

Trading habits drain savings

Money Manager/by Karin Price Mueller

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Retirement isn't always a pot of gold over the rainbow. Years of saving for the future can sometimes take a wrong turn.

That's what happened to Kevin, who came to the Herald for help in straightening out his monthly budget and his retirement savings accounts.

At age 65, Kevin receives a pension of \$396 a month from his former employer, and \$700 a month from Social Security. When he retired 10 years ago, he had a 401(k) plan worth about \$350,000. That's when the financial ups and downs started.

He rolled his 401(k) plan into an individual retirement account in the early 1990s, and he started trading stocks and mutual funds on a very regular basis - sometimes daily.

"It was pretty good. In the bull market, everyone looks like a winner," Kevin said. "I parlayed my account into about \$600,000, and then things started to go the wrong way."

Before his account started losing money, Kevin added even more to it from a home equity loan. In 1996, Kevin decided to rid himself of his credit card debt of \$75,000. To do so, he took out a \$95,000 home equity loan on his Metro West condo. When the debt was paid, he added the extra \$20,000 from the loan to his investment accounts.

Before long, the bull market was over. Declines in the stock market ate up Kevin's account until it was worth about \$220,000.

In the meantime, the retired bachelor's monthly budget was starting to get a little tight, as he tried to keep up with regular expenses and payments to his home equity loan on a fixed income. Because so much of his monthly cash flow goes toward paying off his home equity loan, Kevin would like to get rid of the loan early if possible.

He pays \$550 a month on his home equity loan, plus regular living expenses: \$155 a month in property taxes and insurance, a \$145 a month condo fee, \$187 a month in utilities, \$300 a month for groceries and dining out.

Another huge expense - discount brokerage commissions - came from his frequent trading. In one month, Kevin estimates he spent more than \$1,400 on commissions as he frequently traded his positions. This, at \$20 a trade.

To help keep his cash flow moving, and to fill in some of the spare time he had in retirement, Kevin decided to take a job as a security guard back in August. He earns about \$22,000 a year from the job.

At the time that Kevin contacted the Herald for help, he had \$19,000 in an IRA from the proceeds of his home equity loan. Eleven thousand dollars was invested in Gabelli Equity Trust, and \$8,000 was invested in Fidelity Cash Reserve.

He has \$113,000 in the rollover IRA he created from his 401(k) plan. Of that, \$4,800 is in Eaton Vance Worldwide Health Sciences, \$4,900 in Harris Oakmark Fund, \$4,900 in Royce Low Price Stock, \$5,100 in Strong Short Term Bond Fund and \$93,000 in Fidelity Cash Reserves. He also has a stock account worth \$57,000, with 1,000 shares of Cisco Systems, 200 shares of Modine Manufacturing and \$33,000 in a Fidelity USA Account.

(These totals are from the time he first contacted the Herald. But because he trades so often, Kevin's holdings at the time of publication have changed significantly.)

In cash, Kevin has \$2,000 in a savings account - only enough to cover slightly more than one month's expenses.

SOLUTION: Introducing control will secure finances

The key to Kevin's financial security is to get his excessive trading under control. Not only has his portfolio lost more than 50 percent of its value in the past 18 months or so, he can barely afford the cost of trading commissions.

“The pros have a hard time making that kind of trading work,” says Deb Maloy, a certified financial planner and principal of the Neiman Maloy Financial Group, of Wakefield. “Especially when you're on a fixed income, this market is just too risky.” Kevin's not crying over his losses and he says there are lots of people who are worse off than him, Maloy says. That may be true, she says. But at age 65, it's unfortunate he had to take on a job to improve his cash flow after a lifetime of working.

Still, there's plenty that Kevin can do to improve his financial situation. First off, he needs to get a handle on all the extra trading.

Instead of risking his hard-earned savings by playing the stock market, Maloy, a member of the Financial Planners Association of Massachusetts, suggests Kevin earmark some “fun money” for trading, and invest the rest of his assets with a diversified plan.

She recommends he take about 10 percent of his assets, or \$18,000, and use that for individual stock trading. This would not only limit the risk Kevin takes, but it would also substantially lessen the trading commissions he's paying because he'd probably trade less frequently.

“Imagine, he made 427 trades in a year - the market is only open 250 days a year,” Maloy says. “He was buying 1,000 shares at a time and trying to get 50 cents on it. I say he should buy 200 shares and try to get 4 points.”

For the rest of his assets, she'd like to see 60 percent in high quality bonds, such as corporates, treasuries and/or government agency bonds, with laddered maturities from three to 10 years.

“He says he wants less risk,” Maloy says. “So for equities, he needs a well-balanced portfolio of mutual funds.”

That's where the remaining 40 percent of his holdings should go, Maloy says. She recommends \$40,000 be invested in large-cap funds, split evenly among Vanguard Windsor II, Fidelity Growth & Income, Davis NY Venture Value and Heritage Capital Appreciation.

Another \$15,000 should be in mid-cap funds. Maloy recommends half go to Oakmark Select and half to Fidelity Mid-Cap Growth.

The final \$12,000 should be evenly split among three small cap funds: Royce Low Price, Freemont U.S. Micro Cap and Baron Growth.

Next, Kevin needs a bigger cash fund available for emergencies. Maloy says he should increase the \$2,000 in cash he already has to about \$8,000, which should cover five months of expenses should he lose his job or be unable to work. And because at age 65, Kevin wouldn't be able to get disability insurance, he really needs to make sure he has enough cash to cover his bills.

Using that income today to increase payments on the home equity loan would help secure his ability to pay his expenses in the future, she says.

“He's lucky that the rate on the home equity loan is low [at 6.5 percent],” Maloy says.

She recommends he increase monthly payments from \$550 to \$1,500 per month. The loan would then be paid off in 5 years.

He could use the additional income from the laddered bond portfolio - about \$5,000 or more a year - toward the payments.

Then if Kevin is unable to work, or doesn't want to work, at some time in the future, he won't have to worry about making those loan payments - which actually take up nearly half of his annual income, if you don't include his income from the security guard position.

After the loan is retired, Kevin could then put the money he was paying to the debt to once again build up his mutual fund portfolio.

``The losses he's had are unfortunate, but I don't see it as a total blowout for the guy," she says. ``But he really has to get a handle on the trading."