

RETIREMENT RESOLUTIONS

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Meet Tom and Sandy Thompson. Approaching the end of their careers, they are using the New Year as a starting date to answer their financial questions

So, have you seen enough in this and other editions of *Coastal Style* to decide this is the lifestyle for you? Is a house by the bay or ocean the next place you want to call “home”? If you’re like many of us, the lure of long morning walks on the boardwalk, sandy beaches, spontaneous weekday fishing trips, mid-day rounds of golf or just the smell of the salt air can launch you into a mind-tingling world of “how can I make this home?” and “can I afford to retire now?”.

As financial planners, we meet many people with this same dream. The New Year is a particularly good time to start the process of answering the questions of how to make these dreams a reality. But where do you start?

Meet Tom and Sandy Thompson. Tom is a 58-year-old executive with a major corporation. Sandy is a 57-year-old math teacher with 30 years of service. They have been coming to the beach every summer, bringing their family and their family’s family for the past 30 years. It is the one true place where Tom and Sandy can share an inner sanctum. They currently live in a home valued at \$750,000, outside a major metropolitan area. Their 30-year mortgage has 10 years left before it’s fully paid. With three grown children who are financially independent, they have been able, for the past five years, to maximize their annual savings, pay off their monthly debts, and amass a retirement portfolio worth \$1.4 million. Both Tom and Sandy will be eligible to collect their full pensions this coming August.

It’s New Years Eve. As the ball drops, Tom and Sandy raise their glasses and make a New Year’s resolution - this is the year they will determine how they can make their lifelong dream of escaping to the beach come true. Excited with anticipation, they start bright and early New Years Day pulling together the facts that will help them lay out a plan for potential retirement the following August.

Cash Flow

Sandy suggests that much of this decision will be based on their expected cash flow. She takes out her monthly budget sheet and lists all of their on-going expenses. She then makes a second column to adjust those items that might change once she and Tom move to the beach. She understands that while some costs may go down, her recently retired friends have warned her that during those first years of newfound freedom, many retired couples eat out more frequently, spend more time pursuing expensive hobbies, and participate in frequent social events. She also knows a new house would bring additional costs for such things as decorating, landscaping, and new furnishings (the old stuff just wouldn’t look “beachy”).

While reviewing their budget, she pays particular attention to health care, utilities, entertaining, home improvements, and gifts. She is shocked to see that over the past five years, her utility bills have more than doubled. This reminds her that the expenses that she is evaluating would grow over time. She wonders what inflation rate she should assume and which expense items would be most impacted.

In addition, she is also wary of the need to provide for contingencies - those unexpected expenses that tend to “pop out of nowhere” - new heaters, septic system repairs, new roofs, etc. And then there are the children and grandchildren who can always use “a little help”, and aging parents who may not be as financially set as they originally thought. These surprise expenditures can frequently overwhelm the historical expense reductions we’ve been taught are typical for the recently retired.



Since Sandy is working on the expense side of their cash flow, Tom begins to evaluate their income sources. Both of them have defined benefit pension plans provided by their employers. He has heard there are several payout options with his pension including a lump sum distribution, a single life annuity, and a 50% joint and survivor annuity option. He makes a note to talk to his human resources department to learn more about these options and then consult with a financial professional to further evaluate. For now, he assumes he would take the 50% joint and survivor option which provides 50% of his pension to Sandy should he predecease her. For Sandy, there is no lump sum option, but a variety of annuity options that she also needs to discuss with her human resources department and advisor.

Next, he takes a look at the social security statements they both receive each year. He notes that the earliest they can begin to receive their benefits is at age 62, which is over three years for him and six years for her, after their target retirement date. But in choosing this early start date, he sees that their benefits would be significantly reduced below what they would have received at full retirement age of 66.

When Tom and Sandy start comparing their income to their expected expenses, they detect a definite gap. The gap is most pronounced before they begin their social security benefits. Adding additional debt load by taking on a higher mortgage payment for a new house would only make this situation worse. Since pensions make up a significant portion of their income and do not increase with inflation, some additional measures to reduce costs and/or identify additional sources of income that can keep pace with inflation would be needed to maintain their lifestyle.

Home selection

Sandy and Tom are wondering how much money they'll have to put toward a new home at the beach after selling their current home. Looking at their most recent mortgage statement, they see that they have an outstanding loan balance of \$216,000. So if they sell their house for \$750,000, they would expect to have \$470,000 in cash, after 8% closing costs and realtor fees, to purchase a home at the beach. The beach house where they have been spending their summer vacations is about the same size as their current home. It is listed for sale at \$1 million. While the location is perfect, it is really oversized to accommodate large family vacation gatherings. How often would they really need that many bedrooms to house all the children and grandchildren at the same time? From a financial standpoint, even if they put down all the money from their current home, mortgage payments would be over \$3,000 a month, putting a severe squeeze on their discretionary spending. Dropping back a little in size, they decide to look for something smaller in the same area, and set a goal to buy something for \$750,000 or less.

To mortgage or not to mortgage

From their cash flow analysis, Tom and Sandy realize that the size of their mortgage would be a significant factor in achieving a comfortable alignment between their expenses and their income. Should they apply all the proceeds from the sale of their current home to the cost of their new home, or should they put the minimum 20% down typically required to avoid private mortgage insurance and invest the rest? Should they take additional funds from their retirement portfolio and not have a mortgage at all? Should they choose a 15 or 30-year term? Should the mortgage be a fixed rate or variable?

They list the factors they must consider in making these decisions:

- Current loan rate vs. their expected rate of return on their retirement portfolio.
- Flexibility of being able to access additional cash as needed from their retirement portfolio if some of the proceeds were added to the retirement portfolio vs. used as a down payment.
- Tax liability incurred if they had to take the additional funds from a tax-deferred account.
- Tax benefit of the mortgage interest deduction.
- How comfortable they are with debt?

These are all good topics to discuss with an expert.

Investment Portfolio Income

One potential source to fill the income gap would be distributions from their retirement portfolio. However, they realize that

the majority of their retirement assets are held in tax-deferred employer-sponsored retirement accounts that may be subject to a penalty in addition to ordinary income tax when accessed before age 59-1/2. Tom recalls that as long as he doesn't rollover his company-sponsored plan to an IRA, he would be able to take withdrawals without penalty since he would be over age 55 when leaving the company. Sandy would have the same option with her plan through the school district. Even if they can avoid the penalties, however, withdrawals from these tax-deferred plans would be taxed as ordinary income. A better option may be to take money out of their taxable accounts first to take advantage of the preferential long-term capital gain tax rates, and allow their tax-deferred accounts to continue to grow as long as possible.

Tom and Sandy are not very interested in investments. They would rather spend their time with their family or enjoying their many hobbies. They have never given much thought to their investment strategy, but now that strategy is very important since it would be a major source of their new paycheck. They plan to consult with their financial planner to determine an appropriate investment strategy that would give them the best chance to produce a steady income stream that keeps up with inflation without taking excessive risk.

Part Time Employment

In the short term, before they are eligible for social security and the income-to-expense gap is the greatest, Tom and/or Sandy could consider working part time. Tom has been approached by his current employer to determine if, upon retirement, he would be willing to return as a consultant for a limited number of days per month. He is going to pursue this discussion further to see if they can agree on specific terms. With Sandy's years of experience, she should not have a problem finding a part time teaching position in the growing community to which they are relocating. The key, of course, is not to inadvertently trade off a full time career in their current location, only to inherit another full time career here in their dream location. For most retirees, the gap isn't typically that big and the job only needs to provide enough income to avoid accessing their retirement nest egg too soon. By electing part time employment vs. accessing their retirement portfolio too soon, not only can some of the tax pitfalls and penalties be avoided, but a longer period without withdrawals allows for more build up of funds so there is more to begin with when they no longer want to work at all. In addition, part time work can provide a social bridge that allows you to meet new friends, find out who's doing what in the community, and promote a more gradual and natural pace for reduction of structured time commitments.

Relocating, whether it's upon retirement, company relocation, or alternative employment, is always accompanied by many decisions and critical transitions. Change of states can bring particular challenges related to legal status and documents, including the validity of wills, trusts, durable powers of attorney, drivers licenses, etc. While many of these items can be added to the list, it would appear Tom and Sandy have done some very good thinking about the most critical issues in deciding how to make their dreams a reality. It's a complex set of steps and considerations that have to be carefully analyzed and periodically reevaluated. Having a coach such as a Certified Financial Planner™ or other trusted advisor can be an invaluable asset.

***Editor's note:** Ted Fischer and Burt Hutchinson are partners in the firm of Fischer & Hutchinson Wealth Advisors of Lewes, Del. and are a Registered Investment Advisors. Fischer & Hutchinson provides financial planning and investment advisory services to individuals, trust funds and non-profit organizations. For more, call 302-644-3540 or visit <http://www.fhwealthadv.com/>.*