6 RISKS THAT MIGHT THREATEN YOUR RETIREMENT

A GUIDE FOR INDIVIDUALS AND FAMILIES TO IDENTIFY THE UNFORGIVING RISKS THAT MAY TARNISH THE GOLDEN YEARS.

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6 RISKS

THAT MIGHT THREATEN YOUR RETIREMENT

I've been helping families plan for retirement for over 20-years now. During this time, I've witnessed families thrive throughout their golden years with grace and dignity. Unfortunately, I've also seen the darker side swallow families whole, leaving them in disarray. It is near impossible to insulate yourself from all risks.

I've highlighted 6-risks that are unforgiving and can tarnish the golden years in short order. Our Massachusetts north shore-based financial advisory firm, Stonehearth Capital, has been helping families manage risks and identify opportunities now for almost 40-years. I've put together this report with the help of my colleagues to highlight each risk and to share with you some of the ways we address each of them.

Disclosure: The identified risks and ways to address these risks are not meant to be specific recommendations for YOU.

You will notice that there are often multiple ways to address the risk and the one that works best for you should be implemented only after a thorough analysis has been done by you or with the help and guidance of a professional (like us).

We are welcoming new clients and would love the opportunity to discuss your situation to see how we can help.

LONGEVITY RISK

1

OUTLIVING YOUR MONEY

Longevity risk is the risk of running out of assets while you are still living – in other words, outliving your money. The shift away from defined benefit pension plans to defined contribution plans such as 401(K) plans, has transferred the burden of longevity risk from employers to employees. An increasing number of retirees must now take it upon themselves to ensure they don't outlive their assets.

Here are a couple solutions that we typically explore with families to address longevity risk:

Optimize Your Social Security Benefits

Social Security offers guaranteed lifetime income. Maximizing Social Security benefits is a great way to address longevity risk. Social Security may be your only inflation-adjusted, lifetime-guaranteed source of income. It also does not have investment risk. Maximum Social Security benefits can be obtained if you can delay claiming benefits until age 70. This often requires that you supplement your income using portfolio assets until you start Social Security benefits, but for someone who is focused on longevity risk it is worth considering.

Income Annuities

An income annuity is an agreement between you and an insurance company whereby they promise to pay you income over your lifetime. Since the payments last your lifetime, this is an effective way to address longevity risk.

Watch Your Spending

Another way to reduce longevity risk is to spend less. This will help reduce portfolio withdrawals, thereby extending the lifespan of your portfolio. Tracking your spending and creating budgets is the first step to identifying how to lower expenses. Our clients have the option to use eMoney Advisor to track their spending and to build budgets. Another viable option is Mint.com.

Take On More Risk

Over long stretches of time (10+ years), higher risk investments typically produce a higher rate of return. This can help bolster the size of your portfolio which decreases the chance that your portfolio will run dry before you pass. Remember there is no guarantee that taking on greater risks will result in higher returns. Tread carefully here.

SEQUENCE OF RETURN RISK

2

LARGE LOSSES SHORTLY BEFORE OR AFTER RETIREMENT

Sequence of Return (SOR) risk is when you experience large losses in your portfolio either shortly before or after you retire. Retirees who need to take withdrawals during these periods may watch their once solid financial plan come under severe stress. Not to mention, by drawing down assets when markets are weak means they may not have enough assets to participate in a recovery to help put them back on solid ground.

In order to fully understand the impact of sequence of return risk, as well as how the outcomes can differ, it makes sense to look at an example. Let's look at three different $1mm portfolios over a 30-year period of time, each with an average annualized return of 5%, while taking annual withdrawals equal to $40K, inflation-adjusted at 3.74%.

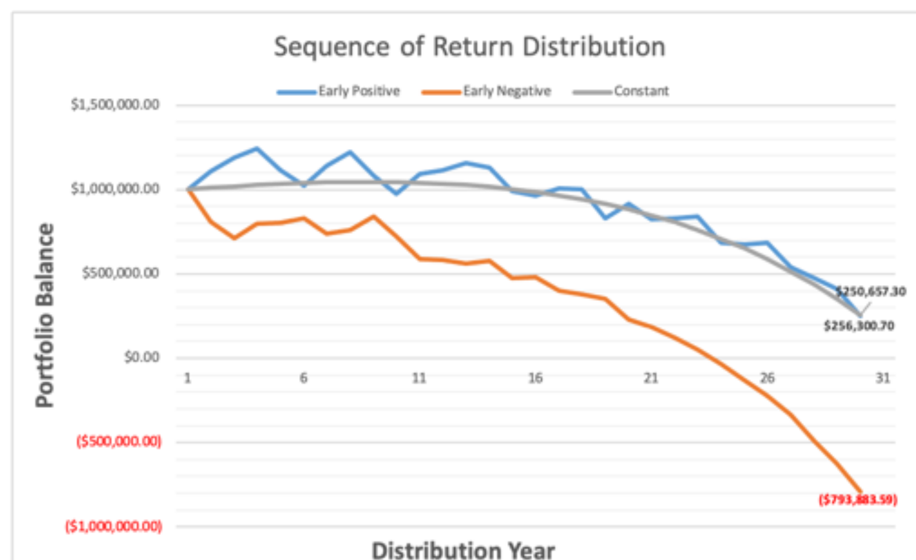
- **Early Positive:** Positive returns in the beginning
- **Early Negative:** Negative returns in the beginning
- **Constant:** Constant 5% return

As you can see from the chart, even though all three of these scenarios experienced similar annualized returns, the timing of those returns resulted in drastically different outcomes.

Here are a couple solutions that we typically explore with families to address SOR risk:

Reduce Expenses

If you can reduce your expenses then you won't need to take as much out of your portfolio to supplement your other income sources. This leaves more money in the portfolio that can be used to participate in the recovery when the market enters the expansion phase. It is usually helpful to make a list of your expenses and put them under one of two categories; needs and wants. Focus on those expenses under the "wants" category to see if there are expenses that can be trimmed, or even eliminated.



SEQUENCE OF RETURN RISK, *cont.*

2

LARGE LOSSES SHORTLY BEFORE OR AFTER RETIREMENT

Reduce Portfolio Risk
There is a natural tendency to reduce portfolio risk as you age because you are no longer saving money and your time horizon is shorter. There are three primary ways to accomplish this:

- Stocks are where most of your portfolio risk comes from. If you want to reduce your portfolio risk, then you should consider reducing your stock exposure. For example, prior to retirement, your portfolio might have contained 60% in stocks, but after you retire you might drop that to 45%.

- We typically suggest that families maintain 5%-10% in cash, savings accounts or CDs. For the next 5-years after you retire you might consider bumping this up to 10%-15% so that if markets selloff then you can supplement your income needs from these more secure accounts to give your stock exposure time to recover.

- Increase your exposure to guaranteed income sources. There are two primary sources:
    - Purchase an income annuity (as mentioned above under longevity risk) that guarantees income throughout your lifetime.
    - Delay claiming Social Security benefits to age 70. Every month that you delay claiming benefits, the government increases the amount that they are willing to pay you for the rest of your life.

LONG-TERM CARE RISK 3

LTC NEEDS MAY IMPACT THE ENTIRE FAMILY

Longer life expectancies and rising costs for long-term care (LTC) needs can create a financial hurdle that should be explored as part of a comprehensive retirement plan. In many cases, family members provide most of the care when needed. If there is a LTC need, the demands of the situation may impact the entire family, including a spouse and adult children. Not having a plan in place can lead to tension among family members. Sixty-two percent of caregivers say caring for a parent has negatively impacted their own financial futures.[1] It is important to think about how you will pay for an LTC event if it happens.

Since 1965, medical expenses have grown 44% faster than general inflation, which could cause any dedicated LTC benefits to erode more quickly than anticipated.[2] The cost of care varies depending on the specific setting where the care is provided (home vs. facility) and your geographic location, as well as the level of care that is required.

There are common misconceptions about how LTC expenses can be covered. Medicare does not cover home healthcare, or custodial care, such as your stay in an assisted living facility or a nursing home.[3]

Medicaid can pay for LTC services, but you must financially qualify, which means as an individual, you cannot have more than $2,000 in total assets. Additionally, Medicaid is set up to pay for nursing home care – the least desirable type of care for most people.

A plan to self-fund LTC expenses can be a potential option for some higher net worth individuals, however, as illustrated by the costs listed above, using income and savings or selling assets may leave a surviving spouse with significantly fewer financial resources or reduce a legacy planned for heirs. Another consideration with self-funding LTC expenses is liquidity. If wealth is tied up in a business, real estate or an investment portfolio, consideration must be given to the ability to access needed capital in a tax-efficient manner.

Seven out of 10 Americans who reach age 65 will need some type of LTC during their lifetimes.[4] There are ways to address the risk of a LTC event derailing your financial well-being in retirement. One of the primary methods of mitigating this risk is through LTC insurance. With LTC insurance, you can protect yourself from a risk that is simply too great to be ignored. An LTC insurance policy can help provide the benefits to keep you at home, where most people would prefer to receive their care.

[1] AgingCare.com, "Family Caregivers Beat the Burden of High Elder Care Costs," June 2019.
[2] U.S. Department of Labor. Consumer Price Index (CPI) for All Urban Consumers, Unadjusted, and the Medical Care Component of the Consumer Price Index for All Urban Consumers, Unadjusted, 12/31/65 – 12/31/18. Past inflation is no indication of future inflation.
[3] Medicare can cover up to 100 days in a nursing home, after a hospital stay of three consecutive days, but only the first 20 days are covered 100%.
[4] U.S. Department of Health and Human Services.

LONG-TERM CARE RISK, *cont.* 3

LTC NEEDS MAY IMPACT THE ENTIRE FAMILY

Even for people who realize the potential benefits of this coverage if they have a LTC event, most people hate the thought of paying premiums for a policy they may never need. The good news is that there are types of insurance coverage that can provide benefits whether you need LTC services or not.

Planning for LTC expenses ahead of time can serve to mitigate the potentially devastating financial impact to a retirement portfolio that these expenses can pose. It can also give you the flexibility to choose to stay in a familiar, comfortable environment to receive your care. One approach is to not attempt to offset all costs of a LTC need.

Many people would be fine to look at benefits that will cover the cost of home care and/or assisted living care, not the full cost of a nursing home. Like other risks that can derail a retirement plan, such as outliving your money, or investment-related risks, the cost of LTC is also a risk that should be addressed in any comprehensive financial plan.

PORTFOLIO MANAGEMENT RISK 4

SELECTING AND MONITORING A PORTFOLIO TO MEET YOUR GOALS & OBJECTIVES

Portfolio management is the task of selecting and monitoring a portfolio of stocks and bonds to meet a set of goals and objectives. As you enter your retirement years, your supplemental income needs (beyond Social Security and/or pension income) will likely come from your portfolio. Therefore, it is essential that you commit the **time**, **energy** and **resources** needed to put together a thoughtful process for managing your portfolio.

Here is a list of some of the more important areas to proactively explore:

Match Time Horizons
An investor's time horizon is the length of time they plan to stay invested before they will need all or a portion of their capital returned to them. Typically, the more time you have, the more risk you can take. Stocks are risky and should be used for longer time horizons of five years or longer while bonds are less risky and are more appropriate for shorter time horizons.

Risk Tolerance
How would you feel if your portfolio dropped 20% over the next 6-months? How about if it dropped 40% or 50%? Investors ability to stomach the different ups and downs in the market coupled with their time horizon, goals, objectives, knowledge, and personality is known as their risk tolerance. Developing a portfolio that aligns to your goals but is also one that you can remain committed to in times of stress is crucial to keeping a sound retirement plan on track. Individual investors can see for themselves what their risk tolerance is by utilizing the services offered through institutions like Charles Schwab or the University of Missouri Personal Financial Planning Department.

Asset Allocation
The balance between stocks and bonds as well as different asset classes or investments is known as your asset allocation. Your asset allocation should match your time horizon and risk tolerance results. There are tools online to help research an appropriate asset allocation for your portfolio, such as Portfolio Visualizer.

PORTFOLIO MANAGEMENT RISK, *CONT.*

4

SELECTING AND MONITORING A PORTFOLIO TO MEET YOUR GOALS & OBJECTIVES

Don't Concentrate
Warren Buffet once stated that diversification is a protection against ignorance. To us, a concentrated position is one that makes up more than 10% of a total portfolio value. While it is important to reduce concentration risk, it is also important to weigh this against other factors such as taxes and step-up in cost basis rules.

Ready or Not, Here Inflation Comes
Over the past 30-years, insulating a portfolio against a rise in inflation hasn't been something investors have had to contend with. While inflation is still extremely low, it is anticipated that inflation is going to continue to rise as a result of the unprecedented fiscal stimulus we have seen over the past few years. As a result, investors constructing a retirement portfolio should consider adding asset classes which may help hedge inflationary risk.

Looking Beyond Traditional Stocks & Bonds
Portfolios for today and going forward should consider including asset classes such as international stocks, emerging market equities, and alternative investments such as precious metals, managed futures, high yield bonds and global bonds, to name a few. While all of these solutions may not be appropriate for each investor it is important to understand that today's investing landscape and product offerings have changed and you might benefit from adding some of these other types of asset classes to your portfolio.

Rebalance
Portfolio rebalancing is a relatively easy way to manage risk and potentially improve your portfolio performance. Each asset class that you decide to include in your portfolio should have "guardrails" to ensure that you maintain a weighting to each asset class that resembles your original intent. This process will help ensure that you follow a "buy low, sell high" mentality.

Accountability
Every investor should have an investment policy statement (IPS) that outlines how you are going to manage your portfolio. You are managing your life savings. That is a very important responsibility and should be given the time, energy and resources necessary to increase your probability of success. Morningstar has a six-step plan for creating an IPS that you can check out here.

INCOME TAX RISK 5

"YOU MUST PAY TAXES. BUT THERE'S NO LAW THAT SAYS YOU GOTTA LEAVE A TIP."[5]

Morgan Stanley ran an ad that said "You must pay taxes. But there's no law that says you gotta leave a tip."[5]

The tax code is ridiculously complex. Every time Congress makes a change, I am guaranteed employment for another five years. Despite its complexity, the long-term tax planning goals are rather simple. First, find ways to reduce your income. Second, find ways to increase deductions. And third, find ways to increase credits.

Stop leaving the government a tip! Instead, check out these tips:

Reduce Your Income

- **Tax Loss Harvesting**
  - If you have a taxable account (personal, joint or trust), then each year you should consider selling any positions that are at a loss. The losses that we accumulate can be used to offset other gains that we take within the portfolio throughout the year. If we end up with more losses than gains, we are allowed to use up to $3K of these excess losses to offset other forms of income (including wages). Any remaining losses can be carried forward to following years, indefinitely.
- **Philanthropy, Qualified Charitable Distributions**
  - If you are age 72 or older, you are required to take minimum distributions from your retirement account (RMD).
  - These distributions are usually fully taxable and must be reported as income on your income tax return. If you are charitably inclined, then you may want to consider donating some, or all, of your RMD (up to $100K) directly from your IRA to a qualifying charity as a qualified charitable distribution (QCD). This will reduce, or possibly eliminate, the need to report the distribution as taxable income, helping to reduce your AGI along the way. As a result of the Secure Act, the age to begin RMDs has been pushed to 72, but QCDs are still available to those who reach age 70.5. Also, be careful not to violate the "ordering rules" and be mindful if you also plan to make a deductible IRA contribution, since these can negatively impact QCDs.
- **Solo 401(K) Plan**
  - If you run an owner-only business with no employees and work over 1000-hours a year (except your spouse), then you should take a look at solo 401(K) plans. Not only are you allowed to make employee contributions, but you can also make an employer profit sharing contribution of up to 25% of your income (20% net income for unincorporated businesses).

[5] Forbes.com, "Hate Taxes? 12 More Quotes You'll Love," January 2013.

INCOME TAX RISK, *CONT.* 5

"YOU MUST PAY TAXES. BUT THERE'S NO LAW THAT SAYS YOU GOTTA LEAVE A TIP."[5]

- **Delay Claiming Social Security Benefits**
  - Every year that you delay claiming Social Security benefits, the benefit increases by 5%-8%. Up to 85% of your Social Security benefit needs to be reported on your income tax return. This means the remaining balance does not need to be reported and therefore represents tax-free income. As a result, the larger the benefit, the more tax-free income you can receive.

Increase Your Deductions

- **Philanthropy, Highly Appreciated Stocks**
  - Within a taxable account (non-retirement), if you paid $100K for Apple stock and it is currently worth $500K, then most people would describe the value of Apple stock as $500K. However, taxes have not yet been paid, which reduces the value. If you sell the stock, you could owe federal taxes at a rate as high as 23.8% (federal). This means the real value is actually closer to around $400K. If you and your family plan to donate money to charities, consider donating appreciated stock instead. Charities do not pay taxes. So, you get to write-off the pretax amount and the charity gets to keep the full value. This is a win-win for both parties.

Increase Your Credits

- **Have more kids!**
- **Consider energy credits.**

Increase Your Income... What?

- **Medical Expenses & IRA Distributions**
  - If you have high medical expenses, then you want to make sure that you have the taxable income necessary to use your medical expense deductions. Unused medical expense deductions do NOT carry-forward, so use it or lose it. IRA distributions are usually fully taxable and therefore offer a quick and easy way to increase your taxable income so you can use the deductions. If you have plenty of non-retirement assets to cover your medical expenses, then you may want to consider doing an IRA-to-Roth conversion to generate taxable income to use up your medical deductions.
- **IRA to Roth Conversion**
  - IRA-to-Roth conversions are a missed opportunity for many families. When a family's taxable income is currently lower compared to what they expect it to be later in life (say after age 75), then you may want to consider an IRA-to-Roth conversion. This typically happens between retirement and RMDs. The conversion will push the family's effective tax rate higher than it otherwise would be, however, this helps to lower RMDs and taxable income starting at age 72. Conversions have the ability to help a family save money on taxes (over their lifetime), plus you can pass more after-tax assets on to your loved ones as an inheritance.

[5] Forbes.com, "Hate Taxes? 12 More Quotes You'll Love," January 2013.

INCOME TAX RISK, *CONT.* 5

"YOU MUST PAY TAXES. BUT THERE'S NO LAW THAT SAYS YOU GOTTA LEAVE A TIP."[5]

I'll Bet You Didn't Know

- **Massachusetts Short-Term Capital Gains Rate**
  - When you hold an investment for greater than 12-months before selling it then it will be considered a long-term capital gain and the profit will be taxed at a rate of 5.00% in Massachusetts. When you sell the investment within the 12-month period, it will be considered a short-term capital gain and will be taxed at a 12% rate in Massachusetts. [6]
- **IRA Contributions**
  - Massachusetts is one of the few states that does NOT offer a deduction on your state income tax return for IRA contributions. The federal government DOES allow for a deduction provided you meet certain criteria. This means that you can have pre-tax funds in an IRA from the federal government's point of view, and after-tax funds from Massachusetts' point of view.
  - It is important to track the after-tax contributions so that when you start taking distributions you "recover" these after-tax funds and do not pay taxes twice on the same dollars. What makes this unique is that all other "deductible/non-reportable" retirement plan contributions do get a tax break in Massachusetts. It is just IRA contributions that are treated differently.

[5] Forbes.com, "Hate Taxes? 12 More Quotes You'll Love," January 2013.
[6] Tax rates. (n.d.). Retrieved February 17, 2021, from https://www.mass.gov/service-details/tax-rates

ESTATE PLANNING RISK 6

ESTATE PLANNING DOCUMENTS SHOULD WORK TOGETHER TO MATCH YOUR WISHES.

Estate planning is the process of putting together the instruments necessary for the management and distribution of a person's estate during their life and after death. It is important that your estate planning documents, account titling and beneficiary designations all work together to match your wishes. Otherwise, unintended consequences may occur. Here are a couple areas to explore:

Important Life Stages

- **18-Year-Old**
    - Most states use age 18 as a demarcation of when a child enters adulthood. When this happens, a child's parents no longer automatically maintain the authority to make legal and medical decisions for them. As a result, it is important for someone turning 18 to consider naming someone they trust to help make legal and medical decisions on their behalf if they are unable to. The primary documents that should be considered at this age are the health care proxy, the living will and the durable power of attorney for finances.
- **Marriage**
    - The next likely milestone is marriage. When someone gets married, it might be appropriate to update the health care proxy, the living will and durable power of attorney for finances to give the new spouse the authority to make legal and medical decisions on behalf of the incapacitated spouse. "Sweetheart" wills are typically used which simply leaves everything to the surviving spouse.
- **Divorce**
    - It is important to review estate planning documents after a divorce.
- **Parents**
    - When children enter the picture, the "sweetheart" wills need to be updated to identify a guardian to care for the child. If a guardian is NOT identified, then the local courts will appoint one. For most families, this provides enough incentive to obtain a will so they can identify a guardian.

ESTATE PLANNING RISK, *CONT.* 6

ESTATE PLANNING DOCUMENTS SHOULD WORK TOGETHER TO MATCH YOUR WISHES.

- **Retirees**
  - Retirement is an ideal time to dust off the estate planning binder. Review each of the estate planning documents to ensure that the named individuals within each are still appropriate and match desired outcomes. This might also be a good time to explore whether or not trusts would be a good addition to the estate plan, especially if your estate is large.
- **Losing a Spouse**
  - After a spouse passes away is another reason to review the family's estate plan.

To Probate or Not To Probate?
Given the choice "to probate or not to probate," most would choose the latter. Probate is a public process involving the court systems to help distribute a decedent's estate. The key to avoiding probate is to eliminate the need to rely upon the decedent's will.

There are three primary ways to avoid probate:

- **Trusts**
  - Trusts can add a bit of complexity; however, they give the decedent more flexibility in managing and distributing assets "from the grave." Beneficiaries are typically identified within the trust document which eliminates the need to review the decedent's will, thereby avoiding probate. Trusts also have the added benefit of being discreet which appeals to those who want to keep their financial affairs private.
- **Joint Ownership**
  - The second way that assets can pass on to someone else while avoiding probate is through joint ownership. If a bank account is owned jointly with another individual, that account will automatically pass to the surviving joint owner provided it was titled joint with rights of survivorship (JTWROS).
- **Beneficiaries**
  - Naming a beneficiary on a particular account prevents the asset from having to flow through the decedent's will and the probate process. A beneficiary designation supersedes the decedent's will. Beneficiary designations can be listed on most accounts, for example, life insurance, annuities, retirement accounts, brokerage accounts and bank accounts. To name beneficiaries on real estate, families should consider a trust.

ESTATE PLANNING RISK, *CONT.* 6

ESTATE PLANNING DOCUMENTS SHOULD WORK TOGETHER TO MATCH YOUR WISHES.

Estate Taxes
Estate taxes, otherwise known as "death taxes" or "inheritance taxes," are owed by estates that exceed certain thresholds (aka exemptions). With a federal estate tax rate as high as 40%, this is an area that should be discussed. States also have the ability to levy a death or inheritance tax. Currently 17-states levy such a tax.

Here is a cool chart that shows which states, the exemption amount and the maximum tax rate (for 2019). Here in MA the exemption is $1mm and the maximum tax rate is 16%.

Ways to Reduce/Eliminate Estate Taxes

- **Estate Tax Sensitive Trust**
    - A traditional estate planning strategy for wealthy families is to have the decedent's share of the estate moved to an irrevocable trust so the assets are not included in the surviving spouse's estate when they pass. This allows the family to double the federal exemption, reducing estate taxes.
- **Portability**
    - A few years ago, Congress passed the portability rule giving surviving spouses the option to file an estate form to preserve any of the federal exemption that was not used by the decedent. In essence, this has negated the need for irrevocable trusts since surviving spouses can still double the exemption through the new portability rule if they pay attention to filing requirements. Irrevocable trusts may still be valuable in states that charge estate or inheritance taxes, like Massachusetts.
- **Other Strategies**
    - Most strategies include some form of gifting assets or giving up control of assets to help reduce the size of the decedent's estate that would be subject to estate taxes.
        - Annual gifts to people ($15K per person in 2021)
        - Funding 529 college savings plans
        - Moving money to irrevocable trusts

DISCLOSURES

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