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THE H GROUP INC®
INDEPENDENT WEALTH MANAGEMENT SOLUTIONS™

November 2012
Volume 12, No. 3

The Long Term Times

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Having Your Cake and Eating It Too
Retirement Income Planning

One of most common questions that we are asked as financial advisors involves retirement income planning. While the question can be phrased in different ways, the gist of it goes something like this: "How can I maximize my retirement income and make sure that my nest egg lasts as long as I do?" Whether the question is asked by a member of the baby boomer generation who has just retired (or plans to in the near future), or a person somewhat older who may have been retired for some time, the level of concern is the same.

The answer is not simple and varies according to the situation of the family involved. While there is no one size fits all solution, there are some general principles to consider, and we thought it might be useful to discuss the various methodologies for retirement income planning.

For those few families who have substantial income from pensions, the pension itself may provide an answer if it is inflation adjusted. Social Security and PERS fit this definition. Assuming that the income from the pensions is sufficient to fund retirement needs and that the income will rise as the cost of living does, these individual's savings may not be the primary part of their retirement income picture. An investment plan that concentrates on growth, with a reasonable reserve fund invested in a conservative manner may be the extent of the planning needed in addition to risk management considerations we'll discuss below.

Most of us will not find ourselves in this situation, however, and for many families their savings and investments will bear the lion's share of their retirement income needs. Years ago we planners used to talk about a "three-legged stool" in regards to retirement income planning. One leg was Social Security, one was the traditional pension, and the third was the pool of savings and investments that families had accumulated. As we discussed above, most of us are short one leg (the pension) and it appears as if the Social Security "leg" may be getting shorter as well!

So what are we to do? We're either retired or will be in the next several years, we have a Social Security benefit and a bucket full of savings, 401(k)s, IRAs and other investments. We know how much we want to have each month as a "paycheck replacement" so that we can live the life we want to. What should we watch out for and how should we invest to make this happen?

First things first

The first steps involve minimizing the non-investment risks to our situation. Are you protected from the risk of catastrophic **health expenses?** You will need to develop a strategy that allows you to have the care you need and which gives you the flexibility you want in regards to location, travel, etc. Most of you have a strategy for your health insurance, but if you don't this is a good time to start. Because health insurance and health care costs have risen so dramatically, it is imperative that you have the insurance you need in place and have made provisions in your budget for the cost of insurance. This is especially true for those of you under the Medicare age of 65.

Remember, your health insurance plan does not cover the cost of ongoing non-medical care which you may need. Stays in a nursing home and home care are very expensive. Is your nest egg big enough to self-insure or should you consider the purchase of **long- term care insurance?** This can be a catastrophic expense for some, and for those families, insurance may be the best answer. Another expense for your budget and bigger withdrawals from your investments to pay for it!

Are there other risks to attend to? There may be. Do you have a pension that pays out over a single life and stops when the pensioner does? If you have a family, you will have to make provisions for that.

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Having Your Cake and Eating It Too *continued from page 1*

Once you have the catastrophic risks attended to, you can focus on an investment design that will allow you the stability to maintain your lifestyle as well as growth to keep you ahead of inflation. Remember that inflation makes your money worth less each year. So, when you think of returns on your investment, it is useful to think in terms of "real" returns or returns after inflation. If we get a 6% return and inflation is 3.5%, we have a 2.5% real return. If we get a 6% return and inflation is 6%, our real return is zero.

Certain investments tend to give positive real returns and others just about stay even with inflation with very small real returns. Stocks, long-term bonds and real estate securities have varying average real returns that tend to be positive. CDs, T bills and money market accounts tend to have very small (or these days negative) real returns. Conversely, those investments with substantial average real returns tend to be volatile, and those that don't less so.

When planning for retirement income, it's useful to have some of each sort of investment described above. Short-term investments have very predictable returns, and when stocks or bonds swoon, they won't be affected. But, too much of this sort of investment can hurt over the long run because your portfolio won't deliver any substantial real returns, and that means your standard of living will decrease as the cost of living increases. Looking from the other direction, having all your eggs in long-term investment baskets can cause you to have to sell depreciated assets when stocks or bonds fall in value. We not so fondly refer to this as "eating your seed corn."

The magic of this sort of strategy seems to be in the mix of investments used; too much of one and you'll be forced to eat your seed corn, too much of the other and you might be eating the last of your canned corn!

Several years ago we did a research study comparing the various sort of asset mixes that we thought made sense for folks who were taking income from their investments. Since that time we have refined our thinking in this regard and have developed some additional strategies that are useful, depending on the situation. If you are a client of ours, we have discussed this with you and will continue to review your overall strategy during our planning sessions. If you are not, we would be happy to have a discussion with you regarding your situation.

Medicare/Medigap

It is open enrollment for Medicare, the time of year when participants can change their Advantage plan and prescription drug plan (should they have a separate drug plan). Medicare Advantage plans can change their benefits from year to year, and that change can make a difference in out of pocket costs for some.

It's worth a trip to Medicare.gov in order to use their interactive tool to choose a plan based on costs. There is a wealth of information there, and the plan finder works pretty well if you would like to purchase a prescription drug or Medicare Advantage plan.

But what if you would like a Medigap plan?

Medigap plans have been around for quite a while. They are the original form of Medicare Supplement, paying for the things that the original Medicare won't. These plans are sold in standardized forms, Plans A through M, allowing the purchaser to easily compare plans and determine the coverage offered. One of these plans coupled with a prescription drug plan, Medicare Part D, can provide a pretty comprehensive package. And because the Medigap plan is standardized, those benefits won't change from year to year (although the price might).

The Medigap plans aren't part of the result list you get when you choose a plan with Medicare's Planfinder. Instead, you have to look around a bit and find the separate area of the Medicare website devoted to these plans. You can search for the companies that offer a particular plan in your area but can't see the plan cost in the list of results. For that it appears you have to go to the website of the particular company offering that plan. I tried this with the list of companies that offer "Plan F" and then chose the first company on the list, AARP, and was taken to the AARP Health Care website. Once there I was re-directed after a few clicks to the United Healthcare website where I finally found the price tag: $139/mo.

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Team Update

Team Update

After our wonderful late summer and fall winter is settling in here at The H Group. With the holidays upon us and the end of the year in sight it's a time to tie up some of this year's projects and begin to make plans for the upcoming year.

Winding down from a busy summer on several fronts **Scott** seems to be enjoying his time in the warm, dry office. He's happy to have gotten to spend time navigating the waters of the Puget Sound and Strait of Georgia and reports that Nanaimo bars are best eaten on the waterfront of the town for which they are named.

Fred enjoyed his usual summer camping trips with his extended family and is pretty excited about his children's successes in sports and the arts with his son getting his first varsity footb all start and his daughter preparing for her first play. He's also spent a fair amount of time this fall watching BOTH his alma mater (OSU) and the U of O with their football successes.

New Faces

Back in January of 2008, **Heather** joined our team as an administrative assistant. Since then, through good times and bad, she's served you all in her most capable way. This month Heather will be assuming a whole new set of duties here at The H Group, and we're excited for her as her career here progresses.

While we'll miss working with Heather, we're excited to announce the newest member of our team, **Sarah Fagan.** Sarah brings a wealth of talent to our group, and if you've not met her already we'll make sure you get a chance to meet the next time you visit. Sarah did her undergraduate work at OSU and received her graduate degree from George Fox. She will be stepping into Heather's role and assisting Fred and Scott with client service, event preparation and a whole host of other things.

Medicare/Medigap continued from page 2

This is a pretty daunting task, and to do this for each of the choices rather cumbersome. It would appear that Medicare has made it more difficult to access information about traditional Medicare and Medigap plans as opposed to the newer Medicare Advantage plans.

If you are purchasing Medicare for the first time your first decision point is to either:

- Choose original Medicare alone and purchase no supplemental insurance of any kind (although this has significant affects on the cost you will pay in the future for plans via an imposed penalty)
- Choose original Medicare coupled with a Medigap insurance plan and an optional separate prescription drug plan.
- Choose a Medicare Advantage plan either with or without prescription drug coverage.

In our area, Medicare Advantage is widely used. The premium cost is low and the benefits have been attractive, but it's worth taking a look at the Medigap plans and original Medicare.

Standby Reverse Mortgages for Retirement Planning

What does a successful retirement mean to you? Everyone has a different idea of what is important to them, but some of the common ingredients are reasonable health, the ability to travel and visit family and the security of not having to worry about their nest egg lasting the rest of their lives.

Not surprisingly, financial advisors spend an awful lot of time thinking about these sorts of things because a safe and comfortable retirement ranks very highly with the kinds of goals that their clients would like their money to enable. Just how to make that nest egg last a lifetime has always been an important topic for analysis and discussion.

We all know that retirement income today looks a lot different than retirement income several decades ago. Folks today are much more reliant on their savings and investments and many fewer individuals have significant income from pensions. After a decade of lackluster returns characterized by two large "bear" markets, strategies that help to preserve portfolio income are more important than ever. If we look at a few possible portfolio outcomes during the sorts of markets we saw in periods like '01-'02 and' 08-'09, we'll see why.

Let's assume a hypothetical situation that features a $1,000,000 portfolio with an annual withdrawal of 5% ($50,000). The portfolio is expected to grow at 6% - 7% and even with the withdrawal there is room for small annual growth. That growth is important because when planning for retirement income over several decades there is a need to increase the annual withdrawal by a small amount each year to account for inflation.

All seems well and good until a situation such as 2008 comes along. Stocks dropped in excess of 60% from the high in late '07 to the low in early 2009. Even assuming that bonds were not affected a portfolio 50/50 in stocks and bonds had a value decrease by close to 30%. This means that the 5% our hypothetical couple was taking from their accounts was suddenly closer to 7.5%. Or, put another way, the $1,000,000 reduced by their annual $50,000 withdrawal and reduced further by market volatility was suddenly worth only $650,000 at the bottom, a breathtaking drop in value.

This couple knows that their 7.5% withdrawal is too large of a percentage to be sustained over time. And they don't feel at all happy about having to liquidate stocks to fund their retirement income needs when they are trading at such low levels. At this point they can either reduce their income draw to 5%, sell bonds in their portfolio in lieu of stocks to provide income or permanently damage their prospects of portfolio longevity by continuing on their current course, eating their seed corn to fund current living expenses.

With a little planning the brunt of this situation could have been deflected. We've long advocated the use of a cash reserve fund - a couple years of expenses in reserve to provide income in times like these. But in these times of low interest rates, the opportunity cost for that sort of fund can be significant. That money in today's environment is earning nothing. But in the above situation such a fund would be of tremendous value, allowing the spending of that cash while waiting for the inevitable upward market movements that follow market downturns of that magnitude.

In a recent study several prominent planners created an analysis of using a reverse mortgage as a complement to traditional portfolio drawdown strategies including a reserve fund. Based on their analysis, published in the Journal of Financial Planning, using reverse mortgages had the potential to provide more favorable outcomes.

Remember, a reverse mortgage allows someone to borrow on the value of their home. Instead of repaying the loan, as happens with a traditional mortgage, the interest is added to principle and the balance grows over time. When the house is sold, the mortgage is paid and the balance of the home value goes to the owner.

Up until recently these sorts of mortgages were very expensive to establish. But, with the advent of the new Home Equity Conversion Mortgage (HECM), these sorts of loans cost much less. Just as with reverse mortgage of the past, these loans can be established for monthly income, for a lump sum or as a line of credit. In the case of the credit line it could sit untouched until needed. It is that latter incarnation that we're concerned with here.

Assuming a client had established this sort of HECM mortgage and had the line of credit available, the situation we described above could play out a lot

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About Scott L. Maxwell, CFP®

Scott L. Maxwell, CFP® has been in practice since 1993 and with The H Group since 2000. He specializes in retirement, income, investment and estate planning. In addition to client specific planning, Scott is a Vice President of The H Group and sits on the Investment Policy Committee. Scott is a charter member of the Financial Planning Association and past Board member of its local Chapter, and he's involved in several community and non-profit organizations in the Portland area.

About Fred L. King, CFP®

Fred L. King, CFP® is an Advisory Affiliate with The H Group and joined The H Group, Inc. in 2004. A graduate of Oregon State University with a degree in Business Administration, Fred has over 15 years of business experience in a variety of roles with several national firms. He specializes in retirement financial needs analysis, investment management, risk management and general financial planning for individuals and small business. Fred is a member of the Financial Planning Association (FPA) and the National Association of Personal Financial Advisors (NAPFA). Over the last six years, Fred has been an educator and judge for Oregon State University's Lifetime Financial Planning Contest. Lastly, Fred has been a contributor to Money Magazine, Wealth Magazine, and FiGuide.

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Our Blog

Each month we come across dozens of stories and ideas that might be useful for our clients. And every once in a while we just have something to say! So we've created a blog. Stop by and visit from time to time. There is even a subscribe button that will allow you to be notified via RSS about our latest updates. Go to www.pdxplanning.com and click on the blog tab!

Annual Economic Update Event – Save the Date

We're pleased to announce our 4th annual Economic Update Symposium, scheduled for January 16th at the World Forestry Center. Mr. Paul de Moor from Fidelity Investments will be sharing his insights about where we've been and where we are heading. The event is sure to be informative and useful as you evaluate your personal financial planning approach for the coming year. Look forward to seeing you there!

Standby Reverse Mortgages for Retirement Planning *continued from page 3*

differently. Instead a taking portfolio withdrawals in a down market, they would access their HECM line of credit. This would allow their entire portfolio to be managed through the market recovery. And, when recovery was sufficient in their portfolio, a withdrawal could be made to pay off the HECM. The line of credit would then sit there, established and waiting for another "rainy day."

Cash reserves and other tools, such as a HECM, can be valuable tools to help your retirement plan withstand market volatility. We're always excited to discuss ways to help make your retirement plan the best it can be.

Here is a link to the article mentioned above:

http://www.fpanet.org/journal/StandbyReverseMortgages/

Many thanks to Cal Abts, Reverse Mortgage Specialist at HomeStreet Bank for his invaluable assistance with this article