

Creative

wealth maximization strategies*

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You Are Not So Smart (but You Can Get Lucky)

“A stupid decision that works out well becomes a brilliant decision in hindsight.”

Daniel Kahneman,
“Thinking Fast and Slow”

If you want to be successful, you should emulate successful people. Seems logical, right? But David McRaney, author of the 2011 book, “You Are Not So Smart,” says the successful – great athletes, wealthy business owners, popular entertainers, powerful politicians – may not know the secrets to their success. Oh, they may *think they know*. But it’s closer to the truth to say the successful are lucky survivors, whose success is attributable just as much to chance, and to what they *didn’t do*, as it is to some unique talent, special insight, or outstanding character trait. By only looking to the survivors, we may miss some of the essential factors in success.

Survivorship Bias

Consider Microsoft co-founder Bill Gates, declared by *Forbes* in May 2017 to be the world’s wealthiest individual. Why did Bill Gates succeed? The best answer is a combination of skill and luck.

Some note that Gates had a predisposition to understanding not only the technology but grasping the business forces at work in the personal computer industry. Where others were developing new product features, Gates was focused on establishing standards that would make Microsoft a platform for all other programs. That insight, and the talent to execute it, were certainly key to Gates’ success.

But Malcolm Gladwell, in his book “Outliers” also posits that Gates was born at the right time (1955) in the right place (a rare high school in the early 1970s with mainframe computer access). Random “lucky” events allowed Gates to capitalize on his unique skills and insights.

Gates is by all accounts a smart guy, but no one (even himself) thinks he is the world’s best businessperson. It is quite possible there are a number of other people with greater business aptitude. Why aren’t they as successful? If we want to know the true reasons for Gates’ success, McRaney says we need to know more about those who had similar skills and opportunities *but failed*; what successful people *didn’t do* may be as important as what they did.

Unfortunately, failures often disappear without leaving a record of their mistakes; who asks for advice from businesspeople who went broke, or the investors who lost all their money? According to McRaney, this ignorance is a problem. “When failure becomes invisible, the difference between failure and success may also become invisible.”

This blind spot about failure is what psychologists refer to as survivorship bias, the error of concentrating on the people or things that succeeded while overlooking those that failed, typically because we don’t know who they are, or how they failed. Because of survivorship bias, McRaney says, “The advice business is a monopoly run by survivors.” We look to Bill Gates, and people like him, for their wisdom about success, but we ignore (or can’t even find) the wisdom of those who failed.

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The Sciences of Luck

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(The latest psychological research indicates that luck is a long-mislabeled phenomenon. It isn't a force, or grace from the gods, or an enchantment from fairy folk, but the measurable output of a group of predictable behaviors. Randomness, chance, and the noisy chaos of reality may be mostly impossible to predict or tame, but luck is something else.

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- Those who considered themselves lucky, and had a history of positive outcomes from random events.
- Those who felt they were unlucky, and had negative results to back it up.

Wiseman found that those who considered themselves unlucky tended toward the following traits or attitudes:

- Narrowly focused
- Goal and outcome-oriented
- Seekers of security and control
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In contrast, those who saw themselves as lucky had these traits in common:

- Open to new experiences
- Easily abandoned routines
- Failed often, but usually rebounded quickly.

Wiseman concluded that "lucky" people, because of their personality profiles, ended up having more interaction with random events, and because of the ways they responded, also increased the likelihood that one or more of these chance encounters would end favorably.

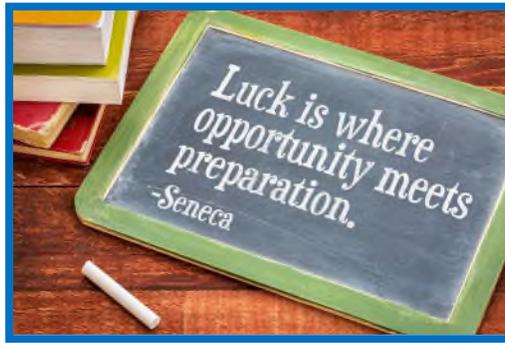
The Real-World Secret to Success

When you strip away survivorship bias, you recognize that, (1) the successful may owe their success to what they didn't do, or that they may have been more lucky than talented. And (2), if you understand that there are favorable ways to deal with the randomness of life, you have a better chance of getting lucky. McRaney combines these two conclusions to produce a real-world success formula:

"Success boils down to serially avoiding catastrophic failure while routinely absorbing manageable damage."

Is There an Application for Personal Finance? (Yes, There Is.)

It's not much of a stretch to apply McRaney's success formula to personal finance. The details might vary, but you can serially avoid catastrophe, and routinely absorb manageable losses, with some combination of **insurance** and **cash reserves**.



Having those two elements in your financial program gives you the opportunity to be lucky, to consider new experiences, to be flexible in your responses, and to fail occasionally while having more opportunities to succeed.

In the abstract, this makes sense. But even though insurance and cash reserves improve our odds of being lucky, this knowledge is often overwhelmed by our survivorship bias. It's hard to ignore the possibility that at least one financially

successful person really knows the keys to success. And if they do, why can't you? Maybe you can – if you also look for the financial failures.

Unlike some other fields, a record of failures in personal finance is available, in the form of bankruptcy filings. In the past 20 years, the most frequent cause of bankruptcy has been large, unexpected medical expenses; a 2015 Harvard University study found medical expenses account for 62 percent of personal bankruptcies in the U.S. The study also reported that three-quarters of those who filed for bankruptcy due to medical expenses **had health insurance**. What they didn't have was cash reserves for deductibles and out-of-pocket costs. You won't hear this from a self-made millionaire, but avoiding a catastrophic medical incident is perhaps one of the "luckiest" things you can do to increase your chances for financial success.

Ironically, this insight about avoiding a catastrophic medical event is part of the Microsoft story. In the early 1980s, Paul Allen, one of Gates' co-founders at Microsoft, was diagnosed with Hodgkin's lymphoma. The disease and its treatment limited Allen's participation in the business, fractured his relationship with Gates, and eventually led to his departure from the company in 2000. Allen is still a wealthy individual (he made the Forbes Top 100 list), but he is nowhere close to Gates.

There is a segment of the financial services industry that likes to tout historical performance as a reason to follow their advice. They have 4-star ratings, 10-year track records, etc. But they might just be lucky survivors, not financial wizards.

Because we see cause-and-effect at work in some parts of life, we want to believe it is in *everything*. But there are too many variables to process and too many things beyond our control.

The insurance-focused financial professionals have it right: Strategies to avoid catastrophic failure and absorb manageable damage are arguably more effective than looking for success secrets from a lucky survivor. ❖



The Stresses in Staggered Retirement



The Holmes and Rahe Stress Scale is a list of 43 stressful life events that can contribute to illness. Developed in the late 1960s and regularly updated, the most stressful life events are relational – the death of a spouse, divorce, and marital separation are the top three.

Retirement comes in at Number 10, which is sort of a surprise, since it's supposed to be an end to the daily grind, and a reward for a lifetime of diligence. So where's the stress? It's the changes that occur when work no longer dominates the schedule. And like other high-stress events, the biggest challenges in retirement can be relational, particularly in a staggered retirement, where one person retires while the other continues to work.

That retirement might cause stress isn't a new discovery. But couples may be surprised by how far-reaching the effects can be, both to their relationships and finances. And the scenario where one person retires only expands the number of issues that must be addressed.

Lifestyle Challenges

Relationship experts know that seemingly small but unresolved issues can create deep, sometimes irreparable fissures in a relationship. When one person retires, small issues can mushroom into large stresses. Here are a few examples:

Schedules. What happens when one person doesn't have to get up for work each morning? Out-of-sync schedules can create relationship stress where none existed. Robert Laura, a social worker turned retirement planner, says "Couples should make a commitment to keeping a regular bedtime," because this simple routine fosters relationship stability in retirement.

Responsibilities. Part of the advantage for couples is a division of labor. Does this division change when one person is no longer working? There may be the expectation that the retired individual has more time to assist in household chores. Or, now that they have the time, the retiree may want to "take over" areas where the still-working partner doesn't want to relinquish control.

Leisure Activities and Social Circle. The workplace can be a social center for many couples; co-workers become friends, and influence leisure activities. At retirement, these social circles may shrink or close. In their place, new relationships may form at clubs, with volunteer organizations or in other recreational pursuits - which may mean adapting to a new set of friends and acquaintances – for both parties.

Financial Challenges

The Holmes and Rahe Stress Scale puts a "change in financial state" six places lower than retirement, but when you combine their scores, the two events are the stress equivalent of a divorce. And a staggered retirement will almost certainly cause a change in financial state.

Household Budget: Primarily because the expenses associated with working can be eliminated, most retirement projections assume a lower cost of living. But when only one person in a couple retires, you may still need two cars, may not be able to move (to a smaller residence or different location) because of work, and you may still be locked into other financial commitments. This financial inflexibility could mean the cost of living is the same, but total income is less.

Social Security: Social Security issues are made more complicated by a staggered retirement. It starts with a decision about when to begin benefits, then continues with electing one's individual or spousal benefit, and concludes with an assessment of the tax consequences of these choices.

Benefits: According to Mr. Laura, the retirement of one person can make the other a "benefit slave," i.e., they must continue working to maintain employer-sponsored health insurance and other benefits. And, if some group benefits are no longer available, a couple may find individual rates for the same coverages are more expensive due to their current ages or physical condition.

Saving: If more of the current income from a still-working partner will be required to make the first retirement possible, this will impact saving for the second retirement. Contributions to retirement plans may stop, and other savings vehicles might need to be considered.

Preparing for a Staggered Retirement

For couples, a staggered retirement is a half-in, half-out condition; as an economic unit, you're working *and* retired. And often, it is less than ideal. Glenn Ruffenach, in a June 2, 2017, *Wall Street Journal* article says:

"Retiring at the same time tends to work better. Most couples, by definition, navigate big changes in their lives together: relocating, starting a family, choosing (and changing) career paths. Retirement, of course, is a *very big change*."

Ruffenach is right. Just addressing the items mentioned above could easily require multiple conversations and extended planning sessions. And ideally, these discussions should take place well before a retirement, staggered or not. Unfortunately, a staggered retirement is often a surprise.

A disability, a company downsizing, a situation with extended family, all might lead to the conclusion that it's just not practical to continue working. If a staggered retirement has the potential to be stressful, an unprepared, forced, staggered retirement is even more so. It's all the same issues, with very little time to prepare.

To mitigate against an unexpected retirement, some financial professionals recommend that households between ages 50 and 60 consider themselves in a "pre-retirement" phase, where some of the following topics might be explored:

- Estimates of retirement income based on today's accumulations.
- Strategies for Social Security, should retirement occur today.

- Transition scenarios for covering income needs if retirement occurs before one person is eligible for Social Security.
- Projections of tax consequences if one person keeps working.

Most of these pre-retirement discussions with a financial professional are money discussions – how much you have, how long it will last, etc. But couples should also converse – with or without a financial professional – about their retirement lifestyle expectations. If the relationship is strong, other stressors will be far more manageable.

Voluntarily or otherwise, most Americans will retire. For couples, this nearly-inevitable conclusion to a working life should be regularly considered, and discussed.

If they prepare during pre-retirement, couples are less likely to stumble, even in a staggered retirement scenario. ♦



The Return of Alt-Mortgages



Interest costs are a drain on any financial plan, so it's understandable that consumers would seek to minimize them. For many, this means finding the lower interest rate and/or the shortest loan term. But there are other options, especially for home mortgages. And in specific circumstances, what at first appear to be higher-cost or riskier loans may be cheaper and provide additional economic benefits.

The primary advantage from these alternative mortgage arrangements is improved cash flow; lower monthly payments put more money under personal control. When monthly savings can be invested to produce returns greater than the costs of borrowing, these alternatives merit serious consideration.

Here are two alternatives to fixed-rate mortgages which are seeing a resurgence in the US market.

ARMs

Adjustable-rate mortgages, or ARMs, have monthly payments that fluctuate as interest rates go up or down. Most ARMs have an initial fixed-rate period, typically five to seven years, during which the rate doesn't change, followed by rate changes occurring at preset intervals. New interest rates are

typically calculated by adding a fixed margin to a financial benchmark, such as the London interbank offered rate (LIBOR). While currently comprising less than 5 percent of all mortgages in the United States, the adjustable-rate format is so common overseas that the phrase "adjustable" isn't even used; they are just called "mortgages."

One of the attractions of an ARM is that the initial interest rate will generally be lower than a comparable fixed-rate loan. And if interest rates are lower when the fixed-rate period ends, future monthly payments will decline as well.

But interest rates are unpredictable, and currently near historic lows. If they climb during the mortgage term, the total interest costs in an ARM might far exceed those in a conventional fixed-rate mortgage. Even though most ARMs have caps that limit how much a monthly payment can increase during an interval, the aggregate costs could significantly exceed a fixed-rate mortgage locked in at today's rates.

Interest-Only

In this arrangement, a borrower's monthly payments reflect only the interest charged each month on a fixed-rate loan; there is no amortization, so the balance doesn't go down. After a specified period, usually five to seven years, the borrower must either refinance the property, pay the balance in full, or begin an amortized payment schedule (resulting in significantly higher monthly payments).

Interest-only loans are less common, and rarely advertised; borrowers may have to ask if interest-only options are available, and meet higher eligibility standards. Compared to conventional mortgages, interest-only borrowers must have lower debt-to-income ratios, higher credit scores, and larger down payments.

Because monthly payments do not reduce the loan balance, lenders may charge a higher interest rate. But even at a higher rate, the interest-only monthly payment may be substantially less than a fixed-rate payment of principal and interest.

Long-Term Financial Certainty vs. Short-Term Cash Flow

For borrowers, a fixed-rate mortgage offers financial certainty – in monthly payments, the costs of borrowing, and when the loan will be paid off. The other options, not so much. An adjustable-rate mortgage, taken to its conclusion, will still pay off the mortgage. But the cumulative interest costs will only become evident as rates increase or decrease. Interest-only loans are a temporary transaction, with only one certainty: the borrower knows that another transaction – a sale, a payoff, a refinance – must occur when the interest-only period expires.

Besides the monthly cash-flow advantages, other factors play a part in determining if alternative mortgage arrangements are desirable. In the context of their larger financial objectives, the current home may not be an integral asset for every homeowner. For example:

A Home as a Temporary Residence: For homeowners who anticipate moving within a few years, the "what-ifs" of an ARM's changing interest rate, or the need to refinance an interest-only loan are non-issues; the house will be sold, and the mortgage paid off. At the beginning of the term, the monthly payments in a fixed-rate mortgage are predominantly interest and pay down very little principal. If the property is sold within a few years of its purchase, there won't be a significant reduction in the mortgage balance. Perhaps it's better to take the guaranteed lower payments from an ARM or interest-only mortgage, and save the difference.

A Home as a Subsidized Rental: Under current tax law, mortgage interest is deductible for many households. In some instances, this deduction can make owning cheaper than renting, especially for families with children, where the primary options are buying or renting a single-family home. In a fixed-rate mortgage, the interest deduction declines over time as more of each payment goes to principal. Although the monthly payment will probably be lower, the full amount can be deductible for the entire period of an interest-only mortgage.

When a homeowner anticipates selling the property (after the children are grown, at retirement, etc.) the mortgage format to use might hinge on which strategy projects to deliver the most cash at the time of sale. If the monthly savings from an alt-mortgage can earn more than the cost of borrowing on a fixed-rate loan, the math favors the ARM or interest-only format. These “extra” savings can deliver additional financial benefits as well, such as increased liquidity and diversification. (And remember, even with no pay-down of principal, rising property values can increase a homeowner’s equity.)

Of course, this discussion is a waste of time if the borrower doesn’t save the difference. A March 27, 2017, *Wall Street Journal* article cautioned that alternatives to fixed-rate mortgages work best with “disciplined” borrowers. If an adjustable-rate or interest-only mortgage is the only way to make a home purchase affordable, it may be an indication that it really isn’t. Alt-mortgage strategies work best for those who have savings and the discipline to save more.



If an alt-mortgage intrigues you, a conversation with a financial professional might help you determine how these formats could fit your unique circumstances. ❖



If your employer offers a 401(k), you probably know the basics: deposits are made on a pre-tax basis, earnings accumulate tax-free, and distributions after age 59½ are taxed as regular income. These features, along with other items, such as loans, hardship provisions, early withdrawals, and required minimum distributions, are determined by government regulations.

What many participants may not know is that employers, as sponsors of a plan, do not have to include every authorized feature in their 401(k)s, and have quite a bit of discretion in

determining the details of their use. To that point, some retirement account experts are now recommending employers purposely restrict or eliminate some 401(k) features. Many of these recommendations involve loans, and while intended to improve retirement saving for participants, could perhaps have an adverse effect on employer-employee relationships.

The Leakage Problem

401(k) rules allow participants to borrow from their accounts. Under most circumstances, the amount available for loan is the lesser of 50 percent of the account balance, or \$50,000. With the exception of funds used for the purchase of a first home, 401(k) loans must be repaid in five years, with payments made at least quarterly.

A loan provision is generally seen by participants as a positive feature in that a portion of their accumulation, while intended for retirement, is available today. And many participants exercise their loan privileges; a high percentage use loans to pay for current expenditures, both necessary (like medical bills) and discretionary (like vacations). This “leakage,” according to 401(k) experts, is undermining employees’ efforts to adequately save for retirement.

Their recommendation to employers? Discontinue or restrict loans, and subject would-be borrowers to screening processes. Robert Lawton, president of a retirement plan consulting firm, put it this way in a June 6, 2017, article for *Employee Benefit News*:

“For employers, a significant factor in helping 401(k) plan participants achieve retirement readiness is protecting them from themselves. In other words, it’s about helping participants avoid making bad decisions.”

Even though 401(k) loans are permissible, an employer is not required to make them available. And while the statutes governing plan loans place no restrictions on how funds can be used, employers can, if they choose, limit or deny loan requests based on their intended use (providing these terms apply to all participants). In effect, the employer can be a loan officer, evaluating if an employee should receive a loan – from his/her own earnings.

Some Proposed Fixes

Lawton mentions the following ways an employer can alter loan provisions to improve 401(k) plan retention:

- **Limit loans to hardship situations.** Employers can require prospective borrowers to document that funds will be used to alleviate specific financial hardships, typically: to pay family education expenses, to prevent eviction or foreclosure, to cover medical expenses, or to buy a first-time residence.
- **Permit only one loan at a time.** Instead of allowing an employee to take multiple loans as long as the total outstanding balance is below government limits, employers can decide that an existing loan must be repaid before new funds are distributed.
- **Require financial counseling.** Employers can require that prospective borrowers review their loan request with HR personnel, meet with an independent financial counselor, or undergo some other education or assessment before approving a loan.
- **Make only employee contributions available.** In plans where the employer contributes to an employee’s account in the form of a match, all employer

contributions can be excluded from consideration for loans.

- **Impose higher fees on the transaction.** Lawton says higher processing fees tend to “dissuade participants from taking a loan and often reduce the amount requested.”
- **Offer employer-sponsored emergency loans.** Some larger employers, such as colleges, have begun to offer short-term loans to their employees as an alternative to 401(k) borrowing. For example, the University of North Carolina offers employees with 12 months of continuous service, interest-free loans up to \$500. It’s not a lot, but may be enough to prevent a 401(k) loan request.

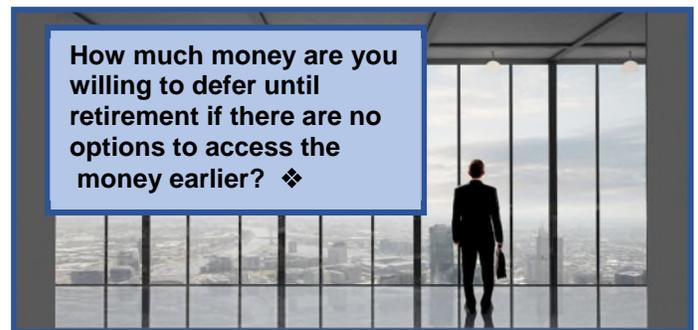
The paternal approach reflected in these suggestions may reduce 401(k) loans, but could create additional tensions in an employer-employee relationship. The financial information required by the plan sponsor to approve or decline an employee’s loan request may give management an unfair advantage in negotiating salaries and promotions. For example, if an employer knows an employee is struggling financially, and knows the reasons why, the employer might be less likely to consider the employee for promotion, even if his/her work performance is stellar.

In the past three decades, many employers have jettisoned pension plans because the long-term financial obligations were both significant and uncertain. 401(k)s, originally intended as retirement supplements, became the replacement for pensions, with all of the risk and responsibility falling to the employee.

With many employees struggling as retirement planners, experts are urging employers to step in again, as financial counselors and loan officers.

A 401(k) is a deferred compensation plan. In exchange for an immediate tax advantage, participants elect to set aside a portion of today’s income, ideally until sometime after age 59½. Loan provisions may allow participants to temporarily reclaim some of their deferred income, but the terms are ultimately left to the employer’s determination. And the terms can change.

These developments might prompt employees to re-evaluate their participation in qualified plans. If loan provisions change, what is the impact on available cash reserves? Should some 401(k) contributions be allocated to other financial instruments? Is it prudent to have one’s financial condition open to employer scrutiny? These specific issues point to an essential general question:



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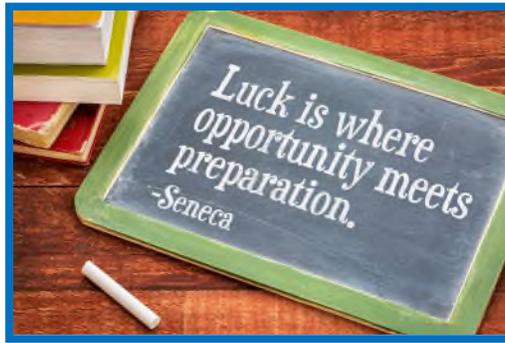
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It's not much of a stretch to apply McRaney's success formula to personal finance. The details might vary, but you can serially avoid catastrophe, and routinely absorb manageable losses, with some combination of **insurance** and **cash reserves**.



Having those two elements in your financial program gives you the opportunity to be lucky, to consider new experiences, to be flexible in your responses, and to fail occasionally while having more opportunities to succeed.

In the abstract, this makes sense. But even though insurance and cash reserves improve our odds of being lucky, this knowledge is often overwhelmed by our survivorship bias. It's hard to ignore the possibility that at least one financially

successful person really knows the keys to success. And if they do, why can't you? Maybe you can – if you also look for the financial failures.

Unlike some other fields, a record of failures in personal finance is available, in the form of bankruptcy filings. In the past 20 years, the most frequent cause of bankruptcy has been large, unexpected medical expenses; a 2015 Harvard University study found medical expenses account for 62 percent of personal bankruptcies in the U.S. The study also reported that three-quarters of those who filed for bankruptcy due to medical expenses **had health insurance**. What they didn't have was cash reserves for deductibles and out-of-pocket costs. You won't hear this from a self-made millionaire, but avoiding a catastrophic medical incident is perhaps one of the "luckiest" things you can do to increase your chances for financial success.

Ironically, this insight about avoiding a catastrophic medical event is part of the Microsoft story. In the early 1980s, Paul Allen, one of Gates' co-founders at Microsoft, was diagnosed with Hodgkin's lymphoma. The disease and its treatment limited Allen's participation in the business, fractured his relationship with Gates, and eventually led to his departure from the company in 2000. Allen is still a wealthy individual (he made the Forbes Top 100 list), but he is nowhere close to Gates.

There is a segment of the financial services industry that likes to tout historical performance as a reason to follow their advice. They have 4-star ratings, 10-year track records, etc. But they might just be lucky survivors, not financial wizards.

Because we see cause-and-effect at work in some parts of life, we want to believe it is in *everything*. But there are too many variables to process and too many things beyond our control.

The insurance-focused financial professionals have it right: Strategies to avoid catastrophic failure and absorb manageable damage are arguably more effective than looking for success secrets from a lucky survivor. ❖



The Stresses in Staggered Retirement



The Holmes and Rahe Stress Scale is a list of 43 stressful life events that can contribute to illness. Developed in the late 1960s and regularly updated, the most stressful life events are relational – the death of a spouse, divorce, and marital separation are the top three.

Retirement comes in at Number 10, which is sort of a surprise, since it's supposed to be an end to the daily grind, and a reward for a lifetime of diligence. So where's the stress? It's the changes that occur when work no longer dominates the schedule. And like other high-stress events, the biggest challenges in retirement can be relational, particularly in a staggered retirement, where one person retires while the other continues to work.

That retirement might cause stress isn't a new discovery. But couples may be surprised by how far-reaching the effects can be, both to their relationships and finances. And the scenario where one person retires only expands the number of issues that must be addressed.

Lifestyle Challenges

Relationship experts know that seemingly small but unresolved issues can create deep, sometimes irreparable fissures in a relationship. When one person retires, small issues can mushroom into large stresses. Here are a few examples:

Schedules. What happens when one person doesn't have to get up for work each morning? Out-of-sync schedules can create relationship stress where none existed. Robert Laura, a social worker turned retirement planner, says "Couples should make a commitment to keeping a regular bedtime," because this simple routine fosters relationship stability in retirement.

Responsibilities. Part of the advantage for couples is a division of labor. Does this division change when one person is no longer working? There may be the expectation that the retired individual has more time to assist in household chores. Or, now that they have the time, the retiree may want to "take over" areas where the still-working partner doesn't want to relinquish control.

Leisure Activities and Social Circle. The workplace can be a social center for many couples; co-workers become friends, and influence leisure activities. At retirement, these social circles may shrink or close. In their place, new relationships may form at clubs, with volunteer organizations or in other recreational pursuits - which may mean adapting to a new set of friends and acquaintances – for both parties.

Financial Challenges

The Holmes and Rahe Stress Scale puts a "change in financial state" six places lower than retirement, but when you combine their scores, the two events are the stress equivalent of a divorce. And a staggered retirement will almost certainly cause a change in financial state.

Household Budget: Primarily because the expenses associated with working can be eliminated, most retirement projections assume a lower cost of living. But when only one person in a couple retires, you may still need two cars, may not be able to move (to a smaller residence or different location) because of work, and you may still be locked into other financial commitments. This financial inflexibility could mean the cost of living is the same, but total income is less.

Social Security: Social Security issues are made more complicated by a staggered retirement. It starts with a decision about when to begin benefits, then continues with electing one's individual or spousal benefit, and concludes with an assessment of the tax consequences of these choices.

Benefits: According to Mr. Laura, the retirement of one person can make the other a "benefit slave," i.e., they must continue working to maintain employer-sponsored health insurance and other benefits. And, if some group benefits are no longer available, a couple may find individual rates for the same coverages are more expensive due to their current ages or physical condition.

Saving: If more of the current income from a still-working partner will be required to make the first retirement possible, this will impact saving for the second retirement. Contributions to retirement plans may stop, and other savings vehicles might need to be considered.

Preparing for a Staggered Retirement

For couples, a staggered retirement is a half-in, half-out condition; as an economic unit, you're working *and* retired. And often, it is less than ideal. Glenn Ruffenach, in a June 2, 2017, *Wall Street Journal* article says:

"Retiring at the same time tends to work better. Most couples, by definition, navigate big changes in their lives together: relocating, starting a family, choosing (and changing) career paths. Retirement, of course, is a *very big change*."

Ruffenach is right. Just addressing the items mentioned above could easily require multiple conversations and extended planning sessions. And ideally, these discussions should take place well before a retirement, staggered or not. Unfortunately, a staggered retirement is often a surprise.

A disability, a company downsizing, a situation with extended family, all might lead to the conclusion that it's just not practical to continue working. If a staggered retirement has the potential to be stressful, an unprepared, forced, staggered retirement is even more so. It's all the same issues, with very little time to prepare.

To mitigate against an unexpected retirement, some financial professionals recommend that households between ages 50 and 60 consider themselves in a "pre-retirement" phase, where some of the following topics might be explored:

- Estimates of retirement income based on today's accumulations.
- Strategies for Social Security, should retirement occur today.

- Transition scenarios for covering income needs if retirement occurs before one person is eligible for Social Security.
- Projections of tax consequences if one person keeps working.

Most of these pre-retirement discussions with a financial professional are money discussions – how much you have, how long it will last, etc. But couples should also converse – with or without a financial professional – about their retirement lifestyle expectations. If the relationship is strong, other stressors will be far more manageable.

Voluntarily or otherwise, most Americans will retire. For couples, this nearly-inevitable conclusion to a working life should be regularly considered, and discussed.

If they prepare during pre-retirement, couples are less likely to stumble, even in a staggered retirement scenario. ♦



The Return of Alt-Mortgages



Interest costs are a drain on any financial plan, so it's understandable that consumers would seek to minimize them. For many, this means finding the lower interest rate and/or the shortest loan term. But there are other options, especially for home mortgages. And in specific circumstances, what at first appear to be higher-cost or riskier loans may be cheaper and provide additional economic benefits.

The primary advantage from these alternative mortgage arrangements is improved cash flow; lower monthly payments put more money under personal control. When monthly savings can be invested to produce returns greater than the costs of borrowing, these alternatives merit serious consideration.

Here are two alternatives to fixed-rate mortgages which are seeing a resurgence in the US market.

ARMs

Adjustable-rate mortgages, or ARMs, have monthly payments that fluctuate as interest rates go up or down. Most ARMs have an initial fixed-rate period, typically five to seven years, during which the rate doesn't change, followed by rate changes occurring at preset intervals. New interest rates are

typically calculated by adding a fixed margin to a financial benchmark, such as the London interbank offered rate (LIBOR). While currently comprising less than 5 percent of all mortgages in the United States, the adjustable-rate format is so common overseas that the phrase "adjustable" isn't even used; they are just called "mortgages."

One of the attractions of an ARM is that the initial interest rate will generally be lower than a comparable fixed-rate loan. And if interest rates are lower when the fixed-rate period ends, future monthly payments will decline as well.

But interest rates are unpredictable, and currently near historic lows. If they climb during the mortgage term, the total interest costs in an ARM might far exceed those in a conventional fixed-rate mortgage. Even though most ARMs have caps that limit how much a monthly payment can increase during an interval, the aggregate costs could significantly exceed a fixed-rate mortgage locked in at today's rates.

Interest-Only

In this arrangement, a borrower's monthly payments reflect only the interest charged each month on a fixed-rate loan; there is no amortization, so the balance doesn't go down. After a specified period, usually five to seven years, the borrower must either refinance the property, pay the balance in full, or begin an amortized payment schedule (resulting in significantly higher monthly payments).

Interest-only loans are less common, and rarely advertised; borrowers may have to ask if interest-only options are available, and meet higher eligibility standards. Compared to conventional mortgages, interest-only borrowers must have lower debt-to-income ratios, higher credit scores, and larger down payments.

Because monthly payments do not reduce the loan balance, lenders may charge a higher interest rate. But even at a higher rate, the interest-only monthly payment may be substantially less than a fixed-rate payment of principal and interest.

Long-Term Financial Certainty vs. Short-Term Cash Flow

For borrowers, a fixed-rate mortgage offers financial certainty – in monthly payments, the costs of borrowing, and when the loan will be paid off. The other options, not so much. An adjustable-rate mortgage, taken to its conclusion, will still pay off the mortgage. But the cumulative interest costs will only become evident as rates increase or decrease. Interest-only loans are a temporary transaction, with only one certainty: the borrower knows that another transaction – a sale, a payoff, a refinance – must occur when the interest-only period expires.

Besides the monthly cash-flow advantages, other factors play a part in determining if alternative mortgage arrangements are desirable. In the context of their larger financial objectives, the current home may not be an integral asset for every homeowner. For example:

A Home as a Temporary Residence: For homeowners who anticipate moving within a few years, the "what-ifs" of an ARM's changing interest rate, or the need to refinance an interest-only loan are non-issues; the house will be sold, and the mortgage paid off. At the beginning of the term, the monthly payments in a fixed-rate mortgage are predominantly interest and pay down very little principal. If the property is sold within a few years of its purchase, there won't be a significant reduction in the mortgage balance. Perhaps it's better to take the guaranteed lower payments from an ARM or interest-only mortgage, and save the difference.

A Home as a Subsidized Rental: Under current tax law, mortgage interest is deductible for many households. In some instances, this deduction can make owning cheaper than renting, especially for families with children, where the primary options are buying or renting a single-family home. In a fixed-rate mortgage, the interest deduction declines over time as more of each payment goes to principal. Although the monthly payment will probably be lower, the full amount can be deductible for the entire period of an interest-only mortgage.

When a homeowner anticipates selling the property (after the children are grown, at retirement, etc.) the mortgage format to use might hinge on which strategy projects to deliver the most cash at the time of sale. If the monthly savings from an alt-mortgage can earn more than the cost of borrowing on a fixed-rate loan, the math favors the ARM or interest-only format. These “extra” savings can deliver additional financial benefits as well, such as increased liquidity and diversification. (And remember, even with no pay-down of principal, rising property values can increase a homeowner’s equity.)

Of course, this discussion is a waste of time if the borrower doesn’t save the difference. A March 27, 2017, *Wall Street Journal* article cautioned that alternatives to fixed-rate mortgages work best with “disciplined” borrowers. If an adjustable-rate or interest-only mortgage is the only way to make a home purchase affordable, it may be an indication that it really isn’t. Alt-mortgage strategies work best for those who have savings and the discipline to save more.



If an alt-mortgage intrigues you, a conversation with a financial professional might help you determine how these formats could fit your unique circumstances. ❖



Your Employer as 401(k) Loan Officer

If your employer offers a 401(k), you probably know the basics: deposits are made on a pre-tax basis, earnings accumulate tax-free, and distributions after age 59½ are taxed as regular income. These features, along with other items, such as loans, hardship provisions, early withdrawals, and required minimum distributions, are determined by government regulations.

What many participants may not know is that employers, as sponsors of a plan, do not have to include every authorized feature in their 401(k)s, and have quite a bit of discretion in

determining the details of their use. To that point, some retirement account experts are now recommending employers purposely restrict or eliminate some 401(k) features. Many of these recommendations involve loans, and while intended to improve retirement saving for participants, could perhaps have an adverse effect on employer-employee relationships.

The Leakage Problem

401(k) rules allow participants to borrow from their accounts. Under most circumstances, the amount available for loan is the lesser of 50 percent of the account balance, or \$50,000. With the exception of funds used for the purchase of a first home, 401(k) loans must be repaid in five years, with payments made at least quarterly.

A loan provision is generally seen by participants as a positive feature in that a portion of their accumulation, while intended for retirement, is available today. And many participants exercise their loan privileges; a high percentage use loans to pay for current expenditures, both necessary (like medical bills) and discretionary (like vacations). This “leakage,” according to 401(k) experts, is undermining employees’ efforts to adequately save for retirement.

Their recommendation to employers? Discontinue or restrict loans, and subject would-be borrowers to screening processes. Robert Lawton, president of a retirement plan consulting firm, put it this way in a June 6, 2017, article for *Employee Benefit News*:

“For employers, a significant factor in helping 401(k) plan participants achieve retirement readiness is protecting them from themselves. In other words, it’s about helping participants avoid making bad decisions.”

Even though 401(k) loans are permissible, an employer is not required to make them available. And while the statutes governing plan loans place no restrictions on how funds can be used, employers can, if they choose, limit or deny loan requests based on their intended use (providing these terms apply to all participants). In effect, the employer can be a loan officer, evaluating if an employee should receive a loan – from his/her own earnings.

Some Proposed Fixes

Lawton mentions the following ways an employer can alter loan provisions to improve 401(k) plan retention:

- **Limit loans to hardship situations.** Employers can require prospective borrowers to document that funds will be used to alleviate specific financial hardships, typically: to pay family education expenses, to prevent eviction or foreclosure, to cover medical expenses, or to buy a first-time residence.
- **Permit only one loan at a time.** Instead of allowing an employee to take multiple loans as long as the total outstanding balance is below government limits, employers can decide that an existing loan must be repaid before new funds are distributed.
- **Require financial counseling.** Employers can require that prospective borrowers review their loan request with HR personnel, meet with an independent financial counselor, or undergo some other education or assessment before approving a loan.
- **Make only employee contributions available.** In plans where the employer contributes to an employee’s account in the form of a match, all employer

contributions can be excluded from consideration for loans.

- **Impose higher fees on the transaction.** Lawton says higher processing fees tend to “dissuade participants from taking a loan and often reduce the amount requested.”
- **Offer employer-sponsored emergency loans.** Some larger employers, such as colleges, have begun to offer short-term loans to their employees as an alternative to 401(k) borrowing. For example, the University of North Carolina offers employees with 12 months of continuous service, interest-free loans up to \$500. It’s not a lot, but may be enough to prevent a 401(k) loan request.

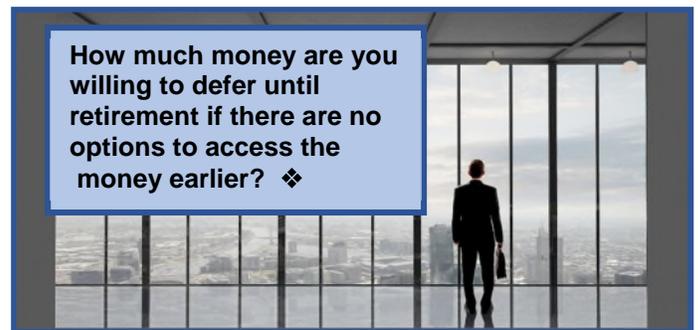
The paternal approach reflected in these suggestions may reduce 401(k) loans, but could create additional tensions in an employer-employee relationship. The financial information required by the plan sponsor to approve or decline an employee’s loan request may give management an unfair advantage in negotiating salaries and promotions. For example, if an employer knows an employee is struggling financially, and knows the reasons why, the employer might be less likely to consider the employee for promotion, even if his/her work performance is stellar.

In the past three decades, many employers have jettisoned pension plans because the long-term financial obligations were both significant and uncertain. 401(k)s, originally intended as retirement supplements, became the replacement for pensions, with all of the risk and responsibility falling to the employee.

With many employees struggling as retirement planners, experts are urging employers to step in again, as financial counselors and loan officers.

A 401(k) is a deferred compensation plan. In exchange for an immediate tax advantage, participants elect to set aside a portion of today’s income, ideally until sometime after age 59½. Loan provisions may allow participants to temporarily reclaim some of their deferred income, but the terms are ultimately left to the employer’s determination. And the terms can change.

These developments might prompt employees to re-evaluate their participation in qualified plans. If loan provisions change, what is the impact on available cash reserves? Should some 401(k) contributions be allocated to other financial instruments? Is it prudent to have one’s financial condition open to employer scrutiny? These specific issues point to an essential general question:



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