AWM Financial Planning

How Sequence of Returns Can Affect Your Retirement

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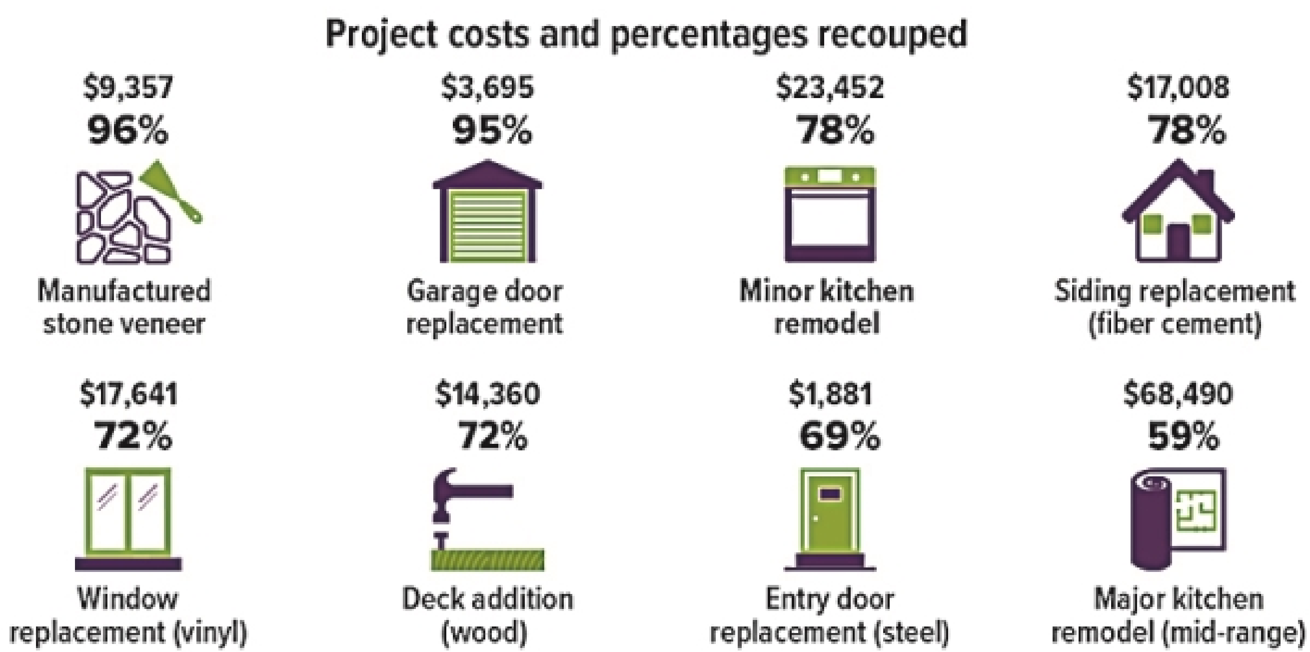
If retirement is near, make sure you are familiar with “sequence-of-returns” (SOR) risk. SOR risk is the chance of experiencing poor investment returns in early retirement (i.e. a bear market). Here is an example. Over a 10-year period, two $500,000 portfolios earned identical annual returns, but in the exact opposite order. Investor A’s portfolio earned negative returns in the first three years, and positive returns for the remaining seven. Investor B’s portfolio earned positive returns in the first seven years, and negative returns for the last three. Both investors withdrew $35,000 a year for retirement income. At the end of the decade, Investor A ended up with $337,734. Investor B had $485,532. Although both investors achieved the same 6% average yearly return over the 10-year time frame, Investor B wound up with nearly $150,000 more. Why? The results are due to the sequence of the returns. Don’t let SOR risk disrupt your retirement, give us a call to discuss how to plan for it!

Unexpected Surge in Renovation Projects

Home-improvement spending normally lags during recessions, but COVID-19 sparked an unexpected surge in do-it-yourself renovation and maintenance projects. Many households whose finances held up during the pandemic devoted time and money to making their indoor and outdoor living spaces more functional and comfortable for working, learning, and recreation.



Sources: Joint Center for Housing Studies of Harvard University, 2020; 2020 Cost vs. Value Report, *Remodeling* magazine (national averages)

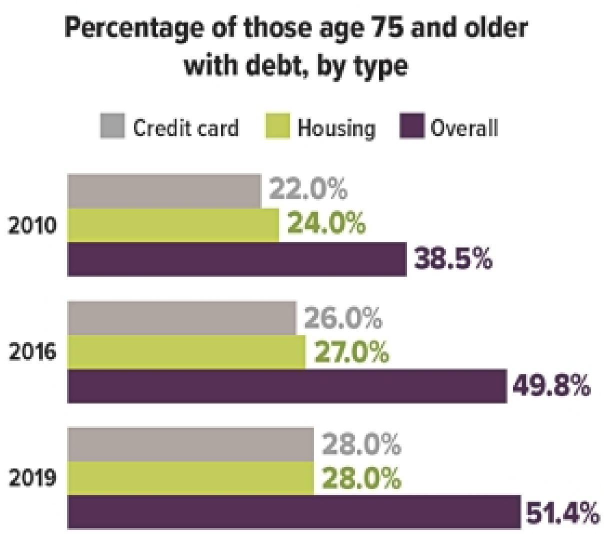
Don't Let Debt Derail Your Retirement

Debt poses a growing threat to the financial security of many Americans — and not just college graduates with exorbitant student loans. Recent studies by the Center for Retirement Research at Boston College (CRR) and the Employee Benefit Research Institute (EBRI) reveal an alarming trend: The percentage of older Americans with debt is at its highest level in almost 30 years, and the amount and types of debt are on the rise.

Debt Profile of Older Americans

In the 20-year period from 1998 to 2019, debt increased steadily for families with household heads age 55 and older; in recent years, however, the increase has largely been driven by families with household heads age 75 and older. From 2010 to 2019, the percentage of this older group who carried debt rose from 38.5% to 51.4%, the highest level since 1992. By contrast, the percentage of younger age groups carrying debt either rose slightly or held steady during that period.

Debt and the Age 75+ Population



Source: Employee Benefit Research Institute, 2020

Mortgages comprise the largest proportion of debt carried by older Americans, representing 80% of the total burden. According to EBRI, the median housing debt held by those age 75 and older jumped from $61,000 in 2010 to $82,000 in 2019. The CRR study reported that baby boomers tend to have bigger debt loads than older generations, largely because of pricey home purchases financed by small down payments. Consequently, economic factors that affect the housing market — such as changes in interest rates, home prices, and tax changes related to mortgages — may have a significant impact on the financial situations of both current and future retirees.

Credit-card debt is the largest form of nonhousing debt among older Americans. In 2019, the incidence of those age 75 and older reporting credit-card debt reached 28%, its highest level ever. The median amount owed rose from $2,100 in 2010 to $2,700 in 2019.

Medical debt is also a problem and often the result of an unexpected emergency. In the CRR study, 21% of baby boomers reported having medical debt, with a median balance of $1,200. Among those coping with a chronic illness, one in six said they carry debt due to the high cost of prescription medications.

Finally and perhaps most surprisingly, student loan obligations are the fastest-growing kind of debt held by older adults. Sadly, it appears that older folks are generally not borrowing to pursue their own academic or professional enrichment, but instead to help children and grandchildren pay for college.

How Debt Might Affect Retirement

Both the CRR and EBRI studies warn that increasing debt levels may be unsustainable for current and future retirees. For example, because the stress endured by those who carry high debt loads often results in negative health consequences, which then result in even more financial need, the effect can be a perpetual downward spiral. Another potential impact is that individuals may find themselves postponing retirement simply to stay current on their debt payments. Yet another is the risk that both workers and retirees may be forced to tap their retirement savings accounts earlier than anticipated to cope with a debt-related crisis.

If you are retired or nearing retirement, one step you can take is to evaluate your debt-to-income and debt-to-assets ratios, with the goal of reducing them over time. If you still have many years ahead of you until retirement, consider making debt reduction as high a priority as building your retirement nest egg.

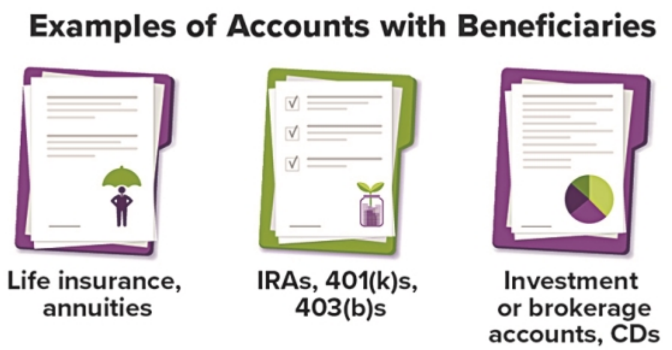
Sources: Center for Retirement Research at Boston College, 2020; Employee Benefit Research Institute, 2020

Life Insurance Beneficiary Mistakes to Avoid

Life insurance has long been recognized as a useful way to provide for your heirs and loved ones when you die. Naming your policy's beneficiaries should be a relatively simple task. However, there are several situations that can easily lead to unintended and adverse consequences you may want to avoid.

Not Naming a Beneficiary

The most obvious mistake you can make is failing to name a beneficiary of your life insurance policy. But simply naming your spouse or child as beneficiary may not suffice. It is conceivable that you and your spouse could die together, or that your named beneficiary may die before you do. If the beneficiaries you designated are not living at your death, the insurance company may pay the death proceeds to your estate, which can lead to other potential problems.



Death Benefit Paid to Your Estate

If your life insurance benefit is paid to your estate, several undesired issues may arise. First, the insurance proceeds likely become subject to probate, which may delay the payment to your heirs. Second, life insurance that is part of your probate estate is subject to claims of your probate creditors. Not only might your heirs have to wait to receive their share of the insurance, but your creditors may satisfy their claims out of those proceeds first.

Naming primary, secondary, and final beneficiaries may avoid having the proceeds ultimately paid to your estate. If the primary beneficiary dies before you do, then the secondary or alternate beneficiaries receive the proceeds. And if the secondary beneficiaries are unavailable to receive the death benefit, you can name a final beneficiary, such as a charity, to receive the insurance proceeds.

Naming a Minor Child as Beneficiary

Unintended consequences may arise if your named beneficiary is a minor. Insurance companies will rarely pay life insurance proceeds directly to a minor. Typically, the court appoints a guardian — a potentially costly and time-consuming process — to handle the proceeds until the minor beneficiary reaches the age of majority according to state law.

If you want the life insurance proceeds to be paid for the benefit of a minor, consider creating a trust that names the minor as beneficiary. Then the trust manages and pays the proceeds from the insurance according to the terms and conditions you set out in the trust document. Consult with an estate attorney to decide on the course that works best for your situation.

Per Capita or Per Stirpes Designations

It's not uncommon to name multiple beneficiaries to share in the life insurance proceeds. But what happens if one of the beneficiaries dies before you do? Do you want the share of the deceased beneficiary to be added to the shares of the surviving beneficiaries, or do you want the share to pass to the deceased beneficiary's children? That's the difference between per stirpes and per capita.

You don't have to use the legal terms in directing what is to happen if a beneficiary dies before you do, but it's important to indicate on the insurance beneficiary designation form how you want the share to pass if a beneficiary predeceases you. Per stirpes *(by branch)* means the share of a deceased beneficiary passes to the next generation in line. Per capita *(by head)* provides that the share of the deceased beneficiary is added to the shares of the surviving beneficiaries so that each receives an equal share.

Disqualifying a Beneficiary from Government Assistance

A beneficiary you name to receive your life insurance may be receiving or is eligible to receive government assistance due to a disability or other special circumstance. Eligibility for government benefits is often tied to the financial circumstances of the recipient. The payment of insurance proceeds may be a financial windfall that disqualifies your beneficiary from eligibility for government benefits, or the proceeds may have to be paid to the government entity as reimbursement for benefits paid. Again, an estate attorney can help you address this issue.

Review All Your Beneficiary Designations

In addition to life insurance, you may have other accounts that name a beneficiary. Be sure to periodically review the beneficiary designations on each of these accounts to ensure that they are in line with your intended wishes.

The cost and availability of life insurance depend on factors such as age, health, and the type and amount of insurance purchased.

Can Creditors Take Your Retirement Savings? It Depends

Given the immense financial hardship inflicted by the COVID-19 pandemic, a rise in personal bankruptcies could be waiting in the wings. For those whose livelihoods have been hit the hardest, it might be important to review the creditor protections that apply to their retirement accounts.

The extent to which assets are protected can vary significantly, depending on the type of account and applicable federal or state law. Being aware of the details can help individuals in financial or legal jeopardy determine whether and/or when they should file for bankruptcy to preserve their retirement funds. It may also help them avoid costly rollover mistakes.

Employer Plans

Most employer-sponsored retirement plans, such as 401(k)s, provide virtually unlimited protection against both bankruptcy and non-bankruptcy general creditor claims under the Employee Retirement Income Security Act of 1974 (ERISA). An example of a general creditor claim is when a person files a lawsuit and wins a judgment in court against the account owner. Thanks to ERISA, creditors cannot attach retirement account funds to satisfy any debts or obligations, regardless of whether bankruptcy has been declared.

Solo 401(k) plans, which are often utilized by self-employed individuals and independent contractors, are not covered by ERISA. This means that solo 401(k) plans — along with other non-ERISA employer plans such as 403(b)s, 457(b) governmental plans, and SEP and SIMPLE IRAs — do not receive non-bankruptcy creditor protection under federal law, though they are fully protected from bankruptcy under the Bankruptcy Code. (Outside of bankruptcy, general creditor protection is based on state law.)

IRAs and Rollovers

Traditional and Roth IRA contributions and earnings are protected from bankruptcy up to $1,362,800 per person until April 1, 2022. This limit is for all accounts combined and is adjusted for inflation every three years. Rollovers from employer plans, including SEP and SIMPLE plans, do not count against this cap. However, the U.S. Supreme Court ruled unanimously that IRA assets inherited by nonspouses are not protected under the Bankruptcy Code.

General creditor protection for traditional and Roth IRAs is based on state law, as it is with SEP and SIMPLE IRAs. So, account owners should carefully consider their own state's general creditor protections before rolling fully protected ERISA plan dollars into an IRA. Those who change jobs should remember they may have two other options: leave savings in the former employer's plan or transfer them to a new employer's plan, if allowed. Unfortunately, retirement account withdrawals and pension benefits paid as income are no longer protected from bankruptcy, so creditors may wait patiently and stake a claim to retirement funds after they are withdrawn.