Casey Mullooly: Welcome back to the Mullooly Asset podcast. This is your host, Casey Mullooly and this is episode 368. We've obviously been doing the podcast for a while now, but I've got to say, this might be the best one yet. We cover why it's important for folks that want to retire before their sixties to have tax flexibility. And we also get into the likelihood of retiring on just cash or fixed income and the importance of having at least to some of your retirement base growing in the market. The guys really brought their a game in this one. We hope you get some good takeaways. So without further ado let's get started.

Casey Mullooly: So I know that this has come up a couple of times now in recent conversations, but I wanted to get your guys' take on this on a podcast so we could share it with some other people as well. And that is how having all of your money invested in a retirement account like a 401(k) can sometimes complicate the retirement picture, especially for folks that are not 59 and a half years old. Why is it important for people who want to retire before 59 and a half to have some money in a bank account or money that they can access before 59 and a half?

Tom Mullooly: The money that comes out of a 401(k), unless it's in some kind of Roth 401(k), but if you have money in a 401(k) and you're trying to access it before 59 and a half, know that it's always going to be taxable, a traditional 401(k) plan. So it's already taxable income when it's coming out. If you're taking it out before age 59 and a half, you've got a penalty on top of that of 10% on top of everything else.

Brendan: Yeah. So you have tax on top of tax, which could take a situation that's otherwise reasonable and doable in terms of what you need from your accounts and what you would have to take out to clear that on a tax basis, unreasonable, if you have to factor in a 10% penalty to go along with it. So you kind of... I think what we've been talking about with folks is taking a page from the FIRE playbook, financially independent retire early in the sense of saving and investing in after-tax accounts. So like he said saving, meaning having cushion at the bank for emergencies or for short-term goals that shouldn't be invested that are going to occur over the next one to five years, I would say. And for stuff longer term than that, just having something to supplement the 401(k).

Brendan: I think probably doing the 401(k) still makes a ton of sense, especially if you're getting some kind of a match. But just considering how you're building these assets, because if you reach the end of the line and you want to hang it up a few years early, but everything's in the 401(k), you could have kind of a problem despite having a balance sheet that otherwise suggests that you could retire because you've done a good job saving.

Tom Mullooly: It's been pretty funny to see some of the looks that we've gotten from clients when we talk about, maybe you should stop putting money or reduce the amount of money that you're putting into your 401(k). And they think that we've got a screw loose, but these folks are the equivalent of being real estate, rich cash poor, they are 401(k) rich, but they don't have cash. And it's going to be very, very expensive to take that money out prior to age 59 and a half.

Casey Mullooly: Yeah. Right. I mean, it is counterintuitive. You'd think as the years leading up to retirement, you want to be socking even more money away. And then to be told not to do that and to just put it in a savings account is kind of like, wait, what? But going back to what you said, Brendan, like a 10% penalty on top of some... That just throws the withdrawal rate of someone's plan completely out of whack.

Brendan: I can't imagine being in a scenario either where I would in good conscience, even if the numbers worked out, recommend that because it just seems like a waste of money. Obviously somebody has got to sit down assuming the numbers work, including a 10% penalty, somebody has to sit down and consider whether they are willing to bear that sunk costs that gets them nothing, basically aside from access to their money for early retirement. It's a trade off and I don't see a scenario as a professional where I'd say, go ahead and just eat that 10% penalty. I think it would have to be an emergency or something and not just that, I want to retire sooner.

Tom Mullooly: In situations where we've seen people building up their cash pile, so to speak, their cash asset outside of their 401(k) in the years leading up to retirement, we see that there's going to be a need to draw down that cash pretty quickly. So that money is not going to be in the market. We spend time talking with folks about the accumulation phase and the decumulation phase and folks that start tapping into their 401(k) right away are going straight from accumulation into decumulation. Having some cash allows a little more time for compounding. And I don't think that that money, that cash that you have really ought to be invested, or at least in a super, super conservative way so you don't have much volatility in the account.

Brendan: If you don't this on the doorstep of retirement though and you're just over time building your assets in your after tax bucket, let's say in a brokerage and your pre-tax bucket of 401(k) or whatever your employer offers, you can come to a situation where you have some nice flexibility in retirement in terms of like staying beneath tax thresholds for things like Medicare or for social security, or just remaining in a tax bracket rather than leaping to the next one, because you can choose to pull from capital gains or fully taxable distributions from the 401(k)IRA sort of thing.

Tom Mullooly: The other thing that it does by having a cash stash, so to speak is it allows you to at least consider looking at the math on maybe doing a Roth conversion on some of the money as well.

Brendan: You can use that money to convert to a Roth, if it makes sense for your situation. It gives you some optionality, but I will say that the idea of backing off the 401(k) contributions to begin building this cash pile, it's... Obviously we've covered how it's counterintuitive, but can be helpful, but I don't think you can overstate the simplicity of the 401(k) because it goes through payroll, it's automatic, it's kind of happening on autopilot behind the scenes for most people, the way they think about it. And then to have that money instead piling up in a place where it's accessible and you have to do some kind of... I mean, you could probably automate transfers into your savings account, but like there's a little bit of extra leg legwork involved for the individual there. And even a little bit of legwork is still more than none, so it's not the default setting.

Tom Mullooly: It puts kinks in the garden hose.

Casey Mullooly: I mean especially after like 25 30 years of working and probably having that money coming straight out of your paycheck, like it's going to be hard to break that habit.

Brendan: But like, if we're saying this to somebody who's within a couple of years of retirement, you're basically viewing that money that you're setting aside as like, you know what your monthly expenses are, so you can see the months of freedom adding up in your savings account. Hopefully that's enough for you to stay out of it, but it's easier said than done and it's right there, like you can just transfer it through your checking and spend it on something too. But if you're disciplined and you're focused on what you want to do and accomplish, I think it's doable, it's just a change.

Casey Mullooly: So would you recommend like an on or off type deal or more of like a dimmer switch and like contributing to both? I mean in like the 401(k) continue, just a lesser amount of 401(k) contributions and then whatever's left to savings or a brokerage account or just like stop 401(k) completely and then put it all in the savings account.

Brendan: It depends, like if you have a runway, then I think the idea is you're diversifying your tax base when you're investing in these different ways. So just right-sizing what's going to a savings account, what's going to a brokerage account, what's going to retirement accounts based on how much you want to have and the diversity of that base that you're looking for in the future. But if it's somebody who's like right on the doorstep and has let's assume a hundred percent of their money in a 401(k) and doesn't even have a savings account just has checking account 401(k)-

Tom Mullooly: Hey, we've seen it.

Brendan: Yeah. Then I'm saying to send that to a savings account and the only consideration for on off with the 401(k) would be like a company match. You obviously don't want to not get the company match because that's free money, but you could go straight down to that threshold to get your match and that's it, sort of thing.

Tom Mullooly: The other wrinkle in all of this is once you're past the age of 50, you can do accelerated contributions as well. And people kind of get hooked on doing that. Well, Hey, instead of doing 19 grand, I can do 26. So in a perfect world, it would be great if you had been building this cash stash all along, but-

Casey Mullooly: Cash stash, got the episode name.

Tom Mullooly: Well, I was going to say, I grew up in the 70s' when dimmer switches were everywhere, so I would be a dimmer guy.

Casey Mullooly: Okay. So how does something like social security factor into this equation as well? Is it something that you want to have enough in the savings account to tide you over until something like social security comes into play?

Brendan: I think like ideally from your retirement date to whenever you project to collect social security, you're going to have to bridge the gap. And so if you want to retire early, let's say you might have a window in your late fifties where you need after tax dollars you can get to, and then hopefully pretax dollars can supplement that throughout your sixties. So you can get to whatever age for social security makes sense for you, which is probably not immediately at 62. You're sort of funding those years where you could otherwise be collecting social security by building up these nest eggs and both of them can kind of get you there depending on how long of a runway that necessarily is for you.

Tom Mullooly: And that's a pretty frequent discussion that we have with folks about whether we should file early for social security versus, "Hey, let's tap into the 401(k) at age 62, three, four, whatever until we get to a number where social security really makes a meaningful addition to our monthly numbers." So it's kind of counterintuitive, I don't think most people are thinking that way, but it is something that enters into our conversations a lot. Like, "Hey, maybe we ought to tap into a 401(k) and then think about stopping for a few years.

Casey Mullooly: As I'm listening to you guys, I feel like the whole conversation just revolves around expenses and what it's going to take for you to live on a month to month or a year to year basis. And it just highlights how important that cashflow is on a monthly basis and how you can have all the investments in the world, but if your expenses are sky high through retirement, then it might not even make a difference.

Brendan: Yeah. I would say a final point about the 401(k) is I think that it's just been so ingrained in everybody to send all the dollars you can there, especially considering the tax incentive to do so. But the tax incentive is for me a secondary consideration and I would put priorities on top of that. And obviously if your priorities are a match with taking the tax incentive to put the maximum you possibly can into your 401(k) then sure. But that's hardly the case for most of the people we come across, so it should be more carefully considered. But I think the people that are telling you to fund your 401(k) as much as you can and do it that... Like it's not coming from a bad place, it's just that it's not one size fits all.

Casey Mullooly: These are the nuances that happen and when we're uncovering and making financial plans for people. So just wanted to share that with our listeners, because I think there was a lot of really good stuff in there, so thanks guys. Another topic that's come up over the course of the last couple of weeks and conversations is the likelihood of retiring with just a cash stash and not being invested in the market at all. I know we don't like to get into... It's a dirty word on this podcast, I've heard Monte Carlo simulations or just the odds of a successful retirement happening when it's just a big pile of cash without it growing at all. So what are the downsides to that and how would we work with an individual in that situation?

Tom Mullooly: Honestly, I think the hardest part is for someone who has not been a regular investor in the market or had a couple of bad experiences and never went back into the market, it's very hard for them to say, "Okay, I've got to change my ways and I really need to embrace this other approach where I have some money at risk." But it's risky to just say I'm going to not invest.

Brendan: Yeah. I think that's the riskier thing when it comes to retirement. I mean, obviously this is all like many other things based off of the expenses, but considering just like average expenses that we come across from folks in the area here, you would have to have many millions of dollars to be in a position where you could have a 100% fixed income portfolio and just retire on that and take the money you need, especially considering the rates that you're going to get on those sort of investments today. So if you're not in that position of having-

Tom Mullooly: Millions and billions.

Brendan: ...tens of... You know Dr. Evil. Tens of millions of dollars, like if you're in that sort of position, then, I mean, you can basically just do the simple math and say, if you have that much money and you have of a reasonable cost of living, you can just back out what you're going to need and say, "Why would we bother?" And I wouldn't blame you for doing so if the math works, why would you bother? That's absolutely right, you don't need any more risk than you should be taking.

Tom Mullooly: So what Brendan is saying is if you have enough capital, you can say, "I don't need any risk."

Brendan: Right. When you've won the game, stop playing. But I have yet to come across somebody who's in that sort of position to do 100% fixed income. Obviously there are many variations in between, depending on cash needs and asset base, but I've yet to come across the individual who doesn't need to take any sort of risk in retirement or generate any kind of growth.

Casey Mullooly: So obviously the approach would be not to have them be 100% invested. Moving from a 100% not invested to a 100% invested, some sort of mix in between there, like you said, depending on the individual and the circumstances.

Brendan: Say they are normal, it's what we're saying, because I think being a hundred percent in stocks as a retiree, drawing from a portfolio is nuts.

Tom Mullooly: And the flip side of that is taking someone who is deathly afraid of roller coasters and strapping them into the first car and say, "Okay, enjoy your retirement, don't look."

Brendan: Right. So right sizing that is what our planning process leads to in terms of all right, what are you going to need from the portfolio? And then what kind of growth are we going to need for that to sustain alongside things like social security or pension income for a 30 year retirement? What do we think that looks like? And talking to the person about why taking that risk is probably less risky than not taking it at all in terms of what they need to do, because the risk there is not taking it and just running out of money, especially considering rising costs inflation over time.

Tom Mullooly: I also think that there's just the unknown of... In addition to not knowing what things are going to cost, what path your life is going to take. Are you going to have a family member that you're going to need to support later on in life? Are you going to relocate? Are you going to be going into a nursing home? I mean, these are things that we don't know. And so we exercise as much care as possible, but there are just some things that we're, we're not going to know until they're on our doorstep. And so that's why we need to be flexible with this and being all in or all out of the market kind of leaves you swinging in the breeze.

Casey Mullooly: So the unexpectedness of life requires the unexpectedness of the market to be in play, right?

Brendan: Yeah. I think since we can estimate what costs look like down the road in terms of what are expenses today? What do they look like in the future? But we don't know how those monthly expenses transform over time, I think is what Tom is getting at. And so a hedge against that is obviously having some money in investments that are going to grow and give us some margin for error with the plan in terms of what we're expecting from costs because we don't know. To say the world today is just going to look exactly the same 10 years from now, except we're going to have 10 years of inflation that runs at exactly 2%. I mean that's probably a reasonable assumption as good as we're going to make without knowing the future, but we don't know the future. So I think you need to have some growth in there to give you some options down the line.

Casey Mullooly: The world's going to be different in 10 years?

Tom Mullooly: The world's going to be different in 10 days.

Casey Mullooly: No way. Come on. So would it be kind of again, like just in increment, like averaging in or-

Tom Mullooly: Baby steps. It has to be, otherwise, like I said before, you're strapping someone in the first car of the rollercoaster. It's just not going to work.

Brendan: Well I like to walk people through that, but I also like to walk them through that investing a lump sum when we're talking about money that we're putting to work for 10, 20, 30 years is absolutely going to perform better over time. And that averaging in is going to be a drag on their returns. However, having said that, I usually then follow that with, we obviously want to do what the client is going to be comfortable with. So if averaging in is the way that we get there, I just want everybody to go in with their eyes wide open that, that's probably going to be a detriment to the performance of how things add up. However, we need clients to stick with what we're doing and if that's how they're going to stick with it, then that's totally fine with us. So it's the right answer, but I do like to preface it with the fact that it's not the optimal answer. And if the client is open to the optimal answer, then I think that that's preferable.

Casey Mullooly: Good distinction there. Yeah. That's going to do it for episode 368. We hope you got some good takeaways from this one. And we'll be back for 369. Thanks for listening.