Ep49: The Most Common Retirement Mistake

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PATTI BRENNAN: Hi, everybody. Welcome to "The Patti Brennan Show." Whether you have $20 or $20 million, this show is for those of you want to protect, grow, and use your assets to live your very best lives.

Today I have Sam Baez with us. Sam is a portfolio manager here at Key Financial, and what I think you're going to find, and what I love about Sam is he really takes a holistic approach to managing money.

It's not just about the pie chart for Sam. He really looks at every individual client's situation to determine the best strategy based on what might be happening today, tomorrow, and for the rest of that person's life.

Sam, welcome to the show.

SAM BAEZ: Thank you, Patti. Thank you for having me.

PATTI: Here we are. We're talking about the most common retirement mistakes, and boy, have we seen them, haven't we?

SAM: Sure have, yeah.

PATTI: To me, it's such a privilege to be able to walk people through different strategies and really take the steps necessary to prevent our clients from making the mistakes that people make over and over again, not because they want to, but because they just don't even realize what those mistakes are.

SAM: Sure.

PATTI: Today you and I, Sam, are going to solve that problem. How about it?

SAM: All right, let's do it.

PATTI: I'm going to ask you these questions based on your experience, and I'll chime in based on what we've discovered together.

	If you were to pinpoint one mistake, Sam – just one mistake – what do you think is the most common mistake people make as they're looking at this retirement horizon?
SAM:	That's a great question, Patti. Obviously there are a number of things to consider when planning for retirement, but I think the most important thing is you have to run the numbers. You have to know where your income is going to come from, and you have to know how you develop a strategy to support that.
PATTI:	It's really interesting. When we say "run the numbers," we are literally running cash flow statements for every year for the rest of that person's life. We're integrating the tax planning, so we're running the tax calculations and considering that as part of the cash flow needs.
	Is it fair to say that oftentimes people are surprised when you actually run the numbers? I don't know about you. Some people come in, and they think, "Oh, Sam, I'm never going to be able to retire."
SAM:	Running the numbers is extremely important when looking at and then developing a plan for a client. It's a lot like taking care of your car. You have to look under the hood – look at the engine, check the oil, look at the air filters – all these different moving parts for a car, where on a daily basis, when you put gas in a car, we're ready to go.
	If we're planning for the longevity of a car, we really want to dig deeper and look at all the moving parts to make sure that we're not going to get blindsided by something that we may have taken for granted or not planned for.
PATTI:	I love that analogy, Sam. I've never used that, and it's a great one, because that's exactly how many of us drive every day.
	We just throw the gas in the car and go. In reality, we do have to take it in from time to time and get our inspections, make sure the brakes are working, make sure that the engine's running, that the oil hasn't turned black on us – although I think oil is black anyway.
	But you know what I mean.
SAM:	Yeah.
PATTI:	It's a really good point, because if one part of this car isn't working, it is not going to go. Or, it'll go, but it won't be efficient. Frankly, it won't last for the 10 years that most of us want to keep our cars. That is not the way you want to go into a retirement, that's for sure.

SAM: Exactly. Piggybacking on the same analogy, a lot of times even when something's wrong, a car will continue to run. You won't even know anything is wrong. A lot of that can happen with retirement, but the last thing you want to do is figure that out 10 years in.

PATTI: Boy, you are not kidding, because then it really is too late, so why not just run the numbers? I think, to take it one step further, isn't it true that when you run the numbers, you're not just running a baseline based on what we think is going to happen? We're going to stress-test it, right?

SAM: Absolutely.

PATTI: Tell me more about that.

SAM: That's actually one of my favorite things that we do, because – I don't want to say it's easy to paint a rosy picture, but we can certainly make certain numbers work, in a sense, as long as everything just runs smoothly.

PATTI: Right. How often does life run smoothly?

SAM: I'll let you answer that question.

PATTI: Yeah.

SAM: It very seldom does, and I think planning ahead will help. Even if things do run smoothly for the duration of your retirement, knowing that you have a plan for when things don't will bring a level of comfort that'll help you actually enjoy your retirement rather than worrying about it.

PATTI: It's a really good idea. Isn't it true that anxiety is fear of the unknown? If we go into this understanding the impact of a bear market right at retirement, or higher tax rates, or higher inflation, or a wedding, the cars, those things are going to...

You know when people are retired, also, Sam, guess what? People have extra time on their hands.

SAM: They sure do.

PATTI: All of a sudden, all of the things that they didn't have time to do like the home improvements and fixing this and fixing that, that really adds up. All of a sudden, people start to do those things.

If we don't include that in the scenarios, then we're going to be using capital that we were planning on for year 10 that's actually being eaten up in year 2. That is often a prescription for an early demise of a person's working capital.

SAM: Absolutely

PATTI: Now that we've identified that running the numbers is really important, what would be the next thing that you find, Sam, is often overlooked by retirees?

SAM: Once we've run the numbers, we kind of have an idea for what the short-term cash flow need is. Now at that point, you have to develop a strategy for providing that income.

It seems easier than it may actually be as far as from an efficiency standpoint, so we want to make sure that, for example, we're being tax-efficient when developing your cash flow strategy. Sometimes it makes more sense to take out of an after-tax account rather than a retirement account.

Until we run the numbers to see what your tax situation's going to be in retirement, or even a couple of years before retirement, we don't know what the most efficient strategy is for cash flow.

At the end of the day, taxes are just money paid to the IRS, so the less that we can pay, the more money you get to keep in your pocket, the more money for vacations, cars, weddings, and whatever that is.

PATTI: To be clear about this, eventually the IRS is going to get the money, right?

SAM: Sure.

PATTI: It's just a matter of deferring it to a later time. Let's say that you're in a 30 percent tax bracket. To the extent that we can defer the tax payment on $10,000, for example, by not taking it as income, taking it out of the IRA, that means that you've got that extra $3,000 left in the account to earn the rate of return.

It sounds like a little thing. Guys, it's a big deal. You do that year after year over time, the compounding aspect of this is huge. That's what we're talking about in terms of efficiency.

How about, does it always make sense to defer, Sam? What about those people who might be retiring a little bit earlier? They're 62 years old. Let's say they've got a nice big 401(k), and they've got some after-tax money. Does it always make sense to go to the after-tax money in that situation?

Let's say they're going to defer on the Social Security, too, so the only source of cash flow is going to be the after-tax accounts.

SAM: Assuming that they are before retirement age, I would say it makes sense to go to the account that's going to not have as high of a tax bill, an after-tax brokerage account.

You could take advantage of long-term capital gains rates, which back to your example, if you're in the 30 percent tax bracket, you can pay 15 percent for long-term capital gains. You're saving half the tax just right there. Again, it's sometimes tough to see that until we actually run the numbers

PATTI: It's a really interesting thing. The tax laws are the same for everyone, but everyone's situation is different.

SAM: That's correct.

PATTI: In other words, everyone is impacted differently by the exact same law. For client A, for person A, what you're referring to might be exactly the strategy that's right for them.

Client B, though, let's say that they're only going to use the after-tax money. They're getting capital gains rates, and their ordinary income rate is very low. All of the sudden, that presents some kind of interesting opportunities, doesn't it?

SAM: Sure.

PATTI: We've talked about this before in prior podcasts. For example, if a client's in a 12 percent tax bracket, guess what? Capital gains are not at 15 percent. That's a big fat zero percent.

SAM: That's right.

PATTI: That's pretty cool. If somebody's got investments or stocks that they've held for a long time, but there's a big gain, those are the years where you want to maybe take those gains, because guess what? You don't have to pay taxes on it. Or those might be the years where we do Roth conversions.

Not the whole 401(k), but let's take out a little bit each year and convert that from a pre-tax that you're going to have to pay that 30 percent, in this example, to a Roth where the money grows tax free. Is that the coolest thing in the world? I like tax-free. How about you guys?

SAM: Yeah, we love tax-free.

PATTI: Absolutely, so tax-free is the way to go.

Let's talk a little bit more in terms of other things that people ask. Let me play devil's advocate.

Somebody comes in to you and asks the question, "Hey, Sam, I'm about to retire. Do I have to adjust my standard of living? Do I need to stop spending money?"

I don't know how often people come in and say, "I'll just cut back. I really don't want to work anymore. It's killing me. I won't do the things that I want to do. I'll just cut back." What do you think about that?

SAM: I think, not to sound like a broken record here, but until we run the numbers, there's just no way of knowing. It's important for us to have all the information to build the plan so that we can let you know.

One thing I love about you, Patti, and the way that you take care of your clients is you're a straight shooter. You'll take care of everybody, but you're also telling the truth, and that, in my opinion, is taking care of your clients.

It's a matter of, "Do you need to adjust your standard of living?" You may, depending on what the numbers look like. You may be able to live even better than you anticipated.

PATTI: It's a really good point, and I think it's so important. We've got to give it to you real, because that's when the real trust, that's when all of that gets developed.

I think that if we're just winging it and say, "Oh, you can retire. You'll be fine," yada yada yada, and we're not backing it up with lots of scenarios and numbers, and, "What if this happened?" and, "What if that happened? What if the kids get married and then divorced and they move back to the house?" or, "What if we need to go to a continuing care community?"

This is life. This is life, guys. Life is kind of interesting. It just has a way of throwing those curve balls, and when the curve balls get thrown at us, it's so much easier to handle it when we understand the impact before it happens, when we recognize that these things can happen, and we can respond accordingly.

We're not going to react. We're not going to panic. We're just going to go from plan A to plan B, because before you retired, we kind of knew that that is a possibility, because it all is.

SAM: Sure, and better to see it on paper than to experience it or live through it.

PATTI: Exactly. I will tell you that I don't want to be a Debbie Downer, like I'm not Debbie Downer here. I want to be optimistic. I want to believe that everybody's going to be financially secure for the rest of their lives. As long as we're monitoring things and continuing to update the numbers…

We're not going to do this once. You don't go to the doctor when you're 50 years old and assume that you're going to be healthy for the rest of your life. No, you go in for checkups. That's basically what we do. It's all part of the planning process. Like I said before, it's a verb. It's not a noun. It's an ongoing process.

We've talked about the standard of living in retirement, and I think that, again, to kind of summarize that – important – run the numbers and include those unusual expenses like cars, weddings, home maintenance, etc., and then the stress test, those numbers too. I think that when we talk about retirees' main concerns, it really is about, do the numbers work, right?

SAM: Sure, sure, and just kind of making sure that we're being open and realistic with what we're expecting in the short term and long term.

PATTI: It's interesting, and one thing that I find often comes up – and you probably do as well – is that the one area that people don't forget about is health care. I am surprised in a way that the number one concern for soon-to-be retirees is the cost of health care.

People are cognizant of it. They recognize it, and it is an important thing. We can plan for all the greatest things in the world. We can plug in those vacations. We can plug in those weddings and the renovation, but we don't know what a person's health is going to be like.

SAM: Absolutely, and that can often be one of the most expensive variables to deal with in retirement. I do appreciate how many scenarios we run in the plan, because certain different rates of return, different jobs can kind of change the trajectory of a plan but maybe still work out. Whereas a big health event can sink a long-term plan.

PATTI: I don't know about you, Sam, but I find a lot of times when we have that conversation, especially if it's husband and wife, that the wife will say, "Well, gee, I will take care of Jon if something happens to him." Then when the event does occur, Susan realizes just how difficult it is to take care of another human being.

They do need to bring in help, so why don't we just run that and see what that looks like? We're not going to change the plans. We're not going to say you have to keep on working because we have to be careful if Jon needs care and you're going to need to hire somebody, but we do want to be aware that that is something that we have to be cognizant of.

SAM: Absolutely.

PATTI: Here is the big, big question mark. It is the market, right? The question is how much of your client's portfolio should be allocated to bonds and stocks? How do you choose the proper asset allocation for a soon-to-be retiree?

SAM: That's a great question. A lot of conventional wisdom would tell you that it depends on your age. At 65, maybe you have as much in bonds as whatever your age is, but it comes down to running the numbers and knowing what the cash flow need is.

Obviously, you have to be comfortable with the strategy yourself, so considering what your shorter-term objectives are – two to three years – that gives us a ball park for how much should be in less risky, more stable investments that we can turn to if the market were to go south on us.

We are expecting that. We never know when it's going to happen. We never know how bad it's going to be, but being prepared for it, that's how you win the game. You have to be prepared for these downturns by preparing for it for the short term. We're in this for the long term, so we want to make sure to work on both ends of the spectrum.

PATTI: OK, folks, for everybody who is listening, in the next podcast, Sam and I are going to be coming back, and we're going to get really in the weeds as it relates to how to develop a portfolio that ideally is sustainable through lots of different economic environments during retirement.

I think that this is really important, because that's the worry that a lot of people have. "How am I going to make this money last? How am I going to live off of the fruit of this tree?"

Sam Baez, thank you so much for joining us today. You've been terrific. I look forward to talking with you again as we get into the weeds about portfolio management strategies for retirement.

Thanks to all of you for listening. We, again, have been getting great feedback on these podcasts. I just looked at something, and we've gotten only five stars, so thanks to all of you who have given us those incredible ratings.

If you have any questions or want to hear about a particular subject, please come to the website at keyfinancialinc.com. Let us know what you want to hear about.

Until next time, I'm Patti Brennan. Thank you so much for joining us today.