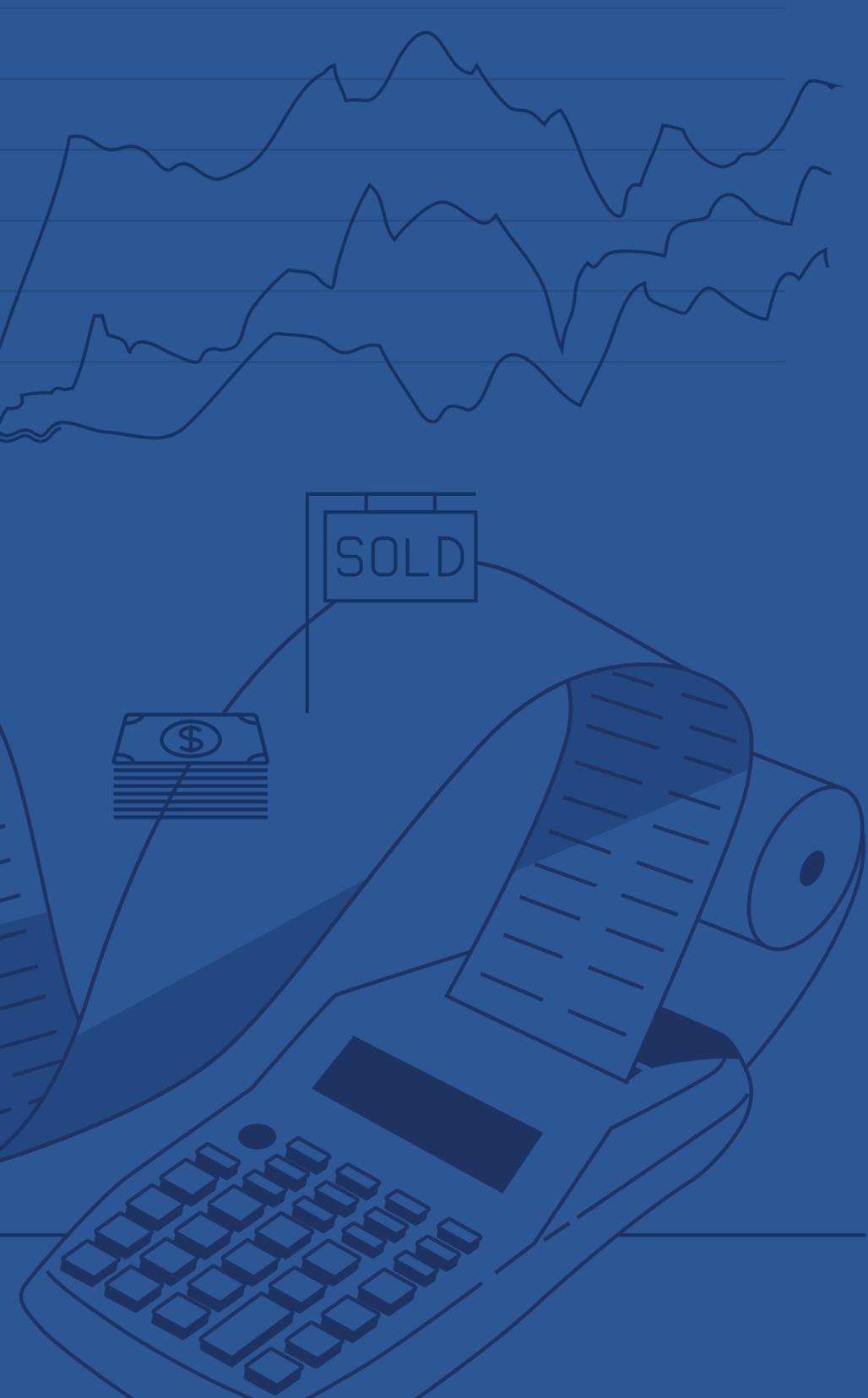




# Optimizing the Income Portfolio

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## INTRODUCTION

During our working years, earned income provides the cash flow we need to meet life's expenses. As retirement approaches, the challenge shifts—we must monetize our work savings to fund years without work. Among the viable strategies are investment income portfolios.

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**Income portfolios have one purpose: to provide a constant monthly cash stream—primarily interest and dividends—without depleting the underlying portfolio.**

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Unlike equity portfolios, where cash is generated by liquidating the portfolio over time, income portfolios are designed to conserve capital while generating income. An income portfolio may be the retiree's only source of personal income, or the income account may be paired with retirement and equity investment accounts.

The challenge is to design a portfolio that provides sufficient cash and can adapt to changing economic and personal circumstances. Over a 30-year retirement, an income portfolio may need to be adjusted three to four times to maintain the required cash flow. It is not a set-it-and-forget-it approach. This guide aims to help you understand your income options and how to structure income investing to meet your unique needs.

**Retirement savings are only one option; other popular income investing uses exist.**

### POPULAR INVESTMENT USES



**Paying off major purchases**  
such as a home or business



**Financing a college education**



**Maintaining a consistent source of cash**  
to supplement employment income



**Providing long-term financial support**  
for a disabled family member



**Smoothing cash flows for workers**  
with volatile and unpredictable incomes



**Funding a travel budget**

## THE RISKS OF TRADITIONAL RETIREMENT PORTFOLIOS

# Why *The 4% Rule*\* Often Fails

The 4% rule has long been a retirement planning staple. This rule suggests that if you withdraw 4% of your portfolio in the first year of retirement—and adjust subsequent withdrawals annually for inflation—a 50% stocks/50% bonds portfolio should last 30 years. Assuming a reasonable rate of return on investment, withdrawals should consist primarily of interest and dividends.

**While the 4% rule is still common in financial plans, it has notable limitations.**

### ANTIQUATED DATA.

The rule is based on historical stock and bond returns data from 1926 to 1976. As the SEC warns, “Past performance is no guarantee of future results.”

### MODERN MARKET VOLATILITY.

Today’s investment markets are considerably more volatile, complex, and influenced by factors far beyond a company’s fundamental value. Liquidating +4% of one’s portfolio during the 2000-2002 bear

market, 10 years before the market recovered, may have impoverished many retirees.

### KEY RISKS TO THE RULE:

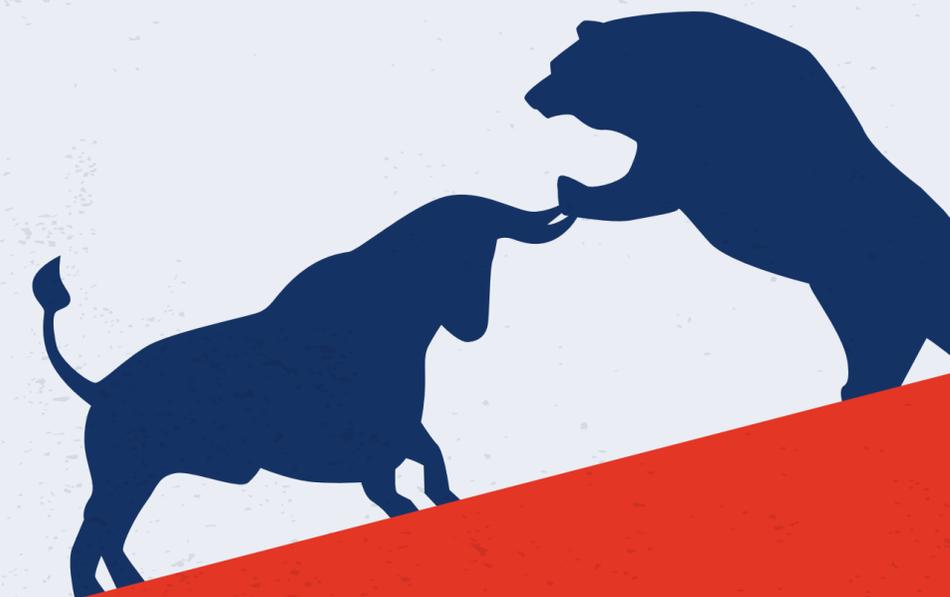
- ✓ High inflation
- ✓ Bear markets
- ✓ Portfolio underperformance
- ✓ Changing withdrawal requirements
- ✓ Longevity risks - retirees may outlive their savings
- ✓ A poor sequence of returns at the wrong time in the life of the portfolio
- ✓ Unexpected losses such as a natural disaster

### A MORE RESILIENT APPROACH: INCOME PORTFOLIOS.

While not without risks, income portfolios go beyond the 50/50 portfolio concept. They target consistent cash flows through allocation strategies that diversify income sources to achieve the desired return with the lowest risk.



**Liquidating +4% of one’s portfolio during the 2000-2002 bear market may have impoverished many retirees.**



\*Bengen, W. (1994). The 4% rule - At what price? Journal of Financial Planning, 7(4), 172-178.

## INVESTMENT POLICY STATEMENT

# A Roadmap for Income Portfolios

The most efficient income portfolios are carefully constructed to acquire assets at favorable costs:

- ✓ **Dividend-paying stocks:** Ideally purchased at market lows rather than peak prices.
- ✓ **Long-term bonds:** Acquired when interest rates are higher.

Paying the right price optimizes income creation.

This process starts with an Investment Policy Statement (IPS), a written document that acts as a roadmap for investment decision-making.

## IPS objectives

### RETURN REQUIREMENT

The IPS should clearly state the desired return objective of the investor. This objective reflects the level of income the investor wants to achieve from their portfolio. It helps guide the investment strategy and asset allocation decisions.

### RISK TOLERANCE

The IPS should assess and define the investor's risk tolerance. Risk tolerance refers to the investor's ability and willingness to withstand fluctuations or potential losses in their portfolio. It helps establish the appropriate level of risk exposure and guides asset allocation decisions.



### AN IPS OUTLINES:

- ✓ Investor goals
- ✓ Risk tolerance
- ✓ Investment strategy
- ✓ Asset allocation
- ✓ Guidelines for portfolio management
- ✓ Criteria for rebalancing the portfolio - considering asset class drift or changes in risk tolerance.

## IPS constraints

### INVESTMENT TIME HORIZON

The IPS should specify the investment time horizon—the length of time the investor plans to keep their portfolio invested. This helps determine the appropriate asset allocation and risk profile.

### LIQUIDITY

Liquidity constraints outline the investor's liquidity requirements, such as cash flow needs or emergency funds. This constraint ensures that the investment strategy considers the investor's short-term liquidity needs.

### TAXES

Tax constraints consider the impact of taxes on the investment portfolio. The IPS should address the investor's tax objectives, such as minimizing tax liabilities or maximizing tax-efficient strategies. It guides investment decisions with attention to tax implications.

### LEGAL

Legal constraints refer to any legal or regulatory restrictions impacting the investment portfolio. The IPS should outline legal considerations, such as restrictions on certain investment types or compliance with specific regulations.

### UNIQUE CIRCUMSTANCES

Unique circumstances include any specific factors that need to be considered, including ethical or socially responsible investing preferences, constraints related to specific industries or sectors, or other circumstances that impact the investment decision-making process.

## Why an IPS matters

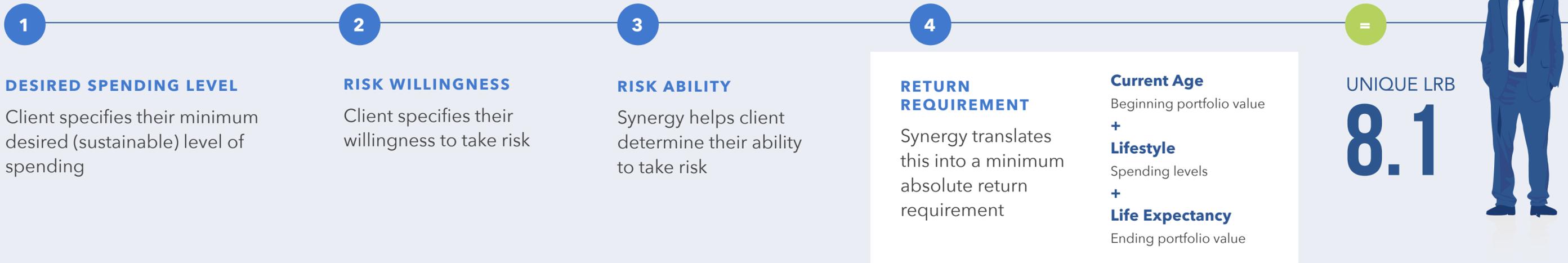
The IPS is a guiding document for investment professionals and individual investors to ensure consistency, discipline, and transparency in portfolio management. It helps align investment decisions with the investor's objectives, risk tolerance, and unique circumstances while accounting for various constraints.

These factors shape the income portfolio's risk/return balance and investments used to achieve the desired return.

We call this approach the Fiduciary Double Check, which ensures that recommendations align with the investor's unique Lifestyle Return Benchmark®.



## The Fiduciary Process



An IPS balances capital consumption and preservation to align with the investor’s goals and risk tolerance. By recognizing trade-offs, the IPS establishes asset allocation and risk management guidelines.

### Capital consumption vs. capital preservation

Capital consumption strategies involve utilizing all the assets by the end of the investment horizon and the end of the investor’s lifespan. This often arises due to:

- ✓ Lower investment returns
- ✓ A high required rate of return that exceeds the capital market assumptions supporting the portfolio.

These strategies prioritize spending or withdrawals that exceed the sustainable income generated by the portfolio, gradually depleting capital over time.

Capital preservation strategies aim to maintain all or part of the investment portfolio balance. This preservation is feasible because the required rate of return for the investor is lower than the returns expected in the market based on the capital market assumptions. By aligning their spending or withdrawal needs with the sustainable income generated by the portfolio, investors can effectively preserve their capital over the long term, ensuring financial stability and security for themselves or their beneficiaries.

### Why regular reviews matter

Regular reviews and updates of the IPS are essential to reflect changing circumstances or goals and to ensure that the investment strategy remains relevant and aligned with the investor’s needs.

## DIVERSIFICATION: A CORNERSTONE OF INCOME PORTFOLIOS

# Understanding Risks

Markets and economies move through cycles that favor one investment vehicle over another.

- ✓ **Bond only portfolios:** vulnerable to interest rate changes.
- ✓ **Dividend portfolios:** vulnerable to market declines, individual company risk, business cycles, and even product obsolescence.
- ✓ **Both bond and dividend stocks:** vulnerable to difficult economic periods when the risk of bond default increases and equity prices may decline, along with reduced profitability to fund dividend payments, spurring interest in alternative income vehicles.

## INCOME PORTFOLIO RISKS

At its most basic, risk is the potential to lose some or all of your investment.



**Investment return doesn't offset inflation.**



**Increased taxes reduce purchasing power.**



**Dividends are cut by the issuer.**



**Security or annuity default.**



**Bonds, CD's, etc cannot be reinvested at equal or higher returns.**

Understanding the character and risks of each income class is a critical part of the income portfolio allocation.

## INCOME PORTFOLIOS STRATEGIES

# A Bond Breakdown

## U.S. Government Treasury Bills

T-bills offer the lowest risk but also the lowest returns. Their short maturities reduce future risk but eliminate the ability to lock in higher rates.

## Certificates of Deposit

FDIC-insured certificates of deposit offer low risk and the ability to ladder maturities from three months to 10 years. Longer maturities typically yield higher returns, although this can vary based on economic expectations. Inverted yield curves occur when long-term CDs offer lower yields than short-term CDs due to interest rate uncertainty.

## Individual Bonds

Bonds are loans to governments or companies in exchange for interest payments over a set period. Investors, or bondholders, expect repayment of the principal plus interest at maturity. If the issuer fails to repay, it's considered a default. Bonds can be traded after issuance, with their prices influenced by current interest rates—rising rates lead to falling

### TYPES OF INDIVIDUAL BONDS

#### GOVERNMENT BONDS

Issued by national and local governments and are considered relatively low-risk investments. They can be further categorized into Treasury bonds issued by the government, agency bonds issued by government-sponsored entities, and municipal bonds issued by local governments.

#### CORPORATE BONDS

Debt securities issued by corporations to raise capital. They offer higher yields than government bonds but also carry higher credit risk. Corporate bonds can be categorized based on credit ratings, such as investment-grade (higher credit quality) or high-yield (lower credit quality or “junk” bonds).

#### AGENCY BONDS

Debt securities issued by government-sponsored entities, such as Fannie Mae or Freddie Mac. These bonds are backed by the government and typically offer yields higher than government bonds but lower than corporate bonds.

prices, and vice versa. Returns on a bond depend on creditworthiness, loan duration, terms, and economic outlook.

## Bullet Bonds

These bonds pay the full principal in a lump sum on the maturity date and cannot be redeemed early. While they usually offer a lower interest rate than similar bonds, they have a guaranteed maturity date.

## Municipal Bonds

Municipal bonds issued by local, county, and state governments are often tax-exempt, appealing to higher-income individuals. They generally offer lower interest rates than corporate bonds. These bonds are categorized as either investment-grade or high-yield (junk) bonds. The latter have lower credit ratings or none, making them riskier in terms of missed interest payments and principal repayment.

## Bond Portfolio Diversification Strategies

### 1. Laddered Bond Portfolios

Laddered Bond Portfolios hold bonds with different maturity dates, often evenly spaced across months or years. This allows proceeds to be reinvested regularly as bonds mature, minimizing interest rate risk, increasing liquidity, and diversifying credit risk.

#### CHARACTERISTICS

##### DIVIDED EQUALLY

The initial investment is divided equally among several bonds

##### REINVEST

Opportunity to re-invest the matured bond into a new bond or other investment

##### STAGGERED MATURITIES

Example, you might be able to build a 5-year bond ladder with a bond maturing every year



## Bond Portfolio Diversification Strategies (continued)

### 2. Barbell Bond Portfolios

Barbell bond portfolios blend long and short-duration bonds. Short-duration bonds offer liquidity and the ability to invest opportunistically as they mature. Long-duration bonds tend to pay higher interest rates to offset the risk of economic uncertainty over the long run.

Long- and short-term interest rates can become inverted, with short-term bonds paying higher interest than long-term bonds. This condition often precedes recessions.

### 3. Immunization Bond Strategies

Immunization bond strategies seek to shield a portfolio from interest rate risk by aligning a bond portfolio's duration with the investor's investment horizon. This stabilizes the portfolio's value regardless of interest rate fluctuations.

#### THE TWO MAIN STRATEGIES ARE:

**A. Cash flow matching:** Aligning the cash flows

generated by the bond portfolio—both income and principal repayments—with the investor's cash flow needs protects against interest rate changes.

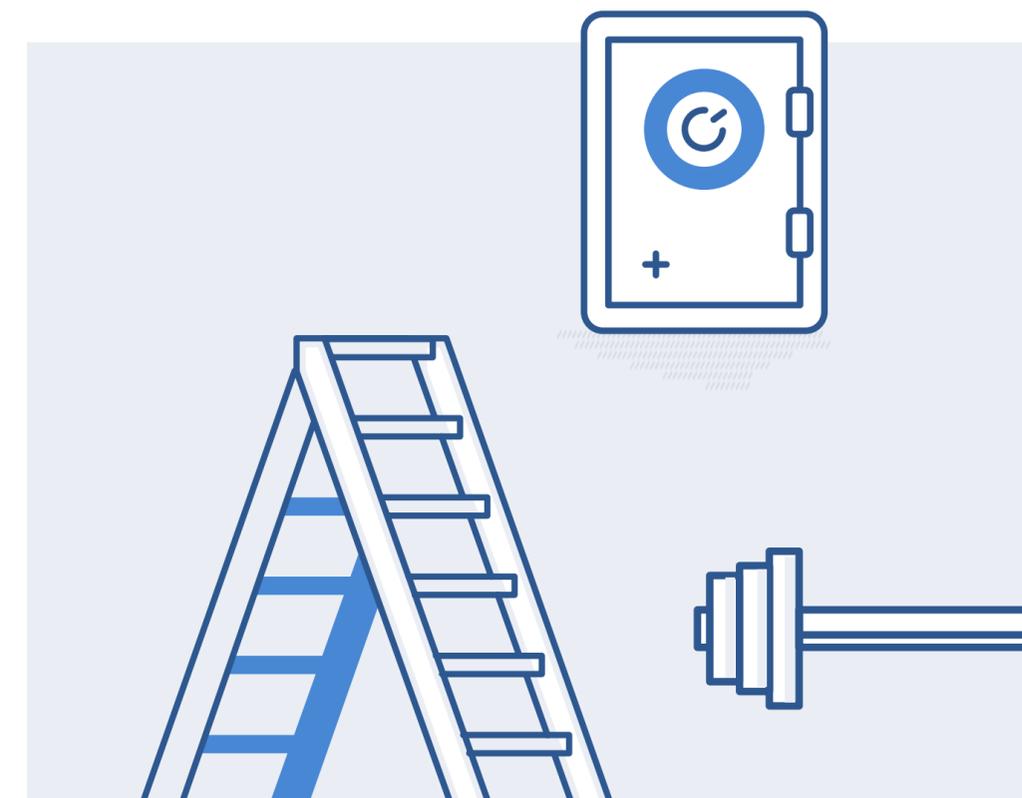
**B. Duration matching:** selecting bonds with durations matching the investor's time horizon or liabilities mitigates the impact of fluctuations in interest rates on the portfolio's value.

These strategies enable investors to manage interest rate risk and maintain more predictable returns from their bond investments.

### 4. Structured Notes

Structured notes blend a bond with an interest-crediting component, forming a hybrid security. These notes, known as "structured," are tailored to fulfill specific investment objectives, ranging from growth and income to risk management or exposure to particular investment strategies or market outcomes. Their adaptability allows for diverse potential payoffs that are often challenging to find elsewhere.

Structured notes typically represent an issuer's unsecured obligation and may offer various fixed-income features, including regular coupon payments and principal protection. Potential returns are tied to the performance of an underlying asset, such as a securities market index, a basket of indexes, an asset allocation index, or individual stocks, and may be realized at maturity. Structured notes may have limited or no liquidity before reaching maturity.



## INCOME PORTFOLIOS STRATEGIES

# Annuities as an Income Investment

Annuities provide a guaranteed income stream for a specified period or the annuitant's lifetime. They offer longevity protection and are valuable in retirement planning and income generation. Including annuities in the income allocation allows investors to have a stable income source during retirement and potentially mitigate longevity risk.

Annuities offer a way to secure a fixed income, reducing the reliance solely on investment returns from traditional asset classes. On the growth side of the coin, annuities should be considered just another asset class to manage risk and seek return. Including annuities in asset allocation helps provide a more diversified strategy for retirement planning. By incorporating annuities into a portfolio, investors can effectively manage risk, optimize tax efficiency, and achieve both short-term income needs and long-term growth objectives.

## TYPES OF ANNUITIES

**A single premium immediate annuity (SPIA)**

A single premium immediate annuity (SPIA) is a simple contract; you make a single large deposit with an annuity company, and your monthly payments begin immediately. Unlike other annuities, SPIA buying requires some foresight, as you use a single lump sum instead of making incremental payments over time.

**A deferred annuity**

A deferred annuity is a contract with an insurance company that promises to pay the owner a regular income or a lump sum later.

**A fixed annuity**

A fixed-index annuity (FIA) links payments to the performance of a stock market index, such as the S&P 500. While the investor is protected from market losses, total returns may also be limited.

## REASONS TO INCLUDE FIA

**PRINCIPAL PROTECTION**

FIA's offer a level of principal protection. Unlike direct investment in stocks or other market-linked assets, the insurance company issuing the annuity contract typically guarantees the principal value of FIA's.

**POTENTIAL FOR GROWTH**

FIA's also provide the opportunity for growth. The annuity's return is linked to a portion of the index's positive performance, subject to certain limitations, such as caps or participation rates. This allows investors to participate in market upside potential while having downside protection.

**TAX-DEFERRED GROWTH**

FIA's offer the advantage of tax-deferred growth. Earnings accumulate on a tax-deferred basis until withdrawals are made. This can enhance an investor's long-term returns.

**RETIREMENT INCOME GENERATION**

Annuities, including FIAs, can provide a guaranteed income stream during retirement for a specific period or the annuitant's lifetime. This consistency can be invaluable, especially in volatile market conditions.

**DIVERSIFICATION BENEFITS**

Including FIAs in a portfolio can offer diversification benefits as they have risk and return characteristics different from traditional debt securities, such as bonds. By adding FIAs to the portfolio mix, investors can potentially reduce overall portfolio volatility and enhance risk-adjusted returns.

**LONG-TERM FINANCIAL PLANNING**

FIAs can align well with long-term financial planning goals, especially for investors seeking to balance growth, income generation, and risk management. The guarantees and potential for growth provided by FIAs can contribute to a robust retirement strategy.

**CONSIDERATIONS OF FIAs:**

- ✓ Surrender charges for early withdrawals
- ✓ Limitations on index participation rates or caps
- ✓ Potential rider fees on overall returns

Investors should carefully evaluate the specific terms and features of FIAs, considering their financial goals, risk tolerance, and other investment options available.

**A variable annuity**

A variable annuity is a type of investment account whose value varies over time depending on the performance of investment assets chosen, typically a variety of mutual and index funds. Since their value depends partly on market returns, variable annuities may provide greater growth than other annuities and income payments throughout retirement. However, they also have far more risk. Variable annuities come in many varieties; no two are the same. Their features differ from other annuity products.

**CONSIDERATIONS OF VARIABLE ANNUITY:**

A fiduciary financial advisor or insurance specialist should provide consultation about including annuities in a portfolio. There are investment risks unique to the design of the annuities:

- ✓ Market risk with index and variable annuities
- ✓ The issuer's financial stability
- ✓ The contract's terms—annuities are insurance contracts with restrictive terms for exiting

Fiduciary planners often avoid variable annuities for several reasons:

- ✓ **High fees and expenses.** Mortality and expense charges, administrative fees, investment management fees, and underlying fund expenses. These fees can significantly erode an investment's potential returns over time, making it less attractive from a cost-benefit perspective.
- ✓ **Their complexity.** It can be challenging for fiduciary planners to fully understand and effectively explain the product's terms and risks to their clients, potentially leading to misunderstandings or misinterpretations.
- ✓ **Surrender charges.** These fees are incurred if the investor wants to withdraw funds from the annuity within a set time after purchase, limiting access to money, liquidity, and flexibility.
- ✓ **Exposure to market risk.** Because they are tied to the performance of underlying sub-accounts, typically mutual funds, they offer growth options but also risks.

Fiduciary planners often prioritize transparency, cost-effectiveness, and simplicity when selecting investment products for their clients, which can lead them to avoid recommending non-fiduciary variable annuities.

## INCOME PORTFOLIOS STRATEGIES

# Real Estate Investment Trusts and Master Partnerships

Private Real Estate Investment Trusts (REITs) and Master Limited Partnerships (MLPs) offer higher yields to income portfolios but come with a higher risk.

Private REITs are not listed on the national securities exchanges and are available only to accredited individual investors through private placements.

In the United States, an accredited investor is considered a financially sophisticated person with less need for the protections provided by SEC regulatory filings.

To be an accredited investor in the United States, you must meet one of the following:

## ACCREDITED INVESTOR CRITERIA

## ANNUAL INCOME

**\$200,000**

single

OR

**\$300,000**

combined a spouse

You must have earned this amount in each of the last two years and expect to earn the same amount in the current year.

## NET WORTH

**\$1,000,000+**

excluding the value of your primary residence. You can also meet this requirement jointly with your spouse or partner.

## ENTITIES

**\$5,000,000+**

An entity that owns assets in excess of \$5 million and was not created with the sole purpose of buying specific non-regulated securities. For example: corporations, partnerships, LLCs, or trusts.

## FINRA LICENSE

Hold a FINRA-recognized license such as General Securities Representative license (Series 7), the Investment Adviser Representative license (Series 65), or the Private Securities Offerings Representative license (Series 82).

REITs own and may operate income-producing real estate or hold commercial or residential mortgages.

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**To maintain their tax status, they must pay 90% of their taxable income to unitholders as dividends.**

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Ideally, REITs offer high, steady dividend income and long-term capital appreciation. While REITs tend to have stable valuations, they are not immune to regional commercial market downturns and the deterioration of local economies. As in all real estate investments, location matters, as does the quality of the real estate property.

### **Private vs. Public REITs**

Private REITs have advantages over publicly traded REITs, such as less regulatory oversight, which may give them greater flexibility and agility in investment decisions. They also have corporate-level federal tax exemptions, so income and deductions flow directly to the investors, potentially resulting in lower tax liabilities. However, private REITs have longer holding periods and are difficult to sell, reducing liquidity and limiting an investor's ability to move funds from a poorly performing investment.

**“The beauty of REITs is that they let you own real estate in a liquid form. You can buy and sell shares just like any other stock, without the complications of direct ownership.”**

**SAM ZELL, BILLIONAIRE REAL ESTATE INVESTOR**

### **Master Limited Partnerships (MLPs)**

Master Limited Partnerships (MLPs) are exchange-traded investments generally involved in minerals or natural resources. These cash-generating assets can produce consistent distributions to investors. MLPs include partnership tax consequences and limited liability to investors for the MLP's debts. On the downside, MLPs historically have experienced higher volatility than stocks or bonds and are vulnerable to regulatory and legislative changes impacting the natural resources industry.



#### **REITS**

An easy way to invest in real estate since they are bought and sold like stocks. You would own apartments, office buildings, cell phone towers, hospitals, and get a share of the rent.

#### **MLPS**

Entities that combine the tax benefits of a private partnership with the liquidity advantages of a stock.

## INCOME PORTFOLIOS STRATEGIES

# Dividend Investing – Stocks that Pay You Back

The traditional concept of increasing bond holdings and reducing stock positions as one ages has challenges. Bonds cannot defend a portfolio from inflation or taxes, and interest earnings are withdrawn to meet expenses, limiting compounding or appreciation. While bonds can be sold at a profit when interest rates decline, the investor loses the higher interest return, making the bonds more valuable and unable to replace that return in a lower interest rate environment without taking on more risk.

Dividend-paying stocks offer both income and the potential for appreciation. Dividends, profit distributions to a company's shareholders (stockholders), typically increase during inflation to maintain the stock's attractiveness. While these stocks are still vulnerable to down markets, a lower stock price does not impact per-share dividend income as long as the dividend remains intact. A stock position purchased to provide \$50,000 in annual dividends pays \$50,000 regardless of stock market valuation.

**With 30 years of experience, I want to highlight**

**an important point:** dividend stocks offer a significant advantage for generating income.

They provide a steady stream of dividend income regardless of market fluctuations. Unlike other forms of investment income, such as interest payments on bonds or rental income from real estate, dividend income from stocks remains consistent as long as the underlying company maintains its dividend payout policy. This stability makes dividend stocks attractive for investors seeking reliable income in all market conditions.

Consider a hypothetical scenario. Suppose a stock initially priced at \$100 per share pays a \$5 dividend per share annually (equating to a 5% dividend yield). In that case, the investor receives \$5 in dividend income per share, whether the stock price declines to \$90 or appreciates to \$105 per share. Thus, the investor's income remains consistent regardless of market valuation.

**DUAL BENEFIT**

Provide both income (dividends) and potential appreciation.

**INFLATION HEDGE**

Many companies increase dividends over time, helping investors maintain purchasing power.

**MARKET RESILIENCE**

Dividend payouts remain consistent regardless of stock price fluctuations, offering reliable income even in volatile markets.

A common mistake investors make is overemphasizing the portfolio's market value fluctuations. While it is natural for investors to monitor their portfolio's performance, focusing excessively on short-term market movements may lead to unnecessary stress and hasty decisions. Instead, investors should prioritize their income objectives, recognizing that the primary goal in a dividend strategy is to generate consistent cash flow, not portfolio value fluctuations.

If income is the primary objective, investors should remain focused on the stability and reliability of their dividend income stream rather than being overly concerned with short-term market volatility. By staying disciplined and emphasizing income generation, investors can effectively harness dividend stocks as a reliable source of income in their investment portfolios.

Another advantage of dividend investing is the favorable tax treatment of dividend income. Qualified dividend income is currently taxed at the same rate as capital gains. Bond income, by contrast, is taxed at your ordinary income tax rate.

### Federal Qualified Dividends Tax Brackets

TAX RATE	SINGLE	MARRIED filing jointly
0%	\$0	\$0
15%	\$47,025	\$94,050
20%	\$518,900	\$583,750

Source: Internal Revenue Service, "Revenue Procedure 2023-24." The IRS treats different types of income differently, and the actual tax rate also depends on the taxpayer. It is important to consult your tax adviser.

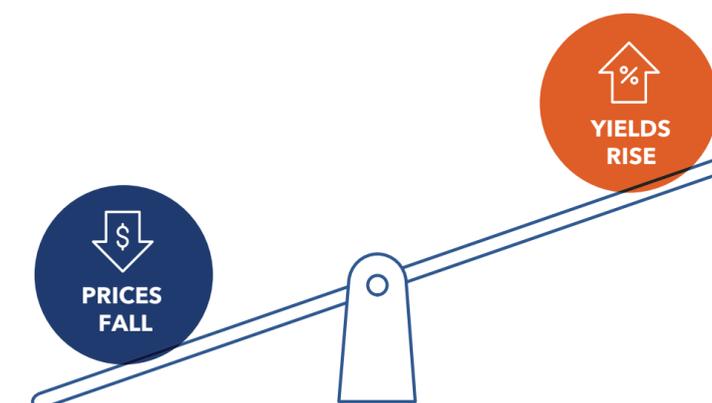
### Understanding Dividend Stocks

Dividends vary, so it is important to understand how they are structured, the health of the underlying company, and the return you can expect over time.

Dividend payers are usually mature companies with a history of consistent earnings. As corporations grow from small-cap to mid-cap and ultimately to large-cap, generating meaningful growth and returns becomes more difficult. A big step forward for a small company is a blip in return for a multi-billion-dollar mature business. Since the large-cap company cannot attract investors through stellar growth, it uses dividends, returning income to its investors to use as they see fit.

Dividend stocks are commonly ranked by dividend yield or dividend payout ratio.

- ✓ The dividend yield is the annual declared dividend on a per-share basis divided by the current stock price.
- ✓ The dividend payout ratio is total dividends paid divided by net income.



### Investors need to understand that declining stock prices result in higher dividend yields.

A higher yield may not be an attractive investment opportunity if the underlying company fundamentals are also declining and the prospects for the company are not favorable.

Dividend companies tend to fall within

**FOUR CATEGORIES:**

The image shows four light blue rectangular boxes arranged in a 2x2 grid. Each box contains a numbered circle and a category name. Box 1 (top-left) has a blue circle with '1' and the text 'S&P 500 Aristocrats'. Box 2 (top-right) has an orange circle with '2' and the text 'Dow Jones Industrial'. Box 3 (bottom-left) has a teal circle with '3' and the text 'Leaders'. Box 4 (bottom-right) has a green circle with '4' and the text 'High Yield'.

Another way to look at dividend stocks is based on the average annual dividend growth rate of the company. This ranking is designed to highlight companies that may experience greater stock appreciation.

CASH COW	STEADY COMPOUND	FAST GROWER
1-5%	6-12%	13%+

**1 The S&P 500 Aristocrats**

Large-cap companies in the S&P 500 index have grown their dividends for at least 25 consecutive years, with most for more than 40 years. While the broader S&P 500 produces around 1.4% in dividends, Aristocrats yield closer to 4% and tend to fall in the **Cash Cow** group. Over time, these companies have made a greater return on equity and shown significantly more resilient earnings growth than most stocks in the S&P 500.

**2 Dow Jones Industrials**

Known as **“Steady Compounds”** these established companies do not grow very quickly but produce reliable returns year after year and are less vulnerable to recessions. A number of these companies fall in the Dow Jones Industrials index. Examples include consumer non-cyclical stocks and utilities.

**3 Leaders**

Leaders tend to include the 100 highest-yielding stocks with consistent dividend growth and the potential to maintain their future dividends. If they are in a hot growth industry or trend, they may also be **“Fast Growers”**.

**4 High Yield**

High-yield dividend payers are characterized by their per-share dividend yield. These companies are higher-risk investments because their high yields can result from declining stock prices or market views that the dividend is unreliable.

**ADVANCED STRATEGIES**

Another benefit of using dividend stocks for the income portfolio is the ability to add an option overlay covered call that serves as a short-term hedge on a long stock position to generate additional return. The strategy is used when only a minor change in the underlying stock price is expected for the life of the written call option. Investors earn income via the premium received for writing the option. However, if the price moves above the option’s strike price and the buyer chooses to exercise the option, the investor forfeits stock gains and is obligated to provide 100 shares at the strike price (for each contract written). While more advanced options strategies are not appropriate for most investors (and are beyond the scope of this paper) there are numerous strategies that can supplement the return of a dividend stock.

SHAPING YOUR INCOME INVESTMENT PORTFOLIO

# Meeting Your Financial Goals

The goal in designing an income investment portfolio is to achieve an optimal balance among different income-focused investments, such as bonds, dividend stocks, annuities, and alternative investments. This involves selecting the appropriate mix of assets within each category, including bonds, dividend stocks, annuities, and alternative investments, to meet the investor’s income needs and financial goals effectively.

This process is guided by the Investment Policy Statement (IPS), discussed at the beginning of this paper. The IPS is periodically adjusted throughout the investor’s lifespan to reflect changing priorities, such as moving from capital preservation to capital consumption, shifting risk tolerances, and evolving income requirements.

The portfolio is not a static allocation. It is intended to be rebalanced periodically, and actively managed to maintain the desired return. The optimal portfolio is one that achieves the desired return with the least risk.

**POTENTIAL STRATEGY COMBINATIONS**

<p><b>1</b></p> <p><b>25%</b> FIXED INCOME ANNUITY</p> <p><b>25%</b> T BILLS</p> <p><b>25%</b> INDIVIDUAL BONDS</p> <p><b>25%</b> DIVIDEND STOCKS</p>	<p><b>2</b></p> <p><b>25%</b> STRUCTURED NOTES</p> <p><b>25%</b> T BILLS</p> <p><b>25%</b> INDIVIDUAL BONDS</p> <p><b>25%</b> DIVIDEND STOCKS</p>	<p><b>3</b></p> <p><b>12<sub>mos</sub></b> CASH</p> <p><b>3-7<sub>yr</sub></b> BULLET BOND</p> <p><b>4</b></p> <p><b>50%</b> BULLET BOND</p> <p><b>50%</b> INDIVIDUAL BONDS</p>
<p><b>5</b></p> <p><b>50%</b> BULLET BOND</p> <p><b>25%</b> INDIVIDUAL BONDS</p> <p><b>25%</b> DIVIDEND STOCKS</p>	<p><b>6</b></p> <p><b>25%</b> PRIVATE REITS</p> <p><b>25%</b> INDIVIDUAL BONDS</p> <p><b>25%</b> DIVIDEND STOCKS</p> <p><b>25%</b> STRUCTURED NOTES</p>	<p><b>Combinations are limitless.</b></p> <p>Positions can be adjusted based on the desirability of individual securities, market conditions, and evolving investor needs.</p>

## Income Portfolio Example

	YIELD	ALLOCATION	PORTFOLIO YIELD
<b>3-year CDs</b>	3.75%	5%	<b>0.19%</b>
<b>High-grade bonds</b>	4.00%	25%	<b>1.13%</b>
<b>High-yield bonds</b>	6.00%	25%	<b>1.63%</b>
<b>Dividend stocks</b>	4%	35%	<b>1.40%</b>
<b>REITs &amp; MLPs</b>	6.5%	10%	<b>0.70%</b>
	<b>100%</b>		<b>5.04%</b>

This is a hypothetical portfolio based on average yields in January 2025. Individual portfolios may differ significantly based on economic conditions, investment selection and current market conditions.

# Putting It All Together – Growth and Income

Up to this point, our focus has been on exploring the dynamics of an income portfolio. Now, it's time to broaden our perspective and integrate both income and growth aspects to complete the portfolio picture comprehensively. By combining strategies for generating steady income with those aimed at achieving long-term growth, we can construct a well-rounded investment portfolio that addresses various financial objectives and provides stability and potential for wealth accumulation.

Integrating multiple portfolios, one for income and one for growth, within a larger investment framework governed by an Investment Policy Statement (IPS) is a prudent approach that aligns with the financial planning process. This strategy recognizes the distinct objectives of income generation and capital growth and allocates assets accordingly to

achieve those goals effectively. For instance, within a \$1 million portfolio, an investor may designate \$400,000 for an income portfolio and \$600,000 for a growth portfolio, each governed by the IPS. The income portfolio, expected to be depleted in 4 years (capital consumption), is structured to provide regular cash flow to meet short-term income needs, while the growth portfolio, not needed for 4 years, is positioned for long-term capital appreciation. Once the income portfolio is depleted, the process begins anew, ensuring a continuous stream of income without compromising the growth potential of the overall portfolio. This strategy, akin to using the right tool for the job, symbolically assigns the income portfolio for income generation and the growth portfolio for capital growth, avoiding the common pitfall of expecting a single portfolio to fulfill both roles. By segregating assets based on their intended

purpose, investors may achieve greater certainty and smoother portfolio returns, enhancing the overall effectiveness of their investment strategy.

Historically, this process was referred to as a split annuity strategy. The split annuity concept offers a strategic approach to financial planning, aiming to balance immediate income needs with long-term growth objectives. By dividing a lump sum of money into two distinct portfolios—an income portfolio and a growth portfolio—investors can effectively address both short-term cash flow requirements and long-term wealth accumulation goals. This concept mirrors the structure of a traditional annuity but adapts it to investment portfolios, allowing investors to tailor their strategies to meet their specific financial objectives.

## Split Annuity

A split annuity concept involves dividing a lump sum of money into two parts and allocating each part to different types of annuities to serve distinct financial objectives. Typically, one portion of the funds is allocated to an immediate annuity, while the other portion is allocated to a deferred annuity.

### 1. Immediate Annuity:

The immediate annuity portion is used to provide an immediate stream of income. With an immediate annuity, the investor pays a lump sum upfront to an insurance company, and in return, the insurance company guarantees a regular stream of income for a specified period or for the investor's lifetime. This immediate income can help cover essential expenses or provide a stable income stream during retirement.

### 2. Deferred Annuity:

The deferred annuity portion is designed for long-term growth and future income needs. Unlike an immediate annuity, a deferred annuity allows the invested funds to grow tax-deferred over time. The investor can choose to receive income payments at a later date, typically during retirement, by annuitizing the deferred annuity or by making systematic withdrawals.

## Split Income and Growth

A split-annuity, adapted to investment portfolios, divides a lump sum of money between income and growth portfolios. It serves purposes similar to immediate and deferred annuities.

### 1. Income Portfolio:

Provides immediate income for short-term needs through dividend-paying stocks, bonds, or other assets, prioritizing consistent cash flow.

### 2. Growth Portfolio:

Focuses on long-term capital growth to meet future goals like retirement or legacy planning. Investments include stocks, equity funds, or asset allocation strategies, aiming to maximize returns and build wealth over time.

A split-annuity approach with income and growth portfolios, annuities, or both provides immediate stable cash flow combined with long-term capital appreciation.

## A case study

Brian and Marjorie are 70-year-old retirees who want to structure their portfolio to meet their income objectives. They have no immediate health problems and own their home. Brian and Marjorie have \$1.5 million in retirement assets in a tax-deferred account and a separate equity portfolio of \$500,000. They would like an income of \$120,000 per year in addition to their social security and other fixed income. They also want to help pay their two grandchildren’s college expenses in five and seven years.

Here, we outline portfolio guidelines and present one potential income portfolio among several options.

It’s important to note the required rate of return (RRR) is based on the principle of capital preservation. The expected return rate would be lower under the concept of capital consumption.

The RRR is determined by dividing the required income from the portfolio by the portfolio’s value. In this case, it stands at 6%. However, this is before factoring in inflation, fees, and taxes. Accounting for these factors and compounding, the RRR increases from 6% to 11.5%. If we used simple math, we would add 6% +2% +1% = 9% before adjusting for taxes.

### Required rate of return

<b>DESIRED INCOME</b>	<b>RRR</b>	6%
\$120,000	<b>+2% INFLATION</b>	= 8.12%
<b>PORTFOLIO VALUE</b>	<b>+1% FEES</b>	= 9.20%
\$2,000,000	<b>+20% TAXES</b>	= 11.5%

Notably, stocks offer the highest expected return at only 7%, considerably lower than the highest RRR of 11.5%. If Brian and Marjorie aim for capital preservation, they might need to adjust their income expectations or consider a capital consumption strategy.

### Capital Market Assumptions<sup>1</sup>

	EXP. RETURN
<b>Stocks</b>	7%
<b>FIA Annuity</b>	4%
<b>Focused Bond</b>	4.8%
<b>T-bill</b>	4%
<b>Cash</b>	3%

### CLIENT WORKSHEET

<b>Brian</b>	<b>AGE</b>	<b>RETIREMENT AGE</b>	<b>TYPE</b>	<b>VALUE</b>	<b>%</b>	
	70	70	<b>Schwab</b>	JT non Q 5	\$500,000	25%
<b>Marjorie</b>	<b>AGE</b>	<b>RETIREMENT AGE</b>	<b>Brian IRA</b>	IRA	\$750,000	37.5%
	70	70	<b>Marjorie</b>	IRA	\$750,000	37.5%
<b>ADVISOR</b>	<b>DATE</b>				<b>\$2M</b>	<b>100%</b>
Mr. Fiduciary	12/14/2024					

Marjorie and Brian evaluate their financial goals, distinguishing between their required rate of return and their desired rate of return. They also assess their risk tolerance and capacity, ensuring their investment strategy aligns with their comfort level and financial objectives.

Goals		
<b>Return</b>	<b>REQUIRED</b>	<b>DESIRED</b>
	6-11%	7%
<b>Risk</b>	<b>Willingness</b>	<b>Ability</b>
	<b>SCORE</b>	<b>SCORE</b>
	40	Above average
	<b>CLASSIFICATION</b>	<b>NETWORTH</b>
	Moderate	\$3,000,000
	<b>SUBJECTIVE</b>	<b>INCOME</b>
	Average	\$120,000

As we delve into the Investment Policy Statement (IPS), we can observe the constraints of the portfolio.

Constraints	
<b>TIME</b>	<b>30yrs</b>
Long term	
<b>TAXES</b>	
Marginal.....	37%
Capital Gains.....	20%
NIIT.....	3.80%
<b>LIQUIDITY</b>	
within 12 mos.....	\$120,000
Annual.....	\$120,000
<b>LEGAL</b> .....	None
<b>UNIQUE</b> .....	None

Considering the goals and constraints, one recommendation emerges. It's worth noting that the expected return on the allocation slightly trails the RRR. This underscores the importance of client education.

Recommendation			
<b>EQUITY</b>	<b>SPLIT</b>	<b>60%</b>	<b>\$</b>
Growth Stocks	30%	18%	\$360K
Dividend Stocks	70%	42%	\$840K
	<b>100%</b>	<b>60%</b>	<b>\$1.2M</b>
FIA Annuity		10%	\$200K
Focused Bond		10%	\$200K
T-Bill		10%	\$200K
Cash		10%	\$200K
		<b>100%</b>	<b>\$2M</b>
<b>EXPECTED RETURN</b>			<b>5.78%</b>

The initial suggestion entails adopting a blended portfolio approach. This involves allocating 60% of the portfolio to risk-on assets and 40% to risk-off assets. Among the risk-on assets, 70% of the 60% is earmarked for dividend stocks, amounting to a total allocation of 42%.

The second strategy outlined involves employing the split income and growth concept. Here, we divide the portfolio into two segments: one for generating income and the other for fostering growth. We initially allocate **22.34%** (\$446,790) to the income strategy and **77.66%** (\$1,553,210) to the growth strategy, resulting in a total portfolio of \$2,000,000.

Income portfolio			\$446,790
YEAR	ASSET	PRESENT \$	DISTRIBUTION
0	cash	\$120,000	\$120K
1	bond 1	\$114,286	\$120K
2	bond 2	\$108,844	\$120K
3	bond 3	\$103,661	\$120K
		<b>\$446,790</b>	<b>\$480K</b>

In the income portfolio, the first year’s income distribution is held in cash, followed by investment in three bonds, with one bond maturing each year for the subsequent three years. It’s important to note that while the income distribution remains constant, the present value of each bond purchased varies due to the time value of money.

While the income strategy generates income, the growth strategy remains invested for four years, aiming to regrow to approximately the value of the initial portfolio. It’s essential to recognize that this scenario is hypothetical, and there’s no guarantee that either strategy will perform exactly as illustrated.

Growth portfolio			\$1,553,210
YEAR	BEGINNING \$	INTEREST	ENDING VALUE
0	\$1,553,210	\$108,724	\$1,661,935
1	\$1,661,935	\$116,335	\$1,778,270
2	\$1,778,270	\$124,478	\$1,902,749
3	\$1,902,749	\$133,192	\$2,035,942
		<b>\$482,731</b>	<b>\$2,035,942</b>

**For many investors, a balanced strategy that incorporates elements of both income and growth can be the best solution.**



## SYNERGY ASSET MANAGEMENT

# Our process is sophisticated.

**Our goal is simple: Help our clients build wealth.**

Income planning is a dynamic process that requires considering goals, constraints, and risk tolerance. Strategies like blended portfolios, split income, and growth approaches help investors like Brian and Marjorie meet their financial objectives. However, market uncertainties mean no strategy is foolproof. Regular reviews, adjustments, and ongoing education are vital for navigating complexities and achieving long-term financial security.

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## It all starts with a conversation.

Give us a call and let's schedule a complimentary meeting.

206.386.5455

[synergyassetmanagement.com](https://www.synergyassetmanagement.com)

[info@synergy-am.com](mailto:info@synergy-am.com)



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### **<sup>1</sup>DISCLOSURE STATEMENT: CAPITAL MARKET ASSUMPTIONS**

This document outlines capital market assumptions (CMAs) for U.S. stocks, fixed index annuities, U.S. bonds, 52-week U.S. Treasury bills, and U.S. cash. These assumptions are intended for informational purposes only and are derived from historical data, mathematical modeling, and professional judgment. They are not guarantees of future performance and should not be interpreted as such. Calculations were performed in June 2024.

The expected returns for each asset class are as follows: U.S. stocks are assumed to generate 7.0%, fixed index annuities 4.0%, U.S. bonds 4.8%, 52-week U.S. Treasury bills 4.0% (based on a long-term normalized average), and U.S. cash 3.0% (also based on a long-term normalized average). These assumptions were calculated using the Black-Litterman model over a 10-year historical period spanning June 2014 to June 2024. The calculations incorporated a risk-free rate of 4.0% and an equity risk premium of 3.5%, with equal market capitalization weights applied to asset classes. Adjustments were made based on the informed judgment of analysts, taking into account best practices and current market conditions. It is important to note that these CMAs focus exclusively on expected returns and do not incorporate risk metrics, volatility estimates, or correlations between asset classes for presentation.

These forward-looking estimates are subject to significant limitations. They rely on historical data, statistical models, and subjective judgment, which inherently involve uncertainty. Future returns may differ materially from these assumptions due to changes in economic conditions, market dynamics, and unexpected events. Additionally, past performance is not indicative of future results,

and the assumptions provided here do not reflect actual returns an investor may experience. The omission of risk-related measures limits the scope of these CMAs and excludes critical factors such as market volatility and specific asset class risks. Furthermore, the Black-Litterman model, while widely recognized, is based on certain assumptions and simplifications that may not fully account for the complexities of real-world markets, and analyst adjustments may introduce subjective bias.

These CMAs are provided solely for educational and illustrative purposes and should not be used as the sole basis for making investment decisions. All investments involve risks, including the potential loss of principal, and individuals should consult with a qualified financial professional to develop a comprehensive investment strategy tailored to their unique circumstances.