Welcome to InFRE's April, 2016 Issue of Retirement Insight and Trends

Retirement InSight and Trends is the quarterly newsletter for the International Foundation for Retirement Education's Certified Retirement Counselors® (CRC®s) to help retirement professionals with the practical application of new retirement readiness, counseling, planning and income management concepts for the mid-market. Find out more about the CRC® and InFRE here.

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April, 2016 InFRE Update: The 6th Editions of the CRC® Study Guides are Coming Soon!

retirement-insight.com/april-2016-infre-update/

Within the next few weeks, InFRE will be releasing revised versions of the CRC® Study Guides (the 6th editions), practice exams, and elearning review modules.

Below is a chart that maps out the changes that have been made to the CRC® study program.

CRC® Study Guide	Content Changes
CRC® 1: Fundamentals of Retirement Planning	• More content on Medicare, HSAs • Continuing care communities • New content on elder fraud
CRC® 2: Fundamentals of Investments	• More content on target date funds • More content on annuities, QLACs • New content on combination income and long-term care products • New content on reverse mortgages
CRC® 3: Fundamentals of Retirement Plan Design	• More content on retirement distributions • More content on beneficiary distributions, inherited IRAs
CRC® 4: Fundamentals of Retirement Income Management	• This is now a “capstone” course, which applies the content from the CRC® Courses 1 – 3 to a retirement income planning process and an optional case study • Includes explanation and examples of retirement income strategies
NEW! CRC® 5: Principles of Retirement Counseling and Education	• New content on the basic processes in counseling, nonverbal communication, effective inquiry • New content on education, learning stages and styles, common communication and education tools

The updated study guides will be available by the second half of May. The online practice exams have been substantially rewritten as well.

If you purchased prior versions of the study guides and still need to take the CRC® comprehensive examination, you will soon receive an email with a PDF study guide supplement that includes the key additions to the new materials, plus a link to the new practice exams.

Updated elearning review courses will also be available by the middle of June.

No Portfolio is an Island

By [David Blanchett, CFA, CFP®, AIFA® – Head of Retirement Research, Morningstar]

Editor's note:
This presentation was delivered in live webinar format in 2016. David's comments have been edited for clarity and length.

*You can view a **YouTube** brief of the original presentation here.*

You may also choose to take the **full length course** to earn 1 CRC®, CFP®, and/or PACE CE credit.

David Blanchett, CFA, CFP®, AIFA – Head of Retirement Research, Morningstar

Advisors demonstrate the quality of their allocations in different ways. A common way is to demonstrate that their portfolio is in or around the efficient frontier, while maybe the existing portfolio or a competitor's portfolio isn't. In some ways, this paints a simplistic picture and an incomplete picture of how good a portfolio can truly be.

InFRE's 2016 1st Qtr Issue of Retirement Insight and Trends

In reality, everyone is different. Everyone has different goals, objectives, assets and liabilities. What that means is there really is no one efficient frontier for everyone. One thing that is really important, though, throughout all of this, is the safety of diversification. The only guaranteed alpha that you can create in investing is diversification. That's why Harry Markowitz won the Nobel Prize for his work for his work back in the 1950s. Diversification is a free lunch. Diversification is very valuable.

Optimal Total Wealth

The idea behind total wealth is that you should diversify your assets. If you have a risk factor in your human capital, you should use your portfolio as a diversifier because it's your most liquid asset. The moral behind all of this, then, is that there really isn't one portfolio for everyone.

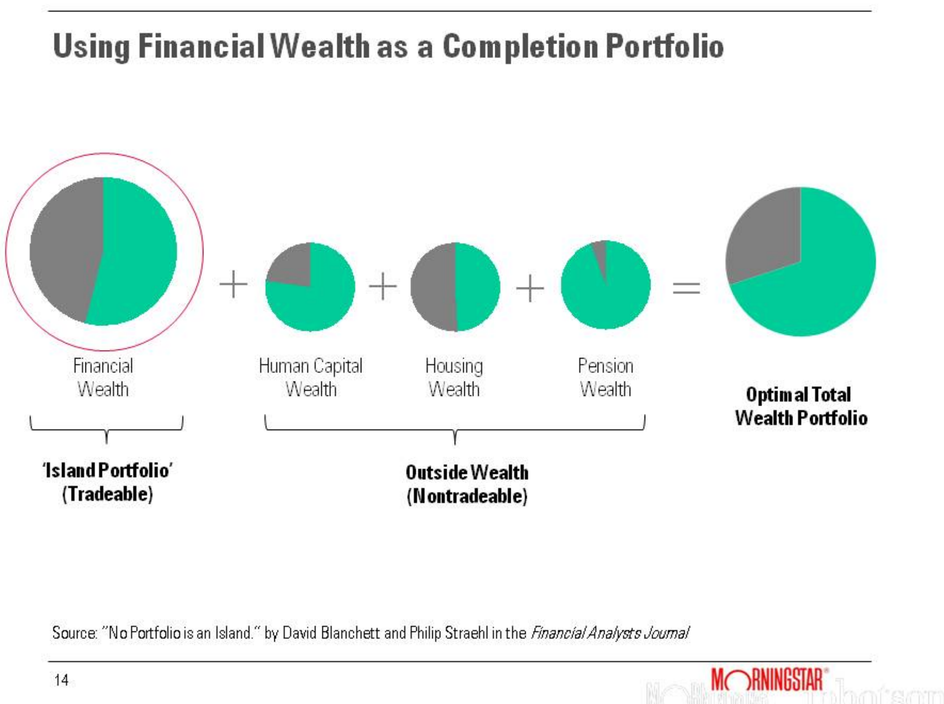
What I don't expect everyone to do is to build a unique portfolio for every single client; that isn't operationally feasible. At Morningstar, we work with a number of relatively large 401(k) plans. We decide custom glide paths based upon a lot of these preferences and risk factors. That's one way to do it. Another way that I think is more realistic for you all is to think about these concepts more holistically. If you have a set of models, maybe create a new set of models, as well, to think about given this investor's holistic risks, all their information, what is the best portfolio for them given the limited opportunity set of portfolios that you've created.

In thinking about wealth, a lot of advisors take a mountain approach. They just look at someone's financial capital. Where someone who is 25 years old has very little, if any, financial wealth. We can define financial wealth as things like financial capital; your 401(k) account, your IRA account, etc. Younger investors have very little financial capital, financial wealth. The goal is as you age, you save money. You save up until you retire, and then you spend it down.

The problem is it's a bit too simplistic. It doesn't really take into account both sides of the complete equation. What are all the assets that are owned by the investor? What are all the liabilities? When you take this perspective, you reach the conclusion of today's presentation that no portfolio is an island. That while investor's wealth is important, it's only one part of the bigger puzzle.

If we think about wealth of the average household collectively, there's maybe four broad buckets you can think about from the assets perspective.

1. Financial capital: their 401(k) balance, their taxable account; their liquid wealth.
2. Human capital: human capital as the net present value of your future wages. So if you're 25 years old, you have another 40 years to work; your human capital is a very large asset.
3. Housing wealth: the equity in your home. Do you own a home? If so, what is its value?
4. Pension wealth: Social Security retirement benefits, income of a defined benefit pension plan, an annuity; that guaranteed income you can receive for life from a variety of sources.



Collectively, these are your assets. With each asset, there's also a liability. Your financial capital exists to fund goals like a 529 account to pay for college, buy a boat, save in my 401(k) to fund retirement. Your human capital is largely used to fund consumption. So if you go out every year and you work, and you make $100,000 a year, most of what you make in your job goes for just basic living expenses. It's paying for your home, your car, your food, your clothes, etc.

You usually have a mortgage when you first buy that house. You'll put 20 percent down, and then that mortgage will obviously disappear over time. Finally is pension wealth; things like Social Security. The liability there is retirement. You accrue this benefit in a defined benefit plan. You use Social Security with the idea being that when you finally retire, you could use this to replace your consumption of the earnings you were making when you were actually working.

So these are, again, four main assets to think about. How do they change over someone's lifetime? Financial capital is very important, but it's only one piece of this much larger puzzle. When you're 25 years old, you don't have anything saved, so all of your wealth is in human capital. You're going to go out and work for 40 more years, and the net present value of those wages is significant.

The goal for most folks is to convert that human capital to other assets over time. For example, you will save for retirement and accumulate financial capital. You will accrue benefits in a defined benefit plan or Social Security. You'll purchase a home. So that when your human capital is depleted, say at age 65, you have other assets that can provide for you for your remaining lifetime. The key, though, is that financial capital – again – is only one part of this big puzzle. When you build portfolios using things like mean-variance optimization, and you ignore the risks of human capital, pension and real estate, so you really aren't building efficient portfolios.

A Better Model for Building More Efficient Portfolios

So what's a better model? Think about your financial wealth as a tradable portfolio. It's relatively easy to reallocate your financial wealth in the scheme of things. It is not very easy to reallocate things like human capital, housing wealth or pension wealth.

So let's just say that you're targeting some kind of hypothetical, total risk level. In this example, we'll just call it 35 percent stocks and 65 percent bonds. If you have human capital and you've got housing wealth and you've got pension wealth, how do you invest your financial wealth to make your overall total wealth as efficient as possible?

That's the key: how do you think about wealth holistically to build more efficient portfolios? This affects outcomes in to ways. The most obvious impact is on the equity level. How should the risk of my portfolio change, given the risk of my other assets? If I've got, for example, a lot of my wealth in pensions, that means I have a bond-like asset in my non-tradable portfolio so I can be more aggressive in my tradable portfolio.

Another example is the asset allocation. For example, if you work in the real estate industry, it might make sense to hold less REITS in your portfolios. There really are different ways this actually impacts what is the optimal portfolio for an investor.

How do you build more efficient portfolios? The key here is that you need to change your portfolio based upon how you're different. We all have different risks. It's these differences among each investor that kind of provides insight into how we should go about thinking about how my portfolio should differ.

One important theory about portfolios in building a more efficient portfolio is human capital. Human capital is this idea that as we age, we deplete this very bond-like asset. Human capital is a relatively safe asset. When you're relatively young, you have this large allocation to this safe asset so you can be aggressive in your portfolio. As you spend down that safe asset of your human capital, your portfolio should become more conservative, as well, to offset this changing risk. Human capital really is a big deal.

Human capital is hands down the largest asset in the world. Becker estimates the value of human capital is at least four times as large as the value of stocks, bonds, housing and all other affects combined. People often ask why human capital matters? An example of this is Enron. Enron was a company where well over a half of the 401(k) was invested in Enron stock. Investing in employer securities is a very bad idea from a diversification perspective.

In theory, you shouldn't have any in it. I understand why you might have some but think about individuals that worked at Enron. They lost their jobs. They lost their retirement savings, and they probably couldn't sell their homes for a good price because they all lived in neighborhoods around each other. So they had this risk factor that wasn't diversified at all. The goal behind this research and this line of thought is how do I improve my clients' and investors' portfolios through diversification?

How Risky are Your Assets?

So an important question to ask is how risky are your assets? This is not only human capital, but I think for every asset your client has, you should ask that question; is it a stock or is it a bond? High level, we think about things like pensions. Pensions are just like a bond. They pay this annual coupon every year as long as you're alive. Human capital is safe. Real estate can be risky or safe; it can be somewhere in the spectrum, especially if you have a mortgage. While residential real estate has been a relatively safe asset, when you apply a five times leverage to the home because you only put 20 percent down, it becomes potentially a very risky asset.

How do I think about my risk in terms of my human capital, which is with my job, my house, etc.? Professors, by and large, have relatively safe human capital. Especially if they're tenured, they have effectively a guaranteed job for as long as they're alive, or at least until they retire. A realtor, though, is much less safe. They have to go out every day, every month, and every year to sell homes that are subject to things like the market interest rates, what are home prices, etc.

The idea behind how risky is your human capital is that a professor can afford to take more risk in their portfolio because they have safer human capital. This can manifest itself in different ways. One example is a professor would need to have less in emergency savings. If you're a realtor, you should probably have at least six months in savings to cover the possibility of losing your job, downturns, etc. A professor can have less. Holistically, the financial capital for a professor can be invested more aggressively than a realtor.

It's a bit more complex than this, though. This idea of total wealth is focused on risk capacity. How much risk can you afford to take, given the risk attributes of your total wealth? There's also risk preference. We commonly assess risk preferences with a risk tolerance questionnaire. It could be, though, that a professor is an individual who could be more aggressive in their portfolio but they choose not to be because they have a more conservative risk preference. So it's important to disentangle these two things.

The first question is, how much risk can you afford to take, given your total wealth? The second is, what do you prefer to take? When we build portfolio for clients, we figure out this client should have 80 percent of their money in stocks, etc. Risk capacity dominates risk preference. So we first determine how much risk someone should take, given the kind of collective risk of their total wealth, and then we ask them, how do you feel about taking risk? Obviously, preference is important. People are different. Preference towards risk but it isn't preference that drives risk aversion; it's risk capacity.

Preference is important, but we think that the capacity is more important. How able is an individual to take on risk, given their total wealth versus how do they prefer risk in the scheme of things? An example of this would be buying an annuity. I know that "annuity" is an interesting word to use; people have very different perspectives. But let's just say that you have a target asset allocation for a target that's 55 percent bonds and 45 percent stocks. Let's just say that you as an investor, or one of your clients, wanted to purchase a single premium immediate annuity (SPIA).

How should that affect your portfolio? An island perspective on asset allocation, you would tell the client go out and buy that SPIA, and I'll rebalance your portfolio back to the target. A total wealth perspective would ask the question: what are the risk characteristics of that SPIA? The reality of a SPIA is it's really just like a bond. It pays this coupon, whether it be monthly or annually, as long as you're alive. So if you buy a SPIA, you've allocated part of your total wealth to fixed income. If you want to maintain a true, risk capacity, total wealth risk level, you would purchase that SPIA from your bond assets and leave the rest of your portfolio alone. After this, your allocation to fixed income would actually decrease from 55 to 40 percent in your portfolio, but your total wealth allocation would be the same.

One thing I think that a lot of clients don't think about when it comes to their portfolios is Social Security. In terms of the largest asset that most clients own when they retire, it's usually Social Security along with other forms of guaranteed income. Remember, for the average American, Social Security is about 40 to 50 percent of their retirement income. For some, it's far more. If you have clients that get most of their income from Social Security, they have this incredibly large bond-like asset. It's important to help them understand that they have this large asset that's very bond-like; you can be more aggressive in your portfolio.

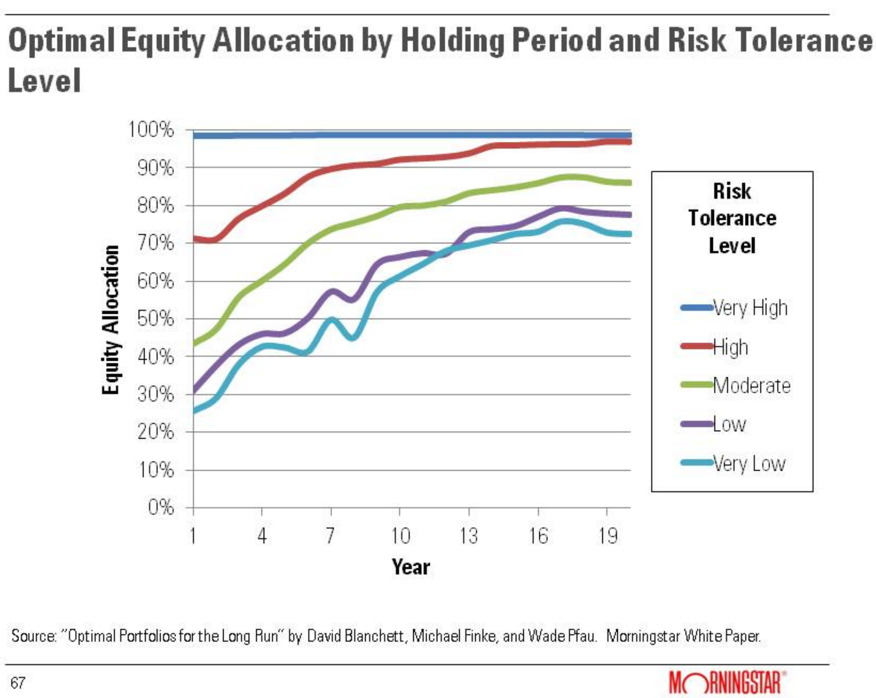
In contrast, if you have a client that has very little guaranteed income, they should be less aggressive in their portfolio because they don't have this offset through Social Security. So what does all this mean? If you think differently about efficient total wealth portfolios, most of us perceive a two dimensional area for equity allocations; this idea of a glide path, or a glide path that becomes more conservative over time. It can decay at different rates, based upon someone's risk preference, etc.

The Optimal Portfolio for the Long Run

Most of us have heard of this concept of time diversification; the longer I hold equities, the less risky they become because the distribution of returns converges around the median. This tends to suggest that equities become less risky over time. But the problem is, this isn't actually a correct depiction of the risk. The longer you hold equities, in reality, they become riskier – not safer. Because the distribution of wealth grows; it doesn't shrink.

So this calls into question, does it actually make sense to hold stocks if you have a longer investment period? If you look at the actual data, the empirical evidence, stocks actually do become less risky over longer time horizons. This actually begs the question, are stocks random? If stock returns are indeed random, time diversification doesn't exist. There's no benefit or should be no reason to have a more aggressive portfolio just because you have a longer investment time horizon. The idea of a random walk is based upon this thing called a drunkard's walk where if you drop a drunk guy off at a bar, where they end up is random, but they should actually come back to the bar.

Michael Finke, Wade Pfau and I conducted an analysis where we looked at 20 different countries, because a big problem today with a lot of research is that it works for the U.S. but doesn't make sense or doesn't work for other countries. We looked at 20 different countries, with different rolling periods. When we asked the question, does it make sense to have a more aggressive portfolio if you have a longer investment time horizon; the answer was yes across the board. Overwhelmingly, we found that investors that have a longer investment time horizon have a more aggressive portfolio.



For example on this slide, the light blue line at the bottom, the very low risk tolerance level, if I'm an investor and I'm very risk averse, and I have a one year time investment horizon, I should have a 25 percent-ish allocation to equities. If, however, my investment horizon is 20 years, that same risk averse investor should have a portfolio that's over 70 percent in stocks. This is significant evidence that suggests that investors should definitely have more aggressive portfolios over longer investment time horizons. We also found that the benefit of being a long term investor is actually increasing. If you can just help your client stay invested, it helps them receive higher long run returns.

Conclusions

So what are some parting thoughts? I think the biggest one is that this really provides evidence for bucket systems. First off, buckets are behavioral. The idea behind buckets is to allocate – especially among retirees – monies in different buckets (cash bucket, a portfolio bucket and an annuity bucket) to fund expenses over different periods. Having buckets is totally behavioral. I can create a portfolio and I can cut it into three pieces, to four pieces, to 12 pieces.

Buckets themselves have no value from a performance perspective. You can create dynamic or tactical rebalancing rules; all these different rules. Buckets help clients understand how their portfolio is funding their goal, and that may allow them to take on more risk. That's where buckets add value. Research suggests that it actually makes sense to have buckets, because the longer the time horizon or the investment period, the more aggressive you should be.

Another conclusion is there are going to be different efficient frontiers for different clients. I don't want to suggest that there's a need to create a custom portfolio for every single client. What it does mean is rethinking this idea of having seven model portfolios, where all your clients have to go into one of these seven portfolios. Because that isn't going to work or help them best accomplish their goals.

Doing this for people is part art and science. People like me may focus more on the science, but understanding clients is critically important to doing this right. That's where you come in; that's where you can help understand your clients, help them determine their goals, help them save for retirement… and then build solutions for them that really help them get there most effectively.

About the author:

David Blanchett,CFA, CFP®, AIFA® is the head of retirement research for Morningstar Investment Management. In this role, he works to enhance the group's consulting and investment services. He conducts research primarily in the areas of financial planning, tax planning, annuities, and retirement plans and he serves as the Chairman of the Advice Methodologies investment subcommittee.

His research has been published in a variety of academic and industry journals and has been featured in a variety of media publications. His research won the Journal of Financial Planning's 2007 Financial Frontiers Award, the Retirement Income Industry Association's 2012 Thought Leadership Award, and the Journal of Financial Planning's 2014 Montgomery-Warschauer Award. In 2014 Money Magazine named him one of the five brightest minds in retirement and in 2014 Investment News included him in their inaugural 40 under 40 list as a "visionary" for the financial planning industry.

David Blanchett, CFA, CFP®, AIFA – Head of Retirement Research, Morningstar

He is a RetireMentor for MarketWatch and an Expert retirement panelist for the Wall Street Journal. He holds a master's degree in financial services from the American College and a master's degree in business administration from the University of Chicago Booth School of Business. He is currently taking classes toward a doctorate in personal financial planning at Texas Tech University.

Retirement Speakers Bureau

Tax Efficient Drawdowns in Retirement

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***By Stephen Horan, PhD, CFA, CIPM*, Managing Director, Credentialing, CFA Institute**

Stephen Horan, PhD, CFA, CIPM, Managing Director, Credentialing, CFA Institute

Editor's note:
This presentation was delivered in live webinar format in December, 2015. Stephen's comments have been edited for clarity and length.

*You can view a **YouTube brief** of the original presentation here.*

*You may also choose to take the **full length course** to earn 1 CRC®, CFP®, and/or PACE CE credit.*

As more investors enter retirement, our focus as advisers shifts from the accumulation phase to the distribution phase. It's a complicated area. We've seen a lot of research, particularly around issues of sustainable retirement withdrawals, and other optimization techniques.

InFRE's 2016 1st Qtr Issue of Retirement Insight and Trends

So much about investing, saving, and distribution is uncertain. The outcomes tend to be based on the vagaries of the financial markets. The advantage is that much of what we'll cover here is more predictable. It's just more consistent ways in which we might be able to add value for our clients. We'll even highlight how we can take advantage of uncertainty in the capital markets.

Conventional Wisdom

Much of what I'll talk about today is derived from a series of three articles from The Financial Analyst Journal. One is a recent Graham and Dodd award-winning article from 2012 that philosophically lays out key concepts for wealth management, specifically in a taxable framework. The other talks about what I termed "Withdrawal Location" back in 2007. More recently, Kirsten Cook, Bill Meyer, and Bill Reichenstein have an excellent article that takes those drawdown strategies to the next level (March/April edition of the Financial Analyst Journal, 2015).

Part of what got me interested in this area to begin with, was that I had a dear family friends whom I was advising, who entered retirement and had a accumulated substantial wealth in tax-deferred vehicles, different Keoghs, IRAs, and things like that, and felt that it was time to start drawing down on those assets because he was entering retirement. He also had substantial assets in taxable structures to draw on as well.

There was nothing for me to point him to that said, "Here's what you should be doing." Although, I gave him what is essentially the conventional wisdom, which is, "Drawdown your taxable accounts first, and when those are exhausted, drawdown your tax-deferred accounts, and then your tax free accounts as a last resort, preserving the tax sheltering features of those vehicles." This is the advice you get from Vanguard, Fidelity, and the American Funds. The list goes on and on. Although there could be worse advice, and in fact, this is not bad advice; but it's definitely not the best advice. We can optimize on it even further. So that's our goal.

Understanding the Basic Economics of Different Tax Structures

Tax-deferred accounts, like traditional IRAs, and 401(k)s, are the economic equivalent of limited partnerships where the government is a limited partner. In consequence, investors end up baring all of the risk and return of the outcomes on the after-tax funds in these tax-deferred accounts. It's the taxable accounts where things look a little bit different, where government actually shares in some of that risk, and that should affect some of our investment decisions.

Here's what I mean: For a tax-deferred account, if you were to withdraw all of the money today, or all of the money at the end of some time horizon, the government is going to have a claim on the principal value of that account. The investor is then the General Partner. They have a claim on 1 minus the tax rate of all of the assets in that account, and no matter what happens, the government is going to take – if the tax rate is 40 percent, for example – 60 percent of both the principal and the incremental return associated with that account.

As a result, investors bare all of the risk and benefit from all of the return, at least on the after-tax corpus associated with that. Maybe the way to illustrate that is if we take a very simple example of $100 in a 401(k), that accumulates a very consistent 5 percent return over 20 years, it's going to grow to about $260 and change pre-tax, but then we'll end up paying tax on that at the end, so it ends up getting eroded to about $170 to $190.

That would be the equivalent end result as if we just started with $72, and accumulated 5 percent compounded return on it on a tax free basis over 20 years. We get to the same point. So, it doesn't really matter whether or not the government takes its chunk out early, or whether it takes its chunk out late.

That's different for a taxable account in which the federal or state government essentially has what would be equivalent to a carried interest in the returns associated with the account. The taxing authority does not have a claim on the principal corpus. It's just on the incremental return. As a result, the investor actually bares less than 100 percent of the risk associated with those returns because the government absorbs some of it.

For example, if we have an investor who has a $100,000 portfolio, there are three equally likely outcomes of 25 percent; 10 percent; or a 5 percent loss – that's a nice, simple 10 percent expected return on a pre-tax basis in a 15 percent standard deviation or volatility. But, if we have a 25 percent return, the government, of course, will tax some of that, so on an after-tax basis it's really only 15 percent. 10 percent would really get eroded down to 6 at a 40 percent tax rate. But, if we end up suffering a loss, the government would share some of that loss by assuming that we could offset some of our gains with losses.

So, the moral of the story is simply that you can see the distribution of after-tax returns is narrower than pre-tax returns. As a result, our standard deviation or volatility is only 9 percent, as opposed to 15 percent. We can calculate, if we want, what that effective tax rate is, or what our effective return is. It depends very much on not just the structure in which the investments reside, but also how those assets are managed.

So, if we had a simple scenario in which we had a tax-exempt investor who was earning 8 percent over 20 years on $1,000, it would accrue tax free to about $4,600. Alternatively, you could think of it as an investment strategy that was passive in the sense that the investor buys and holds stocks; they defer tax payments until the very end of this 20 year investment horizon, and as a result, everything is long-term gain, and they're only taxed at say, 20 percent. They will accumulate less wealth than they would have if they didn't pay any tax. So, their effective annual tax rate, if it were to be levied on a year after year basis, is 11.5 percent. You could imagine a different investment strategy of an investor who is a little bit more active, in which they trade in a way that all of their gains are taxed annually, 100 percent turnover, but just after that one year mark – so, they get the 20 percent preferential rate, and then their accrual equivalent tax rate would be 20 percent. Or they could trade much more frequently than that, and all of their gains are taxed as ordinary income.

The Implications for Pre-Retirement Asset Allocation and Asset Location

Obviously, all of this affects our tax posture. We can calculate that effective annual tax rate by simply setting up the same kind of scenario as we had before: What is the implicit rate of return, or the return that gets us from our pre-tax value to our ultimate after-tax value, depending on how those assets are managed, and what the tax profile is?

What are the implications of all of this? Basically, what it means is that after-tax asset allocation is what ends up really mattering in the accumulation phase. It also means that if we're going to do a portfolio optimization exercise, it really should be done in an after-tax context, rather than a pre-tax context. The bottom line is that we want to use multiple tax structures in the accumulation phase so that we have options or tools that we can use in the drawdown phase.

Here is a simple example of what I mean about after-tax asset allocation. If we look to the left side of this chart, suppose we have an investor who has a $2 million dollar portfolio. $1.5 million dollars is in a 401(k), and it's all invested in stock. $500,000 is in bonds, and that's all in a Roth IRA. Most would look at that and say, "This investor has 75 percent of their wealth allocated toward stock, and that's their asset allocation."

MEASURING AFTER-TAX ASSET ALLOCATION:
A SIMPLE EXAMPLE

Account Type	Asset Class	Pretax Market Value	Pretax Weights	After-Tax Market Value	After-Tax Weights
401(k)	Stock	$1,500,000	**75%**	$900,000	**64.3%**
Roth IRA	Bonds	500,000	**25%**	500,000	**35.7%**
Total Portfolio		$2,000,000	100%	$1,400,000	100%

Note: Withdrawals at the end of the investment horizon are assumed to be taxed at a rate of 40 percent.

In reality, they don't have $1.5 million dollars available to them in their 401(k) because if they're taxed at 40 percent, they only have a claim on $900,000 of that. So, their equity portion is really only 64 percent, as opposed to 75 percent. If we were to think about this in an optimization context, taxes also mean that the optimization process is a little bit different. Each combination of asset class and account structure is a unique after-tax asset.

The reason is that equity has a different after-tax risk return profile in a taxable account than it does in a tax-deferred account or a Roth IRA. The reason for that is that equity is less risky when it's in the taxable account because the government absorbs some of that risk. What does all of this mean for the drawdown phase? If we create multiple tax structures in the pre retirement phase to provide options in the drawdown phase, these are some of the things that we can think about to give us some guidance on how to use them prior to drawdown. But, once we're there in drawdown, what we want to do is use our tax brackets strategically. We want to take advantage of conversion and re-characterization options, and also leverage volatility to our advantage.

Drawdown Strategies to Take Advantage of Tax Structures and the Tax Code in Retirement

I'm going to start simply just to illustrate a few concepts, and maybe try to add on some more interesting scenarios later on. Assume a very simple two account structure scenario where we only have tax-deferred account like a

401(k), or a tax exempt account like a Roth IRA, and three simple drawdown strategies – two which I'll call naïve; one of which is the conventional wisdom of drawdown the tax-deferred account (TDA) first until it's depleted, and then start drawing on the Roth; or the second would be the reverse – drawdown the Roth first, and then the TDA.

If we have a very simple tax environment in which the tax structure is flat and tax rates remain constant, then none of this matters. Both of those naïve strategies will produce exactly the same result under all scenarios, and the problem actually becomes very simple. But, in fact the world is not that simple and straight forward. We have a graduated tax system. We have different tax brackets. So, we can look at what I call an "Informed Strategy". That is to draw on our tax-deferred accounts with taxable distributions that fill up our "Low Tax Bracket".

The goal here is not to minimize our taxes in any given year by shielding as much income as we possibly can from any tax. The goal is really to manage our taxable distributions over the term of the drawdown phase to take advantage of opportunities to get cash out of a tax-deferred account at favorable rates. Then, the question becomes: How can we identify those opportunities?

Here is a simple illustration of our current tax schedule for our progressive marginal tax rates. All I've done here is adjust it for exemptions and deductions, and in this case it's just an example of a married couple filing jointly in 2015. What's kind of interesting is that if we look at this, what we see is that if this couple just does these standard deductions and exemptions, $20,000 of income would never be taxed. In fact, they can have as much as $95,500 of taxable income before they're taxed anymore than 15 percent on a marginal basis. That's pretty compelling. That's actually a lot of income that can be realized at relatively favorable rates. So, those create some opportunities.

PROGRESSIVE MARGINAL TAX RATES ADJUSTED FOR EXEMPTIONS

Exemptions, Deductions, Tax Rates, and Tax Brackets for a Married Couple Filing Jointly in 2015

Marginal Tax Rate	Exemptions, Deductions, AGI Tax Brackets	Income from	Income to
0%	$20,600	$0	$20,600
10%	$18,450	$20,600	$39,050
15%	$74,900	$39,050	$95,500
25%	$151,200	$95,500	$171,800
28%	$230,450	$171,800	$251,050
33%	$411,500	$251,050	$432,100
35%	$464,850	$432,100	$485,450
39.6%	> $464,850	$485,450	greater

* Taxpayers over the age of 65 are entitled to an additional standard deduction of $1,000 per spouse.
** Personal exemptions begin to phase out at AGI of $309,900 and are eliminated at AGI above $380,750.

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The best way I know of to illustrate these points isn't so much with formulas, but with some examples. So, here's a very simple example of an investor who has $1 million dollars in a traditional IRA, $720,000 in a Roth. They can draw on that at different drawdown rates over a 25 year time horizon, and in a way that has their spending rate adjusted for inflation. With these two naïve withdrawal strategies, which are these first two rows, there, what we see is that depending on the drawdown rate, the conventional wisdom actually does improve the result.

PROGRESSIVE TAX RATES

- "Traditional then Roth" is the better of the two naïve withdrawal strategies
- Informed strategies offer substantial improvement

Panel A: Residual Accumulations and Withdrawal Sustainability						
Withdrawal Rate (*w*)	**4.0%**	**4.5%**	**5.0%**	**5.5%**	**6.0%**	**6.5%**
Traditional then Roth	$4,789,549	$3,796,555	$2,825,820	$1,874,359	$920,329	[24]
Roth then Traditional	$3,876,792	$3,120,582	$2,351,591	$1,561,373	$765,010	[24]
Traditional to Exemption	$4,033,009	$3,275,109	$2,501,365	$1,705,852	$913,474	$91,122
Traditional to Bracket 10%	$4,283,768	$3,407,038	$2,588,092	$1,792,728	$992,043	$174,932
Traditional to Bracket 15%	$4,826,322	$3,948,868	$3,072,138	$2,195,409	$1,318,680	$441,950
Traditional to Bracket 25%	$4,789,549	$3,796,555	$2,825,820	$1,874,359	$920,329	[24]

The absolute worst thing to do would be to drawdown on the Roth IRA first. And, to the tune of a $900,000 difference, it was about 4 percent, or even a $400,000+ difference if your withdrawal rate was around 5 percent. The reason for that is simply that if we take distributions from the Roth first, we're missing great opportunities to take advantage of these low tax brackets today, and we'll end up taking larger taxable distributions down the road, that will be taxed at much higher brackets.

PROGRESSIVE TAX RATES

- "Traditional then Roth" is the better of the two naïve withdrawal strategies
  - These incremental accumulations are in relation to the "Traditional then Roth" strategy
- Informed strategies offer substantial improvement

Panel B: Incremental Residual Accumulations and Withdrawal Sustainability over Traditional IRA Naive Withdrawal Strategy						
Withdrawal Rate (*w*)	**4.0%**	**4.5%**	**5.0%**	**5.5%**	**6.0%**	**6.5%**
Roth then Traditional	($912,757)	($675,973)	($474,230)	($312,986)	($155,318)	[0]
Traditional to Exemption	($756,540)	($521,446)	($324,456)	($168,507)	($6,855)	n.m.
Traditional to Bracket 10%	($505,781)	($389,517)	($237,728)	($81,631)	$71,714	n.m.
Traditional to Bracket 15%	$36,773	$152,313	$246,318	$321,050	$398,351	n.m.
Traditional to Bracket 25%	[0]	[0]	[0]	[0]	[0]	[0]

Let's manage that more specifically to those brackets, and look at these different strategies. For this investor, if we just systematically take taxable distributions that fill up our 15 percent take bracket, we can actually add another $250,000 of terminal value in the case of, say, a 5 percent withdrawal rate. One way to look at that is with this chart. This chart just looks at the incremental residual accumulations; how much money is left extra at the end of 25 years for these informed strategies. These are incremental accumulations over and above the conventional wisdom.

So, here is that $250,000 incremental residual value I referenced earlier. When added to the $400,000 to $415,000 – that you can add just by not doing the absolutely wrong, naïve thing, which is drawdown the Roth first – that's an added $720,000 at the end of 25 years, or an extra 8.4 years of withdrawals. That's pretty substantial. I will say this overstates the case a little bit because I've simplified things so much, but I will get to that in just a moment.

A natural question or critique would be, "That's fine. The 15 percent tax bracket works for this investor, but what about other investors?" To be sure, the terms "low" and "high" are relative terms. If I take this same scenario, and double the amount of initial money available on both the tax-deferred account and the tax exempt account, the optimal strategy wouldn't be to fill up the 15 percent bracket; it would be to fill up the 25 percent tax bracket. That actually corresponds to about $172,000 of income. That's a substantial amount of income that can be drawn on.

We could double those initial wealth endowments again to $4 million dollars and $2.8 million dollars, and in that case, the ideal strategy would be to fill up the 28 percent tax bracket. Not surprisingly, the more wealthy the investor, the higher the tax bracket you would want to fill up.

Let's introduce a taxable account into this scenario. This work is really drawing on the Cook, Meyer, and Reichenstein paper I mentioned earlier. They did a really good job of running through different scenarios. I think the drawback of these scenarios, mine included, is that it doesn't give you a closed form solution that applies in any and all circumstances, but I think it provides at the very least suggested guidance on things that you can do and the size of the opportunities.

Here is their scenario. There are about $1.7 million dollars in total assets, and about 1/2 of that is in a tax-deferred account; about 1/6 of it is in a tax exempt account; and, about $550,000 of it is in a taxable account. If we look at that scenario and assume they take out about 5 percent each year on an inflation adjusted basis, we can look at the outcomes from various drawdown strategies. They look at the two naïve ones that I laid out earlier: doing the tax exempt account first, versus drawing down on the taxable account first. So, that second naïve strategy represents the conventional wisdom.

DRAWDOWN SEQUENCE: TAXABLE ACCOUNTS, TDA, AND TEA

Strategy		Phase 1	Phase 2	Phase 3	Longevity (years)
Naïve	#1	TEA	TDA	Taxable	30
	#2	Taxable	TDA	TEA	33.2
Informed	#1	TDA – Fill "low" tax bracket			34.4
		Taxable – Supplement	TEA – Supplement		
	#2	Taxable	TDA – Fill "low" tax bracket		35.5
		TDA conversion – Fill "low" tax bracket	TEA – Supplement		
	#3	Taxable	TEA	TDA – Fill "low" tax bracket	36.2
		1st TDA conversion – Fill "low" bracket 2nd TDA conversion – Fill "low" bracket Re-characterize the lower-valued conversion		TEA	

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If you run that through to its completion, you can run the portfolio an extra 3.2 years by drawing down on the taxable account first; depleting that; then, drawing on the tax-deferred account; deplete that; and, then the tax exempt account; deplete that – assuming, of course, that minimum distributions don't get in the way. I've split this up into three phases to give you a sense, heuristically, what these different strategies will look like.

Before I move onto the informed strategies, it's probably worth pointing out that the extra 3.3 years of withdrawal sustainability is only a little more than ½ of the benefit that we saw earlier in the two account example. The reason for that is that we have a bunch of the capital here, that is in a taxable account that is inherently less tax efficient, generally, and also crowds out and dilutes the benefit of the other tax preferred structures, as well as some of what I would call the diversity of the tax profiles in those structures – the tax-deferred account having a front end loaded tax benefit, and the tax exempt account having a tax benefit on the back end.

Looking at these informed strategies, the first one is the most straight-forward. It's very analogous to the one we laid out before, and that's drawing on taxable distributions from the tax-deferred account to fill up a low tax bracket, in this case it's the 15 percent tax bracket. In the first phase, any additional supplement we would need to get to the required spending of, in this case, $81,000 would come from the taxable account. Over time, we will end up depleting that taxable account with those supplemental withdrawals, and as that happens in phase two, we would still fill up the low tax bracket with taxable distributions, but then supplement from the tax exempt account instead.

If we do that, we can add an incremental 1.2 years of longevity to the portfolio, and that's a fairly modest modification to the strategy. It's not terribly complicated. But, 1.2 years is about $100,000. So, it's probably worth the effort.

Looking at the second informed strategy is a little bit different. It relates to this notion of using Roth IRA conversions to fill up the low tax bracket. In this case, in that first phase, we would actually draw on the taxable account for our spending, and do these conversions on an annual basis up to the point that they fill up the low 15 percent tax bracket. We keep doing that until we've depleted that taxable account and it is no longer available to us, in which case we're going to use the TDA not to do conversions in phase two and three, but to actually fund our spending, and will supplement from the Roth IRA.

It is a somewhat more complicated strategy, but not overly, and that can add another 1.1 years of longevity to the portfolio. That's another $90,000 or so in present value terms.

Finally, the third strategy they look at is a little bit of leg work, and kind of interesting. What they suggest is kind of a combination of the second strategy and a Roth IRA convert often strategy (in the first phase), drawing on the taxable account for all of your spending needs, and using the TDA to fund Roth IRA conversions that fill up a low tax bracket, and do that with two different buckets.

The idea here is to do different conversions that are uncorrelated. They have an equity bucket and a bond bucket. It's not actually the way I would end up doing it, but it illustrates the point. Over time, you're going to deplete the taxable account with that, and you will need to draw on the tax exempt account for your spending needs if you are going to continue to do these Roth IRA conversions. The idea is that you would re-characterize them if they end up going down in value, and take advantage of that tax delta, if you will.

Finally, in the third phase, eventually you are going to have to use the TDA to fund your spending. You're not really going to be able to do the conversions anymore. If we go through that effort, we will add an additional .7 years of longevity to the portfolio. It's a more modest amount, but not unsubstantial, $50,000 in today's terms, or so. But, it is substantially more effort to do on a year in and year out basis.

Tips and Takeaways

One of the things that I really need to emphasize is that I strongly advise against implementing any of these strategies without a very close coordination with the retiree's tax adviser – an adviser who has an intimate knowledge of their tax situation. There are a multitude of tax-related dependencies that could either neutralize the value of some of these techniques, or even make the client worse off. Many of these dependencies revolve around situations that cause a client's true marginal tax rate to differ from their stated tax bracket.

Here are a couple of examples of that: one being how Social Security benefits are taxed. Another one would be the increases in Part B and Part D Medicare premiums as one's taxable income increases. There are also phase outs of itemized deductions, and personal exemptions that investors face as their taxable distributions increase, as well as increases in the preferential capital gains tax rate. So, all of these are things to be cognizant of as you take taxable distributions.

Here's a quick example called "The Social Security Tax Torpedo". As most folks know, there is a range of income that will cause 50 percent of one's Social Security benefits to be taxed. If you go beyond a second threshold, 85 percent of one's Social Security benefits will be taxed. So, what that effectively does is increase one's stated tax bracket. For example, if a retiree has $25,000 of Social Security benefits, but no other income, they end up jumping, not to the 10 percent tax bracket, but to the 15 percent tax bracket very quickly around the $35,000 to $40,000 range. Then, rather than jumping to the 15 percent bracket after that, they're actually jumping up to about 28 percent. It's actually 27.75% effectively. That's the torpedo. Once you go through the torpedo, it ends up being a sunk cost, and not really a factor in incremental decision-making, but if you inadvertently push a retiree into the torpedo, you're actually doing damage. Where that torpedo lays depends very much on their tax situation. Having multiple tax structures available so that one can take a tax distribution when they have an opportunity to have an otherwise low tax rate ends up being very valuable.

Hopefully what we've been able to communicate here is just simply that taxes affect a lot of things. Fundamentally, they reduce investment risk, at least for taxable accounts, but in that accumulation phase, what we want to be able to do is create and use multiple account structures so that we have tools to use in the drawdown phase. When we are there in the drawdown phase, the taxable drawdowns first is probably the best naïve strategy, if you don't really want to put a lot of thought into it. In that sense, conventional wisdom could be a lot worse. But, we can definitely do better by filling up these low tax brackets either with withdrawals or using them for strategic conversions of IRAs.

About the author:

Stephen Horan, PhD, CFA, CIPM, Managing Director, Credentialing, CFA Institute, is a practitioner, educator, and thought leader with 25 years of industry service in multiple capacities.

Dr. Horan's experience includes serving as an expert witness in support of securities litigation, a forensic economist in private practice preparing economic impact studies, a principal of a financial advisory firm, a financial analyst, and as a buy-side account manager and sell-side stockbroker.

Dr. Horan has received numerous research grants, and been awarded various honors, including the prestigious 2012 Graham and Dodd Readers' Choice Award. He has authored or co-authored dozens of articles and books (including The New Wealth Management: A Financial Advisers Guide to Managing and Investing Client Assets).

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Retirement Speakers Bureau

Housing for Retirees: Buy, Sell or Hold?

By Michael Falk, CFA, CRC®, Focus Financial Consulting

Michael Falk, CFA, CRC® – Behavioral Finance & Investment Management Expert

Editor's note:
Below is an adaptation of the live webinar delivered by Michael Falk in 2016. Michael's comments have been edited for clarity and length.

*You can view a short **YouTube clip** of the original presentation here.*

*You may also choose to take the **full length course**, worth 1 CRC®, CFP® and/or PACE CE.*

What if your thoughts about this asset are just wrong?

InFRE's 2016 1st Qtr Issue of Retirement Insight and Trends

We know that historically in our economy and many economies, home ownership has been promoted based on thoughts about how it will contribute to economic growth and, more so, population stability because of how it gets people maybe to behave a little bit better with their neighbors and in their neighborhood.

Everybody talks about the gains they make from real estate over time. Well, that's cyclical; based upon supply and demand – population booms, not enough housing built, people moving to different desired locations.

If you go back hundreds of years and track real estate, you'll see that generally the appreciation is due to the land and not the structure, because structures depreciate or wear out over time. Historically, the average gain on the land has been around 3 percent. This makes a lot of sense when you think about supply and demand. Mother Nature isn't making any more supply of the land, but we keep building houses.

Houses are bought with leverage, and leverage has risks, upside and downside. Maybe you've noticed in recent years that jobs or employment are not always stable. Those in part-time employment or the "gig" economy are people who know that work is not always stable and available. If that's the case, if you need to go where you can work, then a house is nothing more than a lasso that's tying you down. In fact, in the Great Recession of 2008, for way too many people, housing pulled people down. It pulled the economy down. It pulled interest rates down. There is a negative side to leverage.

So, let's talk about your big asset and how to overcome today's low rates that penalize savers and retirees.

What Do We Do about This Big Asset?

It's also a big liability. Some of you are thinking, "No, Michael, I'm going to have that mortgage paid off by the time I enter retirement," and I say, "Good for you. Great plan, appropriate strategy, but it's still a liability."

For a typical retiree, home equity is larger than the value of the accompanying investment portfolio. Wade Pfau has done some fantastic work in this area. I really applaud his work and what he writes. This is, when we say "the big asset," what we're talking about.

Now, when we talk about the big liability, here's what we're talking about: expenses related to the home. Property taxes, utility bills, home maintenance, and upkeep can add up to be a significant portion, such as 30 percent, of the overall household budget (but not including the mortgage, according to the Center for Retirement Research at Boston College). So, it's not only a big asset, but it's also a big liability. We have to balance the asset and liability.

Let's start with the liability side. If you want to do retirement planning really well, stop focusing on the assets and start focusing on the liabilities. If we are talking about 30 percent more in your fixed expenses in your household budget are related to the home, these are expenses that are not choices.

Fixed expenses are what I simply refer to as retiree needs. Variable expenses are mostly what a retiree wants. There's a big difference between needs and wants for purposes of financing your retirement, and the big difference is that you can tighten your belt and skip a want, but you can't tighten your belt and easily, if at all, skip a need. This is so critical because spending dominated by needs exposes retirees to shocks.

If you think about your total spending, what percent of it is needs-based spending? What percent of it is wants-based spending? Because when we're talking about shocks for retirees, what we're really talking about is healthcare. We know that as people age, morbidity, injury, and illness go up, and it doesn't go up in a predictable fashion. Injury and illness don't happen on a schedule. That's why we're calling it a shock, and it can be quite expensive. It can really change the amount of your needs in a short period of time and exponentially over a long period of time.

We also have to consider the low rates that we've experienced for several years now and the potential for low interest rates into the future also as another shock. Retirees are getting hit twice, and maybe that's why we're starting to consider in other ways this big asset called your house?

Ways to unlock your asset:

1. *Sell it and buy another*. There is a baked-in assumption with this very simple potential approach to unlocking your asset is that when you buy another house, it's going to be materially cheaper. If houses depreciate over time and land doesn't, if you're buying a newer house, then it may not be that much cheaper. And where would you live? The challenge here is that for a lot of people, this isn't a house, this is their home. There are emotional ties to this building, and selling it is not something that a lot of people are at ease with.

2. *Sell it and hold it.* A Home Equity Conversion Mortgage (HECM) is a reverse mortgage. With reverse mortgages, there are fees. Historically, this is probably the biggest complaint, that the fees are too high. They're still not cheap, but they have come down materially, and the contracts have become more standardized and safer.

This will convert a portion of your home into essentially an annuity. The bank, the issuer of the reverse mortgage, will start paying you monthly a guaranteed amount. You do not have to make repayments, so you can stay in the home for as long as you live.

It's really important if you're married that both people will sign this, not one of the spouses versus the other, because it's the person who signs the reverse mortgage who gets to stay in the house as long as they live. Some people are concerned because when the reverse mortgage holder passes away, is there still value with the house, or does the bank, the financial institution, just take it back? What if the retiree has a bequest motive? Is there an inheritance goal for children, grandchildren, etc., vis-à-vis the home?

Some people say that if there's a bequest goal, then a reverse mortgage is risky because there may not be a home to leave behind. If that's the case, then you might want to consider life insurance and designate the beneficiary to be whoever you want to leave the money to.

There are also limits with reverse mortgages based upon the home value to protect the financial institution. If this becomes really popular, is there potential for all of these financial institutions who offer these loans – a couple decades down the road maybe – to get a whole lot of housing back onto their balance sheet? Haven't we seen this movie before, when banks start having a whole lot of real estate on their books? This is not a present-day worry, but it does raise some questions about potential changes to this approach down the road.

3. *Borrow from it.* A HECM line of credit is almost like a debit account against your home. What's really interesting is that if you open this thing up when you're first eligible, and you let that line just kind of exist – you don't use it, you don't tap it – the line itself grows based upon a fixed interest rate. Over time, the line is going to continue to get bigger, which means your debit account is going to expand. You never have to make any payments unless you actually use a portion of it. The line could actually become greater in value than the value of the home, which means you've got leverage working for you, indirectly, and you can now borrow, borrow, borrow, even potentially past the value of the home. In addition, you get to stay in it as long as you're alive.

Reverse Mortgage Benefits

If you are getting a reverse mortgage or a HECM line of credit, you can have the option of delaying when you first take your Social Security benefits. If you delay your benefit between full retirement age and age 70, the growth in your monthly benefit from Social Security is roughly an 8 percent rate of return, guaranteed. If you can increase your Social Security benefit because you have another source of income, that means more money because of your home equity, and you can vastly reduce sequence risk.

When you think about retiring, let's take age 65 as an example. Think about the five to ten years before age 65, as well as the five to ten years after age 65. That 10-to-20 year period around your retirement date really has an impact on the quality of your retirement portfolio. This means that if you get a big bad bear market as you approach retirement or soon after you retire, it materially impacts your total retirement spending potential.

If you have access to a line of credit or payments from your house, then if a bear does strike, if the market is tanking, you don't have to take from your portfolio. Just let it sit there and wait for the markets to come back. Having income coming from your house reduces the risk of sequence of portfolio returns, reduces the sequence risk of a bull or a bear market. You can let the money continue to sit there, to come back to a better value, to compound – which is the real magic – instead of liquidating when prices are low. This is a real significant benefit.

Another benefit of reverse mortgages relates to the co-pays that have come into the Medicare world, and how your level of modified adjusted gross income (MAGI) can impact how much you owe in a co-pay. If you have a higher MAGI, your co-payments are higher. If you have a lower MAGI, your co-payments are lower. It's based on your capacity to pay. There's a certain level of fairness to that. We could have a whole lecture on whether or not means testing Medicare is the right way, or if it's doing things properly.

But the good news is that any wealth or income that you get from your house – reverse mortgage or HECM line of credit – are not included in your MAGI. They're non-MAGI cash payments. So, you can create more income from your home, and it won't cost you any more in your co-pays.

There are a myriad details that can come in with some of these issues. Consult with your tax and financial advisors; ask, learn, and take advantage of the potential real, positive things that can come from this.

Might Your Home Un-Welcome You?

As all of us age, we change. Will your home continue to welcome you?

Here are five things that are significant descriptors within any home. Are these welcoming to the changes that you might experience with your health and physicality?

1. Are you going to be able to walk up or down stairs? Is the master bedroom on the second floor? You love this home, you raised a family in this home, but you can't get to your bedroom anymore. What about the width of the doorways or the width of the halls if you are wheelchair-bound? A walker is wider than we are. Can you get down the halls and through the doorways easily?

2. What about cabinets and countertops? Can you reach up to a cabinet to get something out? Is it safe for you to stretch that way based upon what's going on with your health? Are the countertops too low or too high, as a result of your aging?

3. Shower or tub? We see those wonderful commercials about those walk-in, giant tubs. There's a reason for that. Showers become hazardous if they're slippery. They may be awkward or difficult. Tubs can be difficult to get in and out of.

4. What about toilets? Have you ever noticed how low your toilet is? If you have a bad back, or you have trouble with your legs or issues getting up and down, it could be a challenge.

5. By the way, so too your home will age. What is it – about every 20 years you need to change the roof? How long is that air conditioner going to last? What about your boiler or your heater? If you retire at age 65 and you're married, there's a 50-50 chance that you or your spouse are going to make it comfortably into your 90s. In 30 years, all sorts of things in your house are going to need to be replaced. Why are people not talking about this and putting this into their retirement plans, since these replacements are going to be more needs than wants by then? Timing matters.

If the concept here is potentially that you might move – I happen to have great appreciation for downsizing for retirees. So, sell it and buy something smaller, cheaper, and then maybe pursue a reverse mortgage or HECM line of credit. You don't have to take one or one or one. You can combine.

Tips and Takeaways

1. Assets can also be liabilities. Know the issues. Your house, which is an asset, becomes a liability at times when it needs care – a new roof, new gutters, or a new heater. Liability planning should be part of any retirement plan. If I had my druthers, I would say no retirement plan is allowed to be done until the liability planning is done. I think it should be first and foremost.

2. Understand that what we really want to do is immunize your needs, your spending needs. It means that we want to guarantee that we have the money to cover your spending needs. The wants? That would be fantastic, but we have to cover those needs first.

3. The housing asset is best thought of first, not last, in the process. That's the point. This big asset can be incredibly meaningful to the quality of your retirement. It used to be – *used to be* – that when all the assets were exhausted, or slightly before all the assets were spent down, and there was a need for more income, it was then that people thought about a reverse mortgage. No, folks, it's the exact opposite. You want to start using your housing asset in your planning at the very first step. That doesn't mean that you're going to immediately go to a reverse mortgage or tap the home equity line of credit but you still might want to get them opened up.

4. The housing asset can offer unique benefits. The easiest no-brainer is to wait to take your Social Security. The government is going to give you a guaranteed 8 percent return. Your money market funds are paying you virtually nothing – less than a quarter of 1 percent for a money market account – your CDs aren't paying you much, short-term bonds aren't paying much, but you can get 8 percent?

In addition, protection from sequence risk is one of the most meaningful benefits of leveraging that housing asset in retirement. And of course you'll have that non-MAGI income for Medicare means-testing.

5. Your home is a lifetime of savings. Understand how you might spend some of that effort. When you think about it, your home has really just been, for the duration of your mortgage – let's say 30 years – a forced savings program because at the end, when you own the home, you have an equity asset. This is a forced savings program. If you're going to save for a lifetime, shouldn't you figure out how you can start to spend that when you need it?

6. Today's low rates do not have to impair your retirement if you can broaden your focus on generating income. I'm not talking about reaching for yield here, the very famous and most dangerous investment technique. We're not going out and buying a high-yield bond, and selling our short-term U.S. treasuries because they're paying a little more yield. There are other ways.

7. Spending down your home – because you would be spending it down – is a complex decision. It's not insurmountable, but it is a complex decision. Before you sign any forms, make sure you know exactly what it is that you're signing before you lock yourself into any kind of agreement or contract. Consult with your professionals, your tax professionals, your financial professionals. Make sure you understand what's going on, because this is your home. This is, for a lot of you, the biggest asset that you have. You don't want to make a mistake with it.

About the Author:

Michael Falk, CFA, CRC® is a consultant and partner with the Focus Consulting Group in Chicago, and a partner and chief strategist on a global macro hedge fund. Michael and I met in the 1990s, late 1990s, when we both served on the Profit Sharing/401k Council now known as the Plan Sponsor Council of America, on their Communication and Education Committee. At the time, he was the CIO, the Chief Investment Officer, for one of the first firms to provide managed accounts for 401k investors.

In his role of CIO, he was in charge of manager due diligence and asset allocation for a multibillion dollar advisory. His background includes extensive asset allocation research and portfolio development expertise along with a multifaceted understanding of behavioral finance and retirement issues. He believes that the asset consulting perspective should acknowledge that the voice in the crowds can denigrate into madness at times, and that assets should be managed with the serenity to accept the market's realities, the courage to pursue its opportunities, and the ongoing pursuit of wisdom to understand the difference.

Michael Falk, CFA, CRC® – Behavioral Finance & Investment Management Expert

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A score of 70% is required to pass the quiz and earn CE credit. You will see your score on your screen upon submitting your answers. An email will automatically be sent to you for your records as proof of successful completion.