LEWIS
WEALTH MANAGEMENT

Quarterly Newsletter

2nd Quarter 2018

Executive Summary

The capital markets are relatively flat this year, and this makes some investors restless and anxious.

Sometimes this anxiety comes from a deeper concern about whether they are on track to meet their long-term goals or whether they are saving enough money. Making matters worse, they have no objective data to verify or address their fears or concerns.

Some of these fears are real. There is a real retirement crisis looming in this country. As baby boomers start to retire in large numbers, the crisis will start to emerge.

Other fears are not real. You will likely not end up as a "bag lady" or a department store greeter or living under a bridge. These are silly thoughts, but we *all* have them.

Our underfunded Social Security system will run out of money in 2034, and medical expenses are on the rise. These problems must be addressed.

In the meantime, you are best served by taking control of your own retirement and financial future. This will require a real financial plan prepared by a real financial planner – not an informal spreadsheet or an online calculator.

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Market Data as of June 30, 2018

		2nd Qtr 2018
U.S. Equities	Russell 3000 ETF	3.84%
International Equities	MSCI EAFE ETF	-1.01%
Emerging Markets Equities	MSCI Emg Mkts ETF	-7.99%
U.S. Bond Market	Barc Agg ETF	-0.16%
U.S. Bond Short Duration	Barc U.S. 1-3 Year ETF	0.41%
Hedging Strategies	Credit Suisse Hedge Fund	0.10%
Commodities	S&P GSCI Comm ETF	7.82%
Real Estate	iShares U.S. Real Estate ETF	7.81%

The capital markets are relatively flat so far this year, and this makes some investors restless. These investors worry about whether they are making progress toward their long-term goals. They go in search of higher returns. What they usually find is additional risk just in time for the market to turn down.

In my experience, ***some of this anxiety is not about the capital markets; it's coming from a deeper concern about whether they are really on track to meet their long-term goals***. And they usually have no objective data to validate their concerns. It is really about the fear that they are not on track or are not saving enough. They have exceptionally high expectations that their investment portfolio will produce outstanding, positive returns each and every year. They are ill equipped to weather adverse market conditions that are present from time to time.

Restless, they move from one investment approach to another in search of higher returns instead of stepping back to make sure they have an objective, viable, and realistic plan to meet their long-term goals. Let's discuss.

Am I Saving Enough for Retirement?

This question probably produces more financial anxiety than any other. In this installment of the newsletter, I want to discuss the looming retirement crisis in our country and how to make sure you are not part of it.

The American Retirement Crisis

According to the *Wall Street Journal*, Americans are reaching retirement age in worse financial shape than the prior generation for the first time since Harry Truman was president.[1]

They have more debt than ever before. They are still paying off their homes and their children's educations. They are also paying for the care of aging parents.

The average 401(k) will bring in a median income of under $8,000 a year for a household of two. Pensions are a thing of the past for most people.

The household savings rate in the United States is currently 3.2%.[2] This is far short of what is necessary to build a nest egg for a healthy retirement.

Average Americans are placing their hopes on Social Security to provide for them during their retirement. But the program has been in trouble for some time. It's a demographic issue. As baby boomers start to retire, there are more recipients than workers contributing to the fund.

When Social Security was originally designed during the Great Depression, people lived shorter lives. Recipients were expected to draw benefits for only a few years. As we live longer, retirees are drawing benefits for 20 or 30 years or more.

According to the Social Security Administration, the trust fund will run out of money in 2034. Fixing Social Security is relatively simple. A combination of solutions will have to be employed: increasing payroll taxes, eliminating eligibility for high-income recipients, reducing benefits, raising retirement ages. But the politics are hard. None of the solutions will appeal to voters on either side of the aisle. So we keep driving toward the end of the cliff.

Failure is not an option. For millions of Americans, Social Security will be their only source of income during retirement. Without Social Security, many low-income retirees will have no resources to meet their basic needs like food, clothing, and shelter. ***The program must survive. It will – but it will look different, especially for younger workers***.

Making matters worse is the rising cost of health care. Medicare provides catastrophic coverage, and supplemental coverage does not always cover the rest. Retirees will have to pay rising supplemental

[1] Gillers, Tergesen, and Scism, "Retirement Will Be a Problem for Too Many." *Wall Street Journal*, June 22, 2018.
[2] The Federal Reserve Bank of St. Louis (May 2018).

coverage premiums and large deductibles for prescription drugs. Ask any retiree and you'll find that medical expenses are one of their largest financial concerns.

I expect that many Americans, for the first time in history, will be working longer and living on less. It's a sad state of affairs, especially for the richest nation on earth. People will debate how all these challenges will be met and who is to blame for the sad state of affairs of the average American retiree.

Your best defense is taking personal responsibility for your own retirement and not relying exclusively on the government for your well-being.

Are You Saving Enough for Your Retirement?

This is a complicated question. In his book *Your Money Ratio$*, Charles Farrell attempts to answer this question with the capital-to-income ratio (CIR). The CIR assumes that if you have capital worth about 12 times your gross annual income at age 65, you should be able to live on about 80% of your preretirement income.[3]

To calculate your CIR, add up your retirement assets, including your savings, 401(k) plans, IRAs, annuities and CDs, the cash value of your life insurance, the money you have set aside in any other savings accounts, equity in commercial real estate (not your primary residence), and the fair market value of any business interests.

Your Age	Capital-to-Income Ratio (the multiple of your annual income you should have accumulated)
25	0.1
30	0.6
35	1.4
40	2.4
45	3.7
50	5.2
55	7.1
60	9.4
65	12.0

Calculate your CIR and see where you stand. A lot of people are behind this schedule. If that is the case, what should you do?

First, don't panic. Resist the temptation to bury your head in the sand. Each year that you get closer to retirement, your financial issues get harder to solve. In my experience, people's actual situation is almost never as bad as they believe. ***You likely will not be a "bag lady" or a department store greeter or live under a bridge. These are silly thoughts, but we all have them, believe me***. When we complete a financial plan, we feel a lot better.

[3] Farrell, Charles, *Your Money Ratio$* (2010) Penguin Group, at p.17.

Bill and Sarah Smith – A Fictitious Case Study

Bill (50) and Sarah Smith (49) live in a prosperous suburb. They have two boys, ages 15 and 17. Bill is an executive-level professional. Sarah is a teacher at the local elementary school. Bill earns an annual salary of $250,000. Sarah's salary is $50,000.

They have accumulated a total of $650,000 in their retirement accounts and $150,000 in additional savings. They expect an inheritance of $100,000 from Sarah's mother sometime in the next 10 years. Their total retirement savings is $800,000 so far, which is an impressive number.

They are maxing out Bill's 401(k) and Sarah's 403b. Every few years, they save an extra $10,000 when Bill gets a bonus. They are getting ready to send the kids to college and have accumulated $200,000 in two 529 accounts. They know that college bills in the next few years will add additional financial stress.

They live in their dream home. It is worth $800,000. They refinanced their mortgage four years ago, pulling out $100,000 for a new kitchen and some additional improvements. The new loan is a $500,000 30-year fixed mortgage.

They want to retire in 2033, when Bill turns 65 and Sarah turns 64.

According to the CIR, the Smiths should have saved $1,560,000 by age 50 ($300,000 in total income times 5.2). According to the CIR, they are behind. They want to know what to do next.

How Much Do the Smiths Really Need in Retirement?

After some discussion, the Smiths felt that they could live on less than 80% of their current income in retirement. Also, they realized the CIR does not factor in Sarah's school pension, which she anticipates will be $25,000 per year. So, instead of living off $240,000, they could manage on something more like $160,000, especially if they ditch their $2,500 monthly mortgage payment when they retire and college bills are a thing of the past (more on both of these items shortly). This move alone gets their CIR right back on track.

Are There Any Savings Opportunities?

The Smiths do not really know how much they are spending. They think it's about $12,000 a month, but they are not sure. How can they determine this amount?

There are two ways to do this. The first is by starting from the bottom up. This involves tracking your expenditures for several months, categorizing those expenditures, making a budget, and tracking your progress. This is the best method, but everyone hates it, and therefore no one does it.

The second method is to work from the top down. This involves taking a look at your income, taxes, and savings and realizing that you are spending the rest. You can do this calculation on the back of an envelope.

Here is the top-down calculation for the Smiths:

Gross Income: $300,000
Minus Total Taxes: $70,000
Minus Total Savings: $50,000
Equals Total Spending: $180,000 (or about $15,000 per month)

The Smiths saw this calculation and were surprised they were spending this much. They saw an opportunity to save more money.

While their retirement account contributions were being automatically deducted from their paychecks, they had no automatic plan for saving additional money. They set up a $1,500 monthly automatic transfer from their joint checking account to a joint savings account. Now they are assured of saving an extra $18,000 per year for college and/or retirement.

How to Deal With the $500,000 Mortgage

The Smiths have 26 years left on a $500,000 mortgage that they just refinanced a few years ago. The traditional advice is to pay off your mortgage before you retire – and this is good advice. When you own your home outright, your monthly overhead goes down dramatically, and there is a measure of security knowing that no one can foreclose on you if you hit hard times. It also gives you a significant asset to use late in your retirement to pay for long-term care or assisted living. ***In many ways, your paid-off home is your financial ace in the hole***.

Their current mortgage will not be paid off until Bill is 76, and he wants to retire at 65. They will be unable to pay off the loan before retirement, and they do not want to work longer just to stay in their current home, which will be too large for them after the boys leave for college.

After some discussion, the Smiths acknowledge that downsizing the home after the boys leave for college is a good idea. If they downsize to a $500,000 home, they could purchase that home with about $300,000 in equity from their current home (likely more, if the home appreciates in the next three to five years) and finance the rest with a $200,000 mortgage. They believe they could pay off that mortgage with a 10-year loan. That means their primary residence will be completely paid off when they enter retirement, which is ideal.

Dealing With College Expenses

Paying for college is a huge financial burden these days. It is especially difficult when you are also trying to position yourself for retirement. The Smiths have saved enough money in the boys’ 529 accounts to send each of them to an in-state college. If the boys go out of state or attend a private university, they will need to come up with a lot more money.

This is a tough issue. Many parents feel strongly about fully paying for whatever college their children desire to attend. Bill and Sarah understand that if the boys go out of state or attend a private university, they will have to choose between their retirement and the boys' college educations. Not a fun choice.

I tell clients that while their children can get scholarships and loans to attend college, there are no scholarships or loans for retirement. I would advise them to put their retirement first.

They decided to tell the boys, when the time is right, how much they have saved and that they can pay for an in-state college education – a very generous offer, when you think about it. The boys understood this was an important financial consideration that had to be factored into their school search. Both boys understood they would need scholarships or loans if they chose an out-of-state or private university.

Some of my clients have been pleasantly surprised by the scholarship and assistance packages that out-of-state and private universities have offered their student solely for the purpose of leveling the financial playing field with their respective in-state school. Of course, this requires the boys to have excellent grades and entrance exam scores, which are their responsibility.

Not every parent would make this choice. The alternative would be to move their retirement out five years further, when Bill turns 70 and Sarah turns 69, and that may not be enough, depending on the cost of the school the boys are considering.

Now the Real Planning Begins

This type of cursory work is only the beginning of real financial planning. All the Smiths' financial information will need to be put into a sophisticated financial planning program where all the moving parts can be evaluated. These parts include:

Qualified and nonqualified assets
Cost basis of nonqualified assets
Taxes
Required minimum distributions from qualified accounts
Social Security assumptions
Pension analysis
Investment portfolio design and construction
Investment return assumptions
Inflation assumptions
Monte Carlo analysis and bear market testing
Probability of success analysis
Net worth calculation
Insurance analysis
Inheritance assumptions
Real property holdings and growth assumptions

Some people try to skip this step by using spreadsheets or online calculators. I would strongly advise against this approach. In my view, a comprehensive financial plan completed by a Certified Financial Planner professional is a worthwhile investment.

A good plan will give you the confidence and peace of mind that you are truly prepared for your retirement. It will also help you stay disciplined when markets are flat.

If you have questions or concerns about your situation, please give us a call at (855) 353-3800.

Thank you,
Austin Lewis

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