Briefly Noted

Strategies for Unneeded RMDs

The U.S. tax code requires those age 70½ to take annual withdrawals from an IRA, 401(k), SEP IRA or similar type of retirement savings account. These required minimum distributions (RMDs) can create a quandary for those who are forced to take the distributions, but do not need the money. Christine Benz of Morningstar has three suggestions on what retirees in this situation can do with the unwanted cash.

1. **Contribute to a Roth IRA:** Roth IRAs are exempt from the RMD rules. Retirees can contribute new dollars to them if they or their spouse have enough income from working to cover the amount contributed to the Roth IRA. Retirees who do not have earned income cannot contribute new dollars to a Roth IRA, but can do a Roth IRA conversion provided the RMD requirements for the current calendar year are met.
2. **Deposit Into a Taxable Investment Account:** Those without earned income can deposit the excess RMD dollars into taxable account, such as a traditional brokerage account. If the money is not needed for a long time (e.g., intended for an heir), some type of equity investment could make sense. Those with shorter investment horizons and who are in a high enough tax bracket could consider municipal bonds or tax-managed funds.
3. **Allocate to a 529 Plan:** Retirees who plan to take college courses in the future can use a 529 plan to set dollars aside and allow those dollars to grow tax-free. There may also be a state tax benefit to doing so. The money must be used to pay for qualified educational expenses, however.
4. **Make a Charitable Contribution:** Those age 70½ or older can donate up to $100,000 directly from their IRA to a qualified charity. These qualified charitable donations (QCD) reduce the current year's RMD dollar-for-dollar up to $100,000 per year. As such, they also reduce the amount of taxable income for the calendar year. Benz adds that waiting until late in the year to make the QCD allows the retiree to take advantage of compounded returns realized throughout the year.

Source: "What to Do With Unneeded RMDs," Christine Benz, Morningstar, January 10, 2017.

Cognitive Aging Creates Financial Obstacles

The impact that cognitive aging has on those ages 70 to 90 depends on both their financial skill and the type of cognitive impact. Problems can range from relatively minor financial mistakes to a loss of ability to manage personal finances. Throughout the range of impairments, the threat of fraud exists.

An individual's financial capacity is dependent on two types of intelligence. Reading a utility bill and writing a check to pay for it mostly requires crystal intelligence. Crystal intelligence is knowledge. Making financial judgements not only relies on knowledge, but fluid intelligence. Fluid intelligence includes memory, attention and information processing.

With normal cognitive aging, most people retain their crystal intelligence into their 70s and 80s. Fluid intelligence can start to decline as early as one's 30s. These two trends result in older adults being more likely to incur financial judgment problems than to experience a diminished ability for carrying out financial tasks.

While these are normal cognitive changes, impairment has a far more damaging impact. Mild cognitive impairment (MCI) primarily affects financial judgment. Dementia is more severe, diminishing a wide range of cognitive functions. Prevalence rates are 9% for MCI and 3% for dementia at ages 70 to 74 and rise to 37% and 27%, respectively, by age 85. Many of those with some form of impairment are unaware of their compromised abilities. Moreover, they stay confident about their ability to manage their financial matters. This, in turn, causes them to be more susceptible to fraud. Those who are impaired enough to require the services of a caregiver also incur the risk of being financially abused by the caregiver.

Cognitive aging also affects those who are tasked with taking over a household's finances. A spouse with little to no experience in managing financial matters will often find it challenging to do so following the death or impairment of her husband (or his wife) due to age-related declines in fluid intelligence and a lack of previously built up crystal intelligence. Though they can learn the necessary skills if not impaired themselves, assistance is often required initially.

"Cognitive Aging and the Capacity to Manage Money," Anek Belbase and Geoffrey T. Sanzenbacher, Center for Retirement Research at Boston College, January 2017.

Implementing an Age-Banded Approach to Retirement Withdrawals

Popular withdrawal strategies, such as the 4% rule, treat spending as rising throughout retirement. These strategies increase the absolute size of withdrawals in accordance with the rate of inflation. The logic is to tie replacement income to inflation. In doing so, the strategies seek to prevent a retiree's purchasing power from diminishing.

What these strategies fail to consider is that actual spending patterns evolve throughout retirement. A growing amount of data shows retirees changing their spending patterns over time. Some studies show spending dropping gradually as a retiree ages. Research by David Blanchett of Morningstar suggests more of a "smile" pattern: real spending declines a little early in retirement, accelerates its decline during the middle point of retirement before slowing its rate of decline late in retirement. Behind the changes are lesser spending on discretionary items as a retiree ages and higher spending on health care expenses late in life.

One strategy for accounting for such spending patterns would be to project retirement spending to decrease by 10% each decade (e.g., at age 70, at age 80 and at age 90). A key problem with such an approach is that individuals age differently. The timing of health care expenses can be outside of forecast ranges. As such, forecasts based on this type of strategy could be off by several years, as financial planner Michael Kitces points out.

An alternate approach would be to project retirement spending to increase by 1% less than the rate of inflation used to increase withdrawals. The strategy assumes retirement spending will decline, but without the big changes of the first strategy.

Kitces points out that decreases in retirement spending actually tend to reflect reductions in leisure and discretionary spending. Such decreases do not fully offset increases in health care expenses. He argues this tendency makes a category-based spending approach a better strategy. Spending on leisure and travel could be assumed to decline at faster rates per each decade of retirement, while health care spending could be projected to increase during each decade. The upside of this approach is that both category spending and the rate of inflation expected for each category are adjusted at different rates.

Source: "Kitces: A Better Baseline for Retirement Planning," Michael Kitces, Financial Planning, December 30, 2016.

Piotroski F-Score Works Well With More Than Low-Value Stocks

Many AAII members are familiar with Joseph Piotroski's F-Score as a methodology for identifying undervalued stocks. A key part of his strategy is the F-Score. The F-Score is calculated from nine fundamental signals. Though Piotroski designed the score to be applied to stocks trading with low price-to-book-value ratios, his F-Score methodology works with a wide variety of stocks.

The outperformance associated with high F-Scores and the underperformance associated with low F-Scores is particularly evident among stocks with the greatest information uncertainty. Stocks fitting this description include small-company stocks, stocks with low levels of trading volume ("illiquid") and those covered by few analysts. The higher (lower) returns for such stocks with high (low) F-Scores is greater than would be expected when risk is accounted for.

H.J. Turtle of Colorado State University and Kainan Wang of the University of Toledo reached these conclusions after applying the full F-Score to more than 125,426 firm-year return observations for the period of 1973 through June 2014. High F-Scores were defined as ranging from seven to nine. Low F-Scores were defined as zero to two. Scores from three to six were defined as mid. The average nine-variable F-Score for the companies studied on a full firm-year basis was 4.6; the median score was 5.0.

The study's authors found that "every" high F-Score portfolio outperformed its corresponding low F-Score portfolio. This outperformance occurred across companies of all sizes. The returns were the highest for the small-firm portfolio, however. This difference was also evident when the analysis was done on a quarterly basis—the authors described small-company stocks as exhibiting "significantly larger positive marginal performance." This outperformance was found to exist even after adjustments were made to account for the general return premium realized by small-company stocks over large-company stocks (defined as small minus big).

Information uncertainty is credited as playing a big role. Prior research suggests that investors underreact to public information when they are overconfident about their private information. This behavior, according to Turtle and Wang, results in bigger positive returns following good news and lower expected returns following bad news.

Source: "The Value in Fundamental Accounting Information," H.J. Turtle and Kainan Wang, forthcoming in Journal of Financial Research, SSRN, January 17, 2017.