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The COVID Retirement Boom and Personal Finance: How can we save and protect?

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Abstract. Granting periodic income payments to retirees, the Social Security system is undoubtedly an essential part of American retirement financing. Indeed, 90% of American retirees receive Social Security and 57% of its beneficiaries depend on it as the major source of income. While Social Security is indispensable to American retirement financing, retirees ought not to be unduly dependent on it, as current demographic changes imperil the institution's regulation. Over the last decade, the United States retirement population increase rate has been 33.79%, approximately seven times that of the labor force population. This pattern jeopardizes the Social Security system by raising its cost disproportionately to its income. Thus, if such a demographic trend continues, the Social Security System will no longer be able to provide retirees with income. Confronting the possibility of systemic failure of the Social Security system, I will argue in this paper that retirees must take responsibility for their own finances and voluntarily produce income through investing in two asset classes – REITs and bond ladders. My research will discuss two advisable investment plans: REITs and bond ladders. Each method will be evaluated on its safety, periodicity of income, and consistency in the income quantity. Furthermore, for each method, I will examine its upsides and downsides. This research discusses the transfer of financial responsibility from the Social Security system to individual retirees. It proposes retirement plans that the members of our community can practice to produce income.

Keywords. COVID-19 retirement boom, Baby boomers, personal finance, social security

1. Introduction

Social Security is a government program established to supply retirees with financial resources to sustain their living. It is funded through Federal Insurance Contributions Act tax, which is a type of tax that workers pay from their payroll [1]. Social Security is widely regarded as “the centerpiece of U.S. retirement” [2]. 90% of American retirees are provided with necessary living expenses by the Social Security system and 57% of them depend on Social Security as their main source of income [2].

Despite its indispensability as a reliable source of income for many American retirees, the Social Security System is currently on the verge of systematic breakdown due to the prevailing demographic changes. From 2010 to 2020, the retirement population in the United States surged up from 34.59 million to 46.33 million, marking a 33.79% rise [3]. During the same period, the total labor force of the United States increased from 157.11 million to 164.74 million, marking a 4.9% rise. [4]. The disproportionate rise of the retirement population to the

working population implies declining worker-to-beneficiary ratios. This means that while less people are paying into the Social Security system, more people are accruing money from it. As a result of this pattern, in 2009, the cost of the Social Security System surpassed its income [5]. Worse still, the Social Security Trust Funds is projected to be depleted by the year 2034 [1]. In the face of this difficulty, the Social Security system is condemned to fail as it will not be able to provide income to future retirees. This places retirees in a conundrum of having to sustain life without financial security.

In this paper, I argue that the failure of the Social Security system passes on the financial responsibilities to the retirees to invest in safe commodities that generate periodic and consistent income. This paper is based on desk research which involves analysis and review of websites, reports and articles on financial asset classes. Based on my research findings, I propose two main asset classes, REITs and bond ladders, which I believe are safe investments with potential to produce safe, periodic and consistent income for workers after they retire. In section 2, I introduce the proposed asset classes – REITs and bond ladders illustrating why they are advisable sources of periodic and consistent income in the Covid-stricken economy. In section 2.1, I introduce REITs, its reasons for qualifying as a safe investment, its advantages, and disadvantages to retirees. In section 2.2, I introduce bond ladders, with its qualifiers, advantages as well as disadvantages for retirees. In section 3, I conclude the essay.

2. Recommended asset classes

2.1 REITs

A Real Estate Investment Trust(REIT) is a type of company that invests in a portfolio of income-producing real estate properties. It operates on the collective funds of at least 100 investors and is publicly traded. It allows for individual investors to engage in the real estate market and benefit from it [6].

REITs are generally safe to invest in due to their diversity [6]. As REITs own many real estate properties, even if the price of one real estate property plummets, the presence of other real estate properties would balance out the loss incurred. Accordingly, REITs rarely default and are viewed as a stable option for investment. [6]

More so, a REIT is a source of periodic and consistent income. A REIT distributes its income to its shareholders via dividends on a periodic basis, whether monthly, quarterly, biannually, or annually[6].

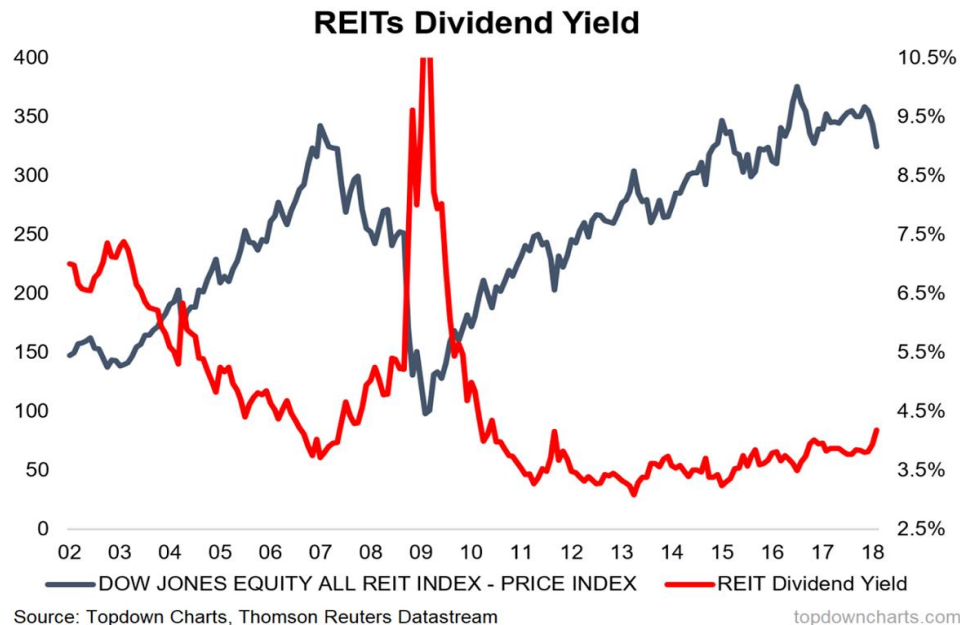


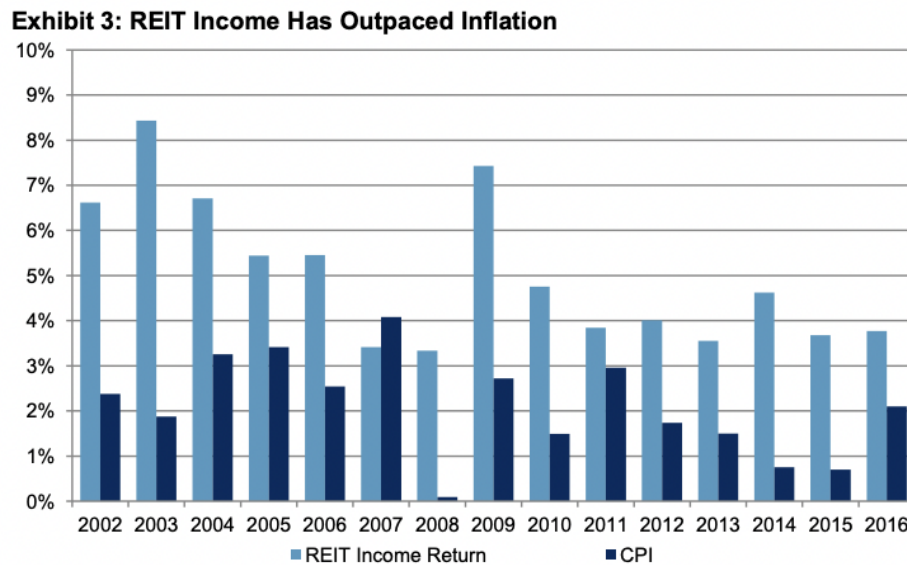
Fig. 1: REITs Dividend Yield

Source: Thomas, 2018, p.1

The amount of income return of REIT for its shareholders is not consistent, but predictable. Figure 1 shows the change in dividend yields of REIT from 2002 to 2018. According to Figure 1, the dividend yield has remained relatively stable from 2010 to 2018, ranging from 3% to 4.5%. As the economy found its normal footing once again after the financial crisis of 2008-2009, the dividend yields held steady with nominal fluctuations. As the dividend yields measure how much dividend is given per share, its low volatility makes income predictable and relatively stable, making REITs an attractive investment option in today's highly volatile market.

For retirees, REITs are an appealing asset class because of its profitability. As of 2022, the average REIT dividend yield is over 3%, more than twice the dividend yield of S&P 500 [7]. In addition, dividends offered by REITs are exempt from corporate level taxation [6]. The absence of corporate taxes on REITs allows for its investors to keep more profit from the dividends. The remunerative nature of REITs dividends make REITs suitable for retirement investment, as it can effectively slow down the rate at which retirement savings exhaust.

More so, REITs as an asset class offer strong inflation protection. Inflation is a phenomenon in which the value of a currency diminishes. It undermines the purchasing power and rapidly increases the prices of necessary goods and services [8]. Retirees' financial security is prone to inflation risk as inflation significantly diminishes the value of their retirement savings. Hypothetically, if the annual inflation rate were 3.5 % for a twenty year period, the purchasing power of retirement savings would be reduced by 49.7%.



Source: S&P Dow Jones Indices LLC; The Bureau of Labor Statistics. Data as of Dec. 30, 2016. REIT Income Return is calculated as the annual difference in return between the Dow Jones U.S. Select REIT Index (PR) and Dow Jones U.S. Select REIT Index (TR). Past performance is no guarantee of future results. Chart is provided for illustrative purposes.

Fig. 2: REIT Income Rate and CPI

Source: Oranzo et al., 2018, p.3

Figure 2 compares the changes in REIT income return with CPI, which measures the average change in prices of goods and services over time. According to Figure 2, the REIT income return rate surpassed the inflation rate, denoted by CPI, every year from 2002 to 2016, with the exception of 2007. REITs are able to attain such resilience against inflation because real estates are highly correlated with rising consumer prices [9]. In other words, the rise in prices is often amplified in the price of real-estate.

However, there are certain risks associated with REITs that retirees should be aware of. Even though REITs may be able to make profits during inflation, they may also be affected by interest rate changes that are designed to guard against inflation. Changes in interest rates may pose a danger to REIT investors by lowering dividends and share prices [10].

High interest rates rapidly increase the amount of debt REITs owe, which hinders REITs from achieving profitable growth. Burdened by these excessive debts, REITs may inevitably be forced to lower dividends [10]. When dividends are lowered, retirees are paid less money, leaving them helpless and at the mercy of dividend returns.

In addition, high interest rates increase capitalization rate. The increase in capitalization rate lowers the values of the real estate assets that REITs own, thereby reducing the price of REIT shares[11].

Furthermore, owners of REITs may also have to contend with low capital appreciation. REITs pay out at least 90% of their taxable income to their shareholders [6]. While this high payout ratio may provide retirees with adequate income, it leaves REITs with little or no money to reinvest into their business and potentially expand it. As such, REITs share prices increase at slow rates.

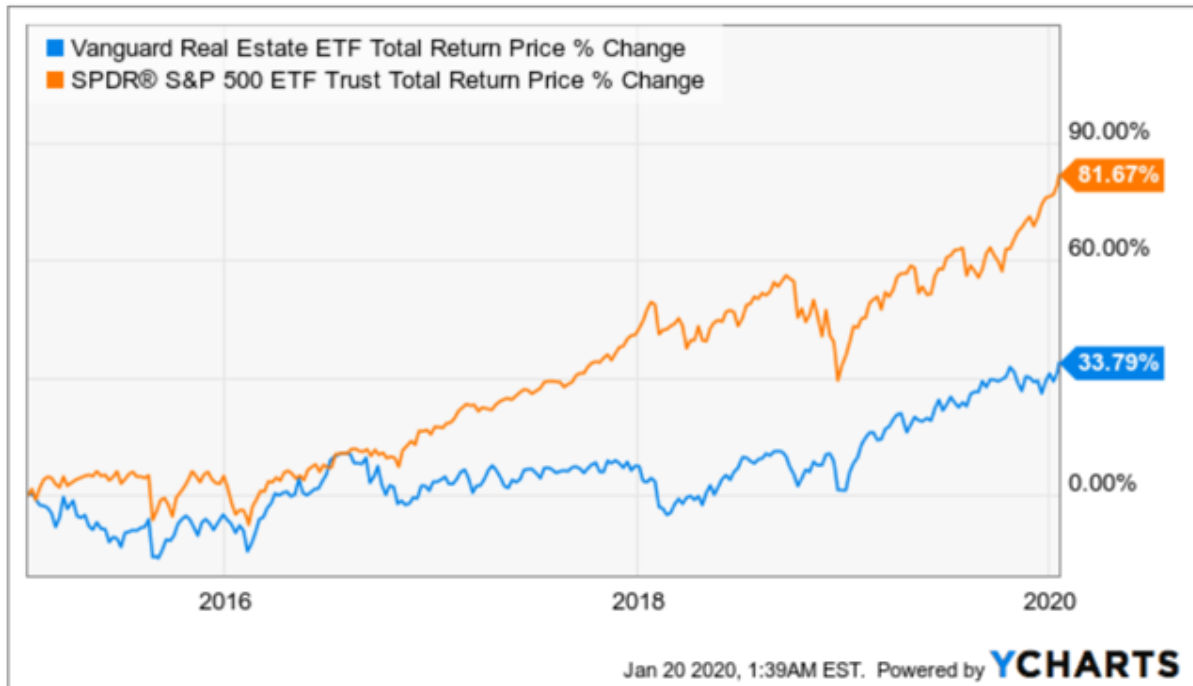


Fig. 3: Total Return Price Change of Vanguard Real Estate ETF and SPDR S&P 500 ETF Trust
Source: Askola, 2020, p.1

Figure 3 shows the total return price change rates of S&P 500 and Vanguard Real Estate ETF, a REIT ETF. According to Figure 3, from 2014 to 2020, the price of Vanguard Real Estate ETF appreciated 33.79% while the price of S&P 500 appreciated 81.67%. This shows that the price of REIT shares appreciates at a comparatively low rate. As such, for investors seeking to profit from capital appreciation, REITs may not be a good choice.

2.2 Bond Ladders

A bond ladder is a strategy for managing fixed income investments in which an investor invests in bonds with different maturity dates [12]. To design a bond ladder, an investor invests in bonds with different maturity dates separated by a specific interval. The individual holds each bond until maturity to avoid selling the bonds at unfavorable costs. For every bond that matures, an individual reinvests the returned principal into a different bond with the best options available [12]. For instance, an investor with \$30,000 will split her investment into three \$10,000 amounts. Then, the individual will equally invest in three different bonds that respectively mature in one, two, and three years. Each time a bond matures, the investor reinvests principal payments from maturing bond into a new bond with high credibility, reassuring coupon rate, and rewarding capital gain.

The safety of a bond ladder is primarily determined by two factors – the credibility of individual bonds and the diversification of the bond ladder investment portfolio. The credibility of individual bonds ensures that the bonds have low chances of defaulting [13]. Major rating agencies, such as Standard & Poor's, are considered to be dependable sources of analysis on bond credibility [13]. Generally, bonds rated A or higher on Standard & Poors are acknowledged as having "strong capacity to meet financial obligations" [14]. However, having a high Standard and Poor's ratings does not mean that bond issuers are free from the risk of default. Therefore, the element of diversification can help investors in this regard. A diversified

bond ladder investment portfolio reduces the possible loss incurred if one bond were to default [15].

Bonds in a bond ladder make consistent income payments called coupons [6]. Investors can calculate the amount of total annual coupon payments by multiplying the coupon rate, which remains fixed for the duration of a bond term, by the face value and dividing it by 100 [13].

Bond ladders generate periodic income through coupon and capital gain. The interval of coupon is determined by the issuer [6]. At the same time, the interval of maturity dates, which yield capital gains, is determined by the structure of bond ladders [12]. The farther the maturity dates are spread out, the longer the intervals are. At the same time, the interval of coupon is determined by the issuer [12].

The utilization of bond ladders as an investment strategy has two main benefits: reduced chances of capital loss and high liquidity.

As retirees invest their retirement savings to lower the rate at which the savings is spent, losing money from investments would be highly undesirable. Fortunately, retirees utilizing the bond ladder method are free from this concern, as long as they hold onto the bonds until they are due. When retirees sell bonds before maturity, they have to do it at a loss as reselling bonds would not appeal to buyers unless it is at a discount price [16]. As long as the individuals do not sell bonds until maturity, they do not risk capital loss [12].

With that being said, another security device innate to bond ladders is that bad performance of the issuing corporation or government does not bring the bond price down [16]. This volatility has always been a threat to prospective investors. However, retirees and their savings are not affected by poor economic performance in the form of reduction of payment [16].

Additionally, the high liquidity of a bond ladder makes it a prospective investment strategy. A bond ladder is spaced out with its maturity dates set at specific time intervals. The principal is returned to investors at every maturity date, guaranteeing them of capital without the need to sell bonds at a discount. The frequently returned principal provides investors liquidity in terms of disposable assets [15].

Liquidity is defined as the availability of disposable assets. In the volatile bond market, liquidity presents individuals the opportunity to be able to invest in bonds when interest rates are high and bond prices are low [13]. Therefore, the high liquidity of bond ladders allows retirees to maximize their profit in the bond market.

Unfortunately, investing in bonds has a high entry fee. For one, bond prices usually begin at a thousand dollars each and this is a price unaffordable to many [17]. According to Go Banking Rates data, 61.1% of Americans aged 55 or older have less than \$100,000 in their retirement savings [17]. Such a shortage of money is not advantageous in the bond market. Having few options, retirees can't diversify their bond portfolio. This lack of diversity exposes investors to a greater danger of default, whereas a diversified bond ladder portfolio reduces the possible loss incurred if one bond were to default.

To add fuel to the fire, bond ladders don't allow retirees to sell them at their discretion. This aspect of bond ladders has repercussions for retirees in times of personal emergency or low interest rates. What this means is that by dipping into bond savings, retirees will have destroyed a rung in their bond ladders forcing them to bear a significant loss [19]. In terms of maximizing one's profit, bond ladders also present restrictions. In times of low interest, bond prices rise, which make them profitable even before they are due [12]. Unfortunately, even if they exceed the profit rate in advance, selling them is not advisable as it will jeopardize the

investor's timing for the bond ladder as a whole [12].

3. Conclusion

This paper argues that the current demographic changes imperil the proper operation of the Social Security system and therefore, individuals will be solely liable for their retirement finances. For individuals to be able to achieve this, I proposed two asset classes suitable for retirees – REITs and bond ladders, both of which are safe sources of periodic and consistent income. For REITs, I argued that they offer inflation protection whilst providing high returns. However, there is a concern for low capital appreciation and vulnerability to high interest rates. Likewise, for bond ladders, I argued that they offer capital protection and liquidity, whilst limited opportunity for diversification and impaired mobility may be the potential downsides.

The future is unpredictable. But foreseeable obstacles, such as inflation and interest rate rise, are there to be certain. To bear arms against these obstacles, retirees must be wise to educate themselves on possible investment strategies. I believe investing in these two asset classes, individuals can establish a stream of consistent income essential to their financial management. Ultimately, the strategy will be the key to achieving financial independence and security without working.

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