SHOULD YOU CHANGE YOUR FEES? P. 50

Financial Planning

INVESTED IN ADVISERS / SEPTEMBER 2016

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THE C SE OF T E MIS ING INCOME SO RCE

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THE MISSING INCOME SOURCE

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BY CHARLES PAIKERT

"We're not changing the way we plan, but we're changing the conversation," says Kacy Gott, senior financial manager for Meritas Wealth Management in Larkspur, Calif.

PHOTO BY PATRICK STRATTNER

In her office in Bloomington, Minn., Janet Stanzak keeps a crystal ball on a table.

"It's a humble reminder that we cannot predict or know the future," says Stanzak, principal of the Bloomington, Minn., planning firm Financial Empowerment, and the 2015 Financial Planning Association chairwoman.

The crystal ball is employed most often when clients come in to talk about their own futures.

Clients are worried about rising health care costs, taxes and having enough money to maintain their lifestyle, Stanzak says. Historically, fixed-income yields have been a stalwart pillar of retirement savings. But yields have been in a long, steady decline.

In July, the yield on 10-year U.S. government bonds fell to a historic all-time low: 1.36%. In mid-August, the rate was 1.51%. The highest-rated 10-year corporate bonds were yielding less than 2% at that time.

And the prospect of rates rising sharply anytime soon appears remote.

The Social Security and Medicare Trustees Report for 2016 is projecting real interest rates — subtracting for inflation — will average 2.7% over a 75-year period.

Investors could see total bond returns as low as 0% to 1% over the next 20 years, according to a recent report by consulting giant McKinsey.

When it comes to clients' worries about loss of income due to the dismal interest rate environment, Stanzak points out that, even though interest rates are low, the rate of inflation has also been minimal.

As a result, Stanzak and other planners say they are focused on asset returns minus inflation.

"Because of the inflation environment, what we need for a real return of around 3.5% to 4.5% with stocks

Making the Most of Social Security

These are worthy strategies for maximizing government retirement income for married couples — even ones headed for divorce.

DELAY FILING

Follow the golden rule for Social Security planning: Delay filing for benefits. This helps protect against one of the greatest risks to retirement income — living longer than anticipated. Longevity risk has become a major concern for planners as life expectancies continue to rise. Consider a married couple where both spouses are 65. There is now a 50% chance one will live till 92, and a 25% chance one will make it to 97.

Historically low interest rates make delaying a better deal than ever. With 10-year Treasuries paying barely over 1%, the guaranteed 8% increase for each year delayed in monthly Social Security payments for life is hard to beat.

COUPLES' STRATEGIES

Last year, Congress did away with the popular file and suspend strategy. However, other features that benefit married couples remain a pillar of Social Security.

The most basic is the spousal benefit. It provides 50% of the worker's benefit to the spouse, who is at least 66 years old, even if that spouse never had a single day of Social Security-eligible earnings.

The restricted filing strategy remains available for anyone born before Jan. 1, 1954. This approach works best when each spouse has a significant work history. Restricted filing allows a person at least 66 years old to claim spousal benefits while simultaneously allowing benefits based on his or her own work history to continue to accrue delayed retirement credits until age 70. At that point, he or she switches to his or her own, higher, benefit.

PLAN FOR SURVIVING SPOUSE

One important goal of retirement planning is to maximize income for the surviving spouse. When one spouse dies, household income can immediately drop significantly, while there may only be a modest decrease in expenses.

The survivor benefits provide the surviving spouse with the higher of either their own benefit, or 100% of their deceased spouse's benefit. Best planning typically entails delaying filing for benefits of the highest wage earner as long as possible until age 70.

REMEMBER THE EX

If a client is divorced from a marriage of at least 10 years and not remarried, he or she is eligible to claim spousal or even survivor benefits based on the work history of the ex-spouse. The ex-spouse need not even have filed for benefits, and it is not necessary to notify the ex-spouse. Surprisingly, if your client remarries after his or her 60th birthday, he or she can still collect survivor benefits based on the ex-spouse . — *Paul Norr*

Paul Norr is a CFP with Bucks County Financial Planning Group in Thousand Oaks, Calif.

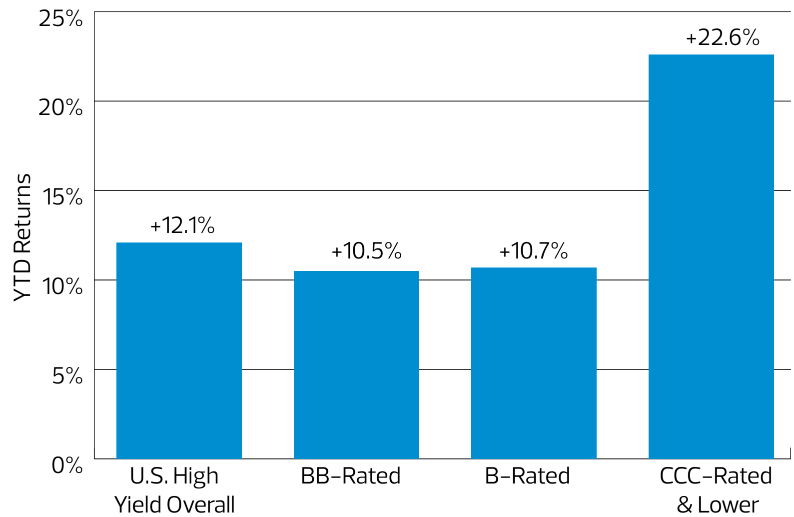
and bonds over the long term is not over the top," Stanzak says. "Even clients who are in their 60s are looking at a 30-year timeline for retirement planning. We're not going to blow up our entire investment philosophy because of the state of interest rates today."

Kacy Gott, senior financial planner at Meritas Wealth Management in Larkspur, Calif., agrees.

"For younger clients — those more than three years away from retirement — we're maintaining long-term real-return expectations of 3.5% to 4%," Gott says.

Though Risky, High-Yield Bond Rates Are Tempting

Total return by category as of July 31



Source: Morningstar, Lord Abbett

A MODEL PORTFOLIO

To achieve those returns, Meritas is using a model portfolio composed of approximately 25% to 30% in fixed income and 70% to 75% in equities.

The fixed-income holdings now have a shorter time horizon and must be of high quality, Gott says. Such portfolios include DFA and Vanguard funds, while 2% or less is in cash, and 6% or 7% is in TIPS.

Equities in the portfolio are overweighted in value stocks, primarily large- and small-cap domestic and international holdings. Domestic and international REITs compose less than 10% of Meritas' model portfolio.

Low interest rates are causing many clients to hold higher than normal levels of cash, notes Ben Emons, chief economist and head of credit portfolio management for Intellectus Partners, a San Francisco-based RIA.

"But," Emons says, "you have to manage liquidity well" — and keep an eye out for investment opportunities.

"A lot of asset classes are improving," he points out, citing companies in the energy market as an example.

High-quality corporates may also be an opportunity, he says, as are "selective" emerging markets assets, keeping in mind currency risks.

'NO MAGIC PILL'

"There's no magic pill to create income in a low-interest-rate environment," Scott Highmark, president of St. Louis-based Mosaic Family Wealth, likes to remind his clients. "You want to structure your portfolio in retirement so you know where your cash is coming from, and be cautious and thoughtful about implementation."

Highmark advises clients to consider dividend-paying stocks that may offer double the yield of 10-year Treasuries.

Despite advisers' warnings, clients who are willing to accept risk and are desperate for yield have been flocking to ETFs specializing in emerging-market bond funds and high-yielding funds holding junk bonds.

The risk may be high, but the yields are tempting: CCC or lower-rated bonds were posting yields around 14% through late July.

Opportunistic clients, particularly the wealthier ones, have more choices, says Greg Curtis, chairman of Greycourt & Co., a Pittsburgh-based family office.

"If a client can manage the behavioral stresses of a 90% stock portfolio — and that's a very big 'if' for most investors — moving to a more aggressive asset-allocation strategy might be preferable to settling for 3% annual returns," Curtis says.

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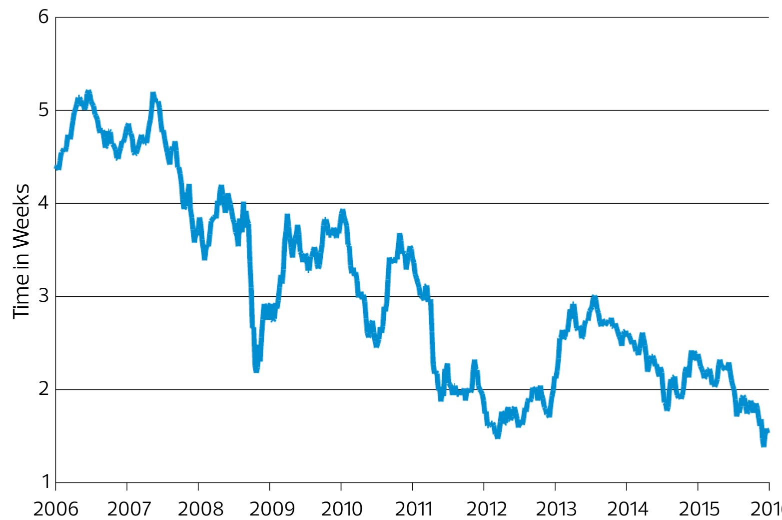
Benchmark Bond on the Decline

Yields on the 10–year Treasury have fallen to historic lows.



Source: Federal Reserve

Select clients may also want to take advantage of the premium for illiquidity, Curtis says.

"Investments that aren't immediately liquid offer investors a return premium over similarly risky investments that are liquid," he notes.

Clients who want to profit from illiquidity need to "identify areas of appropriate illiquid opportunities and invest with the best managers in each sector, typically found in venture capital, private equity, private real estate and long/short hedge funds," Curtis says.

REAL ESTATE BOON

For many clients, especially those who have 30-year mortgages on homes that have increased in value, low interest rates may actually be advantageous when it comes to their retirement planning.

Even clients who have refinanced their home loans in the past few years may find solid financial gains from adjusting their mortgages again. Just calculate how long it takes to amortize the costs of making the change.

"The government is subsidizing part of the interest, so if you have a 3.5% mortgage, after tax, it's 2.5%. If you pay off the mortgage, it's a guaranteed return of 3.5%. But over a 30-year time horizon, equities should earn more than 3.5%"

To be sure, in an ultralow interest rate environment, it's prudent to recalibrate the expectations put forward to a client.

"We're not changing the way we plan, but we are changing the conversation," Gott says. "There has to be lower expectations."

Part of that readjustment means advisers will have to input more-realistic future rates of return for a retirement-planning needs analysis, says Michael Finke, dean and chief academic officer at the American College of Financial Services in Bryn Mawr, Pa.

"If advisers are using a Monte Carlo tool, they'll be using historical asset returns, and they might be giving clients an overly rosy picture," Finke says.

Indeed, advisers should remember that global political and economic unpredictability could fuel continued low rates, cautions Emons.

"Uncertainty has been one of the biggest drivers of interest rates," Emons says.

"And it's hard to see how that's going to change with the U.S. elections coming up this year, European elections next year and a potential surprise from OPEC."

CALCULATOR DISCREPANCIES

When making retirement-planning estimates for income, advisers must be very careful when selecting which calculators they use.

A recent study of retirement income projection calculators by Corporate Insight, a New York research firm, found a spread of approximately 60% between the largest and smallest projections.

"Advisers have to be aware that the returns from the calculations they are using today may be wrong," says Andrew Way, senior retirement analyst for the firm. "Nothing is more dangerous than false confidence."

But advisers should also remind clients that times can change abruptly and unexpectedly.

"The crystal ball reminds us how hard it is to see beyond the moment," Stanzak says. "Rates are low now, but won't be forever." **FP**

Charles Paikert is a senior editor of *Financial Planning*. Follow him on Twitter at @paikert.