The "Income for Life" Conundrum

By Gil Hanoch, April 2011

You can achieve financial freedom using an investment that provides income for as long as you live. A globally diversified stock portfolio with limited withdrawals addresses this need well, and has the side effect of likely leaving your heirs with a large pot of money. While you may be happy to help them out, you may prefer to enjoy more of your money during your lifetime. The article explains why this is impossible, and why it should not bother you.

If you can save a large enough amount, to allow you to make very limited withdrawals from your investments (typically 3%-4% per year) and cover your expenses, a globally diversified stock portfolio may be your best solution for income for life. It provides a unique combination of benefits:

1. **Income for life**. If you choose a low enough withdrawal rate, and keep the diversified portfolio with no individual stock selection or market timing, the portfolio may provide you with income forever, which, by definition, includes the rest of your life.
2. **Automatic inflation adjustments**. Since inflation is the increase of the cost of goods and services, and you own the companies that provide these goods and services, their income and value ultimately grows with inflation. This allows for the portfolio to withstand growing withdrawals that are adjusted for inflation.
3. **Availability for unusual expenses**. The entire investment is available to you at all times, and can support some level of unusual expenses, beyond the typical withdrawal rate. This flexibility can be very valuable if you want to move to a more expensive house, or face a large medical bill or any other extraordinary expense. (This applies to infrequent excess withdrawals – withdrawing a higher percentage for many years in a row will put you at risk of running out of money during your lifetime.)
4. **Growing income, beyond inflation**. The investment is expected to grow over time, despite the ongoing withdrawals. During declines you can keep the income constant (with inflation adjustments). In all other times, as the portfolio reaches new peaks, withdrawing the same percentage of the peak value provides growing income.
5. **Money left for heirs or charities**. A side effect of the money growth is that you get to leave a large pot of money to your heirs or charities of choice.

The problem: While most people are happy to take care of others through the money they leave, some may prefer to enjoy more of their money during their lifetime, while leaving behind a smaller amount.

No solution: Since you cannot know your lifespan in advance, you cannot plan to use up most of your money during your lifetime. Say you increase your withdrawal rate, with an aim to use up most of your money by age 95 (or pick any other specific age). There are problems with this approach:

1. You may live to be 100 or longer, and end up bankrupt. Lifespans have grown at a rapid rate in the past century, and it is impossible to know whether you will live to be 80, 100, or 120.
2. A major stock market crash early in your retirement can result in depletion of your money at a younger age.
3. Instead of seeing your portfolio grow throughout life, you are planning to see it decline over time. This means that instead of having greater means to deal with unplanned expenses, your means decline.

4. The difference between seeing your financial security increase over time and seeing it decline over time, is remarkable. **Your choice will affect your feeling of financial security every day for the rest of your life.**

Why it doesn't matter: When comparing this lifelong income generating investment to the alternatives, even when ignoring the leftover money, this solution seems superior and pleasing. Let's review two common alternatives:

1. **Annuity**: This product is designed specifically to address the need for income for life. While it can work very well, it has several flaws: (1) no flexibility for large withdrawals; (2) income grows with inflation at best – you lose all the excess income growth obtained through stocks; (3) the income depends on the solvency of a single insurance company (compared to thousands of stocks around the world).
2. **Real Estate**: Owning several properties can provide income for life, but does not allow easy access to the principal. In addition, it has no flexibility for large withdrawals. On the contrary – you may incur shortfalls in income through repairs and vacancies. There are some ways around these limitations, including selling a property to cover a large expense, or borrowing temporarily from a home equity line of credit, but they tend to be more difficult to implement and limited than the easy accessibility to a stock portfolio. Despite the limitations, this solution is legitimate, and many people swear by it.

Summary

Using a globally diversified stock portfolio for generating lifelong income has many benefits, and one of them may be seen as a downside by some people – a substantial pot of money left for your heirs. There is no way around this outcome, but when comparing this solution to common alternatives, the benefits clearly outweigh this negative (for those who see it as a negative).