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Planning a Retirement Without Dividends

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Many retirees have certain ideas about how they will occupy their days and how they will pay for it. Dividends are often a part of those plans.

But relying solely on regular checks from dividend-paying stocks or funds for retirement income is an outdated strategy, with little chance of supporting someone for, say, 30-years. This would be the case, even if dividends were not been disappearing at a record pace (as they have in recent months).

For one thing, relying on dividend payers will probably result in a portfolio that's too concentrated in areas like financial stocks, which paid the most in dividends until recently. Financial companies accounted for more than 30 percent of the Standard & Poor's 500 Index's dividend income in 2007, but now account for just 10.6 percent.

Overall, constituents of the S. & P. cut nearly $42 billion in quarterly dividends this year, or 16.9 percent of 2008 payouts. That unprecedented decline followed another, of $15.9 billion, in the fourth quarter. "You are going to see significantly worse numbers this year, and there's more bad news in the pike," said Howard Silverblatt, senior index analyst at S.&P.

Even more disconcerting, especially for retirees, is that the cuts have come from many stocks that were once viewed as blue-chip stalwarts: General Electric, Bank of America, J.P. Morgan. And not only have many of these companies cut their dividends, but their stock prices have also dwindled. So retirees who were relying on the stocks for income may be forced to sell at the worst possible time.

"There is extreme danger in counting on a dividend strategy right now," said Joel Framson, a financial adviser in Los Angeles. "In fact, too many of the decimated portfolios we are seeing in our new clients were caused by people thinking they could capture high dividend yields without taking risk."

Of course, in these unpredictable times, there are no easy answers. Even the most diversified portfolios have taken devastating hits. But there are ways to structure your retirement portfolio so that you won't be forced to sell investments at the most inopportune moments, as well as ways to create a paycheck, of sorts, in retirement.

TOTAL RETURN First, instead of focusing solely on dividend-paying investments, financial planners said that retirees should look at a retirement portfolio holistically. In financial adviser speak, this is known as a total return strategy, which includes drawing upon a collection of dividends, interest and capital gains (when they eventually return). You should devise an asset allocation based on your time horizon and tolerance for risk, among other factors. And all diversified portfolios will see the benefits of dividends — historically, they've accounted for more than 40 percent of stock market returns over the long haul.

In retirement, you withdraw a set amount of money from your portfolio each year, typically around 4 percent, and increase the dollar amount withdrawn each year to adjust for inflation. To ride out these tough economic times, many planners advise forgoing the inflation adjustment, or even withdrawing less. This is especially true for people who are still in the early years of their retirement and worried about outliving their savings.

FIVE-YEAR PLAN In the current environment, this strategy stands out. In the 1980s, Harold Evensky, president of Evensky & Katz Wealth Management, came up with what he calls a five-year mantra. Mr. Evensky believes you should not invest any of the money you'll need in the next five years — whether it's for living expenses or a large purchase or another anticipated expense.

Take a couple with a $750,000 retirement portfolio who needs $30,000 a year. Using Mr. Evensky's strategy, they would set up three separate accounts. The first account would hold two years of expenses, or $60,000. About half of that money would be in a money-market account, while the balance would be in a short-term, high-quality bond fund (like the Vanguard Short-Term Bond Index). Each month, $2,500 ($30,000 divided by 12 months) would be automatically transferred from the money market fund into a second account — a local checking account — to pay their expenses.

"Knowing where their grocery money is coming from makes it a little easier," Mr. Evensky said. "When things get bad, they will know they can look at it, they can touch it and they know they haven't lost a penny."

The third account, the investment portfolio, would hold the remaining $690,000. This money would be diversified among stocks, bonds and other asset classes based on the couple's stomach for risk, age and overall goals. But part of the allocation would include at least three years of expenses in short-term bonds. If there isn't a good time to replenish the cash account, the couple can tap the short-term bonds (that way, they don't have to sell their investments when the markets are down). Otherwise, the cash account can be replenished through rebalancing the investment portfolio.

Mr. Evensky said he tested how this method might work during a period similar to the 1970s, when both stocks and bonds were decimated and inflation was rampant. His portfolio lasted 24 years, whereas a portfolio invested in 50 percent stocks and 50 percent bonds ran out of money after 20 years, and an all-bond portfolio ran dry after 12 years.

IMMEDIATE ANNUITIES With this type of annuity, you give a pile of money to an insurance company, and it provides you with a paycheck until you die. For a 65-year-old male, the payout rate is about 8 percent. So for every $100,000 that man purchases, he will receive $8,000 annually, according to New York Life. Women receive slightly less because they live longer. The payout will be less if you choose to adjust your payments for inflation. Of course, you need to choose an insurer carefully — especially now.

"The promise to pay lifetime income is only as good as the insurance company can deliver," said Karin Maloney Stifler, a certified financial planner in Hudson, Ohio. "Investors must realize that annuities entail credit or default risk by the insurer."

You can spread your risk by buying a few annuities from a few top-rated insurers and only buy up to the amount that the state regulator will insure in the event of a default. Ms. Stifler said that $100,000 is typical.

The big downside with annuities, of course, is that you cannot get your money back. And if you die shortly after you buy the annuity, your heirs will get nothing.

How much annuity do you need? Generally, you shouldn't put all your nest egg into an annuity. One approach is to tally up your essential living expenses (housing, health care, groceries, etc). Then, figure out how much reliable income you have from Social Security, for instance, or a pension. If there's a gap between the two, it may make sense to purchase an annuity to fund the difference, Ms. Stifler said.

PAYOUT FUNDS These mutual funds, which are intended to provide retirees with an income stream during retirement, have only hit the market in the past 18 months or so. There are generally two types of funds, though they're all generally funds that invest in other funds. The first type operates much like a university endowment: it aims to generate a stable income stream — say, 3 or 5 percent — while either preserving or increasing the initial investment. Vanguard and Schwab offer funds in this mold. The second type of payout fund also aims to generate income, but only until a specified date in the future, when the remaining money, if any, is completely distributed. The Fidelity Income Replacement Funds use this methodology.

But when a fund performs poorly, the income generated will also fall. In some cases, the funds will begin to return your principal. That's why some experts say these funds will more likely be used to cover discretionary expenses. Given the complexity of these funds, you really need to understand them fully — and the supporting role they should play in your portfolio — before jumping in.

"They are all interesting approaches, but they are unproven," said Dan Culloton, associate director of fund analysis at Morningstar Inc. "You can lose money, and people have thus far. But they are an interesting proposal for someone who wants to turn their nest eggs into a stream of payments and have some control over the assets and the ability to take money out."