Sigma Summaries

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Will Your Golden Years Be Golden?

Recently, after a discussion with a younger friend, I felt that I had encountered a microcosm of today's society. She and her husband, both approximately 50 years old, have a 19-year-old son and a 16-year-old daughter. Both parents have multiple college degrees and are moderately successful in their careers, which have included a number of jobs over the years. When one looks at their financial situation, however, a different story emerges.

Although this couple spends money in ways that I don't understand, one could not say that they live lavishly. Why is it, then, that they find themselves in their fifties with only a small amount of equity built up in their home worth $400,000, a fair amount of credit card debt, virtually no savings to fund their children's college education and relatively little saved up in retirement accounts?

My impression is that this predicament is not unique to my friend but rather, emblematic to many baby boomers who are in their middle ages, including some of my children. If my impression is indeed correct, I suspect that part of the explanation that is driving this behavior lies in factors that have been shaping our society during the past quarter century. Moreover, these trends may be creating a future societal problem that is not only imminent but with dire financial consequences for those that are exposed.

As one who grew up during the Great Depression, served in World War II, and finished my formal education after the war, I encountered a different world than the one my children are exposed to. On the one hand, I had a government-subsidized education and the availability of a low interest mortgage on the first house that I bought after I got married. On the other hand, I wasn't able to purchase anything else until after I saved the money for the purchase. In fact, I actually paid cash for my first car!

I also moved into a workforce where it was commonplace to have a company paid pension plan which vested over a multi-year period and created, to a degree, company loyalty. Company paid health care was not as common, but the cost of health care was not as expensive as it is today. As a result, many in my generation are experiencing truly golden years. We are living in a home with little or no mortgage and enjoy both the benefits derived from company pensions, Social Security and Medicare. If we use credit cards, it is based on convenience and in lieu of paying cash, and of course, the bill is always paid in full at the end of the month.

I contrast this environment with that of my children and now, my grandchildren. For example, the cost of college education has exploded in recent years. As a result, those graduates who cannot rely on their parents to pick up the tab are often faced with student loans, with some in excess of $100,000, before they begin their first full-time job. Surprisingly, many of these graduates appear comfortable with this large level of debt as many of these loans are government-subsidized and can be paid back over many years in "low and easy" installments. Moreover, if money becomes tight, there is readily available credit through the credit card companies that requires only a small monthly payment as well but often charge between 12% and 22% interest, compounded. Cars tend to be leased, not purchased, which is also a form of borrowing and results in a 2 to 4 year cycle of regularly buying new cars. And of course, when it is time to buy that first house, there are a variety of financing options available, including even interest only loans. As equity is realized in the value of the home, it

is quite common to borrow against this value in the form of an equity line of credit to buy even more toys or pay off debt elsewhere.

Do you begin to get the picture? The expansion of readily available credit, which the government has fostered to contribute to the growth of our economy, has also created a burden that all of us are carrying. As pointed out by James Grant, editor of Grant's Interest Rate Observer, in a recent New York Times op-ed column, the economy's aggregate indebtedness, as a percent of Gross Domestic Product, is about double that of 1958, the last time interest rates were as low as now.

How about on the saving side? Much has been made of the growing popularity of IRA's and 401-k plans as tax-advantaged ways to save for retirement. These plans are funded with employee contributions and in some cases, are partially supplemented by employers as well. What is often overlooked is that the growth of these plans is often offset by the discontinuance of company-paid pension plans that would usually provide a greater benefit than these self-funded plans.

For example, let's assume a retiring executive was to receive a pension of $40,000 at age 65. To replicate this income through the purchase of a lump sum single premium annuity, it could cost in excess of $500,000. If the pension continued for the life of a spouse, the cost would be much closer to $600,000.

Not only does the vanishing availability of company sponsored pension plans place an increasing burden on today's generation, it really demands a very disciplined savings program over a large number of years simply to break even. Unfortunately, the temptation to borrow against or deplete these funds prematurely reduces the likelihood that there will be sufficient capital remaining at retirement to satisfy one's needs.

The upshot of this is that unless those in the baby boomer generation or younger are highly disciplined, many will lack the financial resources in their retirement years that I now enjoy. They may have little equity in their homes, unnecessarily high credit card debt and inadequate retirement income. In addition, they are facing an uncertain future pertaining to Social Security, Medicare and the rising cost of health care.

I wish I had an answer to this conundrum. The first step lies in recognizing that the problem exists and encouraging those we love to prepare for their uncertain future by saving more and reducing their indebtedness, particularly the use of high credit card debt. I also feel that many baby boomers and their subsequent generations may find that they cannot, in fact, retire at the traditional retirement age of 65. In Florida, where I am now a resident, working beyond one's traditional retirement age is commonplace. For some, including myself, the decision to work reflects a desire to remain active and intellectually stimulated. For others, it reflects an economic necessity. Finally, our legislators will have to deal with the rising cost to fund Social Security and Medicare. It seems to me that either benefits will be reduced or taxes will need to be increased, neither of which contributes to one's re-election.

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Sigma has developed a financial planning tool (Sigma's Wealth Manager) to assist individuals in preparing for retirement. This financial planning model allows us to forecast cash flows and portfolio values over a multi—year period (not to exceed 55 years). This exercise has proven invaluable as we assist our clients in developing sound financial plans and appropriate asset allocation strategies.

If you would like to learn more about our investment management and financial planning services, please don't hesitate to give us a call.

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Please remember to contact Sigma Investment Counselors if there are any changes in your financial situation or investment objectives.