Mullooly Asset Podcast 193 - Transcript

Tim Mullooly: Welcome back to the podcast. This is episode number 193. This is Tim Mullooly, and here with me is ...

Tom Mullooly: Tom Mullooly. Hello.

Tim Mullooly: Welcome back. We are going to continue answering your questions. People have been sending in some pretty great questions that they have about their finances and financial planning and investing, and we try our best every week to answer them for you. That's what we're going to keep doing today.

Tom Mullooly: Please understand that when we do answer these questions, most of them are pretty sketchy. They're detail-light in terms of what we get. These are questions that come into a website and they get sent to us, so we have very little information. Understand that our response is not baked into an in-depth financial plan or analysis that we've done for these clients, nor should anything that we mention on a podcast be considered investment or financial planning advice.

Tim Mullooly: Right.

Tom Mullooly: With that, why don't we kick it off and start with our first question this week, Tim.

Tim Mullooly: Sure. First up, the question says, "Should I withdraw from my retirement accounts?"

Tom Mullooly: Okay, so let me give you a little bit of background information that we've got on this. The person writes in, "We're finding ourselves afraid to go into debt after our baby, but we need to pay for daycare costs and tuition to renew a specific license." The total that they estimate would be about $10,000. "It'll be a few months before I start working and making money again, and we have nothing to spare and are barely able to stay afloat paying for kids and braces and sports, the mortgage, health insurance and all the usual bills. Does it make sense to withdraw from our retirement accounts?"

Tim Mullooly: There's one things that we often times talk about with questions like this and it's the importance of having a safety net or some sort of emergency fund. The fact that the bills that they're estimating is only around $10,000 and they say they have nothing to spare, this isn't exactly answering directly their question, but it kind of goes back to probably where the problem started, the fact that they don't have any fallback savings or anything to be able to cover a $10,000 bill.

Tom Mullooly: It's a tough spot. This is someone that I think a financial planner could have helped a year ago, or a year-and-a-half ago. It's a tough spot, but you do need to have that safety net. We really discourage people from taking money out of retirement accounts, only because it's probably the most expensive withdrawal or the most expensive source for money that you can find. When you take money out of a retirement account, assuming that you can, when you do take money out, it becomes taxable just like ordinary income to you, federal and state. So you're going to get a 1099R for this distribution that you make.

On top of all of that, at the end of your tax return you have to take on a 10% penalty. So if you're taking out $10,000, assume your federal tax penalty is going to be an extra $1,000 on your tax bill. Many times people find out that they're getting about 50 cents for every dollar that they need to take out, so in this case you may need to take out, depending on your tax bracket, $15,000 or $18,000 to wind up with $9,000 or $10,000.

Tim Mullooly: So it's a pretty expensive way to have to pay your bills. An emergency fund could help the need to tap into these retirement accounts. Maybe think about scaling back the amount that you're contributing to the retirement account currently, and that'll help you get more cash flow on a monthly basis. Some of these things are monthly bills, so that could help you on a month-to-month basis.

Tom Mullooly: Yeah. We talk a lot in podcasts and in blog posts about how the future you is really going to dislike the current you because you're not doing anything to really help yourself without some kind of safety net. I'm not picking on the person who wrote this question, because I think this applies to most of Americans, that we operate without any kind of safety net, and so a car crash or a big car repair or a trip to the hospital could wind up really decimating any kind of financial footing that you have. So it is imperative, before you start putting away money for future you, meaning your retirement, you have to, have to, have to have some kind of safety net, and it should be at a minimum three months of your fixed and variable expenses. We did a video on this. Tim, you can link to it in the show notes, about how much you should have. That's a minimum three months. In my opinion, should be more.

Tim Mullooly: Right.

Tom Mullooly: Let's move on to the next question about cars and mortgages and debt.

Tim Mullooly: Sure. The question says, "How will buying or leasing a car affect my ability to get a mortgage?" The question goes on to say, "I am currently renting and want to buy a house this year. My car lease ends in January, which is around the same time I want to start looking for a mortgage. How will getting a new car affect my ability to get a mortgage? My credit is average at 680. I plan to pay off credit cards by then, which the credit estimator on my credit card app shows my credit would increase to 708. Would it be better to finance the current leased car or finance another car?"

Tom Mullooly: Oh, boy. It might be better to take the bus.

Tim Mullooly: Right.

Tom Mullooly: So, there's so many things that we need to unpack in this. Car leases, car payments, in general, are supposed to be a patch to get you started in a car. Hopefully, cars will last longer than the last payment, whether it's a lease or a payment on a car. So, one of the little tricks that I used to teach my young clients early on was when you make your last car payment, next month, whatever the car payment is, $375, whatever the number is, send it in to me and we'll put it in your account. Continue to make that payment every month, but pay yourself instead of sending it to an auto-leasing or an auto-finance company.

Whether you have a car lease, if you have a 36-month obligation, it's an obligation. It's a debt obligation. If you have a 60- or 72- or 84-month car loan, it's an obligation. Both are going to affect your credit score, both, to different degrees.

The other things that I saw in this. "I plan to pay off my credit cards." So you've got credit cards, you've got a car lease that you're winding up, and you want to decide should I lease another car or buy another car, which you may not have money for. And then, if you do own these things, some app on your phone is telling you that your credit score is going to go to 708.

Tim Mullooly: I think that was the big thing that stuck out in that question to me was this credit estimator on their credit card app said that their number would increase to 708 or whatever they said. But just the fact that ... I wouldn't rely on a credit card app to tell you whether or not you're going to be able to afford a loan or how's it going to affect your credit score to get a mortgage. I would recommend sitting down with a mortgage banker, someone who is well-versed in mortgages and how getting one would work, as opposed to trusting a credit card app. That's just my personal opinion.

Tom Mullooly: Yeah. Understand that if you talk to a mortgage banker or a mortgage broker, they don't charge a fee for that. They get paid when they put a loan together, so there's no harm in asking someone in the mortgage business to sit down with you and go through the numbers instead of trusting some app on your phone. I think you're going to get some solid advice on which way to go. We actually interviewed a mortgage banker in one of our earlier podcasts this year, and we also put together a video on renting versus buying, as well.

The other thing is when you're looking to buy a house ... Now, the yardage markers have moved all over the field. It's kind of like football. It used to be that 28% or 30% of your gross income could be applied towards a mortgage payment, and no more than 38% or 40% of your total gross income should cover all debt, including the mortgage. For me, that's always been a pretty good rule of thumb. Now, depending on market conditions, sometimes it's more, sometimes it's less, sometimes they move the yard sticks all over the place, but in general, you really need to think about how much debt you're carrying on because if you've got a car payment, certainly if you've got a lease right now and your lease is, say, $400 a month, don't take on a bigger lease. Don't take a bigger one on. Same thing with a car payment. Don't take a bigger one on. Credit cards, they look at your ability to manage credit. That's what your credit score is all about, is how can you manage the credit you've been given already before we give you more.

All right. Enough about that.

Tim Mullooly: Moving on. The next question says, "Should we use our 401K funds to pay off a home equity loan?" A little background on the question, the asker says, "I am 50 years old. My husband is 59. We will have our primary mortgage paid off in one year." Congrats. "But we have a $82,000 second mortgage. We have retirement savings of over $700,000. Is it a good idea to use some of the retirement funds to pay off the second mortgage?"

Tom Mullooly: All right. There's more to this.

Tim Mullooly: Right.

Tom Mullooly: But before we get into the more details, I just want to address a couple of things. Your primary mortgage is going to be paid off in one year. If you understand how mortgages amortize where you have a fixed payment every month, but at the front-end of your mortgage, like Tim, your mortgage, it's mostly interest payments now. When you get to the end of your mortgage payments like these people, it's almost all principal, very little interest. So the write-off that they've been getting on their mortgage has been decreasing every year. Now, if they have this mortgage almost totally done and they've got a home equity for $82,000, the first thing I would say is how much equity do you have in your house? Because when you carry a home equity, you can write off the interest as long as it doesn't exceed the value of the home. You can write off the interest, and it's one of the only interest expenses that you still have.

10 years ago a lot of people were paying for their sons and daughters college education through home equity because they had the equity and they didn't need to take student loans out, so this is something that's still deductible. You may want to look at the idea of expanding your home equity, your second mortgage, to do what you want to do. I kind of gave the answer away by ...

Tim Mullooly: Right.

Tom Mullooly: Let's get into some more of these details.

Tim Mullooly: Right. Another thing, before we get to those details, is they have $700,000 of retirement savings and the second mortgage is $82,000. If they were take $82,000 from their $700,000 of retirement savings, that's almost 12% of their retirement savings that they're not going to have in retirement. That's something you want to think about. It's one thing to pay off the second mortgage, but you need to do some planning ...

Tom Mullooly: You need to manage this.

Tim Mullooly: Right.

Tom Mullooly: Right.

Tim Mullooly: Yeah. You have to handle this the right way, so hopefully we're helping you down that path.

Tom Mullooly: They also gave us a little more information. Do you want to share that?

Tim Mullooly: Sure. It goes on to say, "The interest rate is 4.35%. I realize we will incur a 10% penalty on top of federal taxes, but the extra $1000 per month would be helpful in assisting our pitiful effort at a college savings account. We have a daughter starting college Fall 2018, and she has a younger sister. Wondering if it would be worth it to incur the penalty in taxes to save the interest over the next 10 years?"

Tom Mullooly: So they're talking about paying for college in student loans or whatever over the next 10 years. If you take out a student loan, even if you take out a plus loan, a parent loan, they're payable in 10-year time increments. I don't like this strategy of taking money out of retirement. I probably wouldn't have been as aggressive as these people were to save money for retirement, but they are where they are. So if there's a way that they can slow down tremendously the amount that they're socking away in their retirement plans, that may be something for them to consider.

Tim Mullooly: Right. Reallocating the savings that they're doing on a monthly basis from going into the retirement accounts to getting ready to pay for their daughters' college.

Tom Mullooly: Right. We don't know the details. We need more information, but if someone's 59 and their spouse is 50 years old, and they've got $700,000 socked away for retirement, both of them may be working and both of them may be maxing out their contributions, which, if you're over the age of 50, that's $48,000 between the two of them. You can pay for a lot of college.

Tim Mullooly: Depending on where the girls are going to college, that could be a semester or two.

Tom Mullooly: Sure. So we've got another college-related question now, as well.

Tim Mullooly: Right. Next question says, "Should I use my traditional IRA to pay for my son's college tuition?" It says, "I have a traditional IRA and I am short $3,000 for my son's tuition this year. The school does not have a payment plan. If I use the funds from my IRA and have the $3,000 deposited back within 60 days, will I get hit with federal tax?"

Tom Mullooly: All right, so let's answer this in reverse. If I take money from my IRA and put the money back within 60 days, do I get hit with federal tax?

Tim Mullooly: No.

Tom Mullooly: The answer is right, it's no.

Tim Mullooly: If you do it.

Tom Mullooly: I will tell you that in our experience over all these years, many people attempt to do this. Very, very, very few actually do it where they get the money back in the account on day 59. It just doesn't happen.

Tim Mullooly: Right.

Tom Mullooly: So, good idea. Sounds good on paper. Very poor execution in my experience, what happens, and then it winds up becoming a taxable event. So the $3,000, in this case, would be taxable, plus a 10% penalty on top of all of that, as we outlined in a previous question.

Tim Mullooly: I think this kind of falls back to the first lesson that we gave, the first question, too. I mean, $3,000 means something different to everyone, but in general, that's not a very large amount of money. If they had some sort of savings or emergency fund they could fall back on, they could be able to cover that $3,000 and eventually build it back over time.

Tom Mullooly: The other problem that we're looking at is what happens for the next year of college? There's no preparation for that, so it's a tough spot. People are in a jam. They need to do something to help their kids, pay for college, don't saddle them with a lot of debt. I get it, I completely get it. But they are screwing themselves by taking money out of retirement to pay for today's expenses. It's a tough spot to be in. It really is.

Tim Mullooly: Agreed.

Tom Mullooly: All right. We've got one or two left, right?

Tim Mullooly: Yup. Couple left. Next question says, "Has the recommended stock/bond mix changed throughout the years?" The summary says, "I'm approaching retirement with perhaps 90%/5%/5% in a stock/bond/cash mix."

Tom Mullooly: So that means they have 90% in stocks, 5% in bonds, 5% in cash.

Tim Mullooly: Right. It goes on to say, "Classic advice calls for changing this to less stock, more bonds. Lately I'm reading that bonds are not what they used to be. What should I do?"

Tom Mullooly: All right. This clearly falls in the zone of offering investment advice, so understand that what we're going to talk about is not investment advice because we don't know this person and we can't give information based on two lines.

Tim Mullooly: Yeah, this is not specific at all. Speaking in generalities here.

Tom Mullooly: I don't necessarily know what classic advice means for dropping the stock percentage [crosstalk 00:19:50] ...

Tim Mullooly: I was going to say ...

Tom Mullooly: ... the bond percentage.

Tim Mullooly: I was going to say the same thing. What do you classify that as, classic advice? I don't ... Unsure.

Tom Mullooly: One of the great all-time investors is a guy named Charley Ellis, owns no bonds. No bonds.

Tim Mullooly: Right.

Tom Mullooly: Some people feel more comfortable owning bonds because over the years they've seen what bonds can do on a relative basis. Doesn't mean it always happens, it means relatively when stocks are volatile, bonds are not. When you retire, the idea is, "Hey, we don't want this much volatility in our account, so let's load up on some more bonds and lessen the stock side of things so that our accounts are less volatile." You have to decide am I at my goal for retirement? Am I reaching the dollar number or am I going to be able to withdraw enough over the years where I don't have to have that much in growth oriented investments.

Tim Mullooly: Right. If you the amount you're at, if that's enough for you and you want to scale back some of the volatility, then it might be time to change the allocation that you have to be less stock oriented. But, at the same time, we don't know what's going to happen in the market going forward in the future. Stocks could start underperforming and bonds could start appreciating in value. We don't know what's going to happen.

Tom Mullooly: One other thing that Brendan has spent a lot of time talking about in our meetings is if you were to zoom out and look at charts of some of these bond indices, and even some of these bond ETFs that have been around for a while, and just take a big picture, yes, there's going to be times where bonds, on a short-term scale, where bonds get clobbered. They get destroyed. But that's a relative term. Over the long haul, bonds are a stable place to put money. They do fluctuate, make no mistake, and there are going to be times when you're losing money on your bonds. We've seen it happen. But over the long term, bonds are a terrific place to generate some cash flow and keep the relative performance pretty stable. The problem is a lot of people try to get cute and try to time this stuff and say, "Well, the feds going to do something on Thursday so we need to act now."

Tim Mullooly: And that's where it gets a little fishy for people sometimes.

Tom Mullooly: Okay. Last question that we've got this week. "Do I need to have a retirement plan?" And the person who wrote this in said, "What if I don't want to have any of the retirement plans offered by an employer? Do I have the right to not accept the plan?"

Tim Mullooly: Some companies will automatically enroll their employees in the plan, but that doesn't mean you need to contribute to it. You can scale down your contributions to zero percent and take the income instead of putting money into the retirement plan. So, even though you were automatically enrolled, no, you don't have to. You can take the money in your paycheck if you want. Might not be something that we would recommend a lot of the time, but ...

Tom Mullooly: I think that's good advice. You're not on the hook and you can always zero out your contributions, even if it's just for a temporary period of time.

So that's all the questions that we've got for episode 193. If you have questions, you're probably not the only one who's thinking of them. Get in touch with us and you may wind up seeing it or hearing it on a future production from Mullooly Asset Management. Thanks for listening and we'll catch you on the next one.