CONSUELO MACK | WEALTHTRACK

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Two retirement income specialists, Professor Jamie Hopkins and Financial Advisor, Steven Earhart show us how to create our own paycheck in retirement.

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CONSUELO MACK: On this week's Consuelo Mack WEALTHTRACK: How to maximize your income in retirement. It's a challenging task, requiring a specific set of skills. Two retirement income specialists, Professor Jamie Hopkins and Financial Advisor Steven Earhart guide us, next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack. How prepared are you financially for the big switch from getting a regular paycheck from work to creating your own paycheck in retirement? If you are already in retirement, how's it going?

A recent T.Rowe Price study of baby boomers and Gen Xers with investable assets of at least $50,000 found that 47% of them feel their ideal retirement is "very attainable."Another 45% say it is somewhat attainable.

Other studies find similar levels of optimism about retirement. But it turns out that confidence might be misplaced.

A financial literacy survey by the American College of Financial Services, the nation's largest non-profit educational institution devoted to financial services, found that financial literacy about retirement planning is poor even among the more affluent. In its survey of individuals between the ages of 60 and 75, with household assets of at least $100,000 excluding their primary residence only 20% scored 61% or better in a basic financial literacy test. That means 80% had failing grades. The survey covered topics such as ability to maintain lifestyle, life expectancy, income generation, social security and company sponsored retirement plans.

And it's not just individuals who need to be educated. The American College of Financial Services has created a new program and certification for financial advisors called The Retirement Income Certified Professional designation or RICP, which specializes in retirement income planning because this is relatively new territory for professionals too.

Our two guests are professionally involved in that effort.

Jamie Hopkins is one of the creators of the RICP curriculum. He has a Chair in Insurance and Investments at the College, is an Associate Professor of Taxation there and is Co-Director of The American College New York Life Center for Retirement Income. *InvestmentNews* named him one of the top 40 financial services professionals under the age of 40.

Steven Earhart is the owner of the financial advisory firm Devon Financial Partners. He earned the Retirement Income Certified Professional designation as well as several other professional credentials including Certified Financial Planner and Master of Science in Financial Services. Several years ago he was recognized as a 40 under 40 by the *Philadelphia Business Journal*.

Both guests say the biggest financial challenge for the 10,000 baby boomers turning 65 every day until 2030 and their advisors is transitioning from accumulating assets to turning those assets into income. They say it takes a completely different mindset.

STEVEN EARHART: There's definitely a mindset. They have to switch the switch. We've been programmed to think accumulation, accumulation, accumulation. We see the commercials. We've all seen the commercials. What's your number? Here's your path to your number, and to go from that to your nest egg. Now we have to think about it as an income stream that's going to replace your salary when you step off into retirement and to replace it hopefully for the rest of your life. So it's a completely different mentality. You're working and you're working. Then you step off and say, "Where's my check?"

CONSUELO MACK: So that's a big transition.

STEVEN EARHART: It is a transition.

CONSUELO MACK: Knowledge is power, and it turns out I looked at some of the surveys that you've done, Jamie, at the American College, and essentially the financial literacy is pathetic among pre retirees and retirees, but the more financially literate you are, the better you do in retirement. So Social Security, a very important part of retirement. So what do we need to know about Social Security?

JAMIE HOPKINS: I think one thing for retirees or if you're close to retirement today is that Social Security's going to be there for you in some form or another. We hear a lot of concern about that, but it's not going to go away completely. Why? Well, about one third of the country, that's their only income source in retirement. About two thirds of the country, it's more than half their income. So if we're looking at the three of us, what does that mean? It means if we were representative of the country, two of us would be Social Security almost only or most of it, and one of us, maybe Steve here, would be withdrawing from a portfolio. So Social Security is kind of our floor as we call it in income planning where it's going to provide us some level of money that we can rely on that's going to show up each month, and it's protected against inflation. That's something you didn't worry about the rest of your life. I don't wake up every day saying, "I'm worried about inflation today." You might worry about it in the big scale of things but not on a daily basis, but in retirement, inflation on a daily basis or monthly basis, yearly basis matters because if you have a set stream of income, over 30 years if you don't have that inflation protected, it's going to be worth less than half of what it was when you started. So how do you get by then? Well, you need inflation-adjusted assets there, income streams that are going to deal with that risk.

CONSUELO MACK: Steve, you talked about suddenly in the decumulation phase you need to think about income that lasts a lifetime. Well, Social Security is one source of income that hopefully will last a lifetime. So what do you tell your clients about Social Security? What's changed again in your assessment and your strategy with Social Security?

STEVEN EARHART: The optimal strategy now is to delay it as long as possible if you're healthy. If there are health issues, that's another story, but if you're healthy and your spouse is healthy, you should delay it as long as possible, to the age of 70 because you'll get a good bump in the monthly payments and, as you said earlier, you can't outlive that.

CONSUELO MACK: The decumulation phase. Steve, four percent used to be the golden rule of withdrawal in order to maintain an income stream for a lifetime. If you went above that, you were in jeopardy. Is that still the case, four percent of whatever your nest egg is?

STEVEN EARHART: No, that's part of that traditional thinking and conventional thinking. Four percent really is pushing the envelope.

CONSUELO MACK: It's too much.

STEVEN EARHART: It's too much.

CONSUELO MACK: Oh, man.

STEVEN EARHART: We try to look at it closer to three, and it also depends on what kind of income floor you have, what other guarantees you might have coming in, Social Security benefits, but you really have to be careful with anything north of three percent.

CONSUELO MACK: Why is that? Is it because the returns on your investments that you can expect are so much lower, or are taxes higher? I mean what is it? Why can't you take four percent anymore? Or why it is pushing it?

STEVEN EARHART: Well, people are living longer.

CONSUELO MACK: Living longer.

STEVEN EARHART: That's really the key.

CONSUELO MACK: That makes a big difference. Portfolio mix, the optimum portfolio mix. People used to do the 60/40 thing, 60 percent in equities and 40 percent in bonds. What is it now, or is there any such animal?

JAMIE HOPKINS: I wouldn't really say there's a perfect portfolio mix in general because it's going to depend, as Steve just talked about, how long you want to make this money last for. Well, all of a sudden if we start testing this and a 50/50 split or 40 percent bonds, 60 percent stocks or then 70 percent stocks, 30 percent bonds, we're going to have more potential up side as we move up that ladder and put more equities, more risk into our portfolio, but that's exactly what we're doing. We're also increasing the risk, so there's a higher likelihood that maybe the worst case scenario happens and we lose our funds. So we have to balance that.

Now what we have seen here, the old rule of thumb used to be that you want to have this constant decline in stocks to bonds. So you're going to increase your bonds over time.

CONSUELO MACK: I remember Jack Bogle, the founder of Vanguard, telling me on this program that, "Consuelo, your bond position should equal your age." So if I'm 80, I should have 80 percent bonds in my portfolio.

JAMIE HOPKINS: He'll probably see this at some point and say, "Jamie, why are you talking about this?" but what we've seen is a big change there. The research really doesn't support that anymore. What we've seen is a much more steady allocation works better in the long run. So it means that we don't use that old 100 minus your age to get your stock. We actually stay more level, so it's going to be closer to maybe a 50/50 or 60/40 mix throughout retirement except for this is a time when we're going to lower it. The kind of five years right before and right after retirement, and that's a big reason why you hear the four percent. You say, "Why can I only withdraw four percent of my assets? I'm going to average eight percent through retirement." You might average eight percent, and you can still only draw four. Why? Because it's the sequencing of your returns that really matters, and that's a hard concept for people to grasp initially.

CONSUELO MACK: Sequencing means what?

JAMIE HOPKINS: Sequencing of returns means it matters where you get your returns. So if I have bad returns in the first five, six years of retirement, the first year the market drops 30 percent and I have to pull money out of that, all of a sudden ...

CONSUELO MACK: Like 2009.

STEVEN EARHART: Exactly.

JAMIE HOPKINS: I'm pulling a large amount as a percentage, a very large withdrawal out which makes it eight percent is not sustainable. Even though you might average eight percent through retirement, you can only withdraw four to make it sustainable, and it's because of those bad returns early in retirement that causes that. We don't care about sequence of returns in the accumulation phase. It doesn't matter. If you average eight percent, no matter what your yearly returns are, you average eight. Someone else averages eight. You get the same amount of money. In retirement you have two people that average eight percent. One person could run out of money early in retirement. Someone else could run out later.

CONSUELO MACK: What's the biggest challenge , Steve, to you when you're talking to clients about the decumulation phase when they're close to retirement? What's the biggest hurdle that you have to overcome with them in your planning?

STEVEN EARHART: Accepting the fact that they're going to retire and the paycheck's going to stop and then really having concrete numbers as for what does their retirement look like. We try to drill down. What does their ideal retirement look like? What kind of guaranteed income streams do they have coming in, if any, and what kind of income overall do they need? So sometimes there's a disconnect between current lifestyle and a lifestyle that their nest egg will actually be able to provide. So it's coaching them through that and managing the expectations of that.

CONSUELO MACK: In addition to your saving, your traditional savings, the stocks and bonds that we just talked about, you've got to think of other assets, of how to use other assets that you might have, and one of them was your home to see that as a source of income. So explain how that would work.

STEVEN EARHART: There are a couple of different options to use your home. It could be a safety net, have a home equity loan in case there's maybe a medical expense or you need to tap for some additional income or cash flow. Reverse mortgages are getting a lot more traction now.

CONSUELO MACK: I know. So tell me about that, because I remember 20 years ago reverse mortgages. That was the last thing you wanted to do. What about reverse mortgages? Who should consider them, and how do they work? How would that work?

STEVEN EARHART: I personally think that they're a last resort still.

CONSUELO MACK: Oh, you do.

STEVEN EARHART: I do.

JAMIE HOPKINS: I disagree with him on this one, so we've got differing opinions.

CONSUELO MACK: All right, well, Steve first.

STEVEN EARHART: The right answer first. I just think that that should be saved for ... the house is an asset, number one, and to tap into reverse mortgage when maybe you don't have to, I just think that starts a chain of events. Now if someone's never going to move and they absolutely need income then I think it makes total sense.

CONSUELO MACK: So I can see that because otherwise you've got this asset. You can sell it. You can add to your nest egg with whatever you can make on the house, and if you're downsizing or go to assisted living. So I can see your options. You've got more options if you don't do the reverse mortgage route. That's what it sounds like, but you disagree with that, Jamie?

JAMIE HOPKINS: Yeah. For the last couple years, and we both agree on the first part which is housing has to be considered. It's America's largest asset. It's more than the stocks and bonds.

CONSUELO MACK: How do you monetize that?

JAMIE HOPKINS: Right, and so as he said, a line of credit is one and just use a straight line of credit. There are some down sides to that. They can get canceled and things like that, so it might not necessarily be there when you need it. Now the reverse mortgage they've changed a lot. It's not the reverse mortgage of ten years ago. The regulations in about the last two years have significantly changed the product, brought some of the costs down. They were a very expensive product, but what you see is if you incorporate this as part of portfolio management ... and I'll give a very simple example here. Stock market go back to 2009, and we're withdrawing money from that portfolio to meet our needs, and it drops 30 or 40 percent. Do I want to take money out of my portfolio when it's down 40 percent or borrow from my house at four, four and a half, five percent? Actually that's a very easy decision. The math? You'll never convince me otherwise. The math is better.

CONSUELO MACK: Would you go along with Steve in that case?

JAMIE HOPKINS: So the idea with reverse mortgages today is if you're willing to age in place – you want to live in your house which most Americans do – that you set up the reverse mortgage early, that line of credit. Now you don't tap into it. I'm not encouraging one to go age 62, go and pull it all out, but if you set it up so it's there so if the market drops, you already have it set up, and you can now use that asset instead of your stocks. The other thing is you can pay it back, and you can pay it back just like a traditional mortgage, and the interest is even deductible just like a traditional mortgage. So we actually have people and financial planners using this now and really just treating it as what we say is a non market correlated asset. We set up the reverse mortgage. We only draw from it in years after the markets went down, and in some cases that might be the first three years of retirement because that's actually the biggest risk period. So there are other strategies. Some people hold bonds. They use that purely for the first couple years or cash set aside, but this can be another option for kind of that cash buffer strategy for the first couple years in retirement.

CONSUELO MACK: Another nontraditional asset for many Americans is annuities.
They got a bad rap at one point as well, but now what do you think?

STEVEN EARHART: I think annuities are a great tool in the right place.

CONSUELO MACK: What kind of annuities?

STEVEN EARHART: Well, there are different kinds, but primarily in the retirement income space, I think to provide that floor income annuities are key and, number one, you can't outlive the annuity, so you've taken that longevity risk off the table. The fact that you have guarantees coming in takes the stress off the other assets you have. It frees up potential cash, and I think that a lot of people use – you mentioned bonds – bond laddering. With bond laddering what are you doing? You're spending principal and interest. With an income annuity, you're spending principal, interest and mortality credits or mortality yield which is the surplus from those who don't live long to those who do live long.

CONSUELO MACK: That gives you that added income.

STEVEN EARHART: That's the added income. So it's not as much about the interest rate you're getting. It's more about the mortality credits, and it's not really what an annuity is. It's what an annuity does. So again lifetime income guaranteed no matter how long you live.

CONSUELO MACK: When you do an immediate annuity? When you do a deferred income annuity?

STEVEN EARHART: It depends in the circumstances of the case, but I think they both have a useful place in retirement planning. You have the right income floor, and then you construct it for an income annuity to kick in sometime down the road which, if you know you have that guaranteed down the road, coming in additional income, it frees up the assets today to do some things with.

CONSUELO MACK: How practical is the ... I think it's the deferred income annuity? What's the one that kicks in at 85?

JAMIE HOPKINS: The QLAC, qualified longevity annuity contract.

CONSUELO MACK:All right, so tell me about the QLAC.

JAMIE HOPKINS: So the QLAC's actually a new type of annuity. They haven't been around a long time in this specific form that they exist today. You can put them inside of your IRA or 401(k) plan, and that's where our money is, so that's where we want to be able to buy these things. The idea is you can turn them on at 85. You could turn them on at 80. You could turn it on at 75, but you can't go past 85. So that's the latest it'll let this income kind of turn on for you. Now one of the benefits of it is the principal that you pay to get that annuity is excluded from required minimum distributions when you hit age 70. So there are a lot of people that say, "I don't want to spend this money. I don't want to have to take it out of my IRA when I hit 70." So you can take a portion of that, sit it aside for income starting at 80, 85, and the other thing it does is you get pretty good – if you're thinking about returns – pretty good returns there for safe income, and it kind of takes off some of that longevity risk that you have that you're going to outlive your portfolio and your money. Then somebody always says, "Well, what if I die early?"

CONSUELO MACK: No, exactly. I can hear the objection.

JAMIE HOPKINS: What if I die early? Well, they do come with return-of-premium riders, so you get all the money you put in back.
CONSUELO MACK: Long-term care insurance. Is that an important part of the discussion? Steve?

STEVEN EARHART: It is. It's absolutely a necessary part of the discussion.

CONSUELO MACK: It is?

STEVEN EARHART: They're going to have to pay for it one way or the other. So you have to discuss it, and they should have some type of plan. Obviously not having a plan is also a plan, but they should include family in whatever their plans are.

CONSUELO MACK: Are the policies ... at one point they had gotten very expensive. A lot of insurance companies were withdrawing from the market. Are they a viable option now to actually get a long-term care insurance policy?

STEVEN EARHART: They are. The market has dried up a bit. Benefits provided by the policies have been reduced. Typically now you can only get a five-year benefit where a couple of years ago you could get lifetime. Now we have additional products coming out that are blended products, maybe a life insurance policy with a long-term care rider and an annuity with a long-term care benefit. So there are some other tools you can use, but it's a tough market now.

CONSUELO MACK: Jamie, let me go back to something that we had talked about a little bit earlier. You wrote an article about some of the myths of retirement planning, and one is that you should keep buying more bonds as you get older, and instead you have a different strategy which is to reduce your stock positions in your portfolio before you retire and increase the stock positions in retirement. Can you explain that strategy?

JAMIE HOPKINS: So it kind of looks like this dip where you've got your assets. All of a sudden it drops down, and then you're going to go back up, but I'm not saying you're going to go back up to 100 percent, but right around retirement – and I'm talking again the first five years before and five years after you retire – that right before retirement it is beneficial to maybe lock in some of those gains that you have and say, "You know what ..."

CONSUELO MACK: A year or two before retirement or how soon?

JAMIE HOPKINS: Actually you could even go to five.

CONSUELO MACK: Five years.

JAMIE HOPKINS: Between that kind of five-year timeframe in there. I think that's a safe range to say, "You know what. I have enough money, but maybe just barely enough to get through retirement."

CONSUELO MACK: That's when you're most vulnerable.

JAMIE HOPKINS: It is. So at that point maybe I'm safer just taking that risk off the table for five years and then starting to increase that as the bonds. I can put some of them back into the stock once I'm a couple years into retirement. Now if the first couple years of retirement go very poorly, that the stocks drop, well, one, it might be a good time to buy, but also it might be not a good time to be selling more of your stock. So you actually might see kind of the stock staying there and your bonds being spent down. So you might drop a little bit further, but then hopefully you can get back in and increase that position again. But that's really the strategy, and it's about avoiding these bad years right around retirement. That's what wipes out the portfolio. It's that and longevity. Those are really our two big risks, and then we've got other ones in there, but those two, they can just destroy a portfolio and a retiree's savings and very quickly, too, if we don't plan well around them.

CONSUELO MACK: What would your advice be to clients as far as that kind of dangerous five year before retirement period when you're particularly vulnerable?

STEVEN EARHART: We typically like to have a good liquid cash position or liquid asset position whether it be cash. We talked about the home equity loan. So if there is a turndown in the market, they don't have to sell their stocks at a discount. They can ride it out.

CONSUELO MACK: Some studies have shown that actually having a written plan makes you better prepared for retirement, for a successful retirement. When your clients come to you, do you sit down and kind of write the plan with them, go over it?

STEVEN EARHART: I think absolutely something in writing is the best approach.

CONSUELO MACK: Why is that? Is it because the process helps the client?

STEVEN EARHART: It's not just the process. I think it's psychologically they buy in more, and it's something you can monitor. It's in writing. You can check year to year and say, "Where are we? How do we have to modify it?" versus just a conversation. It's tough to monitor that, stay on top of it.

CONSUELO MACK: The one question I ask every guest on WEALTHTRACK at the end of an interview is if there's one investment we should all make for a long-term diversified portfolio, what would it be? In this case I would ask each of you if there's one thing we should do or one investment we should make to have a successful retirement, what would it be?

STEVEN EARHART: I would say structure some type of a guaranteed income, an income stream that'll cover whatever your fixed expenses are for the rest of your life.

CONSUELO MACK: What might that be in addition to Social Security?

STEVEN EARHART: It could be an annuity strategy. If you're self-employed, it could be some type of a defined benefit plan on top of an annuity, but whatever it is, some kind of a guaranteed income so you have that floor regardless of what happens.

CONSUELO MACK: Jamie, what would yours be?

JAMIE HOPKINS: I think one of the things we need to look at is having tax diversification. We didn't talk a whole lot about taxes here, but taxes eat into our income in retirement. Social Security is taxable. Now what should we do? We need to have Roth assets also. So that's a Roth IRA or Roth 401(k) and that causes us to do something we don't want to do upfront is pay taxes earlier. We've lived our whole life saying, "Hey, how can I not pay taxes?" It can be a good thing to pay taxes when it comes to retirement planning. Convert assets to a Roth account when you near retirement. That's a great strategy for people and can really help them manage their portfolio for a much longer period of time.

CONSUELO MACK: So when you're near retirement, convert your normal IRAs into a Roth because the income coming out of a Roth is not taxed.

JAMIE HOPKINS: Correct. So as we near retirement or just in retirement, our income levels might drop which means what? Lower taxes. That gives us an opportunity to convert some money, pay taxes on our IRA at a lower tax rate. That's really when we want to do it. We want to pay it when our income drops. So we can convert that over and then we have this new source of income that is not subject to required minimum distributions at 70. So we have more control over it, and it doesn't show up as taxable income. Actually doing that, we could even keep Medicare costs down. Our premiums are impacted by our income, and Social Security taxes are impacted by income. So by withdrawing from Roth accounts, we can help manage the taxability of our other accounts too.

CONSUELO MACK: So we're going to have to leave it there. This conversation could go on for many, many more hours which is why you have a curriculum and the RICP certification in which you do that. So Jamie Hopkins, thank you so much for joining us on WEALTHTRACK and, Steve Earhart, thank you so much for being here as well.

STEVEN EARHART: It's been a pleasure. Thank you.

CONSUELO MACK: At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term. This week's Action Point is: D*evelop an alternative retirement income source* to tap in the event of a significant market decline. As our guests pointed out you might want to use other sources of income to avoid drawing down your investments during bear markets. Some alternatives you can do in advance involving your home are setting up a home equity line of credit, or a reverse mortgage line of credit when conditions are favorable to use when they are not. You might never have to use them. You can pay them back if you do. The point is they are there when you need them.

I hope you can join us next week for a rare interview with legendary value investor Bill Miller. Where is he finding bargains now?

For more of our interview with Jamie Hopkins and Steve Earhart please go to our website and click on the EXTRA feature. And keep reaching out to us on Facebook and Twitter.

Have a great weekend and make the week ahead a profitable and a productive one.