LEXINGTON COUNTY Chronicle
AND The Dispatch-News SINCE 1870

December 2010

Income for the rest of your life

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Over the past few months we've covered the dangers of inflation, why it's so important to plan for, and some of the strategies used to protect yourself from it. This month we'll discuss one of the last 2 options in more detail: taking income using reverse dollar cost averaging.

Reverse dollar cost averaging may be one of the strangest terms out there. Here's where it comes from: dollar cost averaging refers to investing in the stock or bond market repeatedly over time. The most common example would be through contributions to your 401k at work. Each pay period, money is invested into your 401k account. Sometimes the market is up; sometimes it's down. Over time, the cost you pay for your investments averages out. Interestingly, the math shows that over time, dollar cost averaging always works to your advantage!

So what is reverse dollar cost averaging? It's the opposite! This means you have money in the stock or bond market, and you take money out a little at a time. A simple example would be if you make a withdrawal from your 401k account each month to live on during retirement.

Here's the problem: the math proves that reverse dollar cost averaging is always hurting you! Why? Imagine you're taking money every month when suddenly the stock market takes a huge tumble – and yes we all know THAT can happen! But next month you still want your income right? The shares for your account have lost value. That means your 401k will have to sell more shares to give you your money.

As someone who has been advising retirees since 1996, this 'planning' has caused some of the most painful situations I've ever seen; and unfortunately, I've seen it all too many times. Here's what this sad story looks like:

Mr. and Mrs. Jones work and save for their retirement for over 40 years. They build a large nest egg – most often through a balanced mix of stock and bond market investments with the help of their stockbroker. When they retire, they shift their portfolio to a slightly more conservative mix of stocks and bonds.

At some point during their retirement the stock market drops significantly. (Think of the 2000-2002 drop of 49% or the 2007-2009 drop of 57%) As the stock market is dropping, Mr. and Mrs. Jones are continuing to withdraw money. (they're living on that money after all) Eventually, the portfolio value has dropped so far that one or both of them have to find work to help them create enough income each month. So much for retirement.

So where was the problem? Is it foolish to invest in the stock market? Not at all. The lesson here is simple but very important:

It is VERY dangerous to trust the stock market to provide you with income! Next month we'll discuss a better way to use stock market investments in your portfolio.

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