Blog How to Treat Social Security and Your Home in Your Financial Plan

Among the questions I'm most asked is how should social security benefits and your home be treated in terms of including them on your balance sheet and investment policy statement (IPS) and specifically the asset allocation table?

When answering the question I begin by pointing out that both Social Security and your home, while clearly assets, cannot be managed in the way you can manage the stocks, bonds, mutual funds, and ETFs you hold in your portfolio — you can neither rebalance nor tax manage (harvest losses). That's why I recommend that neither should be part of your IPS. Having addressed that question, let's take a look how you should consider the two in terms of your balance sheet and overall financial plan.

Social Security

First, clearly social security is an asset — it's no different than an inflation-adjusted annuity. However, for a variety of reasons it doesn't belong on your balance sheet. To begin with you have many issues to consider which make it difficult to value the stream of payments you will receive from social security. For example, the value will be persistently changing as whatever benchmark rate you choose (we would recommend the TIPS yield of the maturity that matches life expectancy) to use for discounting the future stream of payments changes and the time frame shrinks. In addition, the valuation will either shrink on the death of a spouse, or disappear when you pass away (the same issues apply to an annuity — which is why I would not put it on a balance sheet either). And, of course, you have the inflation adjustment to deal with.

Despite not belonging on your balance sheet, social security does play a very important role in your asset allocation decision. The reason is that social security *reduces your need to take risk*. In other words, if your financial plan calls for spending $80,000 a year in retirement, and social security will provide $30,000, your financial assets only have to generate $50,000. All else equal, social security also increases your ability to take risk — without that cash flow you might have to be more conservative in your investments in order to reduce the risk of outliving your assets. Whether you *should* take more risk because your ability to take risk is higher is an entirely different question. The answer to that one depends on how high is the marginal utility (value) of the higher expected (not guaranteed) return you would get by investing more in stocks? In other words, is the upside potential worth the downside risk you accept with a higher equity allocation?

In the good old days of "normal" interest rates, a good rule of thumb was that investors should have a portfolio equal to 25 times their annual spending needs. That figure is the inverse of the commonly used 4 percent safe withdrawal rate (SWR). Using our example of a $50,000 annual spending need, the financial goal should be to achieve a portfolio with a value of $1,250,000 (25 x $50,000). (Without social security the goal would have been $2 million (25 x $80,000), requiring a higher equity allocation.) Achieving the goal of having a $1,250,000 portfolio would allow the investor to withdraw $50,000 the first year, adjust spending in future years for inflation, and have a very high likelihood of not outliving their financial assets. (The bad news is that because of the much lower real interest environment we are now in, a 4 percent SWR is probably too aggressive, with 3 percent being more appropriate).

http://corporate.morningstar.com/us/documents/targetmaturity/LowBondYieldsWithdrawalRates.pdf

We now turn to how to treat your home.

Your Home

While a home should be treated as an asset in terms of having a place on your balance sheet (you can sell it to generate cash to invest/spend), like with Social Security, you cannot rebalance or harvest losses. In addition, because it's such a concentrated, totally undiversified holding — one type of real estate (a residential home) in one specific location — with lots of idiosyncratic risk I recommend you don't consider it an allocation to the broad asset class of real estate. You should also note that if you have a mortgage it should also be on your balance sheet. And it should be treated as a negative fixed income (bond) holding. In other words, if you have $200,000 in bonds and a $200,000 mortgage, your net position in bonds is zero.