High Pointe Capital Management, LLC
One North LaSalle, Suite 2001
Chicago, Illinois 60602
312.726.2500
312.726.6100 fax
www.highpointecapital.com

Innovate. Deliver.

High Pointe

Rock Solid Advice for Retirement Age Investors

"If we save a rock a year, by the time I'm ready to retire we'll have a lot of rocks."

Collecting rocks is obviously not a great retirement strategy, but planning years ahead is! We are fortunate to work with clients who have had the foresight and discipline to save early, and accumulated sufficiently large nest eggs for retirement.

Having a large enough nest egg is essential for living well in retirement, but it is by no means sufficient because the money has to be invested well, and numerous tactical issues have to be addressed along the way. We have discussed many such issues with clients over the years. We thought it would be a good idea to compile some of the more commonly asked questions and share our answers with all clients.

This list of questions is not exhaustive because, frankly, books can be, and have been, written about all of these topics. Nevertheless, we believe this Q & A will provide some food for thought and, hopefully, some comfort that you are well positioned for your financial future. We are available to address any specific issues that might be on your mind that we have not addressed directly with you.

Minimizing Taxes

Are taxes less important in retirement, since my income will be lower?

Not at all! In some ways, taxes are more important than ever. Here's why. Most of your income in retirement is going to be from capital gains, dividends, and interest. Since tax rates differ tremendously on these sources of income, efficient tax management is critical. One of the most logical things you can do is to concentrate your bond investments in tax-deferred accounts like IRAs and 401k accounts and concentrate your stock investments in taxable accounts. This will give you the opportunity to lower your tax burden by ensuring that most of the gains in your taxable accounts are generated by long-term capital gains and dividends which carry a much lower tax rate than interest income and short-term capital gains.

Throughout your career, you were most likely told that you should have a high equity exposure in your 401k plan because it was supposed to be "long-term" money. By contrast, taxable accounts were supposed to be more short-term oriented because mortgage and other expenses needed to be paid out of them. Now, that thinking needs to change. In retirement, the investment time horizons of the 401k accounts and taxable accounts are fairly similar. Therefore, investment time horizon should not drive the decision as to which account should have equities and which one should have bonds. Taxes should drive this decision because there is a real potential to minimize taxes by properly allocating stocks and bonds between tax-deferred accounts and taxable accounts.

Mortgage Debt

Should I pay off my mortgage as I approach retirement?

For most well-to-do individuals, the answer should be yes. Most individuals have a deeply ingrained view that mortgage is a low-cost loan because of the tax deductibility of interest, and that they should be able to do better than this low rate by investing in the "market". There are many reasons why this line of thinking needs to change for most well-heeled, retirement-age investors. First, the tax reform of 2017 limited the interest deductibility to a mortgage amount of only $750,000. Secondly, taking a mortgage and investing it in the stock market has the inherent risk that the stock market could decline, making it much harder to repay the mortgage in the future. Thirdly, most high net worth investors park a significant amount of their assets in bank accounts and money market funds which usually earn less that the cost of the mortgage. In such cases, using the "excess" cash-equivalent assets to pay off mortgage debt makes sense. Last, but not least, there is peace of mind that come from owning your primary home free and clear of any debt.

Withdrawal Strategy

How much of my retirement savings can I withdraw every year?

Historically, many advisers used a simplistic rule of thumb to answer this question. That rule of thumb was that investors could withdraw 4% of their retirement date wealth each year and not have any significant risk of running out of money. According to this rule, an investor with a retirement nest egg of $5 million could "safely" withdraw $200,000 each year in retirement. However, as interest rates have declined over the years, the "safe" withdrawal rate has plummeted. In a study done by Morningstar in 2013, it concluded that the "safe" withdrawal rate had dropped below 3%. That study can be accessed here. (http://news.morningstar.com/pdfs/blanchett_lowbondyield_1301291.pdf).

Practically speaking, we think there is another alternative worth considering too. We have observed that most investors do change their spending as their net worth fluctuates. In light of this observation, an investor could use a rule whereby the withdrawal depends on the portfolio value at the beginning of each year. For example, an investor with a $5 million starting portfolio could withdraw 4% ($200,000) in the first year. Then in the next year, if the portfolio has increased in value to $5.5 million, he could withdraw $220,000 (4% of the new amount). If on the other hand the portfolio has dropped to $4.5 million, he could reduce the withdrawal to $180,000 (once again 4% of the new amount). This approach allows for some adjustment to spending that we think is realistically going to happen anyway.

Safe and Liquid Assets

How much should I keep in safe and liquid assets like bank accounts and money market funds?

While there is no single or correct answer to this question, keeping at least a six to twelve months' worth of expenses in cash-equivalents seems reasonable to us. What is more important, in our opinion, is that the money market funds investors use should be Treasury-Bills money market funds rather than more diversified, higher yielding money market funds that invest in corporate securities. As we saw in the Great Financial Crisis, high-yielding money market funds can have difficulties in times of financial distress. We do not advocate owning "safe and liquid" assets that might not come through during a financial crisis as we view the small extra yield earned from them as an attempt to pick up pennies in front of a steam roller. In our opinion, it is not worth it.

Asset Allocation

Should I reduce my equity allocation as I approach retirement?
Yes, given the higher volatility inherent in equities, reducing equity allocation as one nears retirement makes sense. The logic is simple. Since no new money is going to be added to the portfolio, there is no dollar-cost-averaging opportunity of buying more if the market declines. Moreover, any near-term decline in the market might not be made up because the investment time horizon in retirement is shorter.

Estate Planning

I already have a will and trust. Do I need to do anything else?
That's a great start. Make sure you have a healthcare power of attorney in place as well. It is worth reviewing your documents at least once every five years, or earlier if necessitated by changes in estate laws or your own family's circumstances. Also, it is important to make sure that your assets are re-titled in the names of your new trust as you make amendments to it. Lastly, make sure your IRA accounts have the correct beneficiaries listed as circumstances might have changed since you designated the beneficiaries many years ago. And, please ensure that the beneficiaries are individuals, not trusts.

Charitable and Philanthropic Contributions

I make my charitable contributions from my checking account. Is that OK?
That might be OK for very small amounts but for some investors a different strategy might be better for larger amounts. If you are able to itemize your deductions, you should take a stock that has appreciated significantly in your taxable account and transfer it to a charity account (called a donor-advised fund) that you control. Transferring this stock to the charity account ensures that you will never need to pay tax on the capital gains in that stock. You can then sell the stock and leave the proceeds to be used for charity later. You retain complete control of who gets the money, at what time, and in what amount. Most of your charity dollars should be flowing through such an account. Also, note that it is possible to use your Required Minimum Distribution (RMDs) from your IRAs to make a contribution to your donor-advised fund so that it does not get included in your income for tax purposes.

Recordkeeping and Passwords

How long do I need to keep my tax and investment records? How do I manage my burgeoning list of passwords?
Tax records should be kept for at least seven years. Investment records that establish the cost basis of a security should be kept until the security is sold and seven years have passed beyond the date of the sale. Cost basis for transactions is usually available in the year-end summary of your brokerage accounts and, therefore, that is usually sufficient for recordkeeping.

Passwords have become a necessary nuisance for all of us. As it has become impossible to remember the passwords, and given the risk of online hacking, many experts are recommending subscribing to a service to manage your passwords. A recent New York Times article has some good information. It is available here.
https://www.nytimes.com/2019/10/03/smarter-living/wirecutter/get-your-digital-accounts-ready-in-case-of-death.html

Current Economic Environment

What's your view of the current economic environment? Should I be a little more conservative or a little more aggressive?
We typically suggest staying close to the asset allocation that is right for your risk tolerance and your investment time horizon. Nevertheless, we do have some specific concerns about the current environment

in which asset prices have been propped up by central bankers' actions. We documented our concerns in detail in our last quarterly newsletter which was later published and is available here. https://blogs.cfainstitute.org/investor/2019/07/23/negative-interest-rates-carry-an-umbrella-at-all-times/

In this article, we specifically refer to the idea of having a modest exposure to Treasury bonds to protect against deflation and possibly some exposure to physical gold and gold-mining stocks as an insurance against a financial system hiccup. We do acknowledge that by pushing interest rates even lower, central bankers might be able to drive up asset prices even higher thus requiring investors to balance the goals of participating in the rally while protecting assets on the downside.

In Summary

We hope this discussion is helpful in terms of raising awareness about some relevant topics. Investing in retirement is not a static activity; it does require keeping up with the changes around us. We stand ready to help you navigate the investment landscape in the coming years which are bound to have their full share of surprises.

Chris Olson and Gautam Dhingra
October 21, 2019

P.S. Each client situation is different and, therefore, it is important that the suggestions given above not be construed as client-specific advice. Moreover, please note that High Pointe is neither a legal advisor nor a tax advisor. Clients should make sure that they consult their legal and tax advisors to address their specific legal and tax needs.