

Cash Flow and Allocation Strategies for Retirees

An Interview With Jane Bryant Quinn

Article Highlights

- A reverse mortgage taken out as a credit line at retirement can provide a future source of income when both stocks and bonds are down and allow for a higher withdrawal rate.
- Stock index funds eliminate having to make choices about which stocks should be sold to fund withdrawals and, over time, have beaten actively managed funds.
- Couples who are creating a budget should take into consideration scenarios where both spouses live long lives, where the husband dies first and where the wife dies first.

Jane Bryant Quinn is a nationally known personal finance writer and commentator. Her latest book is “How to Make Your Money Last: The Indispensable Retirement Guide” (Simon & Schuster, 2016). In this second part of our conversation, we discussed how reverse mortgages, stocks, bonds and annuities can be used by retirees to ensure they have adequate levels of cash flow in retirement. The first part of our conversation appeared in the May AAIJ Journal (“Using Cash and Short-Term Bonds to Avoid Taking Losses in Retirement.”)



—Charles Rotblut, CFA

Charles Rotblut: You’ve changed your mind about reverse mortgages and now think they can play a role in terms of adding to retirement income and boosting withdrawal rates.

Jane Bryant Quinn (JBQ): This is a fairly new concept for financial planners. I find it pretty interesting.

A reverse mortgage is taking a loan against your home equity. You don’t have to repay that loan until you sell the house, at which point the interest has accumulated. Then, you have to repay the bank with the proceeds from the sale of the house for both the principal and the interest.

Normally, you think of a reverse mortgage as being used for older people in their 70s or 80s who still want to stay in their homes, but are running out of money. My thought is people of that age with that sort of problem would be better off selling the house and downsizing in some way because they’re still running some risks there.

Aside from that point, the idea is to take the reverse mortgage as soon as you can at age 62. You don’t take it in a lump sum, though. New rules greatly limit the amount you

can take in a lump sum and it also costs you more to do so.

What you do instead is take it in the form of a credit line. You don’t borrow against this credit line, or you borrow only enough to cover your closing expenses, which are not insignificant on a reverse mortgage. After that, you don’t borrow. This is a magic credit line because the amount available to borrow increases every year by the same interest rate that

you are paying; the interest builds up internally on your loan.

So if you don’t borrow for 10 years, the credit line is growing and growing and growing. Ten years from now you can look at it and say, “I can start withdrawing from this source of money as well as from my cash bucket or my stock bucket or my bond bucket.” If you have that at the start, if you set up that cash—that credit line on your reverse mortgage right at the start—you will have four buckets of money. You will have your cash bucket, your bond bucket, your stock bucket and your bucket which is the credit line on your home equity. You could actually take from one of them at various times. [Editor’s note: See part one of this interview for more on the bucket approach.]

This could lead you to a 6% or even 6.5% initial withdrawal plus inflation adjustments if you’re using all four buckets. And, for example, if you’ve used up your cash bucket, but stocks and bonds are still bad, you could take something out of your credit line against your house instead of withdrawing from your short-term bonds.

So you have an extra borrowing source that isn’t costing you anything currently. It’s just building up. It will cost you

in the future, of course, but you can use it to expand your current income. However, I don't recommend this for anyone who doesn't intend to stay in their house for at least 15 or 18 years because the upfront expenses are considerable. You need to be in your house for a long time to amortize the costs. But you might consider it if you really say, "Long term, I'm not going to leave this house. They're going to have to take me out in a box."

CR: *In terms of allocation, you suggest using a very simple allocation: cash, a short-term bond fund, an intermediate-term bond fund and a stock fund.*

JBQ: I believe in simplifying your life. The older you get, the better it is to have simplified your life because you have fewer choices. You can make your life easier. If you need help, somebody can look at your plan and figure out exactly what you've got. People who have complicated portfolios and are trying to make regular withdrawals from their accounts face tough decisions. If you own 25 stocks and you're making regular withdrawals, well, which stock should you sell? Should you sell this one? Should you sell that one? You have to make choices that can be very complicated.

There are lots of studies showing that, in general, when people sell one stock and buy another, the new stock doesn't do as well as the stock they sold. I find this to be a pretty compelling thought. So trying to manage a portfolio of individual stocks gets more complicated. Secondly, it makes it more difficult to follow your plan. The older you get, the more apt you are to be less sure, let's say, about how you should proceed.

As you know from everything I've written, I'm a big fan of the index funds that follow the market as a whole. The research is absolutely compelling that index funds, over time, beat funds managed by professional managers. And if they are beating the professional managers, they are for sure beating what individuals are doing when they try to buy and sell stocks.

With individual stocks, you remem-

ber your winners, every single one of them. You forget your losers. You never average the two together. So you have no idea how well you have performed compared with the market as a whole. I think if people did that, they would find that over their lifetimes they left a lot of money on the table.

I know a lot of people, and especially AAIL members, like to buy and sell stocks. I think that's fine. But I think the money that is going to really matter for you the rest of your life—and for your family if you die first and you're leaving a dependent spouse behind—should be invested very simply in funds that follow the market on a very simple allocation: 50/50 stocks and bonds, for instance.

If you can set some money over to the side, you can do what you want with it. I think that buying and selling stocks can be a great hobby. It's like sport fishing or bicycling, it's fun. A lot of people find it interesting. But you should not do it with the money that completely matters.

I have seen so many widows who thought their husbands were absolutely the sharpest investors in the world. The husbands die. They look at the investment account. There are dogs. There are once-popular stocks that are popular no longer. There's just a mess in there, and they never knew. I think a lot of people who buy and sell individual stocks do like to hide and bury their mistakes. But believe me, your widow will find them.

CR: *You also think that people should stick with bond funds even in a rising interest rate environment just to keep that simplicity of decision making, correct?*

JBQ: Yes.

By the way, intermediate-term funds perform just about the same as long-term funds, except they're a little less volatile. So I don't see why you should buy a long-term bond fund. Do intermediates.

People look at just the price of their bond fund. If interest rates are up, the price of the bond fund will be down, but the fund's manager is using the fund's cash flow to buy new bonds at higher interest rates. That means that

you are accumulating more shares in that bond fund, so that when interest rates turn around and go down, your bond fund will go up in value and you will now have more shares in that fund. All of those shares will benefit from the increase in price.

Don't just look at the price of a bond fund. You have to keep in mind that you are benefiting from these higher interest rates. You are effectively dollar-cost averaging into the lower-cost bonds as they come across. Then, when you've bought them and they turn around, you're going to make some money on it. So the bond funds are a great convenience.

By the way, I'm talking only about high-quality funds. For me, high quality means government funds or it means top-quality tax exempts. Government funds and top-quality tax-exempt funds generally rise in price when stocks collapse. That's what's happened the first couple months this year (2016). Stocks went down. The high-yield funds went right down with the stock market, and the junkiest of the high-yield funds were even worse.

Vanguard did a fabulous study in 2012 of how high-yield funds perform. They concluded that investors are attracted to high-yield bond funds because of their high yield. The yield looks good, but these are low-quality funds holding bonds issued by junk companies. The money that they lose in default, downgrades and calls exceeds the extra yield investors believe they are getting when they first buy the high-yield fund.

You don't see that, of course, when you're looking at your high-yield fund. It goes down, but then you say it'll go back up again. In the meantime, you think you've got this high yield. But the Vanguard study, I thought, showed pretty conclusively there is no free lunch. Your losses through defaults and other disasters in junk bond mutual funds exceed the extra yield you think you are getting.

That study also concluded that it added nothing to the diversification of a portfolio, although it did make it riskier, more volatile. The bottom line is that you're doing just as well with

the government bond fund as you are with a high-yield bond fund over time. You don't realize it, but that's how it works out. And it's less volatile. When the market really goes bad—the stock market goes bad—your government bond funds will often go up. That's what bond funds are for. They're supposed to take the risk, or part of the risk, off your investment portfolio.

CR: *What about annuities? How do they fit into this bucket approach?*

JBQ: Well, an annuity would be an investment outside of the buckets, because you would be buying the annuity in order to increase your guaranteed income. If you have Social Security, a pension and income from an annuity, all of that goes on the income side. When you're talking about bucket investing, you're talking about your financial investments: CDs, stocks, bonds, mutual funds, etc.

I am well on record as warning people off variable deferred annuities with living benefits. You pay a commission of 5% to 7%, sometimes 10%. You pay 3.5% a year in expenses. You have a minimum payout of 5% and you're invested in the mutual funds offered by the insurance company. You will start drawing out from this annuity, say, 10 to 15 years into the future, or whenever you plan to start drawing.

The idea is that you will get a higher cash flow rate out of this because you're invested partly in stocks. If you don't get a higher return, they still guarantee you 5% minimum, which sounds pretty good. However, the expenses are high, and because you have to hold bonds as well as stocks they almost never produce more return than the minimum guarantee after expenses are factored in.

Plus, the so-called minimum guarantee of 5% is basically 5% of your original investment that the insurance company has a special name for. You are not earning 5% on your investment, which is what some people think. What the insurance company is promising is to return your own money in 5% increments. You have to live a very long time before the insurance company starts

Reverse Mortgage Costs and Fees

A reverse mortgage is a loan against the equity you have in your home. It does not need to be repaid as long as you live in the house. You must, however, cover the cost of homeowner's insurance, property taxes and general upkeep.

Almost all reverse mortgages come in the form of a Home Equity Conversion Mortgage (HECM). When taking the loan, you can opt to use it as a credit line you can borrow against at any time. Jane Bryant Quinn views this as the best choice, because the amount that can be borrowed increases at the same rate as the interest being charged on the loan. The longer you delay accessing cash early in retirement, the more you will have access to later in retirement.

HECMs are not cheap, however, and come with several costs, including:

- **Loan insurance fee.** Charged up front by the Federal Housing Administration (FHA), it is 0.5% of the appraised value of your house as long as you do not borrow more than 60% of the allowable amount in the first year.
- **FHA mortgage insurance premium.** Charged annually, it is 1.25% of the outstanding balance of the loan
- **Loan origination fee.** Capped at 2% of the first \$200,000 of appraised value and 1% of the remaining value up to a maximum fee of \$6,000. Can be charged up front or by a higher interest rate.
- **Repair costs.** Houses must be appraised before the loan is closed; if repairs are required, some of the proceeds from the loan can be applied toward costs equating to no more than 15% of the house's appraised value; more expensive repairs must be paid out of pocket.
- **Closing Costs.** These are typical mortgage closing costs and include fees for documents, couriers, title insurance, recording fees, credit reports, etc.
- **Annual Service Fees.** May be built into the interest rate, but some lenders charge separately for them.
- **Compounding Costs.** Interest charged on fees added to the loan.

Reverse mortgage lenders are required to calculate the total annual loan cost (TALC) based on all projected costs over the specified holding periods. A reverse mortgage counselor should be able to provide a more customized breakdown of what you would pay for a given loan.

Source: "How to Make Your Money Last," by Jane Bryant Quinn (Simon & Schuster, 2016).

paying you with their own money. So I think there are just a lot of misunderstandings about what a deferred annuity with living benefits is.

Now, I do like immediate annuities. They're very simple. You put in some cash up front. The insurance company says they'll pay you X dollars a year for life. You can find out which insurance company is paying a higher dollar amount just by going to www.immediateannuities.com and put-

ting in what you want to invest.

So maybe in your 70s, you want to take something out of your bond bucket and use it to buy an immediate annuity. If you do that, you will immediately increase your monthly income for life because you're going to get more income from that annuity than you could prudently draw out of your bond fund.

I think that immediate annuities are good value for people who are trying to make their money last for life but are

not sure if their savings will actually last throughout their lifetime.

CR: *If somebody's entering retirement—say, they're in their early 60s or even mid-60s—any suggestions on how they transition to having a cash bucket for withdrawals? Obviously, we assume they have some savings set aside in a rainy-day fund already.*

JBQ: I would hope and assume that.

I think that as you get into your retirement planning, this is one of the things that you are looking for. You're looking for ways of creating this cash bucket for yourself. It comes out of savings. It comes out of your paycheck. It comes out of whatever cash you can accumulate. But the idea is to keep looking for that and say: "This is what I'm going to want." It goes back to the issue of right-sizing your life when you are planning for retirement.

You say, "Well, how much money am I going to need," which is backward. What you should say is, "How much income am I going to have based on my projected Social Security benefits, my pension and the withdrawals I plan to take?" Then you fit your lifestyle to the amount of income you expect. When you look at that, then you can say, "Okay, there may be a gap between my income and my expenses. I am going to have to create a cash bucket of X dollars." That's your target. That's something that you work on. You add to your rainy-day savings and you build that up.

There's no magic wand that's going to be waved when you're 60 or 65. You can't say "I didn't plan for retirement, but I can magically pull all this money out of who knows where and I'll be fine." This is why I wrote my book "How to Make Your Money Last."

The essence of it is to say, "Okay, at this point I have X amount of money. I

don't know how long I'm going to live, or how long my spouse is going to live. I should plan for 30 years.

"How am I going to make this work? How do I pull money out of my savings? How do I arrange my expenses so that my savings can last over a lifetime? I don't know how long it's going to be. Am I flexible enough so I can plan for 25 or 30 years?" Those are the questions people face.

Individuals also face the question of, "How do I make my money last over an indeterminate life-span?" The odds are that your life-span will be longer than you think it is. You've just got to start getting these pieces together so that you can make that kind of a plan. Nobody's going to do it for you.

Let me say one other thing, if I might. I am very concerned about spouses. Very often—I see this over and over again—a couple retires and they look ahead and they say, "Okay, we're going to have X amount of money." They plan it as if both of them were going to live for 30 years. They plan assuming both people are going to be around.

If, say, the husband is getting a pension, they very often look at it and opt for the single-life pension payout option because it is going to be bigger than a payout option that will also cover the spouse. Very often, a spouse will agree at the time of retirement to take the single-life pension payout option because they think they're going to be a little short of money. They worry how they are going to do in retirement. Three or four years down the line they discover they're okay and then the wife says "Hey, wait a minute, I'm going to lose all that money if you die." So, unless you are absolutely certain that your spouse is going to have enough to live

on if you die first on a pension, cover your spouse 100%.

When you're doing your budget and right-sizing your life, you need to do it three ways. One, assume that you both live long lives. Second, assume the husband dies both early and first, and look at what the wife will have left to live on. Third, if the wife dies first and early, consider what the husband has left to live on. Most likely he had two Social Security checks when he was married and he'll go to one when his spouse dies.

People very often just don't think about how the surviving spouse is going to live after the first one dies. They just make a plan for the two of them together. I see this happen over and over again. I would beg married people to make sure that they have taken care of their spouses.

CR: *That's good advice. Is there anything I haven't asked you that I should?*

JBQ: I guess I'm mostly pounding the table about right-sizing your life, and that's because controlling spending will do a lot more for you over the long term than looking for a better interest rate or a better investment. You do that, right-size your life first, and then think about your investments.

You're leaving money on the table if you're depending entirely on individual stocks. I think that's not the right thing to do. You should treat that as your playpen, not your basic money.

I'd also say to think as a long-term investor. I think the research shows that if you reduce the amount you hold in stocks—you reduce the stock amount and increase the bond amount every year starting at 65—that is the least optimal way to make your money last for 30 years. At least hold steady. ▲

Jane Bryant Quinn is a nationally known personal finance writer and commentator. Her latest book is "How to Make Your Money Last: The Indispensable Retirement Guide" (Simon & Schuster, 2016). Find out more at www.aaii.com/authors/jane-bryant-quinn. Charles Rotblut is a vice president at AAI and editor of the AAI Journal. Follow him on Twitter at twitter.com/CharlesRAII.