Guidelines for a Client's Spending Account

By Sandi Weaver, CPA, CFP, CFA

Most certified financial planners are taught that clients in the accumulation phase should keep three to six months of expenses in an emergency fund. Retired clients usually keep a higher amount, perhaps one to two years of future spending, in lower-risk highly marketable investments. Until this year, U.S. investors have seen a long-run bull market in stocks. Excepting 2020's one-month wonder of a bear market, you'd have to roll the clock back to 2009 to experience the last bear market, defined as a loss of 20 percent or more. That's 13 years; the mind forgets.

One recent new client, retired, had a separate spending account, but 92 percent of their retirement portfolio was invested in higher-risk stocks. Another new client had a moderate asset allocation with 65 percent in higher-risk investments for their retirement portfolio and had wisely segregated next year's spending in a separate spending account. Unfortunately, 67 percent of that spending account was in stock mutual funds.

Accounts for emergencies and short-term cash needs in the next year or two are best invested quite conservatively. Money market funds, CDs, ultra short-duration bonds are frequent contenders for this cash. Those investments seldom suffer larger losses; they're low risk; they can be converted to cash quickly. Even a CD that matures every 90 days and auto-renews can be liquidated in a couple days; the interest penalty is usually negligible.

What isn't always highly marketable and highly liquid are intermediate-term corporate bonds, long-term bonds, stocks, or blue-chip companies. As experienced thus far in 2022, bonds have been extremely volatile, repricing in one of the shortest time frames we've ever seen, along the short and intermediate portions of the yield curve.

The Federal Reserve Board has signaled they're ready to raise interest rates albeit in a measured thoughtful approach. At the same time, they will be reducing their not insignificant balance sheet, adding to this tighter monetary policy. The result? Many bond investments have lost money. Simultaneously, the threat of a less-accommodative Fed has caused investors to rethink valuations in the U.S. stock market, with volatile up-and-down days.

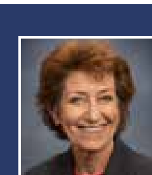
Add to this volatility Russia's military operations in Europe, and risk heightens, losses loom larger, and more. Did anyone predict this on January 1? No, yet the U.S. stock markets suffered losses of 8 percent or more by February month-end. The bond market's aggregate index lost 3 percent as well, an unusual occurrence. That's why the investments used in spending accounts and reserves should be conservative.

A rule to follow: If your client knows they're going to spend the money soon, within the next year, start raising cash and segregate it in a separate account. If the market is fairly valued or higher, sooner is better. For larger amounts, dollar-cost-averaging is usually a good strategy to employ.

A second rule is once you've raised the cash, i.e., sold stocks or bonds, use cash equivalents or investments unlikely to suffer significant losses. With interest rates so depressingly low, it's tempting to reach for higher yields in bonds or greater returns from stocks, but risk level has to be the first consideration. Losing 8 percent on funds a client plans to spend soon hurts.

Another strategy to use when working with retirement portfolios composed chiefly of tax-deferred accounts is to set up a separate IRA, external to the portfolio, as the spending account. That delays the taxable event of withdrawing from the portfolio's IRA until your client is actually ready to spend. The sales can be deposited or rolled over from the retirement portfolio into the spending IRA account on an erratic basis—one or two or three times a year. Meanwhile, the withdrawals from the spending IRA account to your client's bank checking account can be monthly. The spending account IRA can use money markets, CDs, ultra-short bond funds, and other highly marketable highly liquid investments. As long as the spending level is fairly consistent from year-to-year, that avoids paying taxes a year early.

After a 13-year run of bull markets, it's tempting to overlook guidelines. As financial advisers, we need to re-check the data, remember history, and offer clients a steady hand.



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