Motley Fool's *Rule Your Retirement* Newsletter

How to Create Steady Income from a Volatile Portfolio

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Chances are, you've heard the fact that stocks have returned an average of 10% per year. It's one of the foundational reasons we believe in stocks for the long run.

But how often do stocks in real life actually earn those mathematically average returns? Earlier this year, Ben Carlson of Ritholtz Wealth Management endeavored to answer that question. In a post on his blog, he calculated how often stocks and bonds (as represented by five-year Treasuries) have performed within a range that was 1% below or 1% above their average returns from 1926 to 2018. He chose to look at after-inflation returns — 6.9% for stocks and 2.1% for bonds.

He then looked at monthly rolling returns for various holding periods. This table lists the percentage of times that stocks and bonds were within Carlson's specified range (again, 1% below or 1% above their 1926-2018 average returns).

Time Frame	Stocks	Bonds
1 Year	4.4%	16%
5 Years	7.9%	20.6%
10 Years	12.1%	24.3%
20 Years	13.9%	26.2%
30 Years	42.4%	26.4%

The results are rather staggering. Over the majority of holding periods — even those as long as 30 years — stocks and bonds have consistently either underperformed or overperformed their 1926-2018 averages by more than 1%.

In other words: Don't expect to earn the average returns.

This implies that there's a good deal of unpredictability about how much your portfolio will be worth in the future, and that's certainly true. Yet after you retire, you'll be relying on your nest egg to produce a consistent and reliable paycheck.

So how can you create a relatively predictable stream of income from assets that are inherently volatile? We have five suggestions.

1. Shelter some assets

It's old advice, but always worth repeating: Any money you need in the next few years should not be in the stock market. If you're retired, we recommend you create an "income cushion" of money that can cover the next three to five years' worth of expenses. That money could be invested in cash, CDs, money markets, or safe short-term bonds. With this money, you're aiming for safety more than yield (though there are ways to earn up to 2% or more on your cash).

2. Look for income that isn't correlated to the stock market

Each of our Model Portfolios have an allocation to bonds, which often post their best returns when stocks are doing their worst (as long as the bonds are of the safe variety, such as Treasuries and corporates rated A or higher by the ratings companies). So bonds can provide ballast to your portfolio when stocks get stormy.

In fact, over approximately one-third of one-year holding periods, bonds beat stocks. We've seen this over the past 12 months; while the S&P 500 has returned 4.2%, the **Vanguard Total Bond Market ETF** (NASDAQ: BND) has returned 9.6%.

As an alternative to bonds, retirees in their late 60s or older should consider immediate income annuities provided by insurance companies, which provide predictable income for life. There are many benefits to the lifelong guaranteed income from annuities, including research that indicates annuities are superior to bonds in retirement. In an episode of the *Motley Fool Answers* podcast, I interviewed financial-planning expert Dr. Wade Pfau, who explained that "the insurance company is investing that [annuity] money in a bond portfolio, so you get bond-like returns. Plus you get the power of risk pooling, where if you end up living longer than average, you receive these subsidies from the risk pool to help support your spending. And so stocks and annuities work a lot more effectively for retirement income than stocks and bonds."

3. Follow ye olde "eggs and baskets" advice

There's some debate about the value of diversification when accumulating wealth. After all, Jeff Bezos and Warren Buffett wouldn't be among the richest people in the world if they limited their holdings in **Amazon.com** (NASDAQ: AMZN) and **Berkshire Hathaway** (NYSE: BRK.B), respectively, to just 10% of their portfolios (a common rule of thumb).

However, diversification increases in importance for those living off their portfolios; they may not have the time to wait for any downtrodden stocks to recover. By owning stocks of varied sizes, sectors, and nationalities, you increase the chances that *something* will be doing well — or at least not falling as much — at any given time.

4. Take comfort in dividends

The stock market's return is the sum of two components: changes in price, and dividend payments. And the former is much more volatile than the latter.

As we've discussed before, starting in 1958 (the first full year for the S&P 500), there have been only eight years in which the dividends paid by the companies in the index, as a group, were lower than the payouts of the previous year. And in only two years — 1959 and 2009 — were the declines significant. As the past 60 years of the S&P 500 have shown, a diversified portfolio of dividend payers has historically provided a reasonably reliable and growing stream of income.

Year	S&P 500 Dividends	Growth Over Preceding 5 Years
1958	$2.26	N/A
1963	$2.35	3.9%
1968	$3.04	29.6%
1973	$3.61	18.6%
1978	$5.18	43.5%
1983	$7.12	37.5%
1988	$10.22	43.4%
1993	$12.69	24.1%
1998	$16.20	27.7%
2003	$17.39	7.3%
2008	$28.39	63.3%
2013	$36.28	27.8%
2018	$53.61	47.8%

Source

5. Choose the right withdrawal rate

The financial-planning world is awash in research about the amount that retirees can withdraw from their portfolios each year while still being relatively confident that their money will last their lifetimes. Some methodologies result in a consistent, inflation-adjusted amount, year after year. With others, the year-to-year income fluctuates, depending on variables such as portfolio performance or life expectancy. The right method for *you* will depend on many factors, including your need for income consistency, your fear of running out of money, the amount of flexibility in your annual budget, and the amount you'll receive from non-portfolio sources (e.g., Social Security or a pension).