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Ask the Experts: Financial FAQs (Winter 2015)

In this issue, we explore options for financing a second home, take a look at long-term care costs and the tradeoffs of long-term care insurance, and offer our thoughts on prudent retirement portfolio withdrawal rates. Please let us know if youâ€™re interested in learning more about these topics or have questions of your own.

Q. Whatâ€™s the best way to pay for a second home? Should I pull money out of my portfolio or take out a loan?

A. You will likely want to consider a combination of both. It may make sense to pull some money out of your portfolio to â€œbuy downâ€• your loan to get to a monthly payment you can manage. The bigger the down payment, the smaller the monthly check youâ€™ll have to write and vice versa.

That said, interest rates are low right now, making it relatively attractive to borrow rather than to fund the purchase from your portfolio. The key idea here is cost of capital. When you borrow money, your cost of capital is the interest rate you pay on the loan. When you take money out of your portfolio, itâ€™s the rate of return you would otherwise expect to earn on the investments that you liquidate to fund the purchase. Put another way, itâ€™s the opportunity cost of not having the money invested.

Take, for example, a couple with a conservatively invested portfolio who expect to earn 3 percent. If we assume a borrowing rate of 5 percent, they will be paying 2 percent more on the loan than they are expecting to earn on their portfolio. In this scenario, it doesnâ€™t make sense for them to borrow;

they are financially better off to liquidate a portion of their portfolio. (Of course, itâ€™s also important to consider the cost of taxes, if any are due.)

Now suppose the reverse is trueâ€”our couple can borrow at 3 percent and earn 5 percent on their portfolio. In this case, our couple can borrow at a lower cost of capital than they plan to make, meaning they are capturing the 2 percent spread between the two rates and pocketing the difference. Thatâ€™s a good thing.

Another issue to consider is the nature of the loan. You may want to explore borrowing options beyond a traditional mortgage. For example, home equity loans or brokerage lines of credit are sources of borrowing available at attractive interest rates that provide the flexibility to change or skip paymentsâ€”or pay down the loan to reduce monthly payments. These options may be more appealing to individuals with assets but limited regular monthly income.

Q. I am concerned about the cost of health care and long-term care during my retirement years. Should I buy long-term care insurance?

A. This is an important question since long-term care expenses are generally not covered by Medicare. According to Medicare & You, the official U.S. government Medicare handbook, at least 70 percent of people over age 65 will at some point need long-term care services such as personal assistance at home, assisted living, and nursing home care. These services are covered by Medicare only for a limited time, unless they are deemed medically necessary.[1]

Long-term care is expected to be a large out-of-pocket expenditure for many older Americans. While 70 percent of people over age 65 may experience some need for long-term care services, most long-term care episodes last one year or less. However, 12 percent of men and 22 percent of women experience nursing home stays of more than three years. Given that nursing home costs can range upward of $75,000 or more per yearâ€”depending on geographyâ€”this can become a substantial expense.[2]

Without Medicare to pay these expenses, you are left with the options of paying long-term care expenses out of pocket (self-isurance), relying on care from family members, or buying a long-term care insurance policy. Like all forms of insurance, a long-term care insurance policy is easier and cheaper to buy when you donâ€™t need it; in like, when youâ€™re middle-aged and in good health. Even then, these policies are not cheap and may seem like a significant expenditure for something that may or may not pay off. However, for those who can afford it, long-term care insurance can provide a much-needed hedge against healthcare costs (and healthcare inflation) that could otherwise create financial and family distress.

Q. I think I am doing the right things to save for retirement. When I get there, how much should I plan to withdraw from my portfolio, and not touch principal?

A. Unfortunately, the answer to this question is more complex than in years past. Due to the historically low interest rates we are experiencing, it is impossible for most investors to live in retirement strictly off of interest from a high-quality bond portfolio. Instead, it is necessary to take what are known as sustainable withdrawals from a globally diversified portfolio of stocks, bonds, and other asset classes.

The level of withdrawal that is sustainable depends upon a number of factors, including how your portfolio is invested and your expectations for longevity and inflation. Applying the 4 Percent Rule can help you estimate the level of sustainable withdrawals you might expect from your portfolio. This helpful rule of thumb suggests that an investor should be able to safely withdraw 4 percent of the value of her diversified portfolio annually (adjusted for inflation). In other words, each $1 million of retirement savings should generate $40,000 a year of cash flow. That $40,000 can be increased over time to offset the impact of inflation.

Like most rules of thumb, the 4 Percent Rule risks oversimplifying the issue. Our research indicates that 4 percent is a reasonable level of withdrawals for a 20-year period of retirement (again, given a well-diversified portfolio). If you are anticipating retiring early, or if people in your family regularly live into their 90s or 100s, a 3 percent withdrawal rate is more prudent. That approach would produce $30,000 a year, adjusted for inflation, per $1 million of savings. Meanwhile, if you anticipate a shorter periodâ€”like 10 or 15 yearsâ€”4.5 or 5 percent may be reasonable.

While these quick metrics provide some guidanceâ€”and put you into the ballpark of the level of sustainable withdrawal you might reasonably expectâ€—be careful not to rely upon them too much. Prior to making any decisions, you should perform a detailed retirement income analysis that includes all of your savings, assets, and retirement income sources, including Social Security and any pension benefits you are entitled to.

If you have a question for the VESTED team, weâ€™d love to hear from you and see if we can help. Please send your questions to us at VESTEDmagazine@captrustadvisors.com.

Sources:
[1] Medicare & You 2014, â€œCenters for Medicare and Medicaid Services,â€• accessed May 20, 2014, p. 127
[2] Jeffrey R. Brown, Gopi Shah Goda, and Kathleen McGarry, â€œWhy Donâ€™t Retirees Insure Against Long-Term Care Expenses? Evidence from Survey Responses,â€• July 2011, p. 2

Have questions? Need help? Call the CAPTRUST Advice Desk at 800.967.9948, or schedule an appointment with a retirement counselor today.

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