How to Create an Income for Life

ISACO

LET'S GROW WEALTH TOGETHER.

Contents

Disclaimer

The information provided here is based on ISACO Ltd's research and it does not constitute financial advice. Any information should be considered in relation to specific circumstances. ISACO Ltd does not make personal recommendations for particular stocks or investment funds or any other security or any other investment of any kind.

If particular stocks or investment funds are mentioned, they are mentioned only for illustrative and educational purposes. ISACO Ltd offer non-advised sales. These refer to a situation where no personal recommendation is made and the client is left to decide how they wish to proceed.

Please note that we do not provide advice, and therefore, are not required to assess the suitability or appropriateness of investments that you choose. This means you do not benefit from the protection of the FCA's rules on assessing suitability. If you have received a recommendation from your adviser they will be responsible for the suitability of the recommendation.

YOU SHOULD SEEK ADVICE FROM A REGISTERED FINANCIAL PROFESSIONAL PRIOR TO IMPLEMENTING ANY INVESTMENT PROGRAM OR FINANCIAL PLAN.

ISACO Ltd and its employees are not agents, brokers, stockbrokers, broker dealers or registered financial advisors. ISACO Ltd does not guarantee any results or investment returns based on the information in this report. Past performance is no indication or guarantee of future results and the value of any investment you make can go down as well as up. ISACO Ltd does not accept any responsibility for loss occasioned to any person acting or refraining from acting as a result of information contained in this report.

This report presents information and opinions believed to be reliable, but the accuracy cannot be guaranteed. ISACO Ltd is not responsible for any errors or omissions. ISACO Ltd is authorised and regulated by the Financial Conduct Authority (FCA 525147). www.fca.org.uk

Important Information

The value of a fund and the income from it can go down as well as up so you may get back less than you invested. If your fund invests in overseas markets, changes in currency exchange rates may affect the value of your investment. If your fund invests in small and emerging markets, these can be more volatile than other, more developed, markets. Past performance is not a guide to future returns. Due to the greater possibility of default, an investment in corporate bonds is generally less secure than an investment in Government bonds. Default risk is based on the issuer's ability to make interest payments and to repay the loan at maturity. Default risk may therefore vary between different government issuers as well as between different corporate issuers.

Copyright

Published by ISACO Ltd.

Introduction

Stephen Sutherland.
ISACO's Chief Investment Strategist and author of *Liquid Millionaire.*

My name is Stephen Sutherland and my passion in life is investing. I was fortunate enough to have instant success when I first got serious about the stock market. That success early on in my trading career made my love and curiosity for the market strengthen. It's now in my blood and I live, eat and breathe the market 24/7. Some would say I'm obsessed and maybe they are right.

In this report we're going to look at how you can create an income for life. In particular we'll discuss a real risk faced by many people, namely running out of money in retirement. We'll then examine some investment strategies for helping you avoid this.

In case you are wondering, our clients are ISA and SIPP investors and most of the people we work closely with have over £250,000 actively invested. If you are an ISA or SIPP investor with over £250,000 actively invested, this report was written especially for you.

Happy fund investing!

Stephen Sutherland
Chief Investment Strategist and author of *How to Make Money in ISAs and SIPPs*.

The risk of retirees outliving their retirement savings

Imagine sitting down on the day of your retirement to plan your financial future. You know what your annual expenses have been and you want to maintain your current standard of living. So, you consult a recent mortality table and find that if you've made it to your 65th birthday, you can expect to live to 85 years old.

You perform a little calculation and find that, together with your State Pension entitlements, you have just enough savings to maintain your current standard of living and spend all of your savings and future expected earnings by the time you die at the age of 85. But, what if you live longer? Will you be reduced to scraping out an existence on State Pension entitlements alone?

Many people today are discussing the 'retirement crisis', noting that individuals do not save enough and will not accumulate enough cash to retire comfortably. But there is another approaching crisis that is quickly attracting attention: post-retirement. While the retirement crisis centres on the financial struggles of people saving for retirement, the post-retirement crisis focuses on the financial difficulties of people near or in retirement.

To illustrate the unique financial complexities facing retirees, consider 10 school friends who decide to retire at age 65. Now guess when the first of these friends will die. As it turns out, the first death is likely to occur only 8 years into retirement at age 73. Next, try guessing when the last person will die.

The answer is 36 years into retirement, at age 101[1]. Put differently, one retiree needs to pay for just 8 years of expenses, whereas another has to pay for 36 years of expenses. Therefore, the risk of retirees outliving their retirement savings is significant. You could also argue that this longevity risk is actually far greater than investment risk.

[1] Allianz Global Investors – According to calculations by Allianz Economic Research based on the 12th population projection of the Federal Statistical Office of Germany.

A mistake made by investors

Many investors in their late 50s and 60s – approaching retirement or already in – have been coached by media and industry professionals to think about their investing time horizons in a way that, in our view is all wrong. Most people naturally think their time horizon ends when they retire, or when they stop contributing to their retirement funds, or when they start taking cash regularly from their portfolio. They mistakenly think that's when they should reduce most, if not all volatility risk and start thinking ultra conservatively.

Why thinking ultra conservatively could be dangerous

Thinking ultra conservatively can frequently mean an unnecessary and sometimes serious reduction in quality of life later on. Why? People live longer than ever now, yet many invest, by and large, like they expect to die at age 70. Thanks to better education, nutrition and technological and medical innovations, people are living longer today than thought leaders were predicting 50 years ago.

According to the Office of National Statistics, based on 2016–18 mortality rates, a man aged 65 could expect to live another 18.6 years, and a woman aged 65 another 21.0 years. That means the average 65-year old male will live until they are 83 but some 65 year old men will beat this average and live even longer. And our guess is, much longer.

Our suggestion is...

In these next 20 years, there are going to be more medical advancements than we can fully comprehend now and today's retiree is overall more fit, active and healthy than ever before. If you're 65 years old or approaching 65, our suggestion is to adopt a long-time investment horizon, especially if you come from a long-living family and are in good health.

Many investors approaching their retirement mistakenly think that reducing risk by moving out of equities and into bonds and cash instruments is smart. It's true that having a portfolio of gilts and cash won't be as volatile, but volatility risk is just one kind of risk. There's investment risk – the risk that your bonds don't perform. There's also opportunity risk – the risk of missing out on a better investment.

Running out of money, a fear worse than death

In a 2010 poll conducted by Allianz Life Insurance Co of North America on people aged 44 to 75, more than 3 in 5 (61%) said that they feared depleting their assets more than they feared dying. By thinking too short term, many investors approaching retirement invest too conservatively, resulting in poor returns, failing to stay ahead of inflation and, as the years pass by, their retirement pot slowly but surely becomes smaller and smaller.

When approaching your retirement, please don't make the fatal mistake of failing to plan for a long enough time horizon. Volatility and sitting through market corrections may make the investor feel bad in the near term, but if they die before their spouse and fail to plan for the correct time horizon, they could be leaving their partner in aged poverty.

We think it's a big gamble to assume that you and your spouse will be just average and live another 10 years – because you could find out that you're abnormally healthy, live another 20 or 30 years and run out of money after 10. Plus, it's later in life that you'll probably want the additional comforts money can buy. Therefore, investing too conservatively could be seen as high risk.

Without risk, you can't get growth

If you have a long time to invest and most likely you do, the odds are in your favour. The longer your time horizon, the greater the odds that equities will treat you better than cash or bonds – and by a wide margin. Most investors with a long time horizon – 20 years or more – likely need at least some growth. And let's not forget about inflation's impact, which historically is running at about 3% per year, and the cost of investing, roughly 1–3% per year.

Retirees who need their investment portfolios to beat the pace of inflation, the cost of investing and provide some cash flow are doing themselves a disservice by removing all or even most volatility risk from their portfolios.

Without risk, you can't get growth. And without growth, a portfolio can be ravaged over time by withdrawals, the cost of investing and inflation. To help a portfolio survive the long haul, you likely need to hold some portion of your portfolio in stocks most of the time. You can lower the risk of buying individual shares, and provide better diversification, by buying quality funds and holding them over the long term.

How to create a lifetime income

If you buy into our thinking that investing too conservatively could be seen as being risky, you'll probably agree with our 5 step plan for creating a lifetime income:

1) Switch to long-term thinking
2) Invest for growth
3) Health and wellness
4) Time and compound interest
5) Smart income drawdown

1) Switch to long-term thinking

As you've just discovered, many unsuspecting investors make the fatal mistake, when approaching retirement, of failing to plan for a long enough time horizon. Now knowing that many people will live 20–30 years after hitting retirement, you may have realised that you have been thinking too short-term. If so, you now have the opportunity to rethink your plan.

2) Invest for growth

By extending your investment time horizon, you have the opportunity to take on more risk. One option would be to invest in slightly more adventurous funds; funds that have the potential for attractive long-term returns.

Smart investors use tax wrappers such as ISAs and SIPPs to further boost their returns and pay less tax. Outperforming the market over the long term may be extremely difficult to achieve but it is possible. When you're successful in beating the market, it helps you achieve higher returns; helping to reduce the risk of running out of capital later in life.

3) Health and wellness

When an investor changes from short-term thinking to long-term thinking and decides that they are going to aim for growth by investing in growth-oriented funds, another area they ought to consider is their health and wellbeing.

Scientists refer to the following determinants of longevity: country of residence, the country's health care system, genetics, standard of living, healthy behaviour, education and environment. Even though some things are out of our control, such as our genetics, each of us has the power to choose – allowing us the potential to make better decisions relating to our health and wellbeing.

Each of us can decide to take better care of ourselves by learning more about health and nutrition, eating the right foods, exercising regularly and resting appropriately. On the other hand, we can decide to stay ignorant about health and nutrition, eat the wrong foods, refrain from exercise and generally neglect our bodies. The choice is always our own. One course of action will help, and the other will hurt. If you are like us, you already buy into the healthy living concept.

4) Time and compound interest

Compounding can have an incredible effect on money when invested over the long term, especially when you can get your money to grow at a decent rate of return. When you set a longer time horizon and are successful at achieving higher returns, the result is an increased chance of arriving at your financial objectives. It also lessens the probability of running out of money during your retirement.

5) Smart income drawdown

Creating a lifetime income is possible if you take the appropriate action to increase your chances of success. When reaching a long-term target, which could be anything from £500,000 to £15 million or even more, a smart investor could set up an automatic withdrawal plan from their ISA and SIPP accounts to pay them the income to fund their lifestyle.

The guideline rule is to take out a smaller percentage rate than the rate your account is growing at. If an investor had been making 6-8% per year over the long term, the guiding rule would be to withdraw maybe 1-4% each year, ensuring that their retirement pot would continue to grow. If they continued to stick with this simple formula, they would be in effect eliminating the risk of running out of capital and at the same time, creating a continuous stream of lifetime income.

Why ‘lifestyling’ is a flawed strategy

Lifestyling is the practice of reducing the risk to a pension or other investment, typically by shifting to less volatile and lower risk investments. If a fund uses lifestyling, the assets are moved out of equities and into safer investments, such as government bonds and cash, as the investor approaches retirement.

Sometimes these types of funds are called ‘target funds’. We believe lifestyling is a flawed strategy – a concept that’s totally outdated. 30 or 40 years ago, when people weren’t living as long as they are now, the idea of lifestyling may have been a good way to think about investing. However today, a healthy 65 year-old is looking at a life expectancy of 83. That’s eighteen more years of spending and eighteen more years of inflation to erode the buying power of his or her money!

The 4 skills of the master investor

Our thinking is that you have to aim high and make decisions based upon you living much longer than you may have previously thought. As you now know, inflation chips away at the buying power of money, and fees and charges associated with investing can also quickly add up. The key is to condition yourself to think differently. You need to aim high and try to master these four skills:

Skill 1 – How to find and invest in funds likely to beat the market
Skill 2 – Knowing when to enter and exit your investments at the optimum time
Skill 3 – How to get in sync with the market and trade with the trend instead of against it
Skill 4 – How to keep all associated costs, charges and fees low

By mastering these four key disciplines, you'll have a much better chance of achieving your aims. And if you feel you don't have time, get help from a trusted professional you admire and respect.

How to increase the likelihood of staying ahead of the market

The key is to think long-term. See losses in corrections as temporary inconveniences and refrain from getting spooked out of the market in volatile and challenging environments. When you get all these elements right, you'll increase the likelihood of staying ahead of the market and achieving a reasonable rate of return on your capital.

When you make better informed investment decisions, you increase the probability of making a return that outpaces both inflation and the costs associated with investing. Trying to achieve higher returns is going to take time to master. It will involve a tremendous amount of willpower, plenty of hard work and, it goes without saying, a little bit of luck.

Think of your wealth like a cake

We like to think of your total wealth like a cake, split into thirds. We believe that when you reach retirement, which might be at 55 for some, 65 for others and 75 for those who love their work, we suggest that one third of your wealth is invested in the stock market, another third is invested in property and the final third invested in your own business or businesses. Think multiple streams of income.

The stock market and the property market work in cycles. Both of them have bull and bear markets, which means that sometimes they'll be in an uptrend, sometimes a downtrend and sometimes there will be periods where they won't make any price progress for many years. However, if you look at the stock and property markets over the last century, they are both in long-term uptrends.

This means that sometimes the stock market will be hot and other times the property market will be having a nice run. Sometimes your business or businesses will be flourishing. Our expertise is not in knowing how to build a property portfolio and neither does it lie in building a business empire. However, we can give you some pointers regarding the third of your wealth that we believe should be invested in the stock market.

Profit from combining an active strategy with a passive strategy

With the third of your wealth that you allocate to investing in the stock market, we suggest you consider two strategies. The first is an active strategy and the second is more passive. The active strategy involves using your ISAs and SIPP to invest in adventurous funds over the long term. This is your tax sheltered strategy, when you buy quality funds at the lowest possible cost and aim to beat the market.

For money outside an ISA and SIPP, we don't recommend this active strategy because the capital gains tax (CGT) that you'll have to pay will eat into your returns and probably result in underperforming the market. Your passive strategy is one where you don't buy and exit like we suggest you do with your ISA and SIPP strategy. With this passive approach, you'll only be buying, which means there will be no CGT to pay until much further down the road when you start taking income.

By putting in and not taking out, you completely avoid paying CGT, which means you'll benefit from the incredible power of compounding. This passive strategy is a simple one that involves investing in a low-cost index fund or ETF that tracks the S&P 500, and staying fully invested in the fund over the long term. It's a strategy that we're currently executing on behalf of our dad. We call this our 'S&P 500 Strategy'.

How to leave a legacy: the S&P 500 Strategy

If you want to invest in something that you can benefit from yourself, and leave for others to benefit from after you're gone, this could be the strategy for you. The idea is that you will be investing in the S&P 500 for an infinite amount of time, which means the fund will outlive you. Whilst you're alive, it will provide income for you to enjoy and once you're gone, it will continue to provide income for future generations of your family, or alternatively, a charity or cause close to your heart.

The goal of this strategy is to mirror the performance of the S&P 500. By purchasing a fund such as the HSBC American Index Fund (ISIN:GB00B80QG615), you're buying the S&P 500 Index. Purchasing this fund is one way to mirror the performance of the S&P 500 but it's not the only way. There is an ETF (Ticker symbol: SPY) you could use and there are lots of other funds that also aim to track the performance of the S&P 500.

When searching for a suitable tracker, the three things to really keep your eye on are the ongoing charge figure (OCF), the fund's liquidity and its tracking error. We like to buy trackers at low cost, we like them to be liquid and we like them to have minimal tracking error. If they have a low OCF, the tracking error is also usually low. For example, the HSBC American Index Fund has an ongoing charge of just 0.06% and this tells us the tracking error will be minute.

The returns you can make using this strategy cannot be ignored. Over the last thirty years[2], ending December 31st 2018, the S&P 500 registered an average annual total return of 9.06%. With this in mind, we believe that over the long term, mirroring the S&P 500 would probably net you a return of approximately 7–10% per year. This would allow whoever was going to benefit from the fund to draw an income of say, 2–3% per year, allowing the fund to continue to grow at a decent annual rate of return.

[2] Source: Macrotrends.net 30 years annualised returns of S&P 500, period covered January 1st 1989 – December 31st 2018.

S&P 500 Strategy

This method is very simple and consists of four easy steps.

Step 1 – Decide the total amount to invest

For example: £1,000,000.

Step 2 – Decide the time frame for your buy program

For example: Buy program evenly spread over 5 years.

Step 3 – Decide on the number of purchases

For example: 5 equal purchases of £200,000.

Step 4 – Decide when the purchases will take place

For example: On January 1st, for the next five years, buy £200,000 of the HSBC American Index Fund.

Once all your purchases are done, you can sit back and simply let your investment grow. However, there are some clever tactics you can use to help give the fund a boost, which we're going to share with you in a moment.

Think long-term

Losses may occur over the short term and the way to deal with these losses is to think long term and see them as temporary.

During your five year buy program, you are likely to experience at least one bear market and during the bear market, you may feel like cashing in and aborting the whole program. A bear market could surface as soon as your program starts and that means your first buy falling as much as 20% or even much more. How would you feel about that? How would you feel about adding the same amount you added in year one when you are already down 20% or more? These are questions that need careful thought before proceeding.

Smart tactics for boosting your returns: Bear market strategy

As an additional strategy, if you are willing to be more aggressive and want to capitalise on buying the market when it is cheap, you could adopt a bear market strategy to supplement your long-term pound cost averaging strategy. With this approach, you aim to buy when the market is low by purchasing three equal amounts in the trough of the bear market. The first buy is when the S&P 500 is 20% off its recent high, the second buy is three months later and the final buy three months after that.

How does the S&P 500 bear market strategy work?

The strategy consists of 5 simple steps.
Step 1 – You decide on an amount you want to invest
Step 2 – You divide that amount by three
Step 3 – Purchase number one occurs when the S&P 500 is 20% off its high
Step 4 – Purchase number two is scheduled for three months later
Step 5 – Purchase number three occurs three months after purchase number two

Further opportunities to buy when the market is low

Every three months after the third purchase, if the market is trading lower than the third buy price, you have the opportunity to add a further amount if you have the cash available. This amount ideally needs to be equal to the payments you have previously put in. For example, if you had bought using three amounts valued at £50,000, and the market presented the opportunity to add, you would add another £50,000.

There could be as many as 10 further opportunities to add, depending on the depth and duration of the bear market. One thing to remember with this strategy is that even though income is accessible, our recommendation would be to not touch the money for at least 10 years. After a decade had passed, you could then start an income withdrawal program.

Closing thoughts on the S&P 500 Strategy

The S&P 500 Strategy is extremely time friendly, perfect for leaving a legacy and an excellent way to achieve a decent return on capital outside your ISA and SIPP. It's a strategy that could net you an annual return of 7–10% over the long term. It's very simple and straightforward and the rules we've suggested are not set in stone. The key thing here is that you understand the principle, which is to end up making a return almost equal to the return of the S&P 500, using capital outside your ISA and SIPP investments.

This is an investment that should be grown over 50 to 100 years, or even longer. If you are going to take an income from it, try not to touch the account for at least 5 years and when you eventually do start to take an income from it, aim to keep your withdrawals to a minimum, maybe 1–3% per year.

Final thoughts

I hope that you've found the information contained in this report valuable. I also hope that it helps you to take the necessary steps needed to reduce the risk of running out of money in your retirement. And finally, I also hope that what you've learned will help you to create a strategy that results in providing you with a comfortable income for life.

If you would like some one-to-one help and guidance, feel free to get in touch. Our clients kindly say that my brother Paul and I are incredibly friendly, caring and highly responsive to their questions and requests for help, support and guidance. What's more, if you call or get in touch, I promise that you won't be charged a penny and you won't be passed on to a junior associate. Instead you will speak to me or my brother Paul, the founders of ISACO and two directors of the company.

Email me direct at Stephen@ISACO.co.uk

Or call me on my private line: 01457 831 642.

Your friend,

Stephen Sutherland
Chief Investment Strategist and author of *How to Make Money in ISAs and SIPPs*.