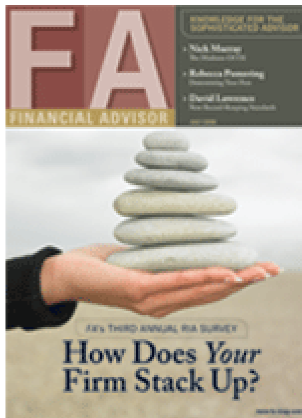

Retirement On Hold

By David J. Drucker
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A popular characterization of the baby boomers is that they've saved little and will therefore draw on home equity to meet retirement income needs. But what happens when neither stocks nor residential real estate holds its value? Retirement plans must be rethought, modified and, hopefully, salvaged.

According to the research report released by Tiburon Strategic Advisors in May 2008 entitled Consumer Wealth, Liquidation & the Retirement Income Challenge: The Impact on the Decline in Home Equity, various trends confirm retirees' dilemma:

• Consumer households' personal assets are dominated by residential real estate, which accounts for more than 80% of assets;
• Consumer households have $9.6 trillion in real estate equity, which reflects a 10% decrease since 2006;
• Baby boomers' savings crisis will be, in part, remedied by their liquidation of residential real estate;
• The number of new and existing home sales is falling; and ultimately, baby boomers' need to liquidate their homes could cause U.S. home prices to collapse by 2015.

What's an advisor to do? We asked our sources to divulge their strategies and found that, while many have been successful in protecting clients' investment portfolios, housing is another story.

Michael Martin, a principal in the firm of Financial Advantage Inc. in Columbia, Md., has always taken a conservative approach to both retirement investing and retirement income planning and finds it is paying off in the current environment. "We're getting an unusual number of happy e-mails from clients thanking us for keeping their portfolios productive and on an even keel. We've always thought that retirement portfolios should be managed actively for absolute returns because sustaining withdrawals is a huge part of the retirement challenge," Martin explains.

His message is that static allocations and passive diversification across the style boxes

is “not appropriate to the goals of retirees, and if the investment manager is attentive to big-picture market signals (such as the fact that a high P/E for the broad indexes portends low future returns, especially when business profit margins are at all-time highs) it is possible to achieve absolute returns, but this also requires a temperate view of return potential.” Financial Advantage has had no down years since January 1, 2000. In this year’s first quarter, Martin says “our portfolios earned 0.0% versus the S&P’s 10% decline.” In other words, his existing retired clients are being very well served.

But then, Martin is a talented portfolio manager with a strong Wall Street background. What about new clients who’ve been sold what Rob Schmansky of Sound Capital LLC in Southfield, Mich., calls “new and untested investments,” namely, “variable annuities and/or managed accounts based on untested” risk-mitigation techniques. “Clients are attracted to the belief that they are investing while cutting their downside risk,” Schmansky says. “However, they are unaware that they may also be cutting their upside potential, and they’re certainly unaware of the costs involved and how those might affect their long-term plan.”

Schmansky says he recently met with a prospect who believed his portfolio had a loss limit of -10%. “This was an all-equity portfolio with a company marketing ‘put options’ as bond substitutes,” he notes. “Meant to achieve returns equivalent to a 60/40 portfolio, this client’s portfolio trailed a blended benchmark by 12% in 2007, while total costs were somewhere around 8% to 12% per year for the options and another 2.4% for manager fees—all in the name of ‘protecting’ his account.”

And then there are the investors who undermine what would otherwise be solid plans—had they worked with a reputable advisor. “I saw a prospect the other day who claims he’s lost nearly 20% since October 2007 and has put off retirement,” says Tom Orecchio of Greenbaum and Orecchio Inc. in Old Tappan, N.J. “He is becoming a client and we are setting up a more diversified portfolio and an automatic savings plan to beef up his retirement savings in addition to maxing out [contributions to] his company’s retirement plan.”

Should advisors look to housing to bail out clients like Orecchio’s? No, says John Sestina of John E. Sestina and Company in Columbus, Ohio. “I’ve always argued that a home is not an investment. In my book Managing to be Wealthy [Kaplan Business, 2000], I build a case for the fact that a house is an expense much like an automobile, not an investment,” he declares. “My research shows a house sells for approximately the amount of money you have put into it. Often overlooked are the non-mortgage costs of home ownership. If one plans to use the house as part of their retirement portfolio, then they put themselves in great jeopardy. It usually means they have overbought and their actual investment portfolio is underfunded.”

True, but nonetheless home equity is already a done deal for many boomers and other would-be retirees. So what are advisors doing to make the best of it in the face of declining home values?

First, it should be said that not everyone has a problem, and that could be said about most generalizations regarding the housing market. “The housing market in Columbia did not boom, so the current trend is that real estate values are holding steady,” says Cheryl Holland, owner of Abacus Planning Group Inc. in Columbia, S.C. “In fact, our two clients who are large-scale residential developers are having their best year ever. We did have a few clients who insisted on purchasing a second residence at peak prices in hot

markets like Asheville, [N.C.], or the coast. Since we do not consider residences an investment asset, though, we never included these assets in the clients' retirement plan discussions."

Second—many advisors have already successfully indoctrinated their clients with Sestina and Holland's philosophy, namely, that their home should not be thought of or relied on as a retirement asset. "I can't think of a single client of ours who is doing something differently as a result of the current decline in housing prices," says Norm Boone, owner of Mosaic Financial Partners in San Francisco. "It's not likely to be a long-term phenomenon—although arguably housing prices needed to come down—and relatively few of our clients view their homes as anything other than a place to live."

Yet horror stories of underwater mortgages and double-digit depreciation are becoming more common, affecting clients' retirement in unanticipated ways.

Delaying Retirement To Work Longer

Countering the common wisdom of many financial advisors, Larry Woolever, CPA of Partnervest Securities in Santa Barbara, Calif., says, "Except for the very wealthy, the value of the primary residence has a great deal to do with retirement decisions. Support for this position comes from the increasing popularity of reverse mortgages. Although there are many reasons why a borrower would find a reverse mortgage attractive, I think there is common consensus that at the root of most of the decisions is a desire for additional cash to meet a pressing need—a nearly universal decision faced by everyone exiting the workplace and facing retirement and a reduced cash flow future."

Woolever describes an almost generic retirement dilemma for many clients near retirement. "Debts and monthly bills don't magically disappear, and clients are living longer and worry about long-term care." Not surprisingly, he says, clients look at the equity in their residence as a possible solution to a seemingly impossible problem. "The decline in real estate values increases the stress level and pressure in making these decisions," he says. "Simply stated, a major resource of the client's financial strength has declined 10%, 20% or, in some cases, as much as 30%. That is devastating!"

This is the very situation faced by one of Woolever's client couples. "Both are in failing health. He is 72 and she is 65. He has an IRA that produces $8,000 yearly, they collect $22,000 in Social Security and he's presently employed, earning about $30,000 annually. Their major debt obligation is a $1,600 monthly [PITI] payment on a 6%, $117,000 mortgage. The residence was at one time worth about $400,000. Unfortunately, it would probably bring only $275,000 in the current market." On the positive side, says Woolever, the clients have saved $265,000 in nonqualified money and have a $100,000 second home that is debt-free and in which they can live.

What effect did the decline in these clients' home value have on their retirement plans? Woolever says they decided to postpone retirement. The man will continue to work as long as his health permits, they'll pay off the mortgage to save the 6% interest and free up the monthly payment, and they'll wait out the real estate market slump to reap a better selling price on their home. "Had their home still been worth the $400,000, giving them $253,000 in equity—$283,000 less an 8% sales commission—plus their $265,000 of savings, they'd have $518,000 in assets and about $26,000 of income, nearly as much as the husband's wages," he continues. "Instead, selling today would leave about $393,000 to invest and about $20,000 per year at 5%. That amount of sacrifice was enough for

them to decide to postpone retirement, continue working, invest what they have and hope for at least a partial recovery in the real estate market."

Ted Feight's mid-50s clients, Tim and Amy, planned to retire in 2006 or 2007 when they would have sold their Michigan home and purchase lakeside land in North Carolina on which to build a large retirement home. But the Michigan home market is in a full-blown recession and the clients' home has taken a heavy hit, says Feight, owner of Creative Financial Design in Lansing, Mich. "Since they have not retired and their current lifestyle is good, they've decided to continue working and wait for the housing market to come back. We've told them that we believe we're in a seven-year cycle—a cycle we've seen twice before over the last 35 years—and that we believe we're just entering the fourth year," says Feight, adding, "They seem to be OK with waiting and working another three years."

Delaying Continuing Care To Rebuild Equity

Whereas Woolever's clients were depending on their home equity to help finance their retirement, Delia Fernandez, owner of Fernandez Financial Advisor LLC in Los Alamitos, Calif., had a client who just wanted a temporary place to live and a little appreciation in home value before moving into a retirement community.

"This client came to me three years ago," says Fernandez. "After having purchased a condo for $600,000 with an interest-only mortgage, she can afford at $3,700 per month PITI—an expense she shares with her [live-in] boyfriend/partner. But they only expected to live in the place until she followed him into retirement."

Now, says Fernandez, the client is looking at a June 2010 mortgage reset that will require her to pay down a fully amortized mortgage balance of $484,000— something she's not eager to do. They had hoped to sell, tap the equity and move into a retirement community with graduated care, explains Fernandez, but the client's home has lost $100,000 in value in the past year and a half and is still falling, so she's put those plans on hold. "She shopped this month for a refinance to see if she could [keep her payments low], but lenders have labeled her neighborhood as one that's declining in value and, even though we're in one of the regions where the conforming rate has reset for 2008 to $729,250, several lenders have told her she'd have to pay $67,000 to buy down the loan and get the best rate."

And even if the client can get, say, an interest-only loan for seven years, Fernandez has pointed out that in seven years her condo may not be worth any more than it's worth now—and it could be worth less. "So I've asked her to consider selling the place and renting instead," says Fernandez. "She could probably rent a comparable place for $2,500 per month versus the $3,700 per month they're now paying, which would lower her monthly expenses [depending on the tax effects]."

Renting may not be a long-term solution for someone who just retired, she says, but given that the client hoped to move anyway, it's a step toward her goal of being free to relocate.

Delaying Common Sense To Invest Everything In Real Estate

Even if your client's residential property values are intact, that's still not reason to assume he'll be OK.

Michael Kothakota's client retired two years ago and began to invest in real estate. "He

decided that my tired old asset allocation strategies weren't going to help him," says Kothakota, an advisor with Edward Jones in Raleigh, N.C. "This 56-year-old withdrew his entire $1.2 million portfolio to invest in several markets, including Las Vegas, Phoenix and Jacksonville, Fla., spending much of his savings traveling to those places to 'do deals.'"

Trying to look out for his client, Kothakota fought him tooth and nail until finally the client fired him, calling him a hack. "Now he's out of money, will need to go back to work soon, and he's back asking me for strategies to recoup his lost assets. Other than him, I've managed to keep my clients above water with appropriate asset allocation strategies."

Dare we say it—there's at least one in every practice. And Chuck Rylant of C.J. Rylant Wealth Management in Santa Maria, Calif., has his, too. "Our most recent client came to us because all of his net worth was in rental properties in Bakersfield. For the past few years he has been pouring all of his savings into rentals hoping to create a fortune. One of his properties that two years ago appraised at $570,000 recently sold for $345,000. He was able to purchase this home with only 3% down and was similarly over-leveraged in all of his properties—plus, he had not diversified outside of real estate." When property values declined, says Rylant, the client was forced to sell many of these homes because he didn't have enough cash flow to keep up with the mortgages.

Fortunately, most of Rylant's clients are between the ages of 35 and 50, so the "consolidation" of California's real estate markets shouldn't derail their long-term plans. "But these recent events do affect them emotionally," says Rylant. "We've recently attracted to the practice some clients who were previously 'do it yourselfers' as well as a couple of new clients who were simply frightened of [this economic environment]."

Delaying Panic By Making Small Adjustments

Donald Cummings of Chicago-based Blue Haven Capital sees discomfort even in clients who probably needn't worry about the effects of declining housing prices on their overall financial picture.

"We recently had a client express some concern that his home's value had dropped from $1.6 million to around the $1.2 million area. His concern was that if he needed to sell, the $400,000 that he would not receive might adversely affect his long-term income generation. Mathematically, I don't think it would have made a big difference, but we raised his portfolio targets to a 63% stock and 37% bond allocation from 60% and 40%. The rebalancing served a psychological purpose to calm him down a bit."

The net long-term result of the recent housing price dip is probably zero for this client, says Cummings. But what his experience points out is that, while the housing market fall is affecting some clients in a very real, quantitative way, it's affecting others in primarily an emotional way. Clients need not only to be solvent, but also to feel solvent, too.

Some observers argue that baby boomers—the demographic group now entering retirement—are less likely than earlier generations to have worked with an independent financial advisor (if only because they're just now beginning to receive inheritances, business sale proceeds, etc.) and more likely to seek advice from name-brand providers, like wirehouses. This poses an additional problem because, in an environment where products must be sold so that brokers can make a living, many of these new clients will be encouraged to tap into home equity for reasons that may or may not benefit them. In

other words, the “sanctity” of home equity—the refrain of advisors like Sestina and Holland—will be viewed in ways that may lead to more panic down the road.

But if all else fails, maybe you could try this approach (imprudent as it may seem): Charles Stanley of Capital Financial Advisors LLC in San Diego, reports, “An insurance salesman friend of mine panicked recently when he lost value in the residence he’d been viewing as his retirement nest egg to be sold in two to three years. Planning to use a major portion of the proceeds to fund an immediate annuity, his house value is now insufficient to purchase that annuity. Having recently been introduced to a new version of life settlements, he instead took a settlement on one of his life insurance policies and purchased another life policy on which he’ll take a life settlement after he has owned it for two years.”

All we can say is that—for some soon-to-be-retirees—desperate times will call for desperate measures.

An independent financial advisor since 1981, David J. Drucker, MBA, CFP, has also been a familiar journalistic voice since 1993. Drucker’s entire body of work can now be purchased at www.DavidDrucker.com in 14 compendiums, by topic.