MORNINGSTAR Managed Portfolios

Outcome-Based Insights
Income Comparison: Two Approaches for Retirement

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Key Takeaways

- We have conducted an income study to help retirees by comparing two popular approaches: an income strategy versus a total return strategy.
- We explore the key considerations, including income stability, the source of withdrawals, and the likely end account value. We also contemplate taxation and behavioral issues.
- The results show that the income approach can be effective for certain retirees, although both approaches have merit.

Meet Linda.

Linda just entered retirement with a $1 million dollar nest egg account from which she plans to drawdown $40,000 per year (a 4% withdrawal rate, without indexing for inflation) for the next 20 years to support her retirement life, so that's $800,000 total payout over the next 20 years. By the end of the 20 years, she will take out the remaining account value. What investment approach can Linda take to meet this income goal?

Two Options

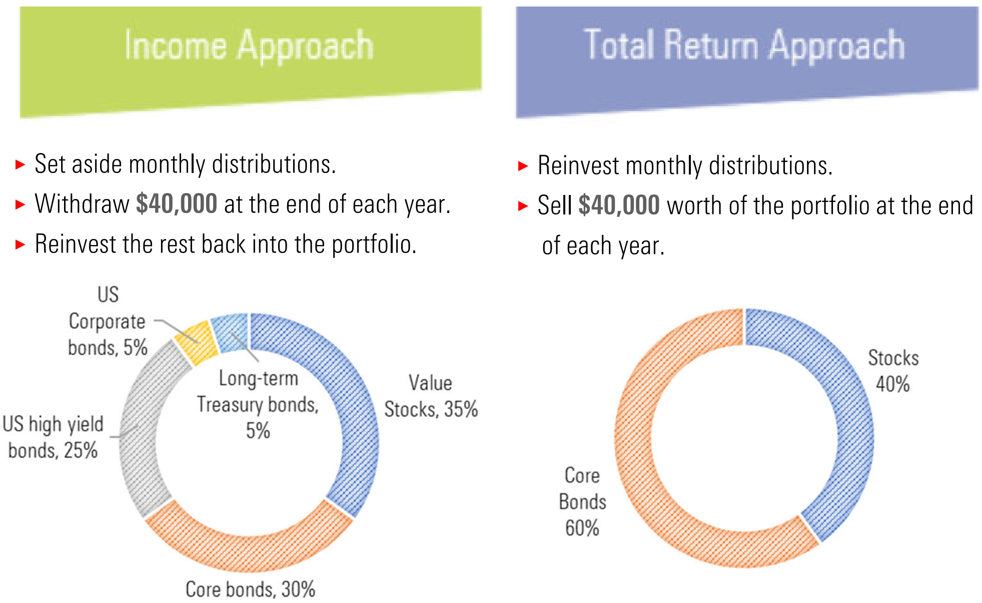
In general, there are two approaches that retirees typically take:

- The Income Approach
- The Total Return Approach

The income approach emphasizes cash flow generation, meaning the investor would withdraw the distributions of their portfolio, such as dividends and coupon payments. To generate the required distributions, income strategies typically tilt portfolios toward asset classes with higher current income, such as high dividend stocks, credit-sensitive corporate bonds and longer-duration fixed income assets.

Meanwhile, total return approaches typically don't rely on distributions as the source of withdrawals. Instead, the investor would accumulate wealth throughout the year, then sell part of the portfolio periodically (in this study, we've assumed annually) to meet the withdrawal needs. Because they don't rely on distributions, these portfolios tend to look much like a traditional target risk portfolio, such as a 40% equity holding and a 60% fixed income holding (we've used stock/bond split of 40/60 for this study).

Exhibit 1 Income and Total Return Strategies Differ on Withdrawal Source and Asset Allocation



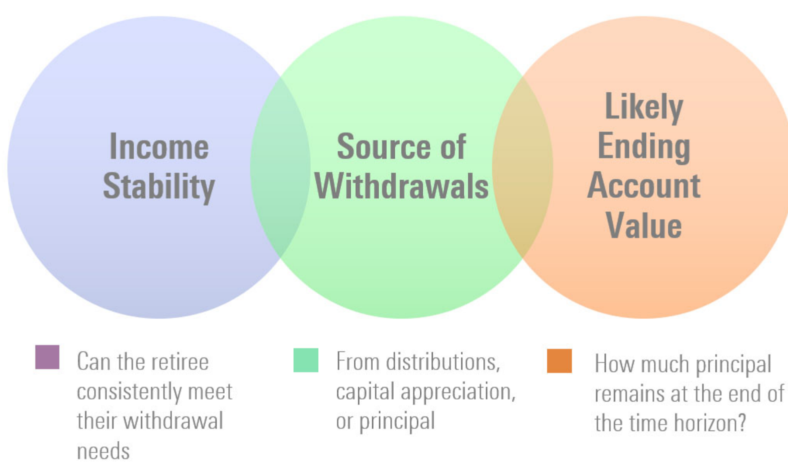
Source: Morningstar Investment Management. Asset allocation assumptions are for illustrative purposes only. Data as of August 31, 2020. Indexes we've used for this illustration are: Core Bonds: Bloomberg Barclays U.S. Aggregate Bond Index, Stocks: Russell 1000 Index, Value Stocks: Russell 1000 Value Index, US High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield Index, US Corporate Bonds: Bloomberg Barclays U.S. Corporate Bond Index, Long-term Treasury Bonds: Bloomberg Barclays U.S. Treasury Long Index. Note, the $40,000 has not been indexed (with inflation) in our study, reflecting the common practice of many retirees to peg at a required nominal withdrawal rate.

Three Criteria to Measure Success

Linda, as a test subject, can take both paths, and we can review her hypothetical outcome from each portfolio, income and total return. But the rest of us aren't so lucky—we need to pick the right portfolio because we only get one shot at retirement. We hope studying Linda's hypothetical results will help advisors lead clients to the right portfolio.

To look at how Linda would have fared with each portfolio type, we identified three key concerns that an income investor would consider when evaluating solutions for income needs—income stability, income source, and end account value.

Exhibit 2 Three Measures Retirees Should Understand



We look at the past 163 rolling 20-year periods (starting from 1987) and examine each of the concerns above to see how Linda would fare using each approach.

The Results

► Income Stability

Before we get to the results, let's take a guess—Which approach do you think would meet the income goal of $40K withdrawal per year for 20 years?

You're right! (The answer is both, actually.) Both the income and the total return approaches met the income goals over all the 163 rolling 20-year rolling since 1987.

For the income approach, this is important—especially given the low-yielding environment. In this regard, we note that as interest rates have fallen, the total distribution level (in both percentage and dollar terms) has also fallen across the 163 rolling 20-year periods. For the total return approach, this is perhaps less important, given it is designed to support the withdrawals from the capital balance.

The key learning here is that the income approach has been able to meet the payout needs despite the low rate environment, which was achievable due to the strong emphasis on income producing asset classes.

► Source of Income

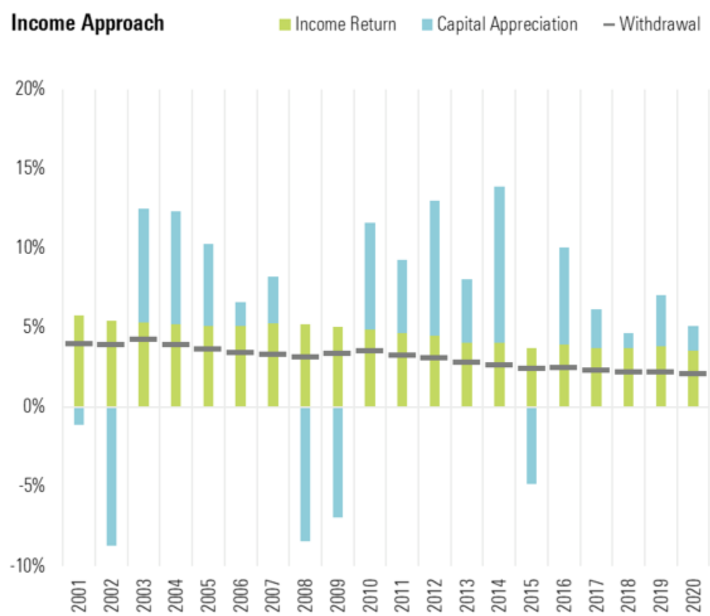
Next, let's take a look at the source of income. In other words, how does each strategy meet an investor's income goals? From income, like dividends and coupon payments? Or by selling assets, either capital gains or the original savings (principal)?

This time, they're not the same. For the income approach, Linda didn't have to dip into her principal at all. That is, the cash flow generated from her portfolio was enough to cover the required payouts for all rolling periods. For the total return approach, it is a different story as Linda was dipping into her principal in 37 of the 163 rolling periods. It didn't happen that often—about 23% of the periods—but when it happened, it could have a negative psychological impact on investors like Linda, especially when it happens after major market declines.

For example, the 20-year period from September 2000 to August 2020 was one such event, where market declines coupled with forced withdrawals. This 20-year period started during the tech bubble, so Linda would have suffered from meaningful losses in the first two years, and again in 2008-09.

Of course, the income strategy would have fallen too, but the difference between the two approaches is that the income strategy was able to meet Linda's income need without needing to touch the principal. This is evident in Exhibit 2, showing the green portion of the bar was higher than the gray dash across all 20 years.

Exhibit 3 The Income Approach Met the Need Every Year From 2001 to 2020



Source: Morningstar Investment Management. Past performance is not indicative of future performance. For illustrative purposes only. Data covers the 20-year period from 9/30/2000 to 8/31/2020.

Unfortunately, this was not the case for the total return approach. Using the same 20-year period from September 2000 to August 2020, Linda would have to dip into her principal in 18 of the 20 years--which reflects the low-yielding environment and the fact the remaining principal was smaller (due to the initial selloff in 2000-02). What happened after the first couple of down years was that, because the portfolio lost so much principal in the first two years from market selloffs and annual withdraws, it never grew back to the size needed to generate enough income to meet future withdrawal needs.

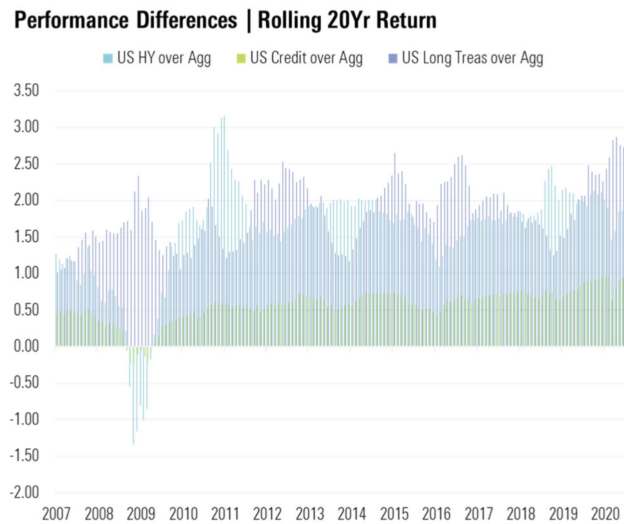
- **Ending Account Value**

People tend to believe that the total return approach will outperform income because you have to give up something if you want income. But that’s not what we found out.

In fact, income outperformed in 83% of the 20-year periods. Part of the reason behind the outperformance was that high-income asset classes performed better than the asset classes that’s in the traditional 40/60 portfolio.

For example, if you look at the rolling 20-year performance of Russell 1000 Value relative to Russell 1000, you will see they outperformance in most periods. The same applies to the fixed income side. We see that US HY, US Credit and US Long Treasury outperformed the Agg in most of the rolling 20-year periods.

Exhibit 4 Fixed Income Choices Can Have a Meaningful Impact on a Retirees Withdrawal Success



Source: Morningstar Investment Management. Past performance is not indicative of future performance. For illustrative purposes only. Data as of 08/30/2020.

History doesn't predict future, but our study suggests the general view that the total return approach will always yield better outcome doesn't always hold true.

About Tax and Behavior

We excluded tax implications from our study, as everybody's tax situation is different. However, we do want to point out that in general, the total return approach could reduce the tax impact. That's because under the income approach, all of the cash flow received by investors could be taxed in its entirety, whereas the total return approach tends to only trigger a tax event on capital gains at the point of sale, which in some cases could be significantly smaller than the entire dividend amount.

There are also key behavior considerations associated with both approaches. If the investor would have a strong negative feeling about dipping into principal, for example (especially when market experiences severe downturn), they should be cautious about using the total return approach.

Exhibit 5 The Pros and Cons of Each Approach

	Income Approach	Total Return Approach
	Multi-Asset Income	Retirement Income
Income Needs	✓	✓
Estate Needs	✓	
Tax Considerations		✓
Behavioral Concerns	• Income will not be at a consistent level in different market environments	• Investors may sell and dip into principal to meet income need when their portfolios suffer losses

Source: Morningstar Investment Management. Past performance is not indicative of future performance. For illustrative purposes only.

Conclusion

We hope this paper provides guidance regarding which income approach may work best for a given retiree. There is no one best choice that works for everyone. Depending on your needs and your key concerns, you may well have a different choice.

The lesson from Linda's income study is that both approaches are likely to meet her income needs. Ultimately, retirees must balance the pros and cons of each approach.

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