Co-signing Loans, Moving to Cash, & Municipal Bonds: MAM Podcast 194 - Transcript

Tim Mullooly: Welcome back to the podcast, this is episode number 194, and this is Tim Mullooly.

Tom Mullooly: And Tom Mullooly.

Tim Mullooly: And today we're going to continue to answer questions that anonymous people send in to a website, they get sent to us to answer. We've been doing that for the last couple episodes, and we've been getting some good feedback from our listeners, so we're going to continue doing that.

Tom Mullooly: It spurs discussions with others that are listening to our podcast or they're reading the transcript online, and it does spur conversation. So, if you've got a question or find yourself hearing something that we're talking about, say, "Hey, that's kind of like my situation." Get in touch with us, we'd be happy to discuss your situation without any kind of cost or obligation. Of course if you're a client, get in touch with us, we want to know what's going on, we need to be aware of your changes and your financial situation. But, by all means, reach out to us, we may feature it on a future podcast or video. If you are going through something that you think is unique, it may not be, sorry to burst your bubble, but a lot of folks go through things and they suffer in silence.

No one's got this kind of problem like I do. That's totally wrong.

Tim Mullooly: It's usually not the case.

Tom Mullooly: So I would encourage you if you have a financial situation we won't have to use any kind of names, reach out to us. And if you are okay with us discussing it let us know and we want to help you get through whatever things you're struggling with when it comes to money. So Tim why don't we jump right in to our mail bag.

Tim Mullooly: Sure. The first question asks, “What does it mean when you move your investments to cash?”

Tom Mullooly: You know these are phrases that we use in the industry that we get used to saying but they really, even though they're simple words they are jargon.

Tim Mullooly: Right, and I read that question and I thought, how does this person not know what that means but we take it for granted that people understand some of the terms that we use on a day to day basis. And that's not the case. You know sometimes people don't know what we're talking about.

Tom Mullooly: So when this person wrote in and said what does it mean when you move our investments to cash, it means that you're selling your investment, maybe it's a stock or it's a mutual fund or it's an exchange traded fund, an ETF. And we're just selling it and we're moving the money to the money market account which should be a short term parking place.

Tim Mullooly: Right.

Tom Mullooly: That's really all it means when we're moving our investments to cash.

Tim Mullooly: And so it means that it's in the account but it's not invested.

Tom Mullooly: Right. People sometimes do that because they're worried about what's going to happen in the market or they want to take a profit in something or they want to take a loss in something and just move on, but they don't have something to move into right away so they move the money to cash or to the money market account.

Tim Mullooly: Sometimes people also use that if they're trying to be more conservative with their investing in their portfolio instead of investing it in bonds or something that is usually more conservative in nature. They just hold it in the money market which is even more conservative than bonds. It sometimes can be used as a substitute for that.

Tom Mullooly: Good question. Let's move on to the next.

Tim Mullooly: Sure, next question says “why do municipal bond funds all seem to lose money for their customers?”

Tom Mullooly: Okay, now that on the surface seems like a head scratcher. And it's a very simple question. Why do municipal bond funds all seem to lose money for their customers. There is so much to unpack from what seems like a simple question. The person wrote in and said I thought that an Oregon tax free municipal fund would return well but a friend invested and got a one percent return.

Tim Mullooly: So the description already kind of contradicts the question. They got a one percent return so the bond fund didn't lose money.

Tom Mullooly: Right.

Tim Mullooly: I think this person had distorted expectations as to how bond funds generally react or appreciate or return.

Tom Mullooly: Probably wasn't very well explained when they bought it.

Tim Mullooly: No.

Tom Mullooly: Or invested in it.

Tim Mullooly: Right.

Tom Mullooly: So let's walk through all of that. First of all, to steal a page from our last podcast, where do municipal bonds typically fall on the risk spectrum?

Tim Mullooly: Generally not that risky.

Tom Mullooly: Not that risky. In fact, up through the early 1980's there was not one single default on a municipal bond, that goes back through the depression. There wasn't a single default. Wasn't until Washington public power supply “woops bonds”, is what they called them, in the 1980's were the first time that they had default. There's been a couple of defaults in the last 30 years, but by and large municipal bonds are a safe investment. Now safe doesn't mean that they're going to be steady returning either because a safe investment means that your principal is relatively safe. Doesn't speak to the returns. So there's two components of bond fund returns. First is going to be the yield that you collect, the interest from a tax free bond is going to be if it's a state bond fund from this particular one in Oregon it's federally tax free and state tax free if you live in Oregon.

And I don't know what the yield is on this fund, but let's just say that it's two percent. So you're going to get a current yield of about two percent and it's going to be tax free federal and state. Now before we go any further, what is a two percent return after taxes. Like if you were to turn this into a taxable investment, what would you have to earn on a taxable bond fund to get the same two percent after tax. It depends on your bracket.

Tim Mullooly: Right.

Tom Mullooly: But I mean you could be getting three percent, and a long term treasury bond now yields about three percent. So the yields are, we're going to say they're pretty much in line with what you should expect on an after tax basis. But the second part of the return is going to come from what happens to the value of the bonds from the time you bought the fund until today. So interest rates move 24 seven and what a lot of people don't understand is that a bond is changing price very day. The bond funds are a portfolio of individual bonds, what the portfolio manager's job is, is he's got to maximize cash flow to his bond fund holders. So he wants the highest yielding bonds he can find. Where is that on the maturity scale? The highest yielding bonds are the furthest ones out in maturity. So typically when you invest in a state tax free bond fund, like Oregon tax free bond fund.

New Jersey tax free bond fund, New York tax free bond fund, where, what kind of maturities are you going to find in that bond fund? 20 year, 25 year, 30 year bonds. Those bonds, the values are all over the map, they're going to go up down sideways depending on what's happening today with interest rates. There's something else however with tax free bond funds that people need to know. In addition to owning a tax free bond from your home state, like Oregon or New York, or New Jersey. A bond fund manager can also own municipal bonds that are tax free in their state but may not be from their state. What are we talking about? Territory. Puerto Rico. That's tax free in 50 states because it's a territory of the United States. So Puerto Rico's been in the news the last year because they're bankrupt. So they've got a lot of municipal bonds that are buried inside of many tax free bond funds. Nobody really seems to know the value of these things.

This is a really good question. There's another territory that's been in the news lately that has some municipal bonds that are floating around and that's Guam. They're in the territory of the United States but they're in the news for another reason. All of their municipalities may get wiped off the map by someone in North Korea. That could be another problem.

Tim Mullooly: Hopefully that doesn't happen.

Tom Mullooly: Hopefully it doesn't happen, but there are so many moving parts, it seemed like a very simple question. I thought these things were really great, but you can lose money in a tax free bond fund. No doubt. If interest rates spike higher in a short period of time, you will lose money. No matter what kind of bond fund you have. Over the long term, you should be okay.

Tim Mullooly: Very good question. Hopefully that answered the person's question. So moving on the next question asks “how much do I have to pay in taxes when transferring to a Roth IRA?”

Tom Mullooly: Okay, this question came with a lot of details about they want to stay in a bracket or not in a bracket or all this stuff. Just understand that when money comes out of an IRA or comes out of a 401k and goes to a Roth, that money hasn't been taxed yet. It has not been taxed yet. So the money that comes out of an IRA or comes out of a 401K will have to be taxed. Anything going into a Roth IRA is always, always, always, always after tax dollars. So anything going into a Roth IRA will be after taxes. So if you have money and it's going to depend on your bracket, say you've got $100,000 in an IRA, you want to convert it to a Roth. You're in the 28% tax bracket. You really should be moving $100,000 into the Roth and then finding the $28,000 in taxes that you have to pay from somewhere else. These Roth conversions are not easy. This is the part that really kind of trips up people. Is that let's go back to this example I just used. IF you have $100,000 and you want to do a Roth conversion, you need to put $100,000 into your Roth.

You can't take $28,000 out for taxes. That's a distribution. That's taxable. So and if you're under age 59 1/2 you're going to have another penalty on top of that. So you have to be prepared to pay the taxes from another source before you consider doing these Roth conversions. It's a lot to unwind with these things, please don't do these on your own. You really do need to be speaking with some kind of financial planner or an investment advisor for some guidance on Roth conversions. It can be very, very beneficial to you but they can also be fraught with potential for mistakes. It's a good question. So Tim, how can I, here's another one, how can I minimize the tax burden on my severance pay?

Tim Mullooly: I feel like that's the in quotes minimize the tax burden is a question we see a lot. And in most cases and in this case also, you can't, you're not going to be able to not pay your fair share in taxes regardless of where it's coming from.

Tom Mullooly: Sorry to be the party poopers, maybe we should rename our podcast the party poopers. But it seems like we do get a lot of people who want to know what's the angle. We've had people on the last couple of weeks ask us what's the hurricane play?

Tim Mullooly: Trying to make a quick buck or save. Not do their fair share.

Tom Mullooly: Right, so how can you minimize taxes on severance pay? The reality is in some companies, they will give you a lump sum and they're required to withhold 40% anyway. So the taxes are already out. So if that's the case in your situation, and you haven't left your job yet, stop withholding your income taxes out of your regular paychecks. So there was a little bit more of a backstory with this. I'm leaving my current job and offered to take a severance package. I was informed the severance will be paid in a lump sum. There you go. I'm considering taking another job in the next few months, but I'm afraid it will push my overall income into the next tax bracket. Okay, so we're recording this in mid-September of

2017. If you're going to take a new job you may want to think about starting that job in January. Just because it's a whole new year. Also if you're leaving the job now, then that paycheck that you were used to having is not going to be there for the last three months of the year. So you're not going to have the income that you were counting on, you're going to have this lump sum severance package so it may wind up evening out anyway.

A few other things, I have no debt, no mortgage or kids. I do have some investment accounts, a Roth IRA, an IRA, a 401K an individual account. 401K was not maxed out, it can't be anyway because you're leaving. Should I contribute $5500 to the Roth or the IRA that's really a question depending on your cash flow and what your safety cushion is. Are there additional ways to minimize my tax?

Tim Mullooly: Unfortunately there isn't.

Tom Mullooly: No there really isn't. All right, the next question is, Tim "how do I choose an alternative trustee for my trust?"

Tim Mullooly: That sounds like a very good question for a lawyer. That's what I would recommend.

Tom Mullooly: That really is the answer for something like that. So it's tough, it's something that you should periodically review. The alternate trustees for your trust because we've had a situation in our office where we had a client who was starting to lose control of their faculties. And they were making terrible decisions and they were giving money away to strangers and there was a lot of potential things that were happening or were about to happen. It's dangerous. Make sure if you have a trust that you have an alternate trustee set up and always update that information. Hopefully a lawyer put that together, you didn't do it yourself. And it would be best to reach out to that attorney or an attorney in your family and take a look at updating that.

Tim Mullooly: So we have about time for one more question. The last question on this episode is going to be "I made a mistake co-signing a private student loan for my nephew. What are my options moving forward?" There's a little bit of summary here of the situation. I'll lay it out here for you guys. They say my nephew came to me last year a week before his first year of college was to start because his FAFSA application had not been accepted due to missing information. I stepped in to help him because his own parents refused.

Tom Mullooly: I'm just going to interrupt you, alright? I just want to go step by step with this thing. So you can fill, if you're going to be a student in the fall you can fill out the FAFSA in January. Eight months before. So if you haven't filled out your FAFSA and it's a week before your first year of college, what's wrong? There's something, there's a real problem here. This should have been done and it's not like if you're a high school senior that you wouldn't know about this. Or your family wouldn't know about it.

First of all everybody in your peer group is filling out the FAFSA. There's also, they get reminders with FAFSA that if you haven't filled it out some schools run out of capital that they can allocate to you so they longer you wait to fill out a FAFSA, and get online, at the school that you want to go to, you're reducing your own chances of getting grant and scholarship money. Don't delay when it's time to do the FAFSA application. Do it in January. Do it as soon as you can, and even if you don't have all the information you can, there's a box that you can check saying if you don't have your tax information we will fill this out later, this is an estimate.

So filling this out in August a week before school is supposed to start, there's already problems here.

Tim Mullooly: Right, and then it goes on to say I stepped in to help him because his own parents refused. If I hadn't cosigned that private student loan for him all of his classes would have been dropped and his dreams dashed.

Tom Mullooly: Okay, again I'm going to go step by step with this thing. Okay? If I hadn't cosigned that private student loan for him all of his classes would have been dropped and his dreams dashed. Let me just, add his dreams would have been dashed for that semester.

Tim Mullooly: Right.

Tom Mullooly: It's not permanent. And so if you don't have your act together in terms of registering for classes and figuring out a way to pay for school, well that's a temporary setback. There's another semester just a few months away, so this is the problem, sometimes we sit down with folks to try to help them with their problems and their financial planning problems and they salt all of their stories with emotion. This is just dripping with emotion. Having all of their dreams dashed because they didn't fill out the FAFSA on time. Give me a break.

Tim Mullooly: Yeah, people get caught up in the emotional side of things and they don't realize that there are logical solutions to their problems, they just need to put the emotions aside for a minute and think clearly or talk to someone who knows what they're talking about.

Tom Mullooly: There is one other thing that I want to add right here at this point, is that if you are a student and say your 18 years old, your parents aren't willing to help you with your college education. You don't have the resources to attend college but you have the desire to attend. You can go to college. This is what college aid is all about. They want to help people who are in this exact situation they will help you secure financial aid so you can attend class. You shouldn't have to worry about this, your job should be to go to class and do well so you can graduate. Not worry about the money.

Tim Mullooly: Right.

Tom Mullooly: So let's go on.

Tim Mullooly: Kind of running on that foot of going to class and doing well, the summary goes on to say he was luckily able to get real financial aid after that first semester but sadly squandered that opportunity and quickly failed his second semester of his freshman year. I just found out this past week that his 1.83 GPA is preventing him from securing financial aid for his current semester.

Tom Mullooly: Okay.

Tim Mullooly: I would hope so.

Tom Mullooly: I know we shouldn't laugh about this, but yeah if you go to school and you're not serious then even the government, the school will be able to tell you hey we're not going to continue to throw good money after bad, be serious when you're going here. Maybe college is not for you or maybe it's time for you to grow up and get serious about your completing your education. So he got very low grades and now he's unable to get financial aid for his current semester, but that kind of now has a boomerang effect on this person who cosigned, right.

Tim Mullooly: Right. It goes on to say right now it looks, it's looking more and more like he won't be able to finish his degree which means I won't be able to defer loan payments much longer.

Tom Mullooly: Okay, so it's looking more and more like he won't be able to finish his degree right now.

Tim Mullooly: Right.

Tom Mullooly: Which means I won't be able to defer loan payments much longer. So I think the first thing that they need to talk about is they need to find out from the financial aid office at school what's going to happen to these loans, when do they kick in. There's no sense guessing about this kind of stuff. Find out the answer from the financial aid office. That should be the next phone call. Call the financial aid office, explain the situation, find out when payments are going to need to start. They will probably bring up the word forbearance which will defer these payments out into the future. And that's a term that you really should look up and get used to and learn about because this may apply to you. So there's actually even more to this backstory, right?

Tim Mullooly: Right. It's never ending. It goes on to say I should have known better than to cosign this loan which was originally $5800 now $6300 after interest which is eight and a quarter percent. Given all that, is there anything I can do to lessen the pain so to speak? Should I just bite the bullet and start making regular payments or for instance, could I ever hope to refinance this loan and get a lower interest rate? I have an excellent credit score and assets which I could use as collateral.

Tom Mullooly: So Tim was being kind and the person actually wrote in and they said could I ever hope to refinance this usurious loan. People speak about usury, usually when they're talking about credit card rates at 18 and 24 percent. I find that people are happy to accept loans and then they start calling is usury at these usurious rates when they can't pay it back and the interest is just compounding. In this case at eight and a quarter percent.

Tim Mullooly: It's not like the loan had a much lower interest rate when they took the loan on.

Tom Mullooly: Right.

Tim Mullooly: They at the time, just assumed that there wouldn't be any problem with paying them back but now that there is a problem the rates are outrageous.

Tom Mullooly: Right, so the person who wrote in also started out by saying I should have known better than to cosign this loan. Yes. You should have known better. Don't cosign loans. Just don't. If you wanted to help this nephew with payments you could give him money on a monthly basis. You could make the payments for him, but to cosign the loan is a mistake. Don't do that. Because he then goes on, this person then goes on to say I have an excellent credit score, well you had an excellent credit score if what I think is going to happen is going to happen. If you don't make the payments it's going to wreck your credit score. Now you are responsible for this. So $6300 is not a gargantuan amount of money, but it can become one if no payments are made. This is how student loans mushroom into much, much bigger problems because it's going to mess up this person, this student's ability to borrow money in the future for a car or a business or a home and it's also now going to have an impact on your credit score as well, not so excellent any more.

This is really very important. Understand the risk that comes with student loans. You have to go to college. If you borrow money for college you have to go. And you have to attend classes, and you have to pay attention. And have to pass all your courses. This is serious. It's almost like a warm up for real life. It's the next stage, it's part of the preparation for real life. I don't want to predict that this nephew is going to have financial problems in the future, I think what they really need to deal with is maturity and some responsibility levels. And so this is a very serious issue that really needs to be tackled. It's very telling that the parents refused to get involved with the student loans for their own child.

Tim Mullooly: That's what I was going to say. And the person says I should have known better, a red flag should have been when the child's own parents wouldn't sign for the loan initially. I mean we don't know these people, we don't know what their situation is like but in general I would say the parents have most likely a better understanding of how this kid is going to react to being in college and maybe they could have foreseen the, him getting a 1.83 GPA and figured it wasn't worth it.

Tom Mullooly: It's a shame that it comes to this. There's not too much more light that we can shine on something like this. The one other thing that I will throw in is that student loans cannot be discharged through bankruptcy unlike all other loans out there, student loans cannot be discharged through bankruptcy. So if you just ignore it, we're going to have situations where in the next few years we're going to have baby boomers who are turning 65 or they're at the point where they want to start collecting social security and those checks will be garnished for student loan payments. It's sad but it's, I would bet that it's happening now, it's going to happen in a much larger scale over the next few years because the government will be repaid. It's terrible.

Tim Mullooly: So to answer her initial question, what are my options moving forward? I would say find out if your nephew doesn't go back to school find out when these loan payments kick in and until you figure out a better solution I would at least make the minimum payments or pay something towards them because to show the loan company that you're actually making an effort, we talked about that in a previous podcast just not making any payments is not a good look.

Tom Mullooly: Good advice. That's right. So Tim we're coming up on episode 200, we're going to have to do something, we'll have to wear our party hats that day.

Tim Mullooly: Our party pooper hats.

Tom Mullooly: That's right. Thanks for listening to episode 194 and we look forward to catching up with you and answering your questions in the next episode, thanks again.