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02.18.2026

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Complex Problems Require Custom Solutions

Building Income Portfolios to Meet Investor Priorities

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SUMMARY

- As an investor's wealth increases, their investment priorities change.
- This transition requires more than simply shifting equity-bond weights, in our view.
- A priority-aligned, tax-aware approach can improve outcomes.

Just as our tastes mature over time—from cheap light beer to carefully brewed IPAs—our investment needs change as wealth accumulates. Early in an investor's journey, the objective is simple: grow assets. With a long time horizon and limited need for portfolio income, investors can tolerate volatility and focus on total return. But as wealth builds and portfolios become responsible for meeting spending needs, income generation and capital preservation take on greater importance.

As clients move from a more accumulation-focused mindset to a more distribution-centric one, the transition can become a pain point for a lot of investors, especially those with sizable taxable gains in portfolios. This is a problem that is exacerbated by the growth equity bull market of the past 15 years. Given that most of us are no longer hanging out at our college haunts, let's spend some time diving into a couple ways we may be able to alleviate some pain.

Balancing Total Return, Income and Protection

For any portfolio, we can consider how much it achieves three primary – and often competing – priorities:

- 1. Total Return:** The ability to maximize long-term capital appreciation potential of the portfolio.
- 2. Income Generation:** The level and consistency of portfolio cash flows generated from dividends, coupon payments and/or option premiums.
- 3. Downside Protection:** The ability of the portfolio to protect principal in a market downtrend.

It is worth noting that there is a tension between these priorities. In order to seek total return potential, an investor must seek risk, which reduces downside protection. Conversely, downside protection is achieved through the reduction of risk, which also reduces the potential for total return.

In a more nuanced dynamic, income generation and total return are also at odds. For income-generating equities, these cash flows paid back to the investor often reduce the ability for companies to reinvest back into their own businesses.

Thus, in our view, income-focused securities often possess less total return potential than growth-oriented ones, where company management is more keenly focused on redirecting excess cash flow back into projects with potential for high long-term returns.

The Flaw of the 'Bogle Rule' – Why '100 Minus Your Age' Falls Short

The common advice in our industry for how to manage this transition is to adjust one’s equity and fixed income allocation as an investor’s priorities change. The “Bogle Rule” (named after Vanguard founder John Bogle) is a popular heuristic that posits 100 minus your age should be your percentage of stocks in your asset allocation. We would argue that the inherent flaw of this approach is that it treats *risk tolerance* and *investment priorities* as the same. Let’s look at how three points on this hypothetical timeline score in our framework:

Table 1: Different Priority Portfolios

Portfolio Type	Capital Appreciation	Income Generation	Downside Protection
Pure Accumulate	●●●●●	●○○○○	●○○○○
Pure Income	●○○○○	●●●●●	●●●●●
A Good Balance	●●●○○	●●●●○	●●●○○

In the above table we lay out the priorities of a “Bogle” style accumulate portfolio and two potential distribution-oriented portfolios. The pure income portfolio is the end goal of the “Bogle” style investing, with an investor eventually fully moving to fixed income. An alternative income portfolio we propose is one that attempts a good balance of appreciation and income. In this portfolio, instead of focusing on equity-fixed income allocation exclusively, we can also adjust our selection, with instruments like municipal bonds and covered calls (or ETFs that invest in these types of securities), in order to create a portfolio that is both generating income while still providing capital appreciation opportunities.

The reason we prefer this approach in many cases is that it helps address two complexities that “Bogle-style” investing ignores. First, the “Bogle” rule leans towards passive index ETFs that, while low cost, are geared towards total return. **By introducing more active and differentiated investment vehicles, we can adjust the priority exposure of a portfolio without having to make large allocation swings.**

Secondly, an investor is not guaranteed to get to a wealth level where they are “set” for retirement. **Between higher structural inflation and increased ‘longevity’ (potential life span of the investor), exposure to capital appreciation is often necessary, even for a retired investor.** If we can take this more nuanced approach to portfolio construction, as well as add tax management on top – since capital gains taxes are a silent killer of compounding returns – we can begin to address this more complex investment problem.

Building an Income Portfolio in a World of Longer Lifespans, Higher Inflation and Capital Gains Taxes

Let’s first focus on the building of an income-focused goal portfolio. As opposed to viewing this as an absolute *reduction* of risk, we instead view it as a *shift* of our risk towards meeting income priorities.

Fixed Income: Investors may take more credit risk to increase yield. Specifically, we can be more willing to take risk on the fixed income side of our portfolio to seek a higher yield, implementing a matching reduction to our equity risk profile. On the fixed income side, both investment grade and high yield bonds provide additional yield over comparatively less risky government bonds. The level of additional yield we receive from investing in credit, referred to as ‘spread,’ is a key data point that will dictate what kind and how much credit risk is appropriate. When we are building a portfolio with an income focus, we are more willing to take on credit risk, since every marginal increase in yield helps us achieve our goal. Given that an aging investor’s risk appetite tends to trend downward, we then must adjust our equity portfolio to accommodate this increase in fixed income risk.

Covered Calls: Generates income, while capping some equity upside. ‘Covered call’ strategies can be a great starting point for this reduction in risk, in our view. A covered call is when the holder of a stock ‘writes,’ or sells, call options on that stock. These call options give the holder (buyer) of the call the right but not the obligation to purchase a security at a pre-specified price (strike price). This means when a portfolio manager initiates a covered call position, they are sacrificing upside on the

stock above the strike price. In return for limiting their upside, they receive income at the initiation of the option. **In other words, a covered call strategy can transform the total return expectations for an individual stock by capping the price appreciation opportunities, while increasing the income generated by the position.** This is a trade-off that often fits our priorities framework effectively, in our view.

Dividend Equities: Selection should focus on both dividend and cash flow generation, in order to avoid concentration in ‘deep-value’ risk. Another equity selection adjustment we can make is an increase in our allocation to dividend equities. While these equities provide an income stream to our equity portfolio, there is some selection nuances that are required when dividend investing, which we touch upon in this [Weekly View](#). While reading this entire piece is highly recommended before diving into dividend investing, a high-level takeaway is that **investors should not blindly seek dividend yield, instead focusing on both dividends and cash flows** (which represent the company's capacity for *maintaining or increasing* dividends in the future). Without this selection emphasis, a portfolio manager may actually be inadvertently increasing equity risk by overleveraging their portfolio to ‘deep value’ companies with limited capacity to consistently pay dividends.

Transitioning to a Goal Portfolio by Using Covered Calls, Municipal Bonds and Tax Loss Harvesting

Covered Calls and Taxes: Moving to transitioning towards our goal portfolio, let's start with the covered calls we discussed above. For a non-taxable portfolio, an advisor can immediately invest assets into what they determine to be the appropriate portfolio. However, for taxable portfolios this transition becomes more complicated. One potential tool to help with this transition is covered calls. Since the advisor is using existing holdings within this strategy, there is not a need to sell their existing equities and generate taxable gains. Additionally, if there is no immediate need for the options income, it can be used for diversification. This is due to the fact that the income premium can be used to purchase new positions, or it can be used to offset capital gains taxes incurred from selling existing positions. Still, given the nature of covered call strategies discussed above, the investor is still sacrificing upside to gain these benefits.

Muni Bonds and Tax Loss Harvesting: Another useful transition tool is tax management. When considering tax management there are two major tools that are often used: Municipal Bonds and Tax Loss Harvesting. Municipal bond income is tax advantaged, with certain bonds being exempt from state and/or federal income tax. However, that does not mean they are appropriate for all tax-aware investors. Instead, in our view, it is important to compare taxable and municipal fixed income on an investor's after-tax yield to determine what instrument is most appropriate.

Tax loss harvesting is another useful tool, where losses in a portfolio are captured through sales and the purchase of proxy instruments. Again, there are limitations to a broad application to loss harvesting. Understanding the exact drivers of the individual instruments can allow for better timing when booking the loss outweighs holding the investment, as well as better proxy selection when a tax sale does occur.

When considering tax management there are a myriad of options for a client to choose from. These range from fully automated algorithm-based approaches to more holistic solutions customized for a specific client's tax situation and overall needs. Each of these approaches has their advantages and drawbacks, as well as situations they are best equipped to handle. We believe it is paramount to interact with a financial advisor to discern which of these approaches is best suited for an investor's specific circumstance.

The Value of Advice: Complex Problems Require Custom Solutions

As investor priorities shift from growth toward income and protection, portfolio construction becomes more complex. Balancing competing priorities, managing taxes, and transitioning legacy holdings all require thoughtful, individualized solutions.

Regardless of the tool that is chosen, the most important aspect to solving these problems, in our view, is the power of financial advice. Without a financial advisor, identifying and quantifying these problems is difficult, let alone solving them. However, when an advisor is brought into the fold, they are able to use this robust toolbox to access the appropriate solution to these complex problems.

At RiverFront, we offer both model and custom portfolio solutions to support financial advisors and their clients in addressing these challenges. We do this by combining the priority-based portfolio design and tactical management mentioned above, alongside the varying levels of tax management solutions that are available to our partner advisors. Regardless of whether or how you interact with us, the broader lesson is clear for advisors: a flexible, holistic, and customized approach can better align portfolios with evolving investor needs.

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All charts shown for illustrative purposes only. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

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ETFs are subject to substantially the same risks as those associated with the direct ownership of the underlying securities owned by the ETF. Additionally, the value of the investment will fluctuate in response to the performance of the underlying index or securities. ETFs typically charge and/or incur fees in addition to those fees charged by RiverFront. Therefore, investments in ETFs will result in the layering of expenses.

A covered call option involves holding a long position in a particular asset, in this case US common equities, and writing a call option on that same asset with the goal of realizing additional income from the option premium. Certain ETFs use a covered call strategy. By selling covered call options, the fund limits its opportunity to profit from an increase in the price of the underlying index above the exercise price but continues to bear the risk of a decline in the index.

Covered calls provide downside protection only to the extent of the premium received and limit upside potential to the strike price plus premium received.

An option is a contract sold by one party to another that gives the buyer the right, but not the obligation, to buy (call) or sell (put) a stock at an agreed upon price within a certain period or on a specific date. A covered call option involves holding a long position in a particular asset, in this case US common equities, and writing a call option on that same asset with the goal of realizing additional income from the option premium. Certain ETFs use a covered call strategy. By selling covered call options, the fund limits its opportunity to profit from an increase in the price of the underlying index above the exercise price but continues to bear the risk of a decline in the index.

As the writer of a covered call option, a client's account forgoes, during the option's life, the opportunity to profit from increases in the market value of the security covering the call option above the sum of the premium and the strike price of the call but has retained the risk of loss should the price of the underlying security decline. In other words, as an account writes covered calls over more of its portfolio, the account's ability to benefit from capital appreciation becomes more limited. The writer of an option has no control over the time when it may be required to fulfill its obligation as a writer of the option. Once an option writer has received an exercise notice, it cannot affect a closing purchase transaction in order to terminate its obligation under the option and must deliver the underlying security at the exercise price.

Investment in options is not suitable for all investors. While describing some specific common risks to options are described above, before investing in a RiverFront solution which includes the use of options and options via ETPs, clients should consult with their advisor before participating. For additional risks, please refer to the Options Clearing Corporation Publication: "The Characteristics & Risks of Standardized Options," (<https://www.theocc.com/about/publications/publication-listing.jsp>) for additional information.

There is no guarantee the tax loss harvesting strategy will generate the desired tax savings or that investments made will generate gains or losses as anticipated. RiverFront does not offer tax, legal or accounting advice.

High yield bonds are debt securities often referred to as "high-yield" or "junk" bonds issued by corporations. High-yield bonds tend to pay higher interest rates because they have lower credit ratings than investment-grade bonds. High-yield securities (including junk bonds) are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities.

In a rising interest rate environment, the value of fixed-income securities generally declines.

Index Definitions:

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Definitions:

Inflation is a gradual loss of purchasing power, reflected in a broad rise in prices for goods and services over time.

Municipal bonds are debt securities issued by state and local governments. The municipal market can be affected by adverse tax, legislative, or political changes, and by the financial condition of the issuers of municipal securities.

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