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Focus on the Basics

It's easy to become overwhelmed when faced with all the decisions that need to be made to ensure you select appropriate investments to help pursue your long-term investment goals. How do you choose the right combination of investments to help you work toward a goal that may be decades away? The answer is to focus on the basics. Make sure you are getting these fundamentals right:

✔ **Don't wait — invest now.** To put the power of compounding to work for you, start investing now. It's easy to put off investing, thinking you'll have more money or more time at some point in the future. Typically, however, you'll be better off saving less now than waiting and saving more later. Consider the savings habits of a 20-year-old couple. The wife starts contributing $2,000 per year to a tax-deferred investment, such as a 401(k) plan, when she is 20. After 10 years, she decides to stop investing and let her money grow until retirement. She has invested a total of $20,000. Her husband starts investing when she stops, investing $2,000 per year from the time he is 30 until he retires at age 65. Thus, he saves every year for 35 years, making a total contribution of $70,000 — $50,000 more than his wife. If they both earn 8% compounded annually, who will have the larger potential balance at age 65? Time and compounding of earnings favor the wife. Before paying any taxes, her balance would equal $462,649, while

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Mortgages: Consult with Us, Too

Are you in the market for a home? Perhaps you need a larger space with room for a dedicated home office, or maybe you've decided to downsize as retirement looms. Perhaps you've decided you'd like a vacation home. Whatever the reason, when considering a mortgage, we recommend a consultation with your financial advisor. Mortgage brokers provide valuable information about interest rates, types of mortgages, down payments, and how credit scores affect options. But they are not in the best position to advise consumers on how the mortgage can best be structured to support long term financial goals.

The Economist recently ran an article titled "Poor Financial Decisions, Regulators are Keen to Stop People from Making Mistakes." Topping their list of poor financial decisions are those that people make when taking out mortgages. "Most American home loans last for 30 years, the interest rate fixed. When rates fall dramatically, most borrowers might be better off if they refinanced. Yet too few do. In 2013, 42% of American borrowers paid rates exceeding 5%, when the average rate paid on new mortgages was less than 4%."

Types of Mortgages: What You Need to Know

Homeowners are faced with the choice of a 15-year or 30-year fixed-rate mortgage, an adjustable-rate mortgage, or a hybrid adjustable-rate mortgage. Perhaps it is the seemingly complex set of choices that drives most homeowners into the 30-year fixed mortgage.

Fixed-Rate Mortgage: With a fixed-rate mortgage (typically 15 or 30 years) the interest is fixed for the entire term. Whether interest rates move up or down in the marketplace, the interest rate on the mortgage doesn't change. If interest rates drop enough, the homeowner may consider refinancing to take advantage of the lower rate.

Adjustable-Rate Mortgage (ARM): Adjustable-rate mortgages (ARMs) were rare in the U.S. until 1981. Though once

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her husband's balance would be $372,204. *(This example is provided for illustrative purposes only and is not intended to project the performance of a specific investment.)*

✔ **Live below your means so you can invest more.** It's a basic fact that most people have trouble coming to grips with — the amount of money you have left over for investing is a direct result of your lifestyle. Don't have any money left over for investing? Ruthlessly cut your living expenses — dine out less often, stay home rather than going away for vacation, rent a movie rather than going to the theater, cut out morning stops for coffee. Redirect all those reductions to investments. This should help significantly with your retirement. First, you'll be saving much more for that goal. Second, you'll be living on less than you're earning, so you'll need less for retirement.

✔ **Maintain reasonable return expectations.** When developing your financial goals, you'll typically decide how much you need, when you'll need the money, and how much you'll earn on those savings. Those factors will determine how much you need to save on an annual basis to reach your goals. The higher your expected return on your investments, the less you need to save every year. However, if your assumed rate of return is significantly higher than your actual rate of return, you won't reach your goals. Thus, it's important to come up with reasonable return expectations. While past returns aren't a guarantee of future returns, you'll want to start by reviewing historical rates of return for investments you're interested in. You can then adjust those returns based on your expectations for the future. Assessing your progress every year will allow you to make adjustments along the way. If your return is lower than expected, you may need to increase savings or change investment allocations.

✔ **Understand that risk can't be totally avoided.** All investments are subject to different types of risk, which can affect the investment's return. Cash is primarily affected by purchasing-power risk, or the risk that its purchasing power will decrease due to inflation. Bonds are subject to interest-rate risk, or the risk that interest rates will rise and cause the bond's value to decrease, and default risk, or the risk that the issuer will not repay the bond. Stocks are primarily subject to nonmarket risk, or the risk that events specific to a company or its industry will adversely affect a stock's price, and market risk, or the risk that a stock will be affected by overall stock market movements. These risks make some investments more suitable for longer investment periods and others more suitable for shorter investment periods.

✔ **Diversify your portfolio.** When stocks had above-average returns for an extended period, diversification acted as a drag on total return. By definition, allocating anything other than all of your portfolio to the best-performing asset lowers your return. But when stocks decline substantially, the disadvantage of investing only in one asset class becomes apparent. Typically, you do not know which asset class will perform best on a year-to-year basis. Diversification is a defensive strategy — it helps protect your portfolio during market downturns and reduce your portfolio's volatility. Diversify your investment portfolio among a variety of investment categories, such as stocks, bonds, cash, real estate, and others. Also diversify within investment categories.

✔ **Only invest in the stock market for the long term.** Stocks should only be considered by investors with an investment time frame of at least five years. Remaining in the market over the long term reduces the risk of receiving a lower return than you expected.

✔ **Don't try to time the market.** Timing the market is a difficult strategy to accomplish successfully since so many factors affect it. Remember that most people, including professionals, have difficulty timing the market with any degree of accuracy. Significant market gains can occur in a matter of days, making it risky to be out of the market for any length of time. Instead of timing the market, concentrate on setting an investment program that works in all market environments and you can stick with in good and bad times.

✔ **Pay attention to taxes.** Taxes are probably your portfolio's largest expense. Using strategies that defer income for as long as possible can make a substantial difference in the ultimate size of your portfolio. Some strategies to consider include utilizing tax-deferred investment vehicles (such as 401(k) plans and individual retirement accounts), minimizing portfolio turnover, selling investments with

Advice on Saving for Children

Your child has finally finished college and started his/her first full-time job. What is the most important financial advice you can give?

Participate in a 401(k) plan as soon as possible. The quality of your children's retirement will largely be determined by the amount of money they save, and a 401(k) plan is a great place for them to start. Because the contributions are deducted before they even see their paycheck, it's a great way to get them into the habit of saving on a regular basis.

Having trouble convincing them this is a good strategy? Perhaps some numbers will make the point. Assume your child starts contributing to his/her 401(k) plan at age 25, contributing $6,000 per year (substantially below the maximum contribution in 2021 of $19,500), with matching employer contributions of $3,000. If he/she earns 8% annually, he/she could have a balance of $2,331,509 at age 65, before the payment of any taxes. What if he/she waits until age 35 to start contributing? At age 65, the balance could be $1,019,549, still a substantial amount, but $1,311,960 lower than if he/she started at age 25. *(This example is provided for illustrative purposes only and is not intended to project the performance of a specific investment vehicle.)*

What if your child still isn't convinced? Consider reimbursing him/her, as part of your annual gift tax exclusion, for any 401(k) contributions.

Don't let your child procrastinate because there are too many decisions to be made. Just encourage him/her to start contributing, reassuring him/her that none of the decisions is permanent.

If your child has the option to contribute to a regular 401(k) plan or a Roth 401(k) plan, suggest contributing to the Roth 401(k). Employer matching contributions will still be made to a regular 401(k) plan, but your child's contributions can go to the Roth 401(k). Your child won't get a current tax break for contributions made, but he/she will owe no taxes on the contributions or any earnings when withdrawals are made.

Please call if you'd like to discuss this concept in more detail or would like help with examples that are more pertinent to your child's situation. ❍❍❍

When Can You Retire?

It depends — consider these factors when setting a target retirement age:

1. What kind of lifestyle do you want in retirement? Given the same monthly savings rate, there is a tradeoff between when you can retire and the kind of lifestyle you can have once you do.

2. What does Social Security consider to be your full retirement age? The government will let you start receiving Social Security benefits at age 62, but those benefits will be less than what you'd receive if you waited until your full retirement age. Of course, if you're not counting on Social Security for retirement income, then you can retire whenever you want and wait until your full retirement age to start taking Social Security benefits.

3. What do your pension plan and other retirement plans consider to be full retirement age? Most pension plans have a certain minimum age at which they will begin paying benefits (at a reduced rate), and a certain age at which you become eligible to start receiving full benefits. Similarly, tax-advantaged retirement plans like 401(k) plans and IRAs penalize distributions (except in certain circumstances) before age 59½. ❍❍❍

Financial Thoughts

In a recent survey, one in five Americans said the pandemic caused them or someone they know to relocate (Source: Pew Research Center, 2020).

The recession is putting many baby boomers in a predicament: a layoff has derailed their plans to work full time to build up their retirement benefits. From March 2020 to June 2020, the unemployment rate for Americans who are at least 55 years old has more than tripled, to 9.7% (Source: Center for Retirement Research, September 2020).

Unemployment caused by COVID-19 has pushed up the share of working age households who cannot afford their current standard of living in retirement from 50% to 55% (Source: Center for Retirement Research, July 2021).

Mortgage debt remains the most significant and common source of debt amount older households, representing 69% of total debt in 2016. Older adults with a mortgage are 4.8% less likely to be retired and 3.1% less likely to receive Social Security benefits. Households between the ages of 62 and 70 with a higher level of debt are more likely to claim Social Security benefits early (Source: *AAII Journal*, June 2020) ❍❍❍

Mortgages: Consult with Us, Too

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introduced, popularity soared, with 68% of loan originations in 1984 being ARMs. But as interest rates declined in ensuing years, ARMs have become less popular. Perhaps that is because they are still relatively misunderstood by consumers.

The Hybrid ARM is the most common form of adjustable-rate mortgage today. The initial rate is locked for a fixed period (usually five or seven years) and then adjusts either yearly (most common) or at another set interval. The interest rate for the ARM is typically based on an index tied to federal rates of interest. Since the consumer is assuming some interest rate risk, the rate during the fixed period of the ARM is typically lower than 15 or 30-year fixed interest rates. If interest rates in the market move up, the rate on the mortgage will increase after the fixed period. If interest rates decrease, then the mortgage rate (and payment) will decrease.

The question that will almost certainly be asked by homeowners is, what if I take an adjustable-rate or hybrid adjustable-rate mortgage and rates go up? No one can predict the movement of interest rates, but the homeowner needs to consider how long they may have the mortgage. According to the National Association of Realtors, since 1985 the median seller tenure in a home has ranged between six and ten years.

Consider this: The Mortgage Bankers Association reports that the median size of a mortgage in the United States is $325,000. Given that the average rate difference between a 30-year mortgage and a 15-year mortgage has been about 0.75%, and that the rate for a 5-year hybrid ARM is another 0.25% less, the difference between the 30-year and 5-year hybrid ARM is about 1%. That is $3,250 per year starting out for the average American. Multiply that by the term of the loan, and the total difference can be close to $50,000 (the amount of interest declines over the 30-year term).

Surveys by the Federal Housing Finance Agency (FHFA) indicate that borrowers are selecting the wrong type of mortgage, leading to overpayment of interest right from the beginning.

One common way to save is to monitor when interest rates drop. Refinancing is the process by which one loan is replaced by another loan with more favorable terms. This is done to reduce monthly payments, consolidate or free up cash. All loans have fees and closing costs, and some have prepayment penalties. Therefore, a holder needs to decide whether a lower interest rate outweighs the various additional costs involved with refinancing. When there is a significant rate drop, it is worth the time to examine whether to refinance and save on interest charges.

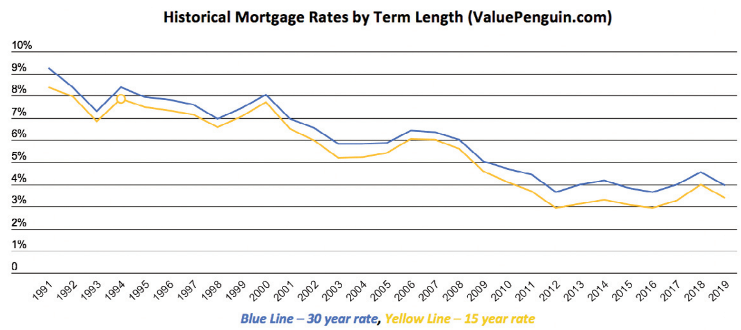
Financial advisors ought to be there to help. The role of a financial advisor is to help make financial decisions. Yet, in one of the most important financial decisions that families and individuals make, over 70% relied "a lot" on lenders or mortgage bankers to get information on mortgages, with only 13.5% relying "a lot" on financial advisors.

Perhaps individuals have been underserved in the mortgage process in the past and this has led to an overreliance on behavioral biases such as familiarity, overconfidence, endowment effects, and status quo. These biases, when paired with an overall preference for certainty and with the fear of higher rates, has led to a preference for fixed-rate mortgages.

There is a wealth of information available about consumer decision making in choosing a mortgage. Both the FHFA and the Consumer Financial Protection Bureau conduct surveys and make the data available through Fannie Mae's website. Their monthly National Housing Survey polls 1,000 consumers about owning or renting a home, the economy, and household finances, including mortgage decision making. There are more than 100 questions.

Sorting through the data, there are a number of startling conclusions:

1) Consumers are at least four times more likely to think that mortgage rates will go up instead of go down. This despite the fact that rates were declining the vast majority of the time that the data was compiled.



2) Consumers therefore lock in their mortgage interest rate almost 90% of the time. Almost 80% of those lock the rate for 30 years.

3) During the application process, consumers were told about a fixed-rate loan 94% of the time, but were not told about a variable-rate loan 51% of the time.

4) Only 23% of consumers listed a lower interest rate as an important part of the decision-making process.

5) Despite the fact that over 70% of consumers take out a 30-year fixed rate mortgage, which typically carries the highest mortgage rate, the average tenure in a home ranges from six and ten years. The average tenure in a mortgage is less, considering that some of the consumers who stayed longer than six to ten years would have refinanced.

Ideally, financial advisors would partner with clients and mortgage brokers during this decision-making process. For homeowners, their primary residence is typically their biggest asset, and their mortgage is usually their greatest liability. A great deal of time and effort should be spent to understand all aspects of the available choices.

At Burke Financial Strategies, we are here to provide our clients with a personalized review of this important financial decision.

Sincerely,

Melissa Montalvo

Melissa Montalvo, CFP®
Financial Advisor

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