CHAPTER 5

THE THREE BUCKETS

Sometimes the questions are complicated
and the answers are simple.
—Dr. Seuss

What does dairy farming have to do with explaining a reverse mortgage loan to your clients? I grew up on a dairy farm in Wisconsin, and even though I have not milked a cow since I was eighteen, I've found that this story is a great way to communicate with my clients. I rarely speak to a client or financial planner without showing the following illustration of the three buckets. I don't know if Cinderella worked on a farm, but I'm pretty sure that she lived in the country, so I think this fits with her story as well. This story actually started because of a discussion I had with my then-sixteen-year-old son, Isaac, several years ago. The buckets that I'm talking about are not filled with milk but with financial assets.

One sunny spring afternoon, Isaac, our youngest of four sons, came home and overheard me and my wife talking about an anonymous client I had helped with a reverse mortgage that day. He paused for a minute in the kitchen

on the way out to play basketball in the driveway. "Hey, Dad," he said. "Those reverse mortgages you do for the old people? I guess it's pretty nice for them because they buy houses and go on trips and get money, but those things really rip off the kids, don't they?"

I was shocked. Any father would want his sons to be impressed with the kind of work they did. Obviously, Isaac didn't feel that way. I was also surprised my sixteen-year-old had a strong opinion about it. "Why do you think that?" I asked.

"Well, I've talked to my big brothers about this. As an attorney, oldest brother Ben doesn't think it's a good deal. And Josh, he's a smart engineer, and he's not impressed with them either."

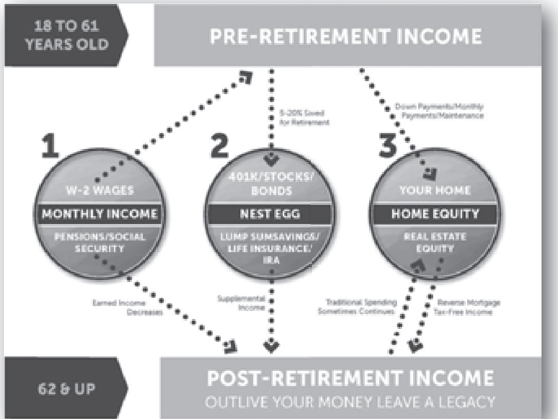
I said, "Have you talked to your third brother, Luke? What did he say?" Luke works in commercial lending for a large bank.

Isaac said, "He doesn't think they're a good idea either because if they were good, then the big banks would be selling them."

I was kind of devastated, but then it got worse. He said, "That's OK, Dad. We understand you have to make a living, but you and Mom aren't going to get one of these when you get older on this house, are you?"

I guess it was OK for me to play Robin Hood and rip off all the other millennials and give to the old people, but I had to at least spare the four of them. I said, "Yes, Isaac. We are going to get one of these the day we turn sixty-two, which is not only good for us but also for you and your brothers."

I began my explanation by drawing three circles and two rectangles on a legal pad, as in the following illustration.



The first bucket represents monthly income, such as social security payments, wages, and pension income. The second bucket represents retirement savings or the nest egg—a lump sum of everything from savings accounts, IRAs, CDs, 401(k)s, and 403(b)s to change jars and gold coins. The income value of this bucket is harder to determine, but this bucket spins off a certain amount of income when needed, either in interest and dividends or by simply cashing in the principal. This money may have been put away years ago and was designed to be spent in retirement. Retirees' biggest fear is that they'll outlive the life of this bucket. Financial professionals spend almost 99 percent of their time analyzing, projecting, sifting, calculating, and recalculating the value and use of the first two buckets but rarely consider the third bucket.

At this point, Isaac interrupted me and said, "I understand all about the second bucket because I talked to Jason, your financial advisor who comes here and helps you invest bucket two."

Then he verbalized what everyone thinks, including most financial advisors: "Why can't you use the money in bucket two instead of doing a reverse mortgage? Because if Jason does his job, then you won't need to worry about the money in the house. "

The fact is that most people don't have enough money in bucket two for the financial advisor to manage until age ninety, and even if they do, then it is more efficiently used, according to the research, if home equity is part of the planning.

I said, "Isaac, think about this. Our house payment is two thousand dollars per month." I pulled out a one hundred dollar bill, which helps keep the attention of a sixteen-year-old. "We deposit twenty of these one hundred dollar bills every single month into bucket three. But as we put money into our home, something strange happens. It turns into equity, and only two people can turn that equity back into cash."

Isaac said, "I know that would be you and Mom."

"No," I said. "It belongs to us, but we are not in charge of turning that equity back to cash. Only a buyer who is willing to purchase our home and to give us cash for the equity in our home or a mortgage lender who, after lots of paper, decides to give us a certain amount of our equity back in the form of cash can do that.

As soon as that mortgage lender gives us that cash, he or she will ask us to pay it back starting the very next month, turning cash back into equity, which defeats the whole purpose of having cash in retirement. So many people place such a high value on equity, which is good, but cash is far better in our retirement years. Equity cannot be accurately valued until you sell, and equity cannot be used until it is converted to cash. It's like having a big chunk of cash in our living room in an unbreakable glass case. We can look at it, but we can't use it."

Interestingly enough, depending on a client's other assets, the third bucket is usually valued at 30 to 50 percent of a client's total net worth. Yet most financial professionals—as well as our four sons—largely ignore bucket three.

As reverse mortgage professionals, we spend the majority of our time on bucket three; however, I spend a significant amount of time explaining to my clients that, for qualified borrowers aged sixty-two and older, their homes are fungible—that is, a significant portion of the equity in their homes can be reduced to dollars. Clients must be able to understand the fundamental difference between their *homes*, perhaps the most intimate object of their financial lives, and their *house equity*. The fact that we live in this asset dramatically affects our attitude toward using it as a retirement tool. But we can't take it with us, and sooner or later, our house will be liquidated and denominated into dollars, just like our IRAs.

I explained these basic things about equity to Isaac using a fake one hundred dollar bill and a real one hundred dollar bill.

The difference between equity and cash is a difficult thing for anyone to understand, whether you're sixteen, sixty-two, or ninety-two. I explained to Isaac that when his mother and I turn sixty-two, we will be getting a reverse mortgage and converting that equity to cash. We will be following the research that has been done by the people in the financial planning community who are much smarter than we are. We will be better stewards of our wealth by spending some of the money in bucket three right away in the beginning of retirement and preserving the assets in bucket two. Ultimately, there is really no difference between the three buckets. They all have money put into them when we have extra, and when we need to take money out for expenses in retirement, we have to convert those deposits into withdrawals. Unfortunately, because we live in the bucket-three asset, it becomes a very difficult mental issue to convert that equity into cash and to take income from that bucket.

Because of this psychological brick wall, many clients refuse to even consider their home equity as a source of cash flow and choose instead to use it as a retirement drain. (See the two arrows by the third bucket, as they can go either way.) The typical retiree takes money out of the first two buckets to fund the third bucket. They pay taxes, insurance, maintenance, and often, a continued monthly house payment when they are well past the age of sixty-two. With a reverse mortgage loan, reverse mortgage borrowers no longer have to do that using buckets one and two, although tax, insurance, and maintenance payments are always required. How many retirees are still contributing to IRAs? Very few. But how many are still contributing to bucket three and plan to do so until the end of their lives in their homes? Most of them. They either make payments, or if the house is paid off, continue to put money into the house in the form of maintenance, taxes, and insurance.

Why do retirees and their advisors have no problem with taking money out of the IRA or savings account to fund retirement cash flow, yet when we suggest a reverse mortgage, they decide to wait until bucket two is empty before calling us? After all, they put money into the second bucket so they would have something when they retired. We must remind our clients that they also have religiously put money into their homes in the form of payments, improvements, taxes, and the like. In its simplest form, a reverse mortgage is nothing more than a tool that turns home equity back into cash without affecting your ability to live in your home. It allows you to withdraw money from bucket three instead of continuing to contribute to it.

I have used this simple drawing to help my clients and their advisors overcome the psychological barrier of withdrawing money from the third bucket. Of course, there is still one argument that comes up often: what about the heirs?

Perhaps that was part of the concern that Isaac and his brothers had. But I know our sons, and greed was not the motivating factor. It was really more of a worry that we were doing something wrong that really didn't make sense financially. Perhaps we were making a foolish decision. Quite frankly, there are many financial advisors (and relatives) who think that anyone who gets a reverse mortgage is making a foolish decision. That is the concern that most children have.

Another chapter will address the desire that most parents have, which is to pass on their home to their children free and clear. But first, let's look at how the three buckets affect the heirs.

Heirs should always be more concerned about Mom and Dad's need for money first, and they usually are. I saw a sign outside a church several years ago that read: "The cost of living is high, but it is still extremely popular." *Thus, the only way you can leave more money for your heirs is if you die early.* Very few children hope that you die early so that they get more money. Think about it: as soon as you retire and less money is going into bucket one, you must start drawing from either bucket two or bucket three. If you take money from the third bucket, then there will be less home equity for the heirs, especially once you consider the negative amortization of a reverse mortgage. But there will likely be more money and appreciation in the second bucket, and no taxes have to be paid when pulling money from bucket three. The experts agree that if you pull money from bucket three early in retirement, then the portfolio longevity of bucket two will, of course, go up, as will your overall net worth. It is obvious that you have *less equity but more cash.* There is less in bucket three and more in bucket two. I encourage my clients to ask their children which bucket they would rather have more assets in—the second or the third—and most choose the second bucket. Those assets are easier to quantify and ultimately, easier to distribute. For example, anyone who has ever tried to sell houses in an estate can relate to that. You have to pay utilities, taxes, and upkeep to take care of the place while dropping the price to find a quick buyer.

It is almost always best to preserve bucket two with bucket three.

The bottom line is that those three buckets of milk from my farm were the same milk. It did not matter which one you sold to the dairy; all had the same value when you poured it out. This is a simple but difficult concept to understand. Most people don't realize that when you pull money from bucket two, you are losing not only the asset but also whatever gains you will make in the future with that investment. There are either real costs or opportunity costs, no matter which bucket you draw from. Many advisors and clients worry about compound interest working against them from the reverse mortgage in bucket three, but they forget about the compound interest working for them at a greater rate in bucket two. It is not free to pull money from bucket two—there is always either a tax cost or an opportunity cost.

When you use bucket three early in retirement, your income will be greater and your retirement nest egg will last longer. Was that not the plan from the beginning?

This story ended with a happily ever after. Isaac graduated from the University of Wisconsin–Madison with a degree in finance and real estate. One of the last papers he wrote was titled "Reverse Mortgages—No Longer the Loan of Last Resort: A True Retirement Tool." All four sons clearly understand the role of reverse mortgages in our retirement *and* their legacy. When they send me birthday cards, they know how many years we have until my wife and I can qualify for our own reverse mortgage as part of our happily ever after.