Life's Three Buckets

Mathius 'Marc' Gertz
MBA, AFC®, CAPS, CDLP

Across the globe, countries are facing an aging population that is unprepared to retire, and many governments are turning to reverse mortgages as an option to help fund longevity — the United States is no different.

With 10,000 baby boomers turning 60 each day for the foreseeable future, the United States needs to be a pioneer of the reverse mortgage product, and it has been.

If you look at the Canadian market, the industry is booming. HomeEquity Bank, the leading provider in Canada, saw volume grow 40% with a product that provides far less in proceeds, protections, and benefits.

In Australia, the government sees the reverse mortgage as part of the solution to help older Aussies retire and age in place comfortably. In China, which has the world's fastest-aging population and a pension system hit by shortfalls, the government announced it would start allowing reverse mortgages for seniors nationwide.

Imagine if the United States government started looking at reverse mortgages as part of a policy strategy going forward for a population that hasn't saved enough for retirement. Until then, let's look at how a reverse mortgage can be used as a planning tool for you and your clients. Imagine if you will three milk buckets.

The first bucket represents monthly income, such as social security payments, wages and pension income. The second bucket represents retirement savings or the nest egg—a lump sum of everything from savings accounts. IRAs, CDs, 401(k)s, and 403(b)s to change jars and gold and silver coins and bars. The income value of this bucket is harder to determine, but this bucket spins off a certain amount of income when needed, either in interest and dividends or by simply cashing in the principal. This money may have been put away years ago with the goal that it would be spent in retirement. Retiree's biggest fear is that they'll outlive the life of this bucket.

Financial professionals spend almost 99 percent of their time analyzing, projecting, sifting, calculating and recalculating the value and use of the first two buckets but rarely consider the third bucket.

Now, most people, including most financial advisors, will think, "Why can't you use the money in bucket two instead of doing a reverse mortgage? If my financial advisor does his job, then I won't need to worry about the money in the house".

The fact is that most people don't have enough money in bucket two for the financial advisor to manage until age ninety, and even if they do, then it is more efficiently used, according to research, if home equity is part of the planning.

Let's say a house payment is $2500 a month, principal and interest. You deposit 25- one hundred dollar bills every month into bucket three. But as we put money into our home, something strange happens. It turns into equity, and only two people can turn that equity back into cash. While the homeowner many own the home, they are not in charge of turning that equity back into cash. Only a buyer who is willing to purchase our home and to give us cash for the equity in the home or a mortgage lender who, after lots of paper, decides to give us a certain amount of our equity back in the form of cash can do that. As soon as the mortgage lender gives the homeowner that cash, she will ask for it to be paid back starting the very next month, turning cash back into equity which defeats the whole purpose of having cash in retirement.

Many people place a high value on equity, which is good, but cash is far better in our retirement years. Equity cannot be accurately valued until you sell, and equity cannot be used until it is converted into cash. It's like having a big chunk of cash in our living room in an unbreakable glass case. We can look at it, but we can't use it.

Now, depending upon the client's other assets, the third bucket is usually valued at 30 to 50 percent of a client's total net worth. Yet most financial professionals largely ignore bucket three. For qualified borrowers aged sixty and older, their homes are fungible*—that is, a significant portion of the equity in their homes can be reduced to dollars. Your clients must be able to understand the fundamental difference between their **homes,** perhaps the most intimate object of their financial lives, and their **house equity.** The fact that we live in this asset dramatically affects our attitude toward using it as a retirement tool. But we can't take it with us, and sooner or later, our house will be liquidated and denominated into dollars, just like our IRA's. (Think of the difference between a real and a fake $100 bill.) The difference between equity and cash is a difficult thing for anyone to understand at any age. Research shows that homeowners are better stewards of their money if they spend some of the money in bucket three right away in the beginning of retirement and preserve the assets in bucket two.

Ultimately there is really no difference between the three buckets. They all have money put into them when we have extra, and when we need to take money out for expenses in retirement; we have to convert those deposits into withdrawals. Unfortunately, because we live in the bucket-three asset, it becomes a very difficult mental issue to convert that equity into cash and to take the income from that bucket.

Because of this psychological brick wall, many clients refuse to even consider their home equity as a source of cash flow and choose instead to use it as a retirement drain. (See the two arrows by the third bucket, as they can go either way.) The typical retiree takes money out of the first two buckets to fund the third bucket. They pay taxes, insurance, maintenance, and often, a continued monthly house payment when they are well past the age of sixty. With a reverse mortgage loan, reverse mortgage borrowers no longer have to do that using buckets one and two, although tax, insurance and maintenance payments are always required.

How many retirees are still contributing to IRA's? Very few. But how many still contribute to bucket three and plan to do so until the end of their lives in their homes? Most of them. They either make payments, or if the house is paid off, continue to put money into the house in the form of maintenance, taxes and insurance.

Retirees and their advisors have no problem with taking money out of the IRA or savings account to fund retirement cash flow, yet when a reverse mortgage is suggested, both clients and advisors opt to wait until bucket two is empty before applying for a reverse mortgage. Why? After all, retirees put money into the second bucket so they would have something when they retired. However, they have also religiously put money into their homes in the form of payments, improvements, taxes and the like.

In its simplest form, a reverse mortgage is nothing more than a tool that turns home equity back into cash without affecting the homeowners' ability to live in the home. It allows for the withdrawal of money from bucket three without having continuing contributions to that bucket in the form of mortgage payments.

But…. I hear you say, what about the heirs? Quite frankly, there are many financial advisors and relatives who think that anyone who gets a reverse mortgage is making a foolish decision. That is the concern that most adult children have. So, let's look at how the three buckets affect the heirs.

Heirs should always be more concerned about Mom and Dad's need for money first, and they usually are. I was on a road trip with my son a few years ago on Route 66 and saw a sign outside a church that read: "The cost of living is high, but it is still extremely popular". Thus, the only way you can leave more money for the heirs is if you die early. Very few children hope their parents die early so that they get more money.

Think about it: as soon as a person retires and less money is going into bucket one, they must start drawing from either bucket two or bucket three. If you take money from the third bucket, then there will be less home equity for the heirs, especially once you consider the negative amortization of a reverse mortgage. But there will likely be more money and appreciation in the second bucket, and no taxes have to be paid when pulling money from bucket three.

Experts agree that if you pull money from bucket three early in retirement, then the portfolio longevity of bucket two will, of course, go up, as will your overall net worth. It is obvious that you have less equity but more cash. There is in less bucket three and more in bucket two. If you ask your clients to ask their children which bucket they would rather have more assets in—the second or the third—most will choose the second bucket. Those assets are easier to quantify and ultimately easier to distribute. For example, anyone who has ever tried to sell houses in an estate can relate to that. You have to pay utilities, taxes, and upkeep to take care of the place while dropping the price to find a quick buyer. It is almost always best to preserve bucket two with bucket three.

One could make the case that retirement planning is a little like dairy farming. You milk a cow and the milk fills up three buckets. The bottom line is that those three buckets of milk are the same milk. It doesn't matter which one you sell to the dairy; all have the same value when you pour them out. This is a simple but difficult concept to understand.

Most folks don't realize that when they pull money out of bucket two, they are losing not only the asset, but also whatever gains they will make in the future with that investment. There are either real costs or opportunity costs, no matter which bucket you draw from. Many advisors and clients worry about

compound interest working against them from the reverse mortgage in bucket three, but they forget about the compound interest working for them at a greater rate in bucket two. It is not free to pull money from bucket two—there is always either a tax cost or an opportunity cost.

When you use bucket three early in retirement, your income will be greater and your retirement nest egg will last longer. Wasn't that the plan from the beginning?

One of the overwhelming positive things about reverse mortgages is that they usually are not only helpful to the clients, but also to the children. As you spend bucket three, you are preserving bucket two for the heirs. The idea that a reverse mortgage is a bad idea for the kids is a myth that was repeated so often that some people started to believe it.

Reverse mortgages have changed the playing field in financial planning. We have come a long way from 1969, when UCLA professor Yung Ping Chen stated his support, before the Senate Committee on Aging, for an "actuarial mortgage plan in the form of a housing annuity". Today, reverse mortgages are being used worldwide, as a way to address the realities of an aging population. Retirement planning that doesn't properly use all three buckets may be shortchanging the client.

Thank you for the opportunity to:

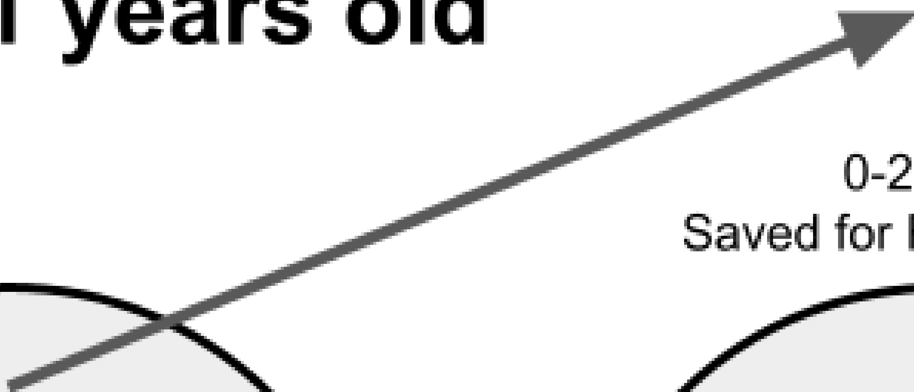
Reverse Your Thinking®, About Reverse Mortgages.

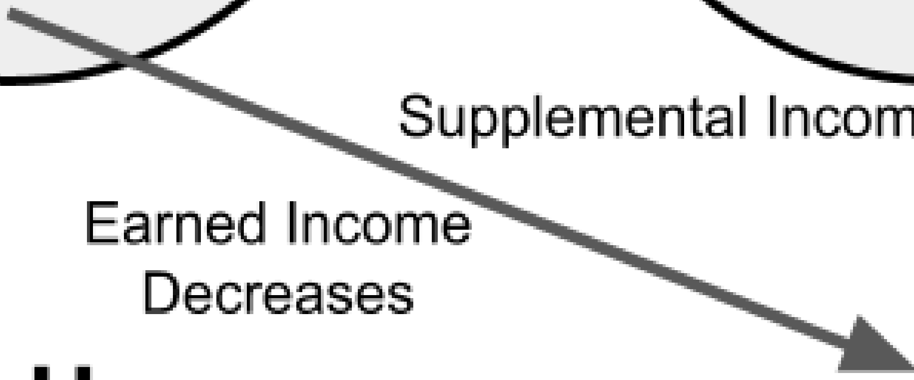
** In economics, fungibility refers to the properties of a good or commodity whose individual units are essentially interchangeable and each of its parts is indistinguishable from another part. IE: essential value is essential value; money is money, regardless of form.*

Sources

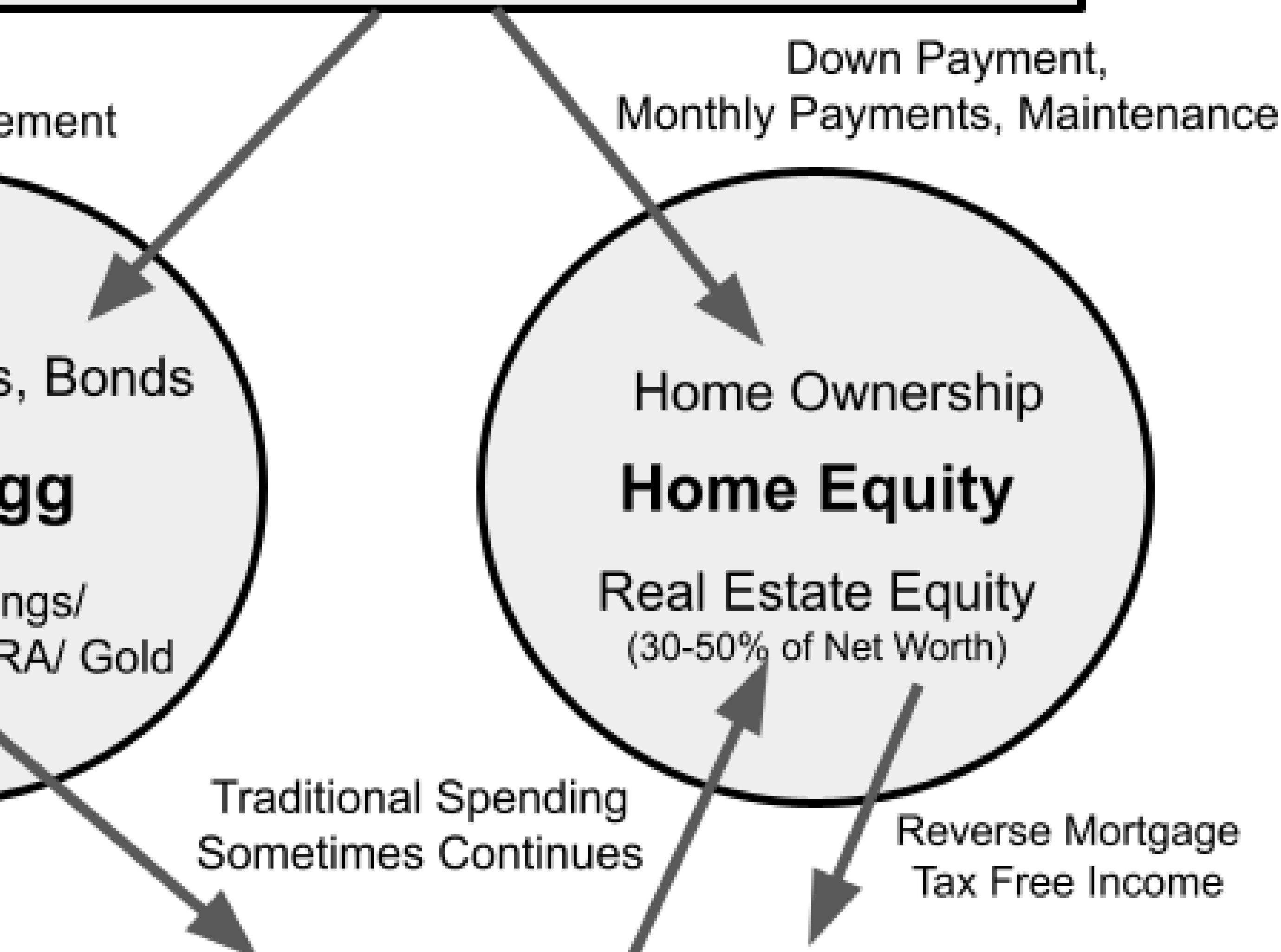
1. Reverse Mortgages Are Booming Worldwide, Yedinak,John, 9-2-2018, Reversemortgagedaily.com
2. Home Equity and Reverse Mortgages, Accola, Harlan J, 2018 Better Way to Live, Inc.

18 to 61 years old





62 and Up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Home Ownership
Home Equity
Real Estate Equity
(30-50% of Net Worth)
Traditional Spending
Sometimes Continues
Reverse Mortgage
Tax Free Income
Post-Retirement Income
Outlive Your Money / Leave a Legacy