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# What Happened to Cash Flow Investing?

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Nothing prompts the abandon of rational thought quite like an extended run of the bulls in the stock market. Many seasoned market players sheepishly admit they had begun to believe that "this time it would be different," as the illusion of an unstoppable Nasdaq juggernaut lulled them into buying outrageous stocks.

## LIVE AND LEARN

The same juggernaut grabbed thousands of novice investors and drew unprecedented numbers of new players into the investment arena. Knowing only a period of extreme growth, many were unprepared for the realities of the downside. Even retirees, traditionally a risk-averse group, were caught up in the mania. An incomprehensible volume of money was lost in the correction of 2000 and 2001. Needless to say, market veterans and the newly initiated alike are revisiting the economic fundamentals, which the new economy had blasted as "antiquated."

One such fundamental, the art of cash flow, had been forgotten due to a 10-year run of returns sometimes as high as 20% to 30%. With such an extended run of the bulls, investors stopped looking at longterm investing as a 3- to 5-year proposition. Many felt that between 30 minutes and the close of the day was long term.

The departure from portfolios providing income at a modest pace may be traced to the surging popularity of investing in the stock market during the past 20 years. It had been standard practice for financial professionals to create portfolios centered on interest income from bonds and dividend income from equities. In the past, this was the standard model for generating cash flow to support investors' income needs. The prevalence of the bull market during the past decade saw this discipline cast aside as investors were seduced by the great capital appreciation of equities in an up market.

## PORTFOLIO PROBLEMS

The shortcomings of building a portfolio primarily around mutual funds become apparent over the long term. "In a bull market, cash flow portfolios begin to seem obsolete to many investors," says Sean Agahi of Valentine Capital RPG (800-88-RETIRE; wwwvcrpg.com). "In a bear market, however, cash flow portfolios may help individuals weather the storm."

For example, mutual funds are unpredictable generators of revenue streams. In an up market, they may perform well, but in a down or static market, the revenue they generate may be more difficult to forecast. That's why it may be problematic to create portfolios based on funds that will generate the stable income streams needed by retirees or those who want to live on replicated income.

Agahi is among an increasing number of financial professionals who have been practicing a time-tested methodology currently enjoying a renaissance. There is no guaranteed investment, but cash flow portfolios may be much better suited to generate steady, predictable income in any market climate. It's important to note that cash flow portfolios may be more effective for higher net worth investors.

## GO WITH CASH FLOW

For example, Dr. Johnson is a retired physician with $1 million to invest. His goal is to withdraw $60,000 or 6% of his principal each year to live on throughout his retirement. Here's how a money manager might use the principles of cash flow to help Dr. Johnson design a portfolio with reduced risk and steady returns.

Based on a current return of 7% to 7.5% on individual fixed-income bonds and average dividends of 1% on equities, Dr. Johnson is instructed to invest 50% in bonds (not in bond funds) and the other 50% in equities. The bonds yield $37,500, and the dividends paid by his equities equals $5,000, a total of $42,500, or 4.25% of his principal. By dividing the return he receives by the amount he needs to withdraw, Dr. Johnson is able to come up with his cash flow/income ratio, which is 70%.

For many 50- to 55-year-old individuals, a cash flow/income ratio of 70% may be viewed as favorable. Comparatively, most conventional retirement plans operate with ratios between 0% and 20%. This is the result of greater dependency on products that generate much, more variable and unpredictable investment returns. As investors become more senior in age and further along in their retirements, their cash flow/income ratios should increase.

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