

Financial Post

News

Converting volatile income to steady stream



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In British Columbia, a woman we'll call Barbara worries about her future. Single and self-employed, she has only herself to depend on now and in the future when, perhaps, she becomes less mobile and less able to look after herself.

Self-employed as a management consultant, she generates take-home income of \$7,642 a month. Through hard work and diligent saving, she has built up \$2.2-million in assets, almost half of which are tied up in her \$1.1-million house. The other half is mostly financial assets. Now, at age 58, she wants to cash in on her achievements, to travel more, to spend time at her mother's home in France, and to be able to depend on her fortune rather than her endless labour. The problem: Turn volatile investment and business income into a steadier stream and make sure it lasts. And create a backup system that will take care of her when she, perhaps, cannot.

The Problem

This is a challenge, for Barbara's registered and non-registered investments will have to generate sufficient cash to replace her business income and to provide for her future well-being. She is considering spending as much as eight months of the year with her mother. She must stretch her assets for the next 30 years and ensure that market volatility never forces her to sell a stocks or to cash in mutual funds.

Family Finance asked portfolio manager and financial planner Adrian Mastracci, head of KCM Wealth Management Inc. in Vancouver, to examine Barbara's financial resources. Her goal is to generate \$60,000 a year in pre-tax income in 2011 dollars beginning when she is completely retired in a few years.

The Five-Year Plan

Year 1 (2011) Sell the house. Barbara might visit her mom for as much as eight months of the year. Keeping her \$1.1-million home

for what amounts to occasional use would be costly on a time-used basis. Assuming that the \$1.1-million can earn 3% a year in 2011 dollars, the annual theoretical occupancy cost is \$33,000, or \$2,750 a month, even when she is not living there. For eight months of vacancy, the house would cost her \$22,000 in what could be investment income if the principal were invested. Faced with these theoretical rent costs, it would be wise for Barbara to downsize to a condo priced around \$750,000. The price difference between her house and the condo, \$350,000, could earn \$10,500 before tax if invested to return 3% over the rate of inflation. That sum plus 3% after inflation on her \$1.1-million of financial assets, or \$32,388, \$11,520 of Canada Pension Plan benefits and Old Age Security payments of \$6,322 a year will give her the \$60,730 in 2011 dollars, which meets her target and leaves a little extra for comfort.

Year 2 (2012) Start downsizing the consulting business. Revenues will fall by about half if Barbara spends half the year away from her office. Any shortfall in money for living and travel expenses can come from Barbara's \$471,000 of non-registered investments. She can and should continue to make \$5,000 annual contributions to her tax-free savings account and should continue contributions during retirement.

Year 3 (2013) If Barbara continues shrinking her business, she will have to choose between drawing down non-registered or TFSA assets or taking CPP early. Under revised rules, starting CPP benefits early reduces payments by 0.6% for each month prior to the 65th birthday at which payments begin. Though being phased in slowly, it is a costly step, for the benefit reduction persists for life. With this in mind, early application for benefits should be a last resort. TFSA space created by withdrawals can be filled later if cash flow permits.

Year 4 (2014) Barbara is now age 62. Living independently, she should shop for a long-term care insurance policy that pays half of total needs. If she self-insures for the rest, she could obtain coverage for approximately \$3,000 a year, Mr. Mastracci says. That coverage could help to offset the cost of private, in-home care that can cost \$1,000 to \$5,000 a month in British Columbia. Private nursing facility costs can be \$4,000 to \$8,000 a month. Costs of \$50,000 to \$80,000 a year would devastate Barbara's capital, he notes. Spending a few thousand a year now can guarantee care that she may need and that she will have no one else to provide or pay for.

Year 5 (2015) As Barbara moves further into retirement, she will have to make her income more dependable, for she will have no one else on whom to depend. She should increase her portfolio weight of bonds to 60%, but she can go further by buying an annuity that would provide a contractual promise of fixed income for her life no matter how long she lives. A 6% to 8% return from capital could be expected. So if Barbara were to consider using as much as \$200,000 of her capital for an annuity, she could have \$12,000 to \$16,000 of pre-tax income guaranteed by the insurance company that sells the annuity and backed by Assuris, the life insurance industry's guarantee fund. However, over a few decades, inflation would erode the annuity's buying power.

For the Longer Term

Barbara has no plans to leave money to anyone, so she can consume her assets in full by the time she dies. If Barbara were to live on income alone and not consume capital, \$1.1-million would produce \$33,000 a year indefinitely. If she consumes capital so that at age 90 she has no remaining financial assets, she would have \$56,121 a year before tax and public pensions, a 70% boost over the model that preserves capital indefinitely. She would lose some income to the OAS clawback, which begins at \$67,668 in 2011, but the issue she must confront is why she should eat up her capital.

Capital consumption could force the portfolio to make riskier investments later in life as assets are eroded. If inflation were to rise or if several investments were to turn out badly, Barbara's margin of error and her safety net would be damaged. Finally, there is no evidence that Barbara would raise her spending just because a financial model says she can. In the end, raising income by eating up capital could increase portfolio risk and add nothing to Barbara's modest standard of living. "Preserving capital really means keeping options, including gifts to good causes," Mr. Mastracci notes.

"Her issue is risk management for her money and herself. She can afford long-term care insurance and should restructure her portfolio not so much to make money as to extend it for the rest of a hopefully long and fruitful life."

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FINANCIAL SNAPSHOT

Monthly take
home income: \$7,348

ASSETS

House	\$1,100,000
RRSP	\$ 555,815
TFSA	\$17,525
Non-reg stock	\$471,000
Car	\$50,000
Cash	\$35,270

TOTAL \$2,229,610

LIABILITIES

None

TOTAL \$0

Net Worth \$2,229,610

MONTHLY EXPENSES

Property tax	\$390
Utilities, internet	\$237
Food & restaurant	\$500
Car fuel, repairs	\$200
Travel	\$300
Entertainment	\$130
Clothing, grooming	\$200
Dental expenses	\$50
RRSP	\$1,190
TFSA	\$417
Car, home ins.	\$370
Critical illness ins.	\$142
Garden & house maint.	\$220
Charity & gifts	\$525
Misc.	\$200
Savings	\$2,571

TOTAL \$7,642

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