On the Case: TIPS Ladder + QLAC + HELOC = Income Security

By Kerry Pechter *Wed, Aug 9, 2017*

Mike Lonier, of Lonier Financial Advisory, solved 'Andrew and Laura's' retirement income puzzle with a combination of products. A certified Retirement Management Analyst, he first builds a safe income floor and then invests for upside.

Financial advisors who have acquired the Retirement Management Analyst designation tend to approach retirement income planning a certain way. They typically lock in a client's "floor" income with safe assets, and then look for "upside" by applying the money that's left over to equities.

Mike Lonier, founder of **Lonier Financial Advisory**, a fee-only planning firm in Osprey, Fla., holds the RMA certificate. He's the third advisor (following Mark Warshawsky on **July 20** and Jim Otar on **August 3**) to offer a solution for the case of Andrew, 64, and Laura, 63, a real (but incognito) suburban professional couple nearing retirement.

Each earns about $150,000 today, and they've saved about $1.2 million, most of it tax-deferred. They own long-term care insurance. They currently work with an advisor at a major brokerage, but they worry that their fees might be too high.

Andrew is willing to work until age 70, but he wouldn't mind retiring sooner. Laura is ready to switch to part-time work now. They haven't decided whether to keep their $1.24 million home indefinitely, nor have they discussed their legacy goals. Their two children are grown and financially independent.

Lonier (right) evaluated their annual drawdown goal—$77,000 from investments, to supplement $75,000 in Social Security—and deemed it too aggressive. Using the RMA framework, he divided their assets into up to four parts.

He dedicated one part to provision of annual floor income, one part to equity exposure, one part to a small cash reserve, and one part to the purchase of a deferred annuity. He also introduces the possibility of a Home Equity Conversion Mortgage Line of Credit (HECM LOC). Here are some specifics from the **plan** he submitted to *RIJ*:

Quick Take Away

For Andrew and Laura, the advisor has determined that their desired $77,000 per year annual drawdown could empty their $1.24 million portfolio (60/40 stock/bond allocation) in as few as 18 years. He recommends that they reduce their essential expenses by $33,000, build a ladder of Treasury Inflation-Protected Securities for essential income, a deferred income annuity to buffer longevity risk and the opening of a home equity line-of-credit.

Assumptions

- Andrew, 64, and Laura, 63, each earn about $150,000 per year, for a combined income of about $300,000.
- Andrew will work four more years until retirement at age 68, earning $150,000 per year and collecting $27,000 in rental income from his second home until retirement. He saves $25,000 per year during those years.
- Laura will work only part-time for four years until full retirement at age 67, earning $50,000 per year and saving $5,000 each year.
- Andrew will claims Social Security benefits at age 70 and Laura will claim at her full retirement age of 66.
- The annual inflation rate will be 2.5%; the long-term discount rate will be 3%. Equities will return 8.5% per year on average (two percentage points less than the historical average).
- Based on a 30% equity, 54.7% bond, 10% deferred annuity and 5.3% cash portfolio, the couple's expected average annual return (net of investment expenses and a 0.25% ongoing management fee) will be 3.88%.
- As a holder of the RMA certificate from the Retirement Income Industry Association, Lonier practices goal-based planning and uses the "build an income floor, then invest for upside" approach.
- The advisor considers the clients' entire "household balance sheet," including assets (home equity, human capital (earning power, pensions), and social capital (Social Security), and liabilities (present value of future income needs), to determine if their retirement is over-or under-funded.

Advice Points

- Andrew and Laura should divide and rank their expenses into essential and discretionary.
- They should pare their essential pre-tax expenses in retirement to a real $110,000 today (or $121,000 starting four years from now). They can budget an additional $30,000 each year for discretionary purchases, to be made cautiously and sparingly.
- Andrew and Laura should allocate 30% or $372,000 of their retirement savings to the pursuit of "upside" by purchasing a global equity ETF, but only if they are willing to use their home equity as a reserve.
- To provide "floor" income for 30 years, the couple should begin building a ladder of Treasury Inflation Protected Securities (TIPS), starting with a 4-year TIPS bond to cover the first year of retirement need from savings, a 5-year TIPS bond for the second year, a 6-year TIPS bond for the third, etc., up to a 10-year TIPS bond for the seventh year, and then an additional 10-year TIPS bond each year thereafter. Money allocated to the floor ladder but not yet expended could be kept in either a rolling CD-ladder or an intermediate bond fund (if the need is over five years away).
- To buffer their risk of outliving their savings, they should apply 10% of savings to the purchase of a joint-life qualified longevity annuity contract (QLAC; a deferred annuity purchased with up to the

lesser of 25% of qualified savings or $125,000) at retirement with income starting at age 80.

Recommendations

The priority for Andrew and Laura is to reduce their essential expenses. As a second step, they must choose whether to incorporate home equity into their income plan or exclude it.

For instance, if they choose to exclude their $1 million in home equity from their income plan, Andrew and Laura should allocate $970,527 to provide real income of $44,000 per year in income to supplement their annual Social Security and pension income of about $75,000.

By using that money to create a TIPS ladder, they can mitigate market risk, interest rate risk, and inflation risk. They can also allocate $124,000 to the purchase of a QLAC four years from now, invest $78,722 in equities and hold $65,851 as a cash reserve.

If they take advantage of home equity, however, they can take some additional equity risk while backstopping their essential income if they experience market losses. The advisor recommends that Andrew and Laura set up a $300,000 HECM LOC. Alternately, the couple could downsize to a smaller primary residence and put $300,000 in cash or they could sell their second home.

With that $300,000 as a reserve, they can allocate $371,700 to stocks (via an ETF representing a global stock index) and apply just $677,549 to build their floor income out of TIPS, CDs and bond funds. The recommendation to buy a QLAC with 10% of their savings and hold a $65,851 cash reserve still applies.

Bottom Line

The couple originally hoped to spend about 6% of their portfolio each year in retirement, or well over the 3.5% or 4% benchmark, and they had no plans to downsize from their current home or sell their second home. They were therefore on track to run out of money too soon.

If the couple follows this advisor's recommendations, their portfolio should last about 32 years instead of about 18 years, assuring them an adequate income until their mid-90s and a projected legacy of about $1.14 million in their investment portfolio.

Current Asset Allocation		
Classes	Amount	Pct.
Cash and cash investments	$49,500	4%
Fixed income (Index funds, ETFs and actively managed funds. Largest single position: DoubleLine Total Bond, ~$100,000)	$340,000	27%
Equities (Index funds, ETFs and actively managed funds in all sectors and style boxes. Largest single position: Apple, ~$90,000)	$745,000	60%
Alternatives	$60,500	5%
Other	$44,000	4%
Total	$1,239,000	100%

Assets		**Expenses/liabilities**	
Real estate			
Primary residence	$1,230,000	Annual mortgage ($248,000 balance @ 2.8%, payoff 11-2013)	$20,500
Second home	$435,000	Annual mortgage ($325,000 balance @ 3.6%, payoff 10-2046)	$17,900
Retirement savings			
Qualified Assets	$1,206,000	Living expense (Utilities, insurance, travel, personal expenses, entertainment, supplies, gifts, fuel, etc.)	$70,000
Other	$33,000	Out-of-pocket medical	$8,500
		Taxes	
Personal property	$50,000	Income taxes	$72,600
2008 sedan	$10,000	Self-emp. tax	$29,000
2013 SUV	$17,000	Medicare tax	$8400
		Still owed on SUV	$10,000
Total assets	$2,981,000	Liabilities	$583,000

Qualified Accounts		
Andrew's qualified accounts		
Traditional IRA		$52,000
	Equities, $52,000	
SEP-IRA		$415,000
	Equities, $168,000	
Roth IRA		$88,000
	Equities, $95,000	
Laura's qualified accounts		
Traditional IRA		$60,000
	Equities, $65,000	
SEP-IRA		$341,000
	Equities, $103,000	
SEP-IRA		$146,000
	Equities, $146,000	
Roth IRA		$104,000
	Equities, $116,000	
Total qualified		$1,206,000