PASSIVE INCOME FOR RETIREMENT

TORO BRAVO INVESTMENT ADVISORS, LLC

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Passive income has become a hot topic and for good reason. Who wouldn't like to generate income without putting in a hard day's work? From teenagers seeking recurring revenue from advertisements on social media to retirees turning their hard-earned nest eggs into a reliable income stream, more people are interested in creative ways to create passive income than ever before.

Despite this enormous interest from all ages and walks of life, securing passive income streams is especially critical for retirees. This is because, over the past several decades, the responsibility has increasingly fallen on individuals to fund their own retirements. Gone are the days of working for the same company for 40 years and retiring with regular pension payments. Sure, an employer may set up, or even contribute to, a retirement plan. After that, however, it's your responsibility to save enough for retirement, while navigating the hostile waters of financial markets while in retirement. Social Security may cover a portion of these needs, but, more than likely, the majority of retirement income will come from the fruits of your labor through saving, planning, and executing a sound income strategy.

Therefore, because passive income will play such a central role for most retirees, it is vital to have a clear understanding of precisely what passive income is and which sources of income will allow you to realize the retirement you envision.

How Can You Generate Passive Income?

While most people have a vague understanding of what passive income is, let's drill down a bit further to gain a more precise grasp of this critical concept. Passive income is often contrasted with active income, or the income earned for a specific job — in other words, the income earned for a hard day's work.

Passive income, on the other hand, is income earned from an activity in which you are not actively involved. Income from rental property, for example, is perhaps the most common activity associated with passive income. In a perfect world, tenants' rent checks roll in every month without having to actively work for those payments.

Business ventures, too, can become passive income streams if they can generate income without active participation, or where the work is done up-front. Royalties from book sales, income from pre-recorded educational courses, or flipping retail products are all examples of this sort of passive income.

The digital age has also opened an entirely new realm of passive income sources where YouTube channels, social media posts, or other digital content can earn money years after its creation through revenue from advertisements or direct payment from customers.

While such business ventures are appealing to some retirees, most prefer passive income streams that require less up-front work — namely, through investing in financial markets. This would include income generated from dividend payments from such instruments as dividend-paying stocks, Real Estate Investment Trusts (REITs), and Business Development Companies (BDCs), or income from interest earnings generated from individual bonds and bond-like instruments. Investment options such as dividend-paying preferred stocks and annuities have features that allow them to be thought of as bond-like instruments.

Now that we have a grasp of some of the most common forms of passive income, let's dive a bit deeper into their distinguishing characteristics.

What Are the Best Passive Income Options for Retirees?

While it's nice to think of passive income as tantamount to money for nothing, the truth is that all forms of passive income come with differing degrees of both effort and risk. Economist Milton Friedman famously remarked that "there's no such thing as a free lunch" in the world of economic development. Well, this punchy aphorism applies to passive income as well. Choosing which income strategy or strategies is best for you will largely depend on several factors, including your personal lifestyle, goals, level of savings, and risk tolerance.

Starting a Business: For retirees who wish to continue working, starting a business venture may work well in securing passive income streams in the future. Of course, it's important to bear in mind this carries a significant amount of both energy and risk. For starters, beginning a profitable business requires a great deal of up-front work — and, sadly, hard work is often not enough to guarantee success. According to the Bureau of Labor Statistics, 50% of all businesses fail within the first five years, while just 35% remain in business after 10 years.[1] Nevertheless, despite many risks, a business venture may still be a viable option for certain retirees.

Rental Property: Rental property can also be a great source of passive income for the right individual, in the right location, during the right market conditions. However, even rental property can be riskier and require more attention than one might initially assume. Realistic calculations of expected return on investment must be made, factoring in mortgage payments, taxes, maintenance, and management costs.

Other questions will also need to be considered, such as: Who will screen tenants and tend to their needs? What are the relevant landlord-tenant laws in your state? What is the current condition of the real estate market? What if the property goes unrented for an extended period? Is the market due for a correction? If so, are you able to weather a significant drop in value? Again, rental property can be an excellent source of passive income for the right person, but all these factors need to be considered.

Investments: Again, income-generating investments are the preferred source of passive income for most retirees, but even these vary widely in terms of risk, return potential, and other factors. For instance, even high-quality, dividend-paying common stocks, REITs, and BDCs carry a fair amount of risk. The reason is that these instruments are not contractually obligated to pay dividends to shareholders. Rather, dividend payments are entirely discretionary. This means that during difficult times, when profits are down, dividends can be cut or eliminated entirely. Dividends can also be reduced if these companies decide to reinvest profits rather than distribute them to shareholders. Of course, this doesn't mean dividends cannot be a part of a successful retirement strategy. But a retirement portfolio that leans too heavily on dividends can experience reduced income at a time when the investor can least afford it.

Passive Income Through Bonds and Bond-like Instruments

A more conservative approach to achieving passive income streams in retirement will typically lean heavily on corporate and government bonds, certain types of annuities, and a special class of stock called preferred stock that often pays a contractual dividend (as opposed to a discretionary dividend, as with common stock). Unlike the uncertainties associated with the kinds of passive income discussed above, these investments are safer because the issuer is bound to the terms of a contract.

The beauty of these investments is that most come with an obligation to make fixed payments at regular intervals, regardless of market fluctuations. Concerning bonds and preferred stock, the par value, or face value, is also returned to you upon maturity, assuming no defaults. Such features make these investments a desirable choice for retirees seeking a reliable stream of passive income while reducing much, though not all, of the work and risk associated with the income sources discussed above.

All Passive Income Sources Require Active Management

It's critical to remember that regardless of the strategy you choose, all passive income sources require a certain degree of diligence and active management. Market conditions—from inflation levels to interest rates—are in constant flux, which can impact even the safest of passive income sources. For this reason, it's imperative to devise a sound strategy heading into retirement and periodically revisit your plan to maximize income while minimizing risk. No strategy should incorporate the "set it and forget it" approach.

Working closely with a reputable financial advisor who specializes in actively managing passive income streams for retirement is an excellent way to help ensure the kind of retirement you've always dreamed of enjoying!

Source:

1. https://www.bls.gov/bdm/us_age_naics_00_table7.txt

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