

Cash-Laden Retirees Need To Put Funds To Work

by Stephen J. Butler

The law of unintended consequences has dealt another blow to conservative retirees who have been investing in bank Certificates of Deposit and short-term debt like money market funds.

Effectively, these investors have saved the banks at a huge personal cost. The Federal Reserve, which controls the money supply, has lowered the rate to almost zero that it charges banks that come to the Fed "window" to borrow. This is an effort to create as much liquidity as possible in a banking world where credit has effectively dried up and is otherwise unavailable as banks struggle to get back on their feet.

Unfortunately, those banks eligible to borrow from the Fed have taken the money, but they aren't loaning it out to people or businesses. Instead, they are loaning it to the federal government, (not to be confused with the Federal Reserve) and earning maybe 2 percent while taking that spread as profit. You can't fault them for that. After all, as one banker was quoted in a January New York Times article, "a lot of our folks have second and third homes and alimony payments and other obligations that require substantial cash." As Bill Gross, the bond-trading genius said, "It's capitalism I guess, but it's not to be applauded."

Meanwhile, there is an unprecedented \$3 trillion in cash sitting on the sidelines waiting to do something, almost anything, to try to make some money. What's a retiree to do?

A couple of ideas come to mind: One is to consider investing in blue-chip, dividend-paying stocks on a dollar-cost averaging basis. In other words, don't write one big check today to a combination of value-oriented and dividend-paying mutual funds. Instead, feed money into the market over a year's period of time to benefit from any downdrafts during that period. Think of this money as funds designed to generate income and try to ignore fluctuations in the capital value. Set up the funds to deposit any dividend income into a checking account automatically. Plan to own these investments indefinitely as a source of income and ignore the changes in capital value.

The wind behind the sustained rise in market values, after the predictable "snap-back" from the crash, is the amount of unemployed cash looking for better rates of return. Sure, there's risk in the market, but compared with no return for the foreseeable future, a little risk doesn't look so bad. When the Fed eventually raises its interest rate even slightly, the market will swoon temporarily, but that hiccup will offer an opportunity to methodically buy into a falling market which will reduce the average cost of all the shares purchased.

The next option, for someone in their 70s who started taking Social Security earlier, is to consider buying back into Social Security to generate the higher-age rate. This could increase Social Security payments by 32 percent and guarantee a larger cost of living increase in dollars. A 70-year-old male has a better than 50 percent chance of living until age 87. At least one member of a couple has a 50 percent chance of reaching age 90. The net cost, after tax refunds, of paying back four years of Social Security might be something in the order of \$60,000 for most people.

To then receive an extra \$7,000 per year, which can increase at normal annual inflation rates of 3 percent, looks good compared to today's \$60,000 in a CD earning nothing. However, to find someone at Social Security who understands it can be a challenge. Out of 32 million recipients, only 90 people elected this option a few years ago. Trust me. It's there.

Meanwhile, let the banks bail themselves out. We'll take our money someplace else.



Let Hungry Squirrels Inspire Your Retirement

by Stephen J. Butler

My dog and I like to watch the squirrels trying to get into our squirrel-proof bird feeder.

The ones still slipping off the domed plastic roof at this late date must be the ones that didn't bury enough acorns. It's painful to watch. I'm reminded of how difficult it is to squirrel away enough money for retirement.

It's not enough to wind up with what looks, on paper, to be plenty of money. We know that there is a "danger zone" for retirees who start taking an income from their retirement account that is not supported by enough gains. Worse yet is a situation where a downdraft in account values, like the one we have just experienced, is compounded by a gnawing away at the balance by the income stream we are spending.

The classic illustration of this problem can be found in Moshe Milevski's research. He uses the example of two actual balanced mutual funds that had the same average rate of return (7.8 percent) over 20 years from 1986 to 2006. However, one had several loss years early and made it back in the end. The other did fine initially and then lost money at the end. We're talking about differences like a 1988 gain of 38 percent for one while the other lost 14 percent that year.

If we had started with \$100,000 and left it alone, our 7.8 percent average gain would have allowed both to accumulate to \$370,000 over 20 years. However, if we are taking out the earnings each year, it makes a big difference as to whether the losses we bear take place early or late. In the fund that had early losses, we're out of money in just 14 years. With losses at the end, we still have \$104,000 at the 20-year mark.

Some suggest having "buckets" of different asset types and taking early money from the cash bucket. The basic idea is to leave money in stocks to protect against inflation and to avoid the possibility of taking income from a plunging stock fund. This may sound reasonable, but it doesn't work very well in practice. What happens over the first seven years or so is that all the cash will be gone and the asset mix will then be concentrated in stocks. That's the last place it should be for someone well into retirement by that time.

Meanwhile, we have inflation and longevity to consider. A 65-year-old woman has a life expectancy of 86 (83 for a male.) Those reasonably certain to become octogenarians could buy an annuity that would guarantee a lifetime income, but here's the rub: At 4 percent inflation, an annuity paying \$1,000 per month today will be paying the equivalent of \$456 in 20 years. We might just as well have lost over half of our money. If this wasn't bad enough, longevity is increasing at a rate of three months per year. In 20 years, this could mean five more years of longevity.

When we consider financial challenges, coming to terms with the "danger zone" is one of the most difficult. The simple answer is to spend only the interest or dividends from investments except in years when the capital has appreciated more than the rate of inflation.

Then, start collecting Social Security as early as possible so as not to tap retirement accounts any more than necessary. Forget the Roth. Select stock investments for their dividend strength and consider combinations of bond funds that generate higher-interest income even though fluctuations in capital value will occur. If the interest is all we spend, those fluctuations won't matter.

We can force feed retirement accounts while we're still working by remembering that 100 percent of the first \$22,000 of annual income can go to a 401(K) plan - \$44,000 for older couples still working. If we need a visual image to get inspired, think of those squirrels in the middle of winter trying desperately to get at that birdseed.

