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Creating Cash Flow From Your Investments

As you reach retirement, creating cash flow from your investments becomes more important. First you need to determine how much, how often and when during the year you will need cash flow from your investments. Do you need cash flow each month to supplement your pension income? Do you need cash flow only periodically during the year to pay for vacations, property taxes, etc.? Some retirees only need lump sum amounts from their investments to replace capital assets (vehicles, home renovations, etc.).

Once you have determined what cash flows you may need from your investments, you can create this cash flow in a number of different ways. Here are some ways that you can manage your investments to provide monthly income:

- Investing in monthly pay GICs or provincial bonds;
- Investing in six or more semi-annual pay bonds with staggered payment dates;
- Investing in twelve or more annual payment GICs with staggered payment dates;
- Investing in fixed income mutual funds with monthly payments;
- Investing in quarterly dividend paying stocks with staggered payment dates;
- Investing in various trust units with staggered payment dates;
- Investing in growth stocks and selling periodically to provide cash for spending;
- Investing in equity mutual funds with monthly withdrawals;
- Combinations of the above strategies.

Monthly Pay GICs
Most financial institutions will provide Guaranteed Investment Certificates or Term Deposits that pay the interest earned each month to the investor. With these investments, the interest that is earned each month is paid by cheque or deposited into your bank account. The GIC may have a term of one to five years. At the end of the term, the principal amount is available for spending or reinvestment at the new interest rate in effect at that time.

To increase the average return on the term deposits or GICs, you should use five-year investments. To avoid the risk of having all the money come due at a time when interest rates are low, you should have about 20% of the investment capital come due each year. This maturing capital can be reinvested for five years.

During the “accumulation of capital” phase of your retirement planning, you may be using compounding interest investments. It may take some time to rearrange your investments to create monthly cash flow. (As much as five years, if you are using 5-year GICs.) It is important that you begin this process prior to retirement.

Annual Pay GICs
Most Guaranteed Investment Certificates or Term Deposits pay interest either annually on the anniversary date or at maturity (compounded). If you do not need the interest until the end of the year or at maturity, this is fine. However, if you are using 5-year compounding GICs you will not be able to get any of the interest (or principal) until maturity. By having 20% of your capital coming due each year, you have the opportunity of using this capital and five years of accumulated interest at least once a year.

If you want monthly access to your funds, you could invest in twelve different GICs each having a different maturity or anniversary date. One could mature in January, February, March, April, etc. so that you have some amount coming due or paying interest each month. Again, 20% of your capital should be coming due for reinvestment each year and be reinvested for five years.

Semi-Annual Pay Bonds
Government of Canada bonds, Provincial bonds and most corporate bonds pay interest on a semi-annual basis (every six months). To create monthly income you can invest 1/6 of your fixed income capital in a bond that pays interest in January and July, another 1/6 of your capital in a bond paying interest in February and August, another 1/6 in a bond paying in March and September, etc. until each month is covered.

You will still want to stagger the maturity dates over at least six years and then reinvest the proceeds for six years or more. You do have access to some capital each year that can be drawn down if you choose.

Fixed Income Mutual Funds
Some Bond funds and Mortgage funds arrange to have the interest earned by the fund paid out each month. Within the bond or mortgage fund the manager staggers the payment dates and maturity dates as you can above. However, in a fixed income fund, you do not have to have as much capital invested to get monthly interest as you would need to create your own bond portfolio.

Be aware that there is an additional risk in a fixed income fund over your own bond portfolio. That risk is that when interest rates increase, bond values decline. If you own the bonds directly, you can always hold on until maturity and get the face value of the bond. In the fixed income fund, the manager may sell the bond before maturity and create a loss.

Dividend Paying Stocks
Many stocks pay dividends. Some pay dividends once a year. Most stocks that pay dividends, pay those dividends quarterly. There are three different dividend cycles. Some companies pay dividends in the first cycle (January, April, July, October). Other companies pay in the second cycle (February, May, August, November) and some companies pay in the third cycle (March, June, September, December). You can buy some stocks from each cycle so that you receive some dividends each month.

Dividend paying stocks can be either common shares or preferred shares. Common shares generally pay a lower dividend but have more opportunity for capital gains as they are entitled to the residual value of the company. Preferred shares pay a higher dividend but have little opportunity for capital gains as they usually have a par value that the company may redeem them for. In the event of a wind-up of the company, preferred shareholders will get paid before common shareholders. Whatever is left of the company after the creditors and preferred shareholders get paid belongs to the common shareholders. (Hopefully, this will never be an issue with your stocks.)

You should diversify your stock investments by owning fifteen to twenty different stocks.

Income Trust Units

Some businesses have changed their structure so that they are no longer corporations. They have converted to trusts. Rather than having shareholders, investors are effectively partners in the business. As partners, investors are entitled to their share of the profits. One of the benefits of this business structure is that the business does not pay any income tax. The profits are allocated to the investor. In many trusts all the profits are paid out to the investors. This creates a higher cash flow to investors than a company that retains some of its after-tax earnings to reinvest in the business.

This higher cash flow comes with some additional risk that may not be recognized by some investors. The first risk is that investors are not shareholders with limited liability. They are owners of the business and may be jointly and severally liable for all the debts of the business.

The second risk is that because the trust pays out virtually all of its cash flow to the investors, little is left in the business to fund growth. New growth must be funded by additional debt or selling new units to investors (which dilutes the ownership of the current investors).

As with dividend paying stocks, you should diversify among a number of income trusts with different payment dates.

Growth Stocks

Some of your investments may be invested in the stock market to allow some growth to cover the impact of inflation. Periodically, you may sell some of these investments. You should save some of the proceeds from the sale to pay any tax owing on capital gains (investments outside RRSPs/RRIFs). The balance of the proceeds are available for reinvestment or spending.

It is difficult to create monthly cash flow from a portfolio of strictly growth stocks (which one do you sell this month, how many shares do you sell each month, what is the commission on small sales). This investment may be more appropriate for long-term capital replacement goals (new vehicle, home renovations, etc.)

Equity Mutual Funds

A more efficient way of creating monthly income from growth stocks is through an equity mutual fund. Once you have invested your capital, you can arrange for a monthly, quarterly or annual withdrawal from the fund(s).

To create income from a mutual fund, you can use the reverse of dollar cost averaging. Most mutual funds will allow you to withdraw a monthly amount from your investment. This can be paid to you by cheque or deposited directly into your bank account. The payment you receive will be a combination of principal and capital gain (or loss).

To set up an automatic withdrawal program, you deposit a lump sum into your investment fund. Then you request a monthly withdrawal amount. Each month an appropriate amount of shares are sold to provide the monthly payment.