And while Morningstar reports that the asset-weighted average expense ratio for target-date funds has declined from 1.04% in 2010, it was still 0.62% in 2018, the last full year for which there is data.

• **Know What To Expect.** Check the fund’s glide plan, or how the assets change as you grow older. “Through” plans tend to have more of a growth strategy, and may be better suited for investors that have other retirement assets, as they will tend to take on more risk to obtain that growth. For investors with more limited assets, a “to” plan, getting you up to retirement, may be preferable, and will tend to be more conservative.

**Fixed Income**

**Preferred Stocks**

Preferred stocks are a special class of shares that are traded like stocks but actually represent debt, like a bond or loan. They do not represent or confer ownership, and the distributions rarely go up. So you’d only buy a preferred for steady income, not capital gains. That said, preferred stock can generate a very steady income.

The yields are usually between 4% and 8%. And preferred shareholders are usually better protected—both in and out of bankruptcy—than common stock holders.

Preferred stock is usually issued at a par value of $25, although shares are sometimes issued for different amounts, including $50 and $100. When the shares are issued, the company announces the shares’ coupon rate and consequent annual dividend (which is the par value times the coupon rate). Although the coupon rate determines the annual dividend at the outset (because preferred shares are debt, so prevailing interest rates and credit conditions will determine what rate the company can issue preferreds at) the annual dividend is actually the number that won’t change over time. The “coupon rate” or yield may.

For example, a company that wants to issue preferreds yielding about 8% would declare an annual dividend for the shares of $2 (because $2/$25 = 0.08). Once the preferreds are trading, the annual dividend won’t change, so the yield may vary slightly. Most preferreds issued at $25 will trade in a range...
between $23 and $27, depending on market conditions and investor sentiment about the company and the preferreds. If the preferreds are trading at $26, then the current yield on the shares will be 7.69% ($2/$26 = 0.0769).

While preferred stock dividends still have to be “declared” by a company’s board quarter-to-quarter or year-to-year (unlike bond distributions, which are mandated), they usually won’t change. In addition, preferred stock dividends are very safe because they are paid before dividends on the common stock. And preferreds are above the common stock in the capital structure, so in bankruptcy, preferred shareholders’ claims over the company’s assets are superior to ordinary stockholders’ (although in practice, both usually get nothing).

Preferred stock dividends are also usually cumulative, meaning that if the company doesn’t pay some (or all) of its promised distributions, investors will receive them at a later date. The unpaid portion is considered “dividends in arrears” and must be paid before any other dividends. Check to make sure your preferred is “cumulative” to see if it has this feature. If it’s “non-cumulative,” skipped dividends don’t have to be made up.

One downside to preferred stock is that preferred holders usually don’t have voting rights as common stockholders do.

Lastly, while preferred stock is theoretically as easy to buy and sell as common stock, some preferred stocks are very lightly traded and may be difficult to buy or, more importantly, sell, at a desirable price. In general, it’s a good idea to avoid preferred stocks trading less than 4,000 shares daily, on average. In addition, preferred ticker symbols are not standardized—they usually take the form of the issuing company’s stock symbol followed by a letter indicating the preferred series, but some also include dashes, dots or a ‘P’ for preferred—so always double check to make sure you’re buying the specific issue you want.

Quantumonline.com is a good source of information on specific preferred stocks, including their annual dividends, call and maturity dates, whether they’re cumulative or convertible, and whether their dividends qualify for the 15% dividend tax rate.

**Bonds**

Bonds have historically been recommended for investors who want to preserve their capital above all else. However, the low interest rates that have prevailed since the financial crisis have driven yields down across the board so that many bonds now yield barely enough to keep up with inflation.

In general, the safer and shorter-duration a bond, the less it yields. Today, the safest treasury bonds aren’t even yielding enough to cover inflation. Many investors and institutions are responding by taking on greater risk, buying lower-quality bonds in search of decent yields. You should be cautious about this strategy; it can get you in a lot of trouble.

In addition, 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, depending on the bond’s coupon rate and how much above face value you paid. You can plug these numbers into a yield to maturity calculator like the one below to find out:


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.

### What is A Bond Ladder?

*Bond ladders are a way of creating your own adjustable-rate income stream, by buying a series of bonds or bond funds with staggered maturity dates. Then, as each security matures, you reinvest the proceeds in a new security at the top of ladder, which becomes your new longest-dated security. If interest rates are rising, the new investments will have higher coupon rates than the investments rolling off the bottom of the ladder, and your yield will gradually rise.*

*While longer-term bonds yield more, shorter-duration fixed income investments carry less interest rate risk. In other words, if you expect rates to go up soon, you’ll want your longest-dated bond to still mature fairly soon (probably within five years) so you’re not stuck holding a bunch of very low-yield fixed income investments for a long time.*

*The most important part of creating a bond ladder that will preserve your capital and work in a rising rate environment is that you only buy individual bonds or defined maturity bond funds. Unlike standard bond funds, bond funds with maturity dates preserve the principal guarantee you get with individual bonds, or the promise that you’ll get your original investment back when the security matures.*

*When the first maturity in your ladder arrives, you can keep your bond ladder intact by reinvesting the redemption value into a new security at the top of the ladder. This will maintain your income stream—and if rates are rising, it will grow over time.*
Annuities

Unlike some of the investments we’ve mentioned, annuities are designed specifically for retirees. They’re a means of securing steady cash flow so that you don’t outlive your assets.

Here’s how annuities work: they are a contract between a financial institution and an individual in which funds are accrued over a certain number of years and then, upon annuitization, paid out annually at a later point in time. Annuities are designed specifically for retirees, serving as a reliable means of steady cash flow during someone’s retirement years.

Pension funds and Social Security payments are forms of annuities. But few people who worked in the private sector have access to pension plans, and Social Security is only fully funded through 2033. Annuities can be structured in one of two ways: to pay out annually over a fixed period of time (say 20 years) or every year until the person receiving the annuity payments perishes. Fixed annuities pay out the same amount every year; variable annuities’ payouts depend on how well the annuity fund is performing.

Annuities make particular sense for anyone who has inherited or been gifted a large lump sum of money and wants to turn it into annual cash flow after retirement. In essence, it’s a way to make that money work for you for the duration of your life and ensure you don’t blow through your inheritance in a matter of just a few years.

The most important attribute of any annuity is its contractual guarantees. Sales pitches for variable and indexed annuities often make big promises about the potential growth of the annuity, but annuities are not the right place to be looking for growth. Indexed annuities were created specifically to compete with CD returns, not beat the market, while variable annuities tend to have a very limited spectrum of potential mutual fund investments. In addition, the high annual fees on variable annuities—averaging over 3%—will eat into any returns quickly.

The contractual guarantees, on the other hand, tell you what the annuity is actually guaranteed to do. Since annuities transfer risk, you want to have full confidence in the company issuing the annuity. You can check the carrier’s ratings on the COMDEX ranking system, which takes into account A.M. Best, Moody’s, Fitch and S&P ratings. Avoid low-rated companies. States insure annuities to a point, but it’s not FDIC-level coverage.

What do annuities provide? Principal protection and income for life.

You can ladder annuities in the same way you ladder bonds. As of this writing, yields are quite low, so investors interested in buying an annuity today might want to buy a smaller annuity now, and add additional annuities in the future, when rates might be higher. For example, you could buy one small annuity every five years for the next 15 years, or one every other year for the next six years.

Trading Options for Income

Dividends and interest payments are the standard ways to earn a steady stream of income in retirement. Trading options is a way to generate additional income from stocks you already own.
Covered calls are the least risky way to trade options and increase your retirement income. A covered call, also known as a Buy-Write, is a strategy in which the trader holds a long position in a stock and writes (sells) a call option on the same stock in an attempt to generate income.

For example, let’s say you own 100 shares of fictional stock XYZ, which is currently trading at 25. You then sell one XYZ August 26 Call (expiring 8/21/2015) for $1 for each of your 100 shares. Because you don’t have a position in the call until you execute this trade, this would be an order to “Sell to Open.” Let’s take a look at a few scenarios for this trade:

**In scenario 1**, XYZ shares trade flat for the next month and the stock stays at the 25-strike price. The options you sold will expire worthless and you will have collected your full premium of $1 per share ($100). Thus you will have created a yield of 4% in one month’s time.

**In scenario 2**, XYZ shares fall to 24. The options you sold will expire worthless and you will have collected your full premium of $1 per share ($100). However, your 100 shares of XYZ will have lost $100 of value. Thus, you are breakeven on the trade. At this time, you could simply sell the next month’s calls against your stock position.

**In scenario 3**, XYZ shares fall to 23. The options you sold will expire worthless and you will have collected your full premium of $1 (or $100). However, your shares of XYZ will have lost $200 of value, so you would be down $100 on the trade. At this time, you could simply sell the next month’s calls against your stock or exit the entire position by selling your stock.

**In scenario 4**, XYZ shares rise above 26. The owner of the 26 calls will exercise his right to buy the stock from you, leaving you with no position. However, you have collected your $1 (or $100) from your call and your stock position has appreciated another $100. You are up $200 on the trade and have created a yield of 8% in just one month. At this time, you can move on to another trade or buy the stock again and sell another call.

In two of those four scenarios, you create a yield of at least 4%—income that comes in addition to whatever dividend that stock may already pay. In another scenario, you break even and there is no harm done. Only one of the four covered-call scenarios is a losing proposition.

If you think earning as much as 8% extra income in just one month on a stock you already own is worth that risk, then covered calls are a good, fairly low-risk way to squeeze more money out of your retirement portfolio.
STEP 3: TAKING CARE OF THE DETAILS

Now you know what kind of investments you’re interested in, and how to choose them. But before you start loading up your portfolio, here are a few more practical items you should know.

Market Timing and Surviving Downturns

The best time to buy an umbrella is before it starts to rain. So even when the market is roaring ahead, it’s still important for all investors to have a crash contingency plan in place—especially if you’re a retiree who depends partly on your investment income to cover living expenses.

Retirees need to ensure that that income will continue even during periods of major price declines. As we discussed earlier, most stock dividends fit the bill, but take a hard look at any income-focused funds you hold. Are they just passing on dividend income, or are they generating income through some price-reliant strategy like covered calls or return of capital? You don’t necessarily need to sell these holdings now, but do figure out if you can live without that income in the event of a market crash. If not, figure out how you’re going to replace it.

Stock dividends can remain a great source of income in almost all market environments. Over the past 80 years, between 30% and 40% of stocks’ total returns have come from dividends, not price appreciation. Morningstar has crunched the numbers going back to 1927 to show that dividend income accounts for 41% of the annualized total return from large-cap stocks, 35% of the total return from mid-cap stocks and 31% from small-cap stocks.

Plus, dividend-paying stocks are less volatile than other stocks. Data collected by Eugene T. Fama and Kenneth R. French shows that dividend payers are 5% to 20% less volatile than other stocks. Their volatility does increase when overall volatility increases (as it has in recent years), but dividend payers are generally much calmer (measured by looking at the average standard deviation of trailing monthly returns).

Resilient, cash-rich dividend payers are the best vehicle for maintaining a steady income during troubled times in the market. They lose less of their value during corrections, they’re less volatile overall and they keep paying you regardless of what prices are doing.

Market collapses can come in many varieties. The 2008 crash hit all stocks hard, but the worst damage was done to stocks of financials, housing-related companies and businesses with high debt or business models based on borrowing. The 2000 crash hit tech companies particularly hard, which was especially devastating for investors who owned mostly dot-coms.

Look at your holdings individually. What type of event would be the worst-case scenario for each one? Do you have other holdings that would also be devastated in this situation? Be frank with yourself. If you have too many holdings with similar risk factors, you probably need to diversify.
Developing a Sell Strategy

Even in the absence of a full-fledged crash, you need to have a sell strategy that you can apply to all your stocks individually. Though income investing is mostly a buy-and-hold proposition, that doesn’t mean buy-and-hold-on-for-dear-life whatever happens. And it certainly doesn’t mean buy and hold, regardless of how far the stock falls.

Our *Cabot Dividend Investor* system, IRIS, requires that stocks meet several criteria to maintain a Buy or Hold rating. These criteria include benchmarks for payout ratio, cash flow growth, dividend growth rate and other factors that are important to the company’s continued ability to pay its dividend. When one of these factors falls below our required level, we change our rating to Sell.

Looking for these “red flags” gets us out of stocks that don’t have the strength to hold up to a big crash. (It also keeps us concentrated in the best stocks with the best future potential.) You can create your own simple sell discipline by writing down rules for yourself like, “If a stock cuts its dividend, sell.” This won’t get you out at the top (dividend cuts are usually last-ditch moves, after all), but it will keep you from holding onto losers forever.

You may also choose to sell a stock when the potential for reward has declined, even if risk has not increased. Keep a long-term perspective, but to paraphrase a saying often credited to the economist John Maynard Keynes (although probably apocryphally), when the facts change, it’s okay to change your mind.

It’s also fine to sell a holding because you think your money will be treated better elsewhere, whether in the intermediate- or long-term. If a company is going through a challenging period and expects below-par performance over the next several years, there’s nothing wrong with moving your money into something with better risk/reward profile in the meantime. If the original investment is high enough quality to be worthy of long-term investment, you can always come back to it.

The simplest sell rules are those based on price. Ask yourself: What type of losses (percentage-wise) am I willing to absorb? Our growth advisories suggest you employ a 10% to 15% loss limit, but you’ll probably choose to give some of your income-generating holdings more leeway.

Coca-Cola (KO), for example, lost 30% from the 2007 market peak to the 2009 trough. A growth investor would have (and should have) sold. But the company never cut its dividend. In fact, it raised its dividend on schedule in 2008 and 2009. And the blue chip recovered its 30% hit by the end of 2010, and has continued to thrive since.

The bottom line is that if you’re holding a diversified-enough portfolio that includes the right kind of dividend stocks, you’ll be able to ride out crashes like 2008’s without batting an eye. Not many investors can say that.

Most investors will want to employ different sell rules for different types of investments. In the *Cabot Dividend Investor* portfolio, for example, I have lower short-term performance standards for our higher-

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**Should I Use Sell Stops or Stop Losses?**

*Only if you’re on vacation (or can’t keep an eye on your portfolio for some other reason). The rest of the time I think mental stops are more appropriate, so you don’t get stopped out by intra-day moves or “flash crashes.” I just check my closing prices and sell the next day if necessary. It gives you a lot more control over your selling price, and keeps you from getting stopped out on an intra-day fluctuation.*

The level of your mental stop should depend on both your risk tolerance and investment thesis for that particular stock.
quality “safe income” investments, which I’m more confident in long term (because they’ve been selected for their long and consistent histories and low risk).

How Many Stocks?

Portfolio management includes everything from determining your investment goals to setting loss limits, but there are still a few nuts and bolts we haven’t addressed yet. One is how many positions your portfolio should include. The answer varies depending on your investment style, time horizon and portfolio size, but the bottom line is this:

Own enough stocks to give you meaningful diversification, but few enough that each individual investment matters ... and not so many that you don’t have time to manage them all.

Or as our V.P. of Investments, Mike Cintolo, has written: “The question is really whether you want to be average (which you can do by owning index funds and a couple dozen names), or whether you want to strive for awesome performance ... which normally comes via owning a few top-notch, revolutionary leaders, and knowing them inside out.”

Concentration does increase risk, but it also makes it easier and less time-consuming to keep track of your stocks, and makes above-average performance more achievable. One big winner won’t affect your results very much if it only makes up 3% of your portfolio. But a larger position in that same investment could mean a very big payday.

As Mike argues very well above, the more you spread out your money, the closer you inevitably get to being average. Take the assumption to its extreme: if you owned every stock in the market, you’d be exactly matching the performance of the market.

Warren Buffett has said pretty much the same thing about his own portfolio (which is Berkshire Hathaway). Way back in 1995, he said, “The giant disadvantage we face is size: In the early years, we needed only good ideas, but now we need good big ideas.”

But even if you’re not managing a portfolio the size of Berkshire Hathaway, there’s a size at which your positions are just too small to make a difference.

And if you have a smaller portfolio (in terms of the amount of dollars you have to invest), commission costs can really eat into smaller buys and sells, making larger positions more economical.

And yet, despite all the advantages of having fewer, larger positions, I still often hear from investors who own more stocks than they want to or think they should. The reason these investors wind up with too many stocks is the same reason you wind up with too much of anything (shoes, antiques, knick knacks)—too much buying and not enough selling. Buying a new stock fills investors with a sense of infinite possibility and hope for the future. Selling a stock is final, and many investors see it as a chore.
Diversification

In addition, diversification is usually one of the first portfolio management principles investors learn. And one easy way to feel diversified is to own a lot of investments. However, too often investors don’t achieve real diversification because they fail to consider all the ways in which their various investments are connected.

One thing most investors get right is diversifying by industry. That means making sure investments from any one industry—finance, or consumer discretionary, or industrials—don’t make up too large a portion of their portfolio. It’s a good rule, and one too many investors learned the hard way after betting everything plus the shirt off their back on the 2000 tech bubble.

But you can diversify by asset class as well, owning some bonds, some stocks and some real estate or alternative investments.

For 401(k) investors, diversification also usually includes quarterly or annual rebalancing to keep their best-performing assets from becoming too large a portion of their portfolio.

You can also use diversification as a tool, to protect your portfolio from specific events or effects, or to limit your risk of loss. This type of diversification limits your exposure to any type of broad market influence, whether it’s a downturn in a specific sector, rising interest rates, a foreign political crisis or a totally unforeseen event.

For example, rising interest rates are bad news for bond funds, which will be stuck holding low-yielding bonds that depreciate in value as newer, higher-yielding bonds become available. But you should also be aware of the effect rising rates could have on other segments of your portfolio. REITs, utilities and other companies that carry a lot of debt will see their borrowing costs rise as interest rates climb. Preferred stocks will likely see some declines, and leveraged CEFs and other funds will have to adjust.

But there are several industries and asset classes that will benefit from rising rates, and diversification can mean making sure you have appropriate exposure to these investments in your portfolio as well. For example, insurance companies become more profitable when rates rise, because they can earn higher returns on their investments and reserves.

You can use diversification to hedge against other macro trends in the same way. The rising dollar is bad news for U.S.-based multinationals, but good news for international companies with significant U.S. sales, as well as domestic utilities. Rising consumer spending and lower unemployment have both meant bad news for interest rate-sensitive investments but are great news for consumer discretionary companies. A sufficiently diverse portfolio can balance the negative and positive effects of things you can’t control.
On the other hand, there is such a thing as too much diversification. Warren Buffett has said, “Diversification is protection against ignorance. It makes little sense if you know what you are doing.” Many investors take diversification to an extreme, investing only in broad index funds because they believe it’s impossible to beat the market. Others buy so many stocks that their own portfolios begin to resemble index funds. But remember, the more your portfolio starts to look like the broad market, the closer your returns will be to average. That’s fine if you’re happy matching the indexes, but not if you want to be above average.

In other words, even though diversification will help you limit risk by offsetting losing positions with winning positions, the opposite is also true—losses will offset gains and reduce returns.

**Paying Taxes In Retirement**

Most investors assume their taxes will decrease in retirement. In fact, generating most of your income from Social Security and investments can have surprising tax consequences.

Any profits you earn from selling stocks, bonds, mutual funds or real estate are still subject to capital gains taxes. If you’ve held an investment for longer than a year, the current rate is 15%. Short-term capital gains (held less than a year) are taxed at your regular income tax rate. Withdrawals from tax-deferred accounts such as traditional IRAs and 401(k)s are also taxed as ordinary income.

Those taxes can eat away at your profits at any stage of life. In retirement, with no full-time job as your main source of income, taxes can erode your nest egg.

 Thankfully, there are ways to soften the blow. Those include:

**Roth IRAs**

A Roth IRA is the best, simplest source of tax-free retirement income. You fund the account with after-tax dollars, which grow tax-free. Once you reach age 59 1/2, you can begin to withdraw the principal and any gains—including gains from price appreciation, dividends and interest—without being taxed.

In addition, withdrawals from a Roth IRA don’t count as income for early recipients of Social Security (who receive less Social Security for every dollar they earn over $15,000). Thus, for many retirees, it makes sense to convert your 401(k)s and traditional IRAs to a Roth IRA in either the first year of retirement (when you have no more employment income) or even earlier. You will owe some taxes on conversion, but the earlier you move the funds, the more time they’ll have to grow tax-free.

**Tax-Advantaged Investments**

In addition to doing your investing in a tax-advantaged account, retirees can reduce their tax burdens by generating tax-advantaged income and owning tax-advantaged assets. These include:

- **Qualified Dividends.** One of the best tax gifts the U.S. government has made to retirees is also the simplest to take advantage of. Investors who receive dividend income from qualified stocks owe taxes on only 15% of that income, no matter how much they earned! (You do need to have held the stock for over 60 days, including the ex-dividend date, in order to qualify for the lower dividend tax rate.)
Most ordinary dividends paid by U.S.-based companies will qualify. However, some foreign companies also pay qualified dividends, and special or extraordinary dividends can be classified as qualified as well.

Qualified dividends are one of the most common types of distributions, so whatever your investing style or income needs, you can probably find investments that pay qualified dividends that fit it.

- **Municipal Bonds.** Many retirees (and people in high income-tax brackets) like muni bonds for their potential to generate tax-free income. That’s because you don’t owe Federal income tax on interest paid by general obligation bonds issued by state and local governments. The interest is often free from state and local taxes as well, especially if you live in the state where the bond was issued.

Munis are also usually very low risk, since the interest payments are mandatory and the principal must be repaid on maturity. Stick to investment-grade-rated issues (so nothing issued by Detroit) for the most reliable income stream.

- **Master Limited Partnerships.** Master Limited Partnerships, or MLPs, don’t pay taxes at the corporate level and pass most of their income on to investors. In addition, distributions from MLPs are heavily tax-advantaged, with most of the tax burden deferred until the MLP is sold, so they can be great investments for retirees trying to reduce their taxes.

Investors who own MLPs usually find they owe income taxes on 10% to 20% of their MLP distributions. The other 80% to 90% of the distribution is considered Return of Capital, which is not considered income. Instead, it’s treated as if the MLP is simply giving some of the money you’ve invested in it back to you. As such, you’re not taxed on this portion of the distribution. Instead, it reduces your cost basis in the MLP.

And your cost basis will continue to be reduced by the Return of Capital amount (sometimes called shielded income) each successive tax year. However, if you sell the MLP, you’ll then owe taxes on your gains. In addition, if you’re investing through an IRA, you probably want to avoid MLPs, because the Return of Capital is considered unrelated business taxable income (UBTI) and can trigger a big tax liability for your IRA.

- **Business Development Companies.** Business Development Companies, or BDCs, are another tax-advantaged type of investment that pays very high distributions. Some BDCs pay distributions that are taxed at ordinary income tax rates, but others consistently designate a portion of their distributions as Return of Capital, which aren’t taxed until you sell your shares.

Some BDCs may also designate some of their distributions as qualified dividends, which are taxed at a lower 15% dividend tax rate.

How the distributions are treated depends on how the BDC earned the income. Interest the BDC earned from loans and preferred stock is taxed at your normal income tax rate, for example, while qualified dividend income from preferred stock will be taxed at the 15% rate. You can check how a BDC’s past distributions have been taxed to see how a specific BDC generates most of its income.
Charitable Contributions

Did you know you can reduce your tax burden by making charitable contributions directly from your portfolio? If you donate stock that has appreciated in value since you bought it, you get a tax deduction for the current market value of the shares, regardless of your cost basis. So if you invested $3,000 in 1995 and your investment is now worth $5,000, you can donate the shares to charity now, write off the $5,000 donation and owe no tax on the $2,000 gain.

State Taxes

You’ll also want to consider what state taxes you’ll owe in retirement. If you live in an income tax state, you’ll likely still owe state income tax. Some states exempt social security income or income from qualified retirement plans, but others don’t. You may also face state estate and inheritance taxes. Some states give tax breaks to retirees through, including property tax credits for seniors.

You can find out your own state’s tax policies toward retirees with Kiplinger’s useful map at this link:

www.kiplinger.com/tools/retiree_map

If you’re considering relocating in retirement, you’d be wise to make tax issues one of your considerations.

Choosing a Financial Advisor

Retirement is supposed to be relaxing. After decades of hard work, you don’t want to be bogged down with too many time-consuming or arduous tasks. That includes investing.

Even savvy investors sometimes want help with some of the details of investing, like figuring out which investments to put in which account, how long they can expect their money to last and avoiding taxes. For many, hiring a financial advisor to do the dirty work for them is an easy decision. The harder part is finding the right financial advisor.

How do you find the right financial advisor? Start by seeking referrals from friends—particularly friends with similar financial needs and around the same life stage (i.e. retired or soon-to-be retired) as you. You want to find a financial advisor you can trust. A recommendation from a person you trust is a very good start.

Next, limit your search to fee-only financial advisors. You don’t want someone who earns commissions for steering you toward specific investments, recommending another advisor, or trying to sell you annuities or insurance. That’s an inherent conflict of interest, and advisors who charge that way don’t always have your best interests at heart. You want an advisor who charges a flat fee or rate.

If an advisor receives commissions or fees for selling clients specific funds or annuities, or recommending money managers, your financial wellbeing won’t be his first priority.

You can also check to see if an advisor is certified and licensed—and whether he or she has had any regulatory actions, violations or complaints filed against them—by using FINRA’s BrokerCheck tool or the IRS’s own website.
Trustworthiness is important. But you also want an advisor with a strong track record. During your initial interview with a financial advisor, ask for their documented track record (not just the track record of funds he or she has recommended). If that track record shows a history of failing to beat the market, you’ll probably want to look elsewhere.

Other things to look for when choosing a financial advisor include what types of services they provide, what types of clients they specialize in, and what his or her investment approach is. You want someone who has experience with retirees. Some advisors simply recommend the same investments regardless of a person’s life stage, so you want someone who is accustomed to financial planning for—and during—retirement.

Also, you want your advisor’s investment approach to at least somewhat align with your own. For instance, if you want to invest conservatively and take on little risk, you don’t want to be advised by someone who prefers to be more aggressive and go for home runs at every turn. (Although frankly, we more often hear from subscribers with the opposite problem: an appetite for exciting growth stocks and an advisor who just wants to sell them bonds and index funds.)

Above all, you want a financial advisor with whom you feel comfortable. If you don’t like your financial advisor, you’ll be less likely to turn to them for advice, and less likely to take the advice when you do. Most importantly, the more comfortable you are with your advisor, the less stress you’ll feel about where you’re putting your money.

**Bequeathing and Gifting Investments**

Investing for and during retirement is primarily about having enough money to sustain you and your family through your remaining years and decades. That often includes your spouse and may also include leaving something for your children or other family members.

You may want to leave money to children after you’re gone, or to gift them money for things like down payments on houses, weddings and grandchildren’s college funds while you’re still alive. Plus, there are benefits to you for doing so.

Say your retirement portfolio is doing very well, and you have significant investing profits that you don’t want to pay astronomical capital gains taxes on. You can either transfer some of the appreciated assets to your estate with the intention of passing them on to an heir or gift the profits to a relative in a low tax bracket.

Bequeathed property benefits from a step-up, which shields gains unrealized by an owner at the time of his or death from income taxation. Investment earnings that you gift to a child or grandchild while you’re still alive offers a similar shield, and has the additional benefit of being tax-free for the person receiving the gift if their tax bracket is 25% or lower and thus doesn’t have to pay long-term capital gains taxes.

Your children or grandchildren will surely appreciate the gesture, and it will help prevent those pesky capital gains taxes from eating away at your overall return.
In Conclusion

I hope you finish this handbook feeling both better educated and better prepared to take control of your own investing in retirement. I encourage you to use the guide as a hands-on resource when making investment decisions and refer back to the early sections if you ever lose sight of the big picture. Remember, no one cares about your money as much as you do, which makes you the best-qualified person to manage it.

Enjoy retirement!

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. In his Cabot Income Advisor, Cabot Retirement Club, and Cabot Dividend Investor advisory services, Tom combines a scientific, quantitative approach to stock analysis with the practical, personal and honest advice that have characterized Cabot’s services since 1970.