NOLAN WEALTH MANAGEMENT
WEALTH MANAGEMENT SOLUTIONS

On The Mark

Addressing the Income Challenge

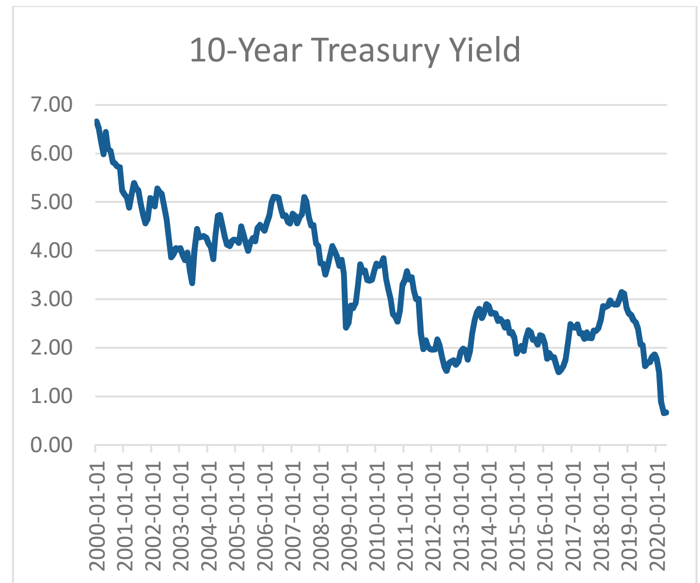
June 2020

Key Takeaways

- Low interest rates are likely to persist, limiting the income and return from cash and government bonds.
- Investors need to remain flexible on ways to address the income challenge by expanding the idea of where you can look for income in your portfolio.
- Building a plan that can adjust to dynamic markets and choosing a withdrawal rate that is sustainable are likely parts of a successful income plan going forward.

Implication of low interest rates

For investors and savers, interest rates look very different today than several decades ago. My parents often recite the good old days when they were able live off the income from their savings. Two decades ago, at the start of 2000, the 10-year Treasury yielded was 6.7%. Interest rates have continued to fall consistently to 3.8% at the start of 2010 to a measly 0.7% in May 2020. This has important implications for return expectations of bond performance. According to research by Blackrock, the 10-year Treasury yield at the start of the decade provides a good gauge for bond returns using the most commonly cited bond index of Bloomberg Barclays Aggregate Index (AGG) going forward. For example, the 10-year Treasury was yielding 3.8% on Jan 1, 2010 and the annualized return for the AGG through the decade was 3.75%[1]. Extrapolating those results to today results in low return potentials over the next 10 years as the 10-year Treasury started the year at 1.8% and has since fallen to roughly 0.7% as of May 1, 2020. That means that if you were to retire today and invest $1 million of your hard-earned nest egg in the 10-year Treasury, you could only count on $7,000 a year and perhaps even less than that after accounting for inflation.

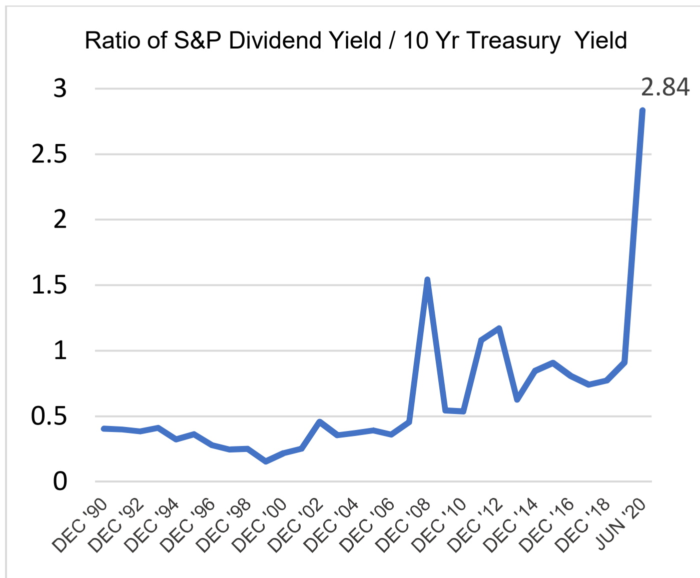


Source: Fred Economic data

What can income investors do?

Flexibility is key for investors looking to make the nest egg last longer. The idea of income can come from harvesting capital gains along with interest and dividends, even spending down some of your principal. Below, we have highlighted some of the considerations for investors going forward.

Investors will likely need to accept greater risk through investments like high-yield bonds, real assets, and equities. Equity investments may be suitable to provide growth and income for those with time horizons of greater than five years and who are prepared to take additional risk. Despite the recent rally in stocks, given historically low Treasury yields, the ratio of S&P 500 dividend yield compared to the 10-year Treasury yield is near the highest level since the 1990s, which provides additional sources of growth and income.



Source: FactSet. 12/23/90-6/12/20

That does not mean Treasuries and higher quality bonds do not have a place in your income portfolios going forward. Instead, likely the primary purpose of Treasuries will be as a buffer during periods of market volatility rather than a source of returns like years past.

Building a retirement portfolio by including additional sources of income like equities introduces yet another challenge called the sequence of return risk. In simple terms, that means as investors you may encounter poor returns early on in your retirement as you begin taking distributions from your comingled portfolio of stocks and bonds. This has a potential to impair the portfolio returns as selling assets like equities at their lows may prevent the recovery of the portfolio. A simple solution to address this conundrum has been to utilize a bucketing strategy. The strategy separates your investments into "buckets" for near term, medium- and longer-term spending. Addressing your near-term income needs so that you have adequate cash or lower-risk investments while separating your growth assets can help you ride through a low yield period or a period when equities are down.

Lastly, as investors we cannot control market returns but there are areas we can control, such as planning for our goals, that can adjust to the dynamic markets and selecting the withdrawal rate. With low yields likely to stick around for a while, investors need to rethink the historic guideline of 4% withdrawal rule to a likely lower starting withdrawal rate. Perhaps the most important part to address the challenge is to have a goals-based plan that helps you track success along the way.

Challenges of a low-interest rate environment leaves investors with the hard choices of reducing spending rates, pulling more from savings earlier or taking on more risks to answer the real-life conundrum of making retirement assets last. While it may not be simple, flexibility and a thoughtful approach are they key for investors to rise to the income challenge.

[1] https://www.barrons.com/articles/with-rates-so-low-income-investors-need-to-rethink-bonds-51591404975?emailToken=961ad13fb4cfa380df5879a81978cd33m6ZploSS7LwRIzr9MV52TN%2FZvVyhcNP2E9q1IV%2B2G5DKqI7%2BeiQfJC2ckYrCRtC1fPu7T0u0wb7xwe9BsSKCo9bXTC7T4%2BPjaU81bzPj3HINwxvixiuPWS94yaA%2BumrI

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The Standard & Poor's 500 Index (S&P 500) is an unmanaged group of securities considered to be representative of the stock market.

The Bloomberg Barclays U.S. Aggregate Bond Index is a market capitalization-weighted index comprising Treasury securities, Government agency bonds, mortgage backed bonds, corporate bonds, and some foreign bonds traded in the U.S.