

Building an income strategy into your investment portfolio

Making informed investment decisions and monitoring your portfolio are fundamental to building wealth. But what about when you need to draw on the wealth that you've built?

Steps can be taken to effectively structure your portfolio so that the income you need is paid out to you when you need it — leaving the remaining investments with the opportunity to grow. Consider the following guidelines.

Identify your needs

If you know that you're going to need income from your portfolio to supplement your other sources, such as employment income or pension payments, it's best to build that factor into your financial plan. Perhaps you want to help pay for a child's post-secondary education three years from now, or you're

planning to take a sabbatical. Or, if you're approaching retirement, you might be ready to start drawing on your savings.

Regardless of your reason for needing income, the first thing to establish is how much money you'll need. Next, determine when you'll need it and for how long. If you're approaching retirement, for example, an estimate can be made of how much you'll need to cover your basic expenses — such as housing costs, car expenses, taxes, insurance, food, and medical expenses — plus any discretionary spending.

Consider other factors

It's also important to plan for some contingency, as your circumstances could change and expenses could go up.

Another consideration is inflation. We generally recommend factoring in

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Can dividends *boost* your portfolio?

Thanks to the 2006 federal budget, qualifying dividend income received on or after January 1, 2006, is now taxed even more favourably at the federal level. In addition to the possible tax benefits, however, there can be solid investment reasons to include dividend-paying stocks or mutual funds within a diversified portfolio:

- **Dividends represent earnings** — a company with a strong dividend record typically has a history of generating profits that are often expected to continue.
- Many stocks that pay dividends are considered **valuable "defensive" holdings** in uncertain markets. The dividend stream tends to support the stock price during market declines.
- When corporate profits are strong, dividends may increase. Not only does this mean additional income but also that the **share price may rise** as a result, increasing the potential capital gain.

Building income

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an inflation rate of 3%, the top of the Bank of Canada’s current inflation-control target range.

While many expenses occur monthly, some, such as tax installments, might be quarterly. Other expenses, such as travel, will arise on an irregular basis. The intervals at which you’ll need specific income will influence how your portfolio should be structured.

Establish distributions

Once it’s determined how much you’ll need and how frequently, withdrawals from your portfolio can be set up accordingly. The strategy that works best for you will be based on your current investments; however, the following potential income-producing mechanisms may be considered.

Bond ladder. Bonds typically

provide semi-annual interest payments and return your principal at maturity. By establishing a “ladder” of bonds with different maturity dates, you can receive regular income distributions, while ensuring dependable returns even as interest rates fluctuate. Similarly, dividend-bearing stocks can be used to establish a monthly pay portfolio (see chart below).

Income trusts. Income trusts generally invest in a portfolio of businesses that have the potential to generate regular earnings which are then flowed through to unitholders. However, distributions are not guaranteed, and will depend on the performance of the businesses held by the trust. Remember, too, that these are equity securities and that their share price can rise or fall.

Systematic withdrawal plan. If your portfolio includes mutual funds, you may want to consider establishing a systematic withdrawal plan. Under the plan, a predefined amount is

withdrawn from your portfolio on a regular basis, and the remaining capital retains the potential to grow. Each payment will consist of a mixture of distributions from the funds and capital gains from the redemption of fund units.

Factor in the tax

Although investment decisions should never be driven solely by tax consequences, their impact should be reviewed before applying any financial strategy. When you’re drawing income from your portfolio, the tax effects will depend on the source of the distribution.

Withdrawals from a Registered Retirement Savings Plan (RRSP) or Registered Retirement Income Fund (RRIF) are fully taxable. So are interest payments, such as those generated by Guaranteed Investment Certificates (GICs) and bonds.

Dividends, whether paid directly or distributed through a mutual fund, qualify for the dividend tax credit, which reduces the taxes payable (see “Can dividends boost your portfolio?” on Page 1). And capital gains are taxable on only 50% of their value.

Some income trusts, and mutual funds that hold them, may make “return of capital” distributions. These are not taxable in the year of receipt; instead, the distribution reduces the investment’s adjusted cost base, resulting in a greater taxable capital gain (or a smaller capital loss) when the investment is eventually sold or transferred.

These are just some of the aspects to consider when creating an income strategy. At ScotiaMcLeod, our goal is to work with you to generate the cash stream you need, when you need it — all within the context of your overall goals and risk tolerance. ■

Building a monthly pay portfolio

By holding shares that have an established record of regular distributions, it’s possible to receive a reliable monthly stream of tax-advantaged dividends.

Goal: \$21,600 annually

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Stock A 10,000 shares, pays \$0.18 quarterly	\$1,800			\$1,800			\$1,800			\$1,800		
Stock B 20,000 shares, pays \$0.09 quarterly		\$1,800			\$1,800			\$1,800			\$1,800	
Stock C 15,000 shares, pays \$0.12 quarterly			\$1,800			\$1,800			\$1,800			\$1,800

For illustrative purposes only; may not accurately reflect dividend payments.

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