<u>Saving For a Home, Nearing Retirement, & Index Funds - Transcript</u>

Tim Mullooly: Welcome back to the podcast. This is episode number 198. This is Tim Mullooly.

Tom Mullooly: And this is Tom Mullooly.

Tim Mullooly: We're getting closer and closer each week to episode 200. We've been saying it, but we actually need to ... Let’s think of something special to do for number 200.

Tom Mullooly: We'll have some kind of special celebration. Talking about getting closer and closer, we're getting closer and closer to our microphones, too.

Tim Mullooly: Right. Got some new stands here for our mics, upgraded the setup a little bit.

Tom Mullooly: That's right. We get the content for these podcasts from questions that come in through a website. They are sometimes financial planning questions. Sometimes they're investment questions. Sometimes they are money management questions, or things about cash flow. They're great questions. If someone is writing into a website to ask questions, it means that this is really bothering them, and they need some answers to it. It's also a little disappointing to think that there's no one in these people's lives who can answer some of these questions, so we're happy to help, but it's worth mentioning that if you have a question on one of these topics or a related question, get in touch with us. We're very rarely going to be discussing specific investment advice on these podcasts. A lot of these things are general in nature, and we encourage our listeners to reach out to us if they want to get into a topic that was covered a little deeper.

Tim Mullooly: Right. And these questions are usually just good springboards to get us going to talk about the question that's asked, and then also leads us into bigger discussions about some underlying problems that could help prevent some of these issues, as well.

Tom Mullooly: That's a good point, Tim. There's a lot of questions that come to us where what they're asking may not actually be the root issue. Sometimes it will take us off on a little bit of a tangent, but it's worth talking about. Why don't we jump into the first question this week?

Tim Mullooly: Sure thing. The first question we have today asks:

“Should I lower my contributions to my 401(k) as I near retirement?”

The summary says, "I currently maximize my 401(k) contributions, including catch-up, but I am retiring with a great financial plan next year at age 55. Should I reduce my 401(k) contributions? My employers' match is 6%. That will give me more cash to use for the next 10 years before enrolling for Medicare. I will also delay social security until the age of 67."

Tom Mullooly: Okay. A lot to unpack there. This person is going to be retiring next year at age 55.

Tim Mullooly: Right.

Tom Mullooly: Most people now, when you talk about retirement, they're talking about 65 or beyond. He's raised some interesting points. At 65, you can enroll to receive Medicare. You can start receiving social security at 62. As people get older, like this person, his normal age for social security will be 67, like it will be for me. It had been 65. There's a lot going on here.

His question is, "I currently maximize my 401(k) contributions, including the catch-up." I wanted to also say that Tim wasn't referring to the stuff you put on a hamburger. The catch-up means that once you're age 50 and you're in a 401(k) plan, the annual maximum contribution for you as a participant, an employee participant, is normally $18,000 per year.

But once you reach the age of 50, you can actually make contributions up to $24,000 a year as a way to kind of catch up, accelerate what you are doing to sock away as much as you can for retirement. He's retiring with a great financial plan next year at age 55. "My employers' match is 6%."

Tim Mullooly: Depending on how great this financial plan is that this person's talking about, my initial opinion is if you're going to be retiring at age 55, that's a little earlier than most people expect to retire. You're probably going to need as much money in your retirement plans as possible.

I would actually do the opposite. I would think about contributing as much as you can before you retire because once you retire, you're not going to be able to put any more money into that 401(k).

Tom Mullooly: Let's just kind of think this through. If you're contributing $24,000 like this person is to a 401(k), we don't know what he's got in the 401(k). We don't know if he's got a pension. We don't know what his financial situation is. But if you're putting $24,000 in pre-tax to your 401(k), if you lower your contributions or eliminate your contributions, at this point, you're going to have an additional $24,000 each year in taxable income.

The whole idea with putting money away for retirement is so that the money can grow on a tax-deferred basis until you take it out at a later age. You'll have time for this money to compound, and you're deferring the taxes until hopefully you're in a lower tax bracket. No one can predict where tax brackets are going to be when you decide to start taking money out of your 401(k), but I would make sure that your contribution is at least 6%.

The thing that has just got my ears a little pointy when I heard Tim read the question back is this person wrote in and said, by lowering my contributions, this will give me more cash to use for the next 10 years before enrolling for Medicare.

It sounds like there may be some issues with cash flow now versus retirement later. This goes back ... Tim, we can link to almost every single podcast that we've done where we talk about managing cash flow. Manage today's cash flow so the future you doesn't hate you in the future because you messed up today.

Tim Mullooly: That's probably the number one underlying theme. You could answer almost every question you ever answered on this podcast with that. Make sure your cash flows are in order. It's going to make your life a lot easier. This person says they have a great financial plan, which they might.

We don't know the details about that, but if they've thought it through and they did all the numbers, running the number of different accounts they have, income, 401(k)s, planning to retire at age 55, then that's great. But my gut reaction is if you're typing this question into a website asking for some random person's opinion, it might not be as great of a financial plan as you think, if you're asking for a second opinion.

Tom Mullooly: Okay. I would definitely make sure that if you're going to reduce your contributions, make sure you get that employer match. 6% is pretty healthy.

Tim Mullooly: Let's move onto the next question. The next question asks:

“How do I choose a good index fund to invest in and where should I buy one?”

The summary says, "I'm 25 years old and have a decent amount of savings in a variety of different six month and one year CDs. I would like to move some of my savings into an index fund to get a higher return on my investments. I'm wondering what entails a good index fund and how/where should I buy one?"

Tom Mullooly: Oh boy. Again, let's go through this. The person writes in, "I'm 25 years old and have a decent amount of savings." Some people think $250,000 in savings is not enough. Other people think $50 is enough. Everybody's definition of a decent amount of savings is going to be different, but the money is in six month and one year CDs. Great. This is savings. What he's trying to do is say, "Hey I feel stupid with my money sitting in CDs at very low interest rates when I see the stock market going up every day. What should I do?"

This is one of the dangers I see in people just blinding throwing money into an index because some people believe that it's guaranteed money. It's not. Brendan, who's not on the podcast with us today, but Brendan talks about how returns are lumpy. Another way of putting it is, as he describes it, is that ketchup bottle, like we had from the first question.

If you turn a ketchup bottle upside down and you're pounding on the bottom of it to get the ketchup out, nothing happens. Nothing happens. Nothing happens. And then all of a sudden you get this big blob. That's what stock market returns are like. It's lumpy. It doesn't come in straight lines.

And I think the problem with a lot of novice investors is that they just see the stock market going up and feel that they're not making a smart decision by having their money in the bank.

What is this money really?

Tim Mullooly: It's savings for this person. If you're 25 years old, odds are, you still have a lot of big purchases left in your life to make. Would investing that money really be the best thing to do? If you don't need this money for, say, buying a house or buying a car or something big, then putting it into an index fund for a long time, over that long period of time, odds are you're going to see pretty decent returns.

But if you're 25 years old and you're going to need this money in the next two or three years to put a down payment on a house, I would recommend leaving it in the savings account where it is now. You never know what's going to happen over that short amount of time.

Tom Mullooly: Good advice. What we talk about all the time before you begin investing, you need to put money into a savings account, several months of your fixed expenses at least. Three to six months at a minimum, so that you can make better decisions with the dollars above and beyond that. Don't bet the rent. Good question.

Tim Mullooly: Definitely. The next question that we have here asks:

“Should I start investing in a Roth IRA at 70 years old?”

Tom Mullooly: I love getting questions like this.

Tim Mullooly: Right. The summary goes onto say, "I'll be 70 and a half years old in December. I'm told I'll have to take a certain amount out of my retirement plan. I don't want the money right now. What would be the best way to invest those funds? I'm thinking about a Roth IRA."

Tom Mullooly: Okay. A Roth IRA is attractive in many ways because when you put money into a Roth IRA, it's already after tax dollars. Then the money compounds without any taxes until you take it out, including never taking it out.

This money can compound for a very, very long time. But I just want to walk back what this person wrote. "I'm going to be 70 and a half years old in December." They're taking their first required minimum distribution this year from the IRA.

Tim Mullooly: From a traditional IRA.

Tom Mullooly: Right. "I'm told I'll have to take a certain amount out of my retirement plan." Then they go on to say, "I don't want the money right now." Well, you have to take it.

Tim Mullooly: It's required.

Tom Mullooly: It's a required minimum distribution.

Tim Mullooly: It's not a suggested minimum distribution.

Tom Mullooly: Right. It's a required minimum distribution. You have to take it out. Your broker or bank, wherever the IRA is, can have taxes withheld for you, just like in a paycheck, so you don't have to write a check to the government, but you have to take a minimum amount out each year now going forward. If you want to put money into a Roth IRA, there's nothing stopping you, except one thing. You've got to have earned income. You have to have earned income to put money into a Roth IRA.

Tim Mullooly: Right. Unlike a traditional IRA, there's no age really that stops you from having a Roth IRA, but you do need to have earned income to be able to have a Roth IRA account.

Tom Mullooly: We get the same question at the opposite end where parents want to open up a Roth IRA for the kids. On paper, sounds like a great idea. But the problem is, if the kids don't have jobs, if they're five or six years old, you can't have a Roth for them. They have to have some kind of earnings. To this person who wrote this question, if you have a part-time job where you're making $6000 a year, for example, you can put $5500 ... Well now wait a minute. They're 70 years old. They can put $6500 a year into a Roth. You can put away up to 100% of your income, or in this person's case, $6500 each year, but you've got to have the earned income. If you're not working, we're sorry.

Tim Mullooly: Right. Moving onto the next question. It asks:

"Can I continue to contribute to my Roth IRA after my SEP IRA is set up?"

"I am an independent contractor who is considering setting up a SEP IRA account. In the past, I have only contributed to a Roth IRA, but I would like to put more money away for retirement. I am under the income limits."

Tom Mullooly: Okay. This person knows that there are income thresholds for Roth IRA contributions. If you make too much money, there's thresholds where you can't contribute any more to a Roth IRA. I believe we're going to have to ... In the transcript, Tim, let's make sure we get the numbers right. But the ballpark numbers are if you're a single filer, it's about $110,00 a year in adjusted gross income, and about $180,000 a year in modified adjusted gross income for couples filing jointly. Tim, you're going to get those numbers straight in the transcript.

Tim Mullooly: Yep, absolutely.

Tom Mullooly: This person is an independent contractor who is under the income threshold. They can put money into a SEP IRA, and they can put a lot into a SEP IRA. They can put away, depending on how the numbers break, they can put away up to almost $50,000. If they're under the income limits, they can still do a Roth IRA.

Tim Mullooly: Yep.

Tom Mullooly: Good question. Let's go onto the next one.

"How should I save when I'm trying to buy a home within the next five to 10 years?"

The person writes in, "I'm currently saving $130 into an online savings account that earns 1.3% APY, annual percentage yield, and $55 into a brokerage account that's earning currently," I'm pausing because I can't believe this number.

"This brokerage account is currently earning 13.7% return every two weeks. Not a typo. My brokerage account has about $2300. The savings account is about $1400. With the time horizon of five to 10 years, which one would be more beneficial to save into? I'm planning on doubling or tripling my savings rate once I pay down my $7000 in credit card debt. I'm currently earning a little over $43,000 a year. My raise this year will bump me up to 50 grand."

Tim Mullooly: Let me just get this straight. Is the person asking which account would it be better to save into, the one earning 1.3% or 13.7%?

Tom Mullooly: Right.

Tim Mullooly: That's a tough one.

Tom Mullooly: A little sarcasm from Tim Mullooly. I think the one ... If you take 13.7%, which they're earning every two weeks, and you multiply that by 26 weeks, you make a return of 356% on your money. That's simple interest. It's not compounded.

Tim Mullooly: Oh boy. This is our big sigh.

Tom Mullooly: Yeah. I have my doubt about a brokerage account that's earning 13.7% in a year or every two weeks. I just don't see how this is possible.

Tim Mullooly: Right. Even if it was 13.7% a year, it would still be a no-brainer.

Tom Mullooly: Right. Here's my ... Let's take this question and just twist it a little bit. Let's just say he's got a savings account that's paying 1.3% and he's got a brokerage account where last year, in the last year, he's earned 13 and change. Does that mean that he's going to earn 13 and change every year going forward?

Tim Mullooly: Definitely not. In fact, he should probably expect to not have that happen. I mean, looking back at what we just said about the ketchup bottle, market returns are usually pretty lumpy. On a year-to-year basis, it'd be foolish almost to expect 13.7% every year.

Tom Mullooly: Now I've been doing this for 30 years. I don't remember two years back to back that return the exact same percentage return. The odds of this repeating again in the next year are pretty slim. The other point that I wanted to make in this is that they're also trying to pay down $7000 in credit card debt. I'm sure that's not a 0% ... Well I'm not sure, but I hope that it's a 0% interest because if they're paying any kind of interest there, that's almost a guaranteed return if you were to pay that down, as well.

Tim Mullooly: Another thing that I wanted to bring up, kind of going back to the very first question that we had, the savings account that they have is obviously in their eyes, returning significantly less than the brokerage account, but 1.3% isn't terrible in a savings account. And if they're trying to buy a home within five to 10 years, that's a short amount of time. Having that money that you need to buy a home with, it might not be something that's worth putting into the risky stock market. It might be better off just loading up that savings account and getting your 1.3%.

Tom Mullooly: Right.

Tim Mullooly: That's just my two cents.

Tom Mullooly: From the year 2000 through 2009, the first decade of this century, the S&P had a gain of about 0%. The only thing you got for 10 years were the dividends. You made no money, in terms of price appreciation. There have been periods of time recently where the stock market hasn't been a friend to the investor. Word to the wise, if you're saving money, like Tim said, that you're planning on using in the next couple of years, five years maybe, for a down payment on a house, keep it safe. You don't want to have to worry about timing the market to get your down payment out of the house.

Tim Mullooly: It's such a big decision and a big payment for people to make, gambling it or putting it at risk at all is a big gamble.

Tom Mullooly: Yeah.

Tim Mullooly: That's going to do it for episode number 198. Thanks for listening. Like we said in the beginning, if you have a question or something you want us to talk about on the podcast, get in touch with us. You can find us at Mullooly.net. That's M-U-L-L-O-O-L-Y.net or give us a call (732) 223-9000. We will see you next week on the last episode before the big 200, number 199.