Three Steps to Annuity-Free Income

By Kerry Pechter *Wed, Nov 2, 2011*

For retirees who say, 'Don't sell me a product!', Thornburg Investment Management recommends a retirement income strategy built on 'endowment' spending, three buckets and its own dividend fund.

"The rich," F. Scott Fitzgerald famously wrote, "are different from you and me."

For Fitzgerald's tycoons, that meant wearing excellent shirts and driving recklessly. For today's millionaires, it means having enough money not to worry about running short of it in retirement. And, it can be added, without needing an annuity. Consequently, many so-called high net worth investors avoid annuities.

"Don't sell me a product!" they say, according to Jack Gardner of Thornburg Investment Management. As Gardner put it in a 2010 essay, certain clients are "loath to accept the loss of control and expense" of insurance products.

For the annuity-averse, Gardner recommends a three-point plan for generating a predictable retirement income without an annuity. As he explained recently at the Center for Due Diligence conference in Chicago, it entails dividend stocks, "endowment-style" spending curbs, and three common-sense asset buckets.

Dividend play

The first point of the plan involves using dividend-paying stocks. Just by owning the top 100 dividend-paying stocks in the S&P 500 instead of the S&P 500 Index, he said, a retiree household could increase its annual income by as much as 25%.

Annualized total returns of the S&P Dividend Aristocrats Index, he said, have been higher than the returns of the S&P 500 for every four-year period since 1990 except in the period that included the end of the dot-com bubble in 2001.

Faced with low bond yields and a future that promises little bond price appreciation, investors can't help but find a dividend stocks play attractive. Ideally, Thornburg says in its literature on the topic, a dividend stock portfolio should include global equities, which often pay higher dividends than U.S. companies.

Thornburg's own dividend income fund, Investment Income Builder Fund, holds about 80% equities and 20% bonds. Its largest holding is an Australian telecom. More than half of its bonds are rated BBB or lower, and almost 54% of its holdings are outside the U.S.

Are dividend stocks the answer for yield-hungry retirees in a zero-bound world? Recently they've drawn a crowd of admirers, but popularity isn't necessarily good, says fee-only advisor Russell Wild of Allentown, Pennsylvania, the author of *ETF for Dummies*.

"A lot of pundits have jumped on board the dividend bandwagon," Wild told RIJ. "It's one of the most popular categories in new ETFs right now. They have a recent edge in performance, but when things get popular, their edge tends to get lost.

"One should be cautious about something that's hot. They're a good long-term investment, but are they really much better than value stocks? Also, if you have an all dividend stock portfolio you won't be optimally diversified."

Endow yourself

The second prong of Gardner's no-annuity retirement income strategy involved withdrawal smoothing of the type that endowments commonly use to make their money last over a 30- to 40-year time horizon.

Instead of blindly withdrawing a certain percentage from their portfolios every year and increasing that amount by the rate of inflation, Gardner proposed a formula that limited spending to 90% of the previous year's withdrawal plus only 10% of the current portfolio balance times the withdrawal rate. The resulting amount would then be increased by the inflation rate.

"When things aren't going well, you need to tighten it up," Gardner said. "Don't keep up with inflation. Spend less than inflation."

For example, suppose a retiree withdrew $50,000 from a $1 million portfolio in the first year of retirement. Then suppose a bear market in the next year reduced the portfolio value to $800,000, while inflation reached 6%. His base withdrawal for the second year of retirement would be $51,940.

Gardner arrived at that number by starting at $45,000 (0.9 x $50,000), then increasing it by $4000 ($800,000 x 0.1 x .05) and then increasing that amount by $3,940 (.06 x $49,000) to get $51,940.

That's a compromise between the $56,000 that a fixed-dollar payout formula (plus 6% inflation) would have provided and the $42,400 that a fixed percentage payout formula (plus 6% inflation) would have provided, all else being equal.

Someone who retired in 1973—the start of stagflation—and followed the endowment policy would have seen his portfolio last for 30 years. The same hypothetical retiree, using a fixed-dollar strategy, would have run out of money after 21.5 years, according to Gardner's calculations.

Three easy buckets

In addition to dividend-paying stocks and an endowment style drawdown strategy, Gardner recommended holding assets in three time-segmented buckets. No surprises here.

The first bucket is a checking account. The second bucket contains enough cash to cover two years of expenses and to avert any need to sell depressed assets. A third bucket contains the rest of the assets, in stock and bond mutual funds.

Gardner’s three-point strategy is aimed at people who don’t want the complexity or expense of annuities and can afford to self-insure against longevity risk. But one could argue that even the wealthy can benefit from the survivor credits that come from mortality pooling.

While annuities are admittedly not cheap, neither is Thornburg’s own Investment Income Builder Fund. The A-share carries a front-end load of 4.5% and an ongoing expense of 1.21%. The C-share carries a one-year 1% contingent deferred sales charge and an ongoing charge of 2.02% (1.90% with a Thornburg subsidy through at least February 1, 2012.) The I-share has no front-end load and cost 93 basis points a year, but participation requires institutional-sized purchase amounts.