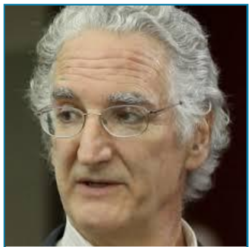
Robert Merton on the Promise of Reverse Mortgages and the Peril of Target-Date Funds



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Robert Huebscher – 02 Nov 2015 19:11
Target-date funds are an exceptionally bad way to save for retirement, according to Robert Merton. But, he said, reverse mortgages are a powerful – yet largely untapped – tool for retirees to improve their standard of living.

Read more at Advisor Perspectives

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Don Graves – 03 Nov 2015 10:14
An EXCELLENT article accentuating the profound role that Housing Wealth is playing in compreshensive (even global) finanical planning. The recent postiive changes in program (lower costs, finanical assesment, equity protection) have all contributed to wide and incerasing acceptance of finanical thought leaders across american. Even FINRA changed their position! Now is a great time for advisors to learn all they can and not be caught off guard when clients begin to ask. Great work Bob - www.HousingWealth.net

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Michael Finke – 03 Nov 2015 10:37
For those interested, here is his presentation on reverse mortgages at the recent MIT Center for Finance and Policy conference. Merton's a great presenter and makes a strong case for expanding the market.

http://techtv.mit.edu/collections/cfp2015/videos/32751-on-the-design-of-reverse-mortgages

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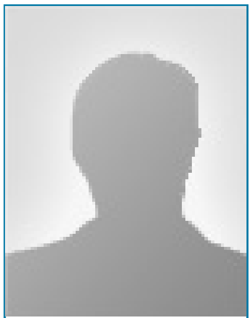

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Michael Falk – 03 Nov 2015 14:23
Thanks Bob.

TDF's may be a convenience for DC participants, plan sponsors, DC vendors, but they far from ideal for those who use (or default to) them. I have advocated against TDF's in many industry speeches over the years as well as specifically in a 2011 article published by PSCA and in my forthcoming Monograph for the CFA Institute Research Foundation. I can only hope that more coverage on this dramatic oversimplification will postively impact stakeholder behaviors. Can we hope the same for DC vendors?

As it pertains to reverse mortgages, the concept is solid. However, theory and practice are not the same. With the costs being what they are, this is likely best as "the final lever" to pull on for more income. And, those costs may not drop materially in the future due to lender risks (poor upkeep/maintenance, resale.) More importantly, should the house even be kept? Is there a bedroom on the entry floor, are the doorways wide enough for a wheel chair and several other similar questions should be addressed with any long-term residences. For bequest motives, could we all just remember that thing called... life insurance?

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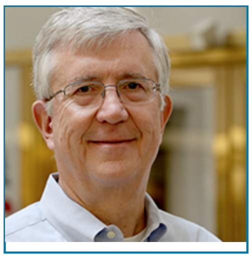

EDIT

Tom Davison – 03 Nov 2015 16:45
Bob, thanks for reviewing Merton's perspectives on Reverse Mortgages and TDFs. Reverse mortgages will be a key for many homeowner's retirements. They are designed to provide access to cash based on home equity and obviously can boost spending. Less obviously but more powerfully can boost spending through synergy with investment portfolios. And somewhat counter-intuitively, and even boost estate sizes.

On this site, Joe Tomilinson and Wade Pfau have posts with further descriptions. There have been a series of Journal of Financial Planning articles by three sets of authors analyzing half a dozen ways to combine reverse mortgage funds with withdrawals from investment portfolios, all showing significant improvement in lifetime spending. As a shameless plug, a co-author and I just published an extensive literature review and analysis of current thinking about reverse mortgages in the Journal of Retirement, pointing out that they may be used very differently by individuals whose retirements are underfunded, are constrained, or are well-funded.

The great mistake in thinking about reverse mortgages is to relegate them to a role of as a last resort, rather than an integral component of a retirement income plan, and considering implementing them early in retirement. Holistic planning leads to enhanced results, which are sorely needed for many. And even for well-funded retirees, they can play important roles such as refinancing traditional mortgages and serving as emergency funds. And even help address financial challenges faced by divorcing elders.

A key step for planners will be to actually run a good lifetime projection of an individual's retirement with and without a reverse mortgage and see how it plays out. Intuition fails when compound interest is involved, and flails when variable returns are present.

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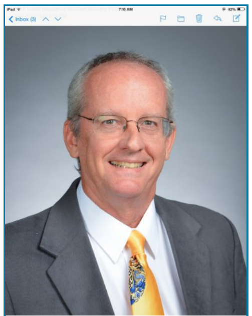
Michael Orf – 03 Nov 2015 16:48
Dr. Merton is one of the few non reverse mortgage salesmen touting this as a good idea. It is using the magic of compounding interest against your client! When you analyze it more completely you will find that the client gets a better deal by selling her home for full value and then investing and applying those funds towards a rental and living expenses. Reverse mortgages are tools for transferring your clients' home



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wealth to the banks and their salesmen. Clients get a lump sum or monthly payments amounting to less than half of the equity while the balance is consumed by interest charges and origination fees. The client is usually still on the hook for property taxes, insurance, and home maintenance.

Target date funds are weak due to conflict of interest. Look at the portfolios. They only use in-house funds for their diversification. Understandable, but not exactly the best for the client.

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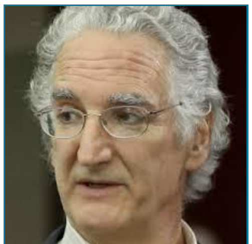

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Robert Huebscher – 04 Nov 2015 09:27
What are the limits to the size of a reverse mortgage?

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Wade Pfau – 04 Nov 2015 10:24
Bob,

For the HECM program, the limits are based on the value of the home up to $625,500. For homes worth more than that, the available credit will be based on this cap.

I'm another non-reverse mortgage salesperson who has come to take a more positive view about reverse mortgages as well.

Michael Orf, I think many aspects of reverse mortgages have improved in recent years. I am a bit puzzled by your comment, "The client is usually still on the hook for property taxes, insurance, and home maintenance." I mean, of course they are. But why is that a negative?

I posted a new research article about reverse mortgages yesterday:

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2685816

Wade

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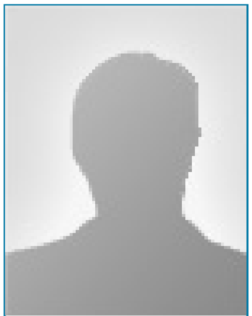
Eric Stubbs – 04 Nov 2015 10:24
Target date funds are far from ideal for fiduciary reasons. We can also acknowledge



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that one size doesn't fit all. That said, I disagree with the notion that age is an especially bad proxy for risk preferences: One can show that in a multi-period world, individual risk preferences likely depend strongly on the {PV(future income)/Lifetime wealth}. Age isn't an ideal proxy for this, but it isn't a bad first-order simplification, especially if combined with some education on different glide paths and why one 50 yo might like the "2030 fund" while another prefers the "2040". For many retail investors, given a choice between being approximately right and completely wrong, TDF's aren't that bad.

Michael makes an excellent point comparing reverse mortgages to house sale, investment and rental. In addition, reverse mortgages seem especially vulnerable to (elder) abuse within the financial industry. Theory notwithstanding, as a practical matter i doubt I could ever advocate for them.

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Joe Tomlinson – 04 Nov 2015 10:55
Add me to the list of non-salespeople who like reverse mortgages. I don't see downsizing and reverse mortgages as necessarily competing. Before entering into a reverse mortgage, it makes sense for people to be in the home they plan to stay in for a long time or for life. That could be a long-time family home or a downsized home purchased for retirement. For some, both downsizing and a reverse mortgage on the downsized house may make sense if they want to generate as much income as possble. I had originally thought reverse mortgages should be left as a last resort, but doing my own research and reading research by others convinced me that "now" may be a better choice than "last resort."

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Charles J Stevens Jr – 04 Nov 2015 11:00
TDF's to my way of thinking are another product designed to make up for the almost total lack of economic education offered to anyone who graduates from high school. Just default to a TDF and, voila, when you retire, you'll have amasssed all the money you need to live happily ever after.

The problems with this solution are twofold. There are 2011 TDF's still trading (so much for target) and the newly created retiree will have no clue how to manage their nestegg at possibly the most financially vulnerable time in their life as they have never before been faced with this task.

40+ years ago during one of my first prospect meetings, the International Sales Manager for a hardware component manufacturer said to me, during your career, you will become amazed at the economic ignorance of the average American citizen. The only thing that has changed in the interim is the economic comprehension of the "average American citizen" has markedly decreased.

Rather than being a "solution" my wager is they will become a bigger problem as time goes along.

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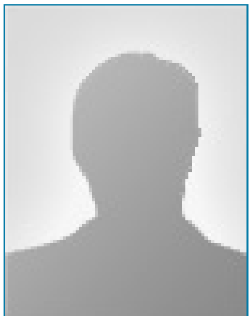

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Steven Smith – 04 Nov 2015 11:21
Good advertisement for DFA's new target date funds, which largely switch to TIPS at the target date. Which may or may not turn out to be a good product, depending on how TIPS perform.

Since when did smart people become so focused on "income" in the traditional sense. What matters is total return and the ability to convert that growth into spendable cash. This is especially true in an era where the traditional dichotomy between income and principal (capital gains) has all but disappeared; both in the marketplace and the law. For example, in the market we now have buy backs vs. dividends and zero coupon bonds and strips.

For 15 years now state legislatures have been adopting the Uniform Principal and Income Act, which includes both the power to adjust and the ability to create or convert a trust to a total return unitrust - both concepts recognizing the primacy of MPT's elevation of total return over the obsolete concept of income vs. principal.

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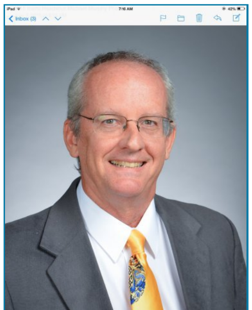

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Michael Orf – 04 Nov 2015 11:34
This is a partial list of the costs associated with a reverse mortgage:

You get to pay closing costs (again) on a home you already own. This time the costs are quite a bit higher.

They include origination fees, upfront mortgage insurance, and appraisal fees.

The interest rate that is consuming the balance of your equity is higher than that of a regular mortgage.

You still pay the annual (and rising) costs of property taxes, insurance and repairs on an asset that is being gradually transferred from your balance sheet to that of the bank.

Renting or even a HELOC are better options. Doesn't it seem like the banks are getting a much greater benefit in this deal?

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Wade Pfau – 04 Nov 2015 13:19
Michael:

I incorporated those costs in to the research article above. I hadn't made much of the property taxes, insurance, and repairs, since that is otherwise always an aspect of owning a home. But all the other costs are in the analysis.

About HELOCs, reverse mortgages have a number of attractive features relative to a HELOC. That's what helped Harold Evensky switch his loyalties after the 2008 financial crisis.

About renting, that is interesting and worth researching some more. However, a basic assumption is that the individuals wish to remain in the same house. If they don't care where they live, then it's a whole different ball game.

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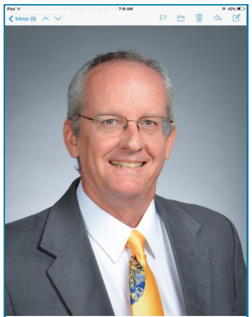
Michael Orf – 04 Nov 2015 14:47
Wade,

There is an emotional attachment in wanting to live out one's years in a familiar



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setting. I read your just published paper and appreciate the different paths you project. Another cost to consider is the loss of the tax exemption a homeowner receives when selling an appreciated homestead. It could be as much as 500k of tax-free funds for a couple that is willing to sell and rent or downsize.

I suppose the tapping of a HELOC during a bear market and then paying it back during the following uptrend from a diversified portfolio could be a prudent use of one's home equity. Having a home free and clear is one of life's goals and part of the American retirement dream. The reverse mortgage could turn it into a nightmare.

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Joe Tomlinson – 05 Nov 2015 10:19

Michael,

I suggest that it's worth considerting options and looking at actual numbers before rejecting potential solutions out of hand. If people need retirement income and can't generate enough income from what they have saved, a reverse mortgage may be a good option. And, given current interest rates and some other considerations, it may be worth evaluating taking out a reverse mortgage early in retirement rather than waiting until a cash need arises down the road. Re: downsizing, as I suggested yesterday, for some it may make sense to downsize (and utilize the $500,000 exemption) and then consider a reverse mortgage on the downsized residence. I don't think anyone would advocate taking out a reverse mortgage for a few years and then downsizing--not enough time to amortize the up front costs.

Joe