Retiring On Investment Interest: Can It Be Done?

by Steven P. Orlowski,CFP (Contact Author | Biography)

The first and sometimes only retirement income plan that comes to mind for the average investor is interest only. Interest only is just what it sounds like: you are invested in interest-bearing investments and whatever interest you earn is the money you spend. This is a simple strategy, but it isn't as easy to implement as you might imagine.

The simplicity of the strategy is one of its appeals. Who hasn't thought of retirement that way? You retire with $1 million and invest the total in a portfolio of fixed-income investments at 6% and live off of the interest ($60,000 per year plus Social Security and your pension if you're so lucky). Then, at death, you leave behind the entire $1 million you started with. What could be better? As it turns out, there are some serious flaws to this approach. Let's take a look.

The Principal Principle
For starters, interest only means interest *only*. The principal is out of reach. This can be referred to as the "principal principle". You *need* all of the principal to create the income, therefore the entire principal is off limits, unless you *want* a declining principal balance and declining income. Let's say you implement this strategy and then need to buy a car, or put a roof on the house, and withdraw $30,000 to do it. In this case, you are left with $970,000 in principal. As a result, your income will decline from $60,000 per year to $58,200 (6% of $970,000). So even if you don't withdraw any more money for the rest of your life except the $60,000 per year in income (ignoring inflation for now), then you will still be reducing your principal every year, and by ever-increasing amounts. In year two, your principal will fall to $968,200, causing you to earn less and requiring you to withdraw even more principal in the years to come. (For more, see *Managing Income During Retirement*.)

When Interest Only Works
A true interest-only strategy can work only for those with excess capital. If you retire with $1 million but only need $55,000 per year of supplemental income, keeping with our 6% assumption, you will need $917,000 to produce your income. That will leave you with $83,000 that could be used for emergencies or irregular expenditures.

The structure of the interest-only portfolio is simple, which can give you plenty of room to customize the portfolio for your personal preferences. The first consideration is the average yield of the portfolio. If you know you need $25,000 per year and you have $500,000 to invest, then divide $25,000 by $500,000 (25/500) and you'll get 0.05, or 5%, your cash-flow requirement. You'll also need to consider taxes, depending on what type of account you have (tax-deferred or not). Certain types of fixed-income securities may or may not be appropriate. (Learn about different fixed-income securities

and how they can be used in *Too Many Bonds To Choose From?*)

Once you've determined the yield you need, it's time to go shopping. Even though the yield on a fixed-income security may be lower than your target, it may still fit as a piece of your portfolio. In order to boost the average yield, you can look to other bond types, like agency, corporate and even foreign bonds. Ultimately, each investor needs to be aware of the risk inherent in each type of bond, like the risk of default or market risk and the likelihood of large price fluctuations. You can even lose money with Treasuries if you sell them at the wrong time.

In addition to diversifying the portfolio by type of bond, you can and should also buy bonds with varying maturities (called laddering). This will help you hedge against some of the aforementioned risks. (To learn how to implement this strategy, see *The Basics Of The Bond Ladder*.)

Mutual Funds and Interest Only
Some investors try to use mutual funds for their interest-only strategies, but this is not really interest only. Theoretically, it could work, so long as the funds being used pay out a consistent amount of interest. But since bonds mature, bond mutual funds' interest payments don't stay the same. In years of lower interest, you'd likely be forced to liquidate principal, which is more akin to a systematic withdrawal plan, which is in violation of the principal principle. Investing in a portfolio of mutual funds is easier than building a portfolio of fixed-income securities but it does not provide the same benefits. (To learn more, read *Systematic Withdrawal Of Retirement Income*.)

Deferred Annuities
Another useful tool is the fixed deferred annuity. A fixed deferred annuity is an interest-bearing account with similar characteristics to a certificate of deposit (CD). Unlike a CD, it is not FDIC insured, although most have guaranteed principal and interest. Deferred annuities are often overlooked as an option, but the interest rates on fixed annuities are frequently, if not usually, higher than CDs and Treasuries; they also provide a high level of safety.

Remember that there are many types of annuities. For an interest-only strategy, a fixed deferred annuity is appropriate. A fixed immediate (income) annuity is not; neither is a variable deferred or variable immediate annuity. You want predictable interest coupled with safety of principal. Immediate annuities use up the principal and variable annuities, like mutual funds, can decline (or increase) in value. Each type has its place, but for an interest-only strategy, fixed deferred is the one. (For more insight into different types of annuities, see *An Overview Of Annuities*.)

The Hidden Problem: Inflation
Inflation will likely always be a problem. The historical rate of inflation is about 3% per year. In our original scenario - the retiree with $1 million and a 6% yield - we ignored the impact of inflation. Unfortunately, that person might immediately experience erosion of the portfolio because by year two, $60,000 could be insufficient. This is critical. We don't want to accidentally violate the principal principle, but if we do violate it, we want to do so intentionally. Some people do retire and decide up front to allow some erosion. Managed erosion is OK. Accidental erosion is not. Therefore, when establishing a retirement income plan, you need to inflate your income need to the end of your planning period (life expectancy). Our fictional retiree would not be living on $60,000 for long after

inflation is taken into consideration. This is a big strike against interest only. A portfolio of fixed-income securities offers little to no opportunity for inflation protection (except for Treasury inflation protected securities (TIPS)). This is also why you really need to have excess savings to do interest-only properly.

The Bottom Line
Ideally, if you've done your homework and have accurately concluded that interest only is not only doable but sustainable, you'll want to blend your holdings, using bonds, CDs and annuities, into a "rainbow portfolio". All portfolios, regardless of strategy, should have elements of a rainbow in them. A rainbow covers the entire spectrum of color, which means that a rainbow portfolio should be as well diversified as possible. Use many types of securities and stagger the maturities to create that ladder. You'll be happier and more successful if you do.

Be thorough and careful when working out the numbers. Interest-only portfolios can work, but if you assume that one will work for you without working out the details, you may find yourself without adequate retirement funds. (For more, see *Stretch Your Retirement Budget*.)

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Steven P. Orlowski, CFPÂ® is President of Orlowski Financial Counsel, LLC, a Registered Investment Advisor providing fee-based Financial Planning, Portfolio Management and Insurance and Investment Advisory services. Steven is a twenty year veteran of the financial services industry, having served in the capacity of a stock broker, trader, financial planner and portfolio manager during that time.

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