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Mr. America and Barbie:
Distortions in Personal Finance

Apparently it's not that hard to accumulate a million dollars for retirement. For example:

"If a 25-year-old, pack-per-day smoker quits smoking and puts the money he saves into savings, he can rather easily build $1,000,000 by retirement. All he needs to do is save his money in an IRA and select a small-company, stock mutual index fund. (Remember, adjusted for inflation, this person will probably have between $3,000,000 and $4,000,000 of inflated dollars.)"

or:

"Let's say that at age 18, you decide you can save and invest $500 per year. How long will it take you to become a millionaire? If you match the average stock market return of 10.5%, you'll get there by age 94.

Keep in mind, though, that you should be able to beat the stock market and become a millionaire a lot sooner. If you take the time to learn a lot and become an excellent investor, earning perhaps 16% or more, on average, per year, you could be a millionaire in your 60s. And this assumes you won't save more than $500 a year -- which you will, right?"

and:

"I just saved about 66% of my pay without really noticing it, and in under ten years I woke up and realized I didn't have to work for a living any more."

These are actual statements from websites encouraging saving; they aren't setups for sales pitches for a product, program, or service. These "experts" are sincerely telling you, based on their observations and experience, that saving a million dollars is not only doable, but easy.

Do these conclusions inspire and motivate you? Or does this message seem a little off?

Because for something that is supposed to be easy, very few Americans are doing it. A 2015 report from the National Association of Government Defined Contribution Administrators, Inc. found that 45 percent of Americans have saved exactly nothing – ***zero, zilch, nada*** – for retirement. The National Institute on Retirement Security reported that median retirement account balances for pre-retirees was $14,500 (uh, that's not even close to $1 million), with 62 percent of Americans aged 55 to 64 having saved less than one year of their annual income.

Distortions and Comparisons are Counter-Productive

When you combine mathematics and extreme behavior, the projected results are theoretically possible, but extremely unlikely. And it's questionable if anyone is better off for knowing this information.

The three examples featured above contain distortions that make them meaningless for most Americans. Two of them represent time horizons of 40-plus years of saving and compounding. One assumes an expensive bad habit can be painlessly converted to saving. Another requires investment expertise equaling or exceeding that of professionals. And the other requires a Spartan lifestyle in order achieve both a high level of saving and a low target for retirement income.

In This Issue…

* The title of this newsletter should in no way be construed that the strategies/information in these articles are guaranteed to be successful. The reader should discuss any financial strategies presented in this newsletter with a licensed financial professional.

These approaches tend to produce what might be called Mr. America and Barbie financial models. They sort of resemble real life, but on closer examination, the distortions make them impractical.

Mr. America is a real person, but his physique is the product of rare genetics, pharmaceutical enhancement and a very time-consuming training regimen. Contrary to what some exercise magazines and nutritional supplement ads claim, the vast majority of American men can never become Mr. America.

And Barbie? Well, according to a December 2014 post on medicaldaily.com,

> A disturbing chart that converts the doll's body scale into a real-life human being's reveals that…if Barbie were an actual woman, she would be 5'9" tall, have a 39" bust, an 18" waist, 33" hips and a size 3 shoe! (S)he'd be forced to walk on all fours and would be physically incapable of lifting her over-sized head.

(Yep, that sounds like someone to emulate.)

There is research that finds Barbie's distorted physique has a negative impact on how some young girls perceive their own bodies and attractiveness. In a similar way, these distorted financial examples present impossible strategies that could leave you feeling depressed about your own financial condition (especially if you're older), because apparently you aren't smart enough, you haven't lived cheaply enough to make up for your ignorance, and now it's too late.

Some people can detect the unrealistic aspects in these financial scenarios, and negate their potential for discouragement. But because the distorted perspective is about saving (a good thing), it can be hard to completely dismiss the message, especially if you know you need to be better at it.

An interesting new financial behavior study indicates that even "realistic" scenarios involving peers who have succeeded in saving can have a negative impact on those who feel they are underachieving. A group of researchers led by Dr. James Choi, a professor at Yale School of Management, studied workers enrolling in employer-sponsored retirement plans. To encourage saving, the researchers, acting as advisors, told one group of potential savers how much their peers were contributing. Another group was given no info on their peers, but only told the benefits of the plan.

The results were unexpected: Those who heard how much their co-workers were saving ***were less likely to enroll in the retirement plan.*** Remember, this wasn't distorted Mr. America or Barbie financial info, but actual numbers from their peers. Why would this data discourage saving? In a September 20, 2015, *Wall Street Journal* opinion piece titled, "Don't Compare Your Savings to That of Your Peers," Dr. Choi offers an explanation:

> Peer information will always contain an element of social comparison. Our findings suggest that exposing employees who are saving little or nothing for retirement to information about their higher saving coworkers is a discouraging reminder of their low economic status, and that makes them less likely to increase their savings.

1. Believe your situation can turn out okay.
2. Get professional help.

For those already struggling to save enough, the apparent success of others "just like you" doesn't appear to help. Rather, it is discouraging.

It's Not Too Late

So what can you do when you haven't been saving, and don't have decades to accumulate a substantial retirement account? While it might be helpful to disregard the distorted examples and comparisons to your peers, it doesn't give financial underachievers a template for remedying their saving deficiencies. There have to be realistic options, especially for those with short time horizons to retirement.

Here are two key thoughts for making realistic retirement progress, no matter where you are right now:

1. Believe your situation can turn out okay. This isn't some self-help mumbo-jumbo. Making the best of what can be, starts with a better mindset.

The ideal retirement has been sold as 30 years of traveling, indulging grandchildren, and playing golf. It sounds great, but for many it's a Barbie plan, almost impossible to achieve. Yet even though their savings may not approach $1 million, plenty of older Americans have figured out how to live satisfying lives. They have retirement plans that look like them, ones that match their circumstances.

Whatever you have or haven't done thus far, you have to believe that whatever you do now will be a step toward making the future better. People do nothing because they don't believe anything can make a difference.

2. Get professional help. The examples at the beginning of this article featured one key action: quitting cigarettes, learning how to invest, or saving two-thirds of your income. If you're older and haven't saved a lot, it's unlikely that one change is going to be a financial silver bullet. As Steven L. Nelson, author of several "for Dummies" books, writes: "If you're 50 years old, you can't make one decision and expect that single good decision to grow to $1,000,000." Getting to a better place financially will probably require a series of adjustments, and expert assistance.

Financial professionals can not only provide plans and products, but also offer positive reinforcement, management tools, and personal service to make these necessary changes happen. Getting better financially does not have to be a do-it-yourself project.

Saving is not easy. It never has been. But it is worthwhile. No matter how poorly someone has saved thus far, any improvements will be beneficial. Look past the distortions to implement workable strategies that incrementally move you toward a better financial condition. ❖

WORK WITH SOMEONE WHO CAN HELP YOU *GET REAL* ABOUT RETIREMENT!

Transitioning to Self-Employment

For Americans who aren't confident they are saving enough for a comfortable retirement, one response is to work longer. Theoretically, this gives you more years to save and fewer years to live on savings. The math for extending your earning years makes sense, but research and anecdotal evidence suggest it's not as easy as telling your employer you've decided to stay on the job until 70. In fact, working longer may require considerable thought and planning.

In the 2014 version of its annual survey on retirement, the Employee Benefit and Research Institute (EBRI) found that almost half of American retirees are forced out of their jobs due to changes at their company such as:

Down-sizing or closure:	18 percent
Changes in skills required for their job:	7 percent
Other work-related reasons:	22 percent

And a March 2015 AARP survey found that while workers between the ages of 45 and 70 have a lower overall unemployment rate than their younger counterparts, those who become unemployed after 45 have a much harder time finding a new job. And if they do, it's often for less pay, or part-time.

Note that the first word in the EBRI acronym is "Employee." The surveys do not include those who are business owners or self-employed. And other research suggests the parameters for retirement are different for this group of workers. A December 2012 report from the Small Business Association found that:

> The small business owner has a significantly later expected retirement age than an employee. In fact, the small business owner may be less likely to retire all together. Specifically, small business owners in 2010 reported that they would retire on average at age 72.6, while the expected retirement age among employees was 68.4.

For older workers, transitioning to business ownership or self-employment may be a viable path to extending their earning years. These options can not only be career extenders as far as earnings, but also allow for a gradual retirement, one that moves from full-time work to flexible hours and part-time commitments, and continues to add income to the family finances.

The Logistics of Transitioning to Self-Employment

Successfully transitioning to self-employment often requires a financial re-education. The metrics for compensation are no longer as simple as an hourly wage or monthly salary; self-employed and business owners have different income tax calculations, including the amounts assessed for Social Security and Medicare. Some tax breaks may be available, but the self-employed usually pay full price for benefits; there are no employer subsidies. And tracking business expenses is a must, both for tax reasons, and to provide an assessment of one's profitability.

Sampling advice columns from those who have successfully made the transition to self-employment, several financial recommendations are repeatedly mentioned.

► **Prepare a comprehensive business plan and a budget.** The intangibles of self-employment can sound wonderful: no boss, fulfilling work, flexible hours. But remember, a primary reason for considering this path is to extend or improve your saving potential. The scenario as you envision it must be profitable.

A business plan is an attempt to determine if and how you can make self-employment or business ownership profitable – if not right away, then at least in the long run. The importance of thorough research and deliberate preparation cannot be overstated.

A personal budget is a companion to the business plan. Most transitions to self-employment are not seamless, where new income immediately equals or exceeds old employment. So how will this (hopefully temporary) decline in income affect household expenses?

► **Have cash reserves.** Recommended amounts vary, but a sizable cash cushion is essential. As a new business venture, you need sufficient capital. Marco Terry writes in a June 23, 2015, article for theselfemployed.com, "the last thing you want is to run out of money just as your business is taking off." Besides whatever start-up capital is required, savings for six months of living expenses is a fairly standard recommendation; in terms of cash flow, transitioning to self-employment can be a lot like losing a job.

The prospect of transitioning to self-employment could prompt changes in current savings allocations. For example, it may be prudent to suspend or decrease contributions to retirement accounts because you might need those funds before age 59½.

► **Recalibrate your insurance programs.** The individual, as a business owner or self-employed, is the crucial piece of financial capital – if he/she doesn't work, neither does the business. And the only real financial back-stop for most sole proprietors is insurance. Because workers may have options to continue insurance from their current employer, adjusting insurance programs should be considered ***before*** a transition.

- Medical insurance for the self-employed and business owners is a primary concern; the potential for an illness or accident to be financially catastrophic is so great that it is imprudent to be without it. If coverage is available through a spouse's plan, great. Group coverage through a business or professional association may be an option. And if you're over 65, Medicare, including Part B, might work. Budget constraints may necessitate a high-deductible plan, which could affect cash reserve needs.
- Older self-employed individuals and business owners may find it challenging to secure disability insurance, as carriers may not issue new non-cancellable, guaranteed renewable policies to applicants over 55 or 60. This leaves Social Security as the only source for disability protection.
- A life insurance benefit can help assure the increased economic value of an extended career. In particular, whole life insurance can be a valuable asset for older workers transitioning to self-employment. Both guaranteed[1] and accumulating cash values[2] can be a source of reserves, or accessed as capital for start-up expenses. Dividends[2] and loans/withdrawals[3] offer management options to keep the coverage in force during periods of fluctuating income.

– Self-employment or business ownership may also require new types of coverage, such as liability insurance, or errors and omissions protection.

Explore the possibilities

Whether self-employment or business ownership is a realistic career extender depends on a number of factors, including your skills, age, health and current financial condition. But if you're thinking you may want to work longer, transitioning to self-employment might be a profitable career path. ❖

► Are you considering a transition to self-employment or business ownership? A meeting with your financial professionals could be beneficial to evaluate and adjust your financial resources.

[1] All whole life insurance policy guarantees are subject to the timely payment of all required premiums and the claims paying ability of the issuing insurance company.
[2] Dividends are not guaranteed. They are declared annually by the company's Board of Directors.
[3] Policy benefits are reduced by any outstanding loan or loan interest and/or withdrawals. Dividends, if any, are affected by policy loans and loan interest. Withdrawals above the cost basis may result in taxable ordinary income. If the policy lapses, or is surrendered, any outstanding loans considered gain in the policy may be subject to ordinary income taxes. If the policy is a Modified Endowment Contract (MEC), loans are treated like withdrawals, but as gain first, subject to ordinary income taxes. If the policy owner is under 59 ½, any taxable withdrawal may also be subject to a 10% federal tax penalty.

The Impact of Tweaked Assumptions

Every conventional retirement plan involves assumptions about the future. Some of these assumptions are essential to plan execution, but hard to quantify. How can you mathematically value assumptions that one will stay married, maintain good health, live in a house, keep a job, and be able to save?

In terms of success or failure, other retirement assumptions aren't as important as the material issues listed above. But because they can be defined in mathematical terms, and used in calculations to project the future, these assumptions often form the basis for financial decisions. Typical mathematical assumptions include annual rates of return, rate of inflation, future costs of living, and life expectancy.

Using mathematical assumptions in a retirement plan is understandable, but perhaps a mistake, because mathematical projections cannot always account for real life. Consider how divorce, illness, loss of employment or increased expenses could change present financial conditions and impact long-term projections.

Beyond these real-world shortcomings, there are ways that even a modest difference in assumptions can result in a startling shift in projected outcomes.

"What is a realistic rate of return?"

A typical retirement methodology begins with assumptions about how much personal earnings will increase until retirement, then determines a target retirement income based on a percentage of earnings in the year before retirement. This number becomes a baseline for working backwards to determine how much must be saved each year to provide retirement income.

The amount to be saved is dependent on the assumed average annual rate of return which will be applied to retirement savings; higher rates of return require smaller deposits, and vice versa. A key question follows: *What is a realistic rate of return?*

An Internet search of the phrase "realistic rate of return," offers a lot of opinions, but little consensus. You can find intelligent arguments for any number between 12 and 2 percent, with outliers arguing for 20 percent or -1 percent. Many conservative assumptions – those that theoretically have a high probability of being attainable – cluster between 4 and 8 percent.

With such a broad range of "realistic" assumptions, it's easy to see how different rates of return could produce radically different outcomes. But a small adjustment between two high probability assumptions does the same thing. Here's an example:

Suppose you're starting from zero, have 30 years to amass the funds, and your retirement accumulation target number is $1 million. Using a conservative average annual rate of return of 8 percent, how much money must be saved each year to reach your goal? Look at Table 1.

TABLE 1 – 8% AVG. Annual Rate of Return

YR	ANNUAL DEPOSIT NEEDED	ANNUAL EARNINGS	TOTAL ACCUM.
1	**$8,500**	$680	$9,180
2	$8,500	$1,414	$19,094
3	$8,500	$2,208	$29,802
4	$8,500	$3,064	$41,366
5	$8,500	$3,989	$53,855
6	$8,500	$4,988	$67,344
7	$8,500	$6,068	$81,911
8	$8,500	$7,233	$97,644
9	$8,500	$8,492	$114,636
10	$8,500	$9,851	$132,987
11	$8,500	$11,319	$152,806
12	$8,500	$12,904	$174,210
13	$8,500	$14,617	$197,327
14	$8,500	$16,466	$222,293
15	$8,500	$18,463	$249,256
16	$8,500	$20,621	$278,377
17	$8,500	$22,950	$309,827
18	$8,500	$25,466	$343,793
19	$8,500	$28,183	$380,477
20	$8,500	$31,118	$420,095
21	$8,500	$34,288	$462,882
22	$8,500	$37,711	$509,093
23	$8,500	$41,407	$559,000
24	$8,500	$45,400	$612,900
25	$8,500	$49,712	$671,113
26	$8,500	$54,369	$733,982
27	$8,500	$59,399	$801,880
28	$8,500	$64,830	$875,210
29	$8,500	$70,697	$954,407
30	**$8,500**	**$77,033**	**$1,039,940**

Depositing $8,500/yr. isn't an outrageously large number, and many Americans committed to saving for retirement would probably find it doable. But in light of current interest rates, and just to be on the safe side, suppose we choose a lower "conservative" return assumption of 5 percent. How will that affect the deposit requirements? Take a look at Table 2:

TABLE 2 – 5% AVG. Annual Rate of Return

YR	ANNUAL DEPOSIT NEEDED	ANNUAL EARNINGS	TOTAL ACCUM.
1	**$15,000**	$750	$15,750
2	$15,000	$1,538	$32,288
3	$15,000	$2,364	$49,652
4	$15,000	$3,233	$67,884
5	$15,000	$4,144	$87,029
6	$15,000	$5,101	$107,130
7	$15,000	$6,107	$128,237
8	$15,000	$7,162	$150,398
9	$15,000	$8,270	$173,668
10	$15,000	$9,433	$198,102
11	$15,000	$10,655	$223,757
12	$15,000	$11,938	$250,695
13	$15,000	$13,285	$278,979
14	$15,000	$14,699	$308,678
15	$15,000	$16,184	$339,862
16	$15,000	$17,743	$372,605
17	$15,000	$19,380	$406,986
18	$15,000	$21,099	$443,085
19	$15,000	$22,904	$480,989
20	$15,000	$24,799	$520,789
21	$15,000	$26,789	$562,578
22	$15,000	$28,879	$606,457
23	$15,000	$31,073	$652,530
24	$15,000	$33,376	$700,906
25	$15,000	$35,795	$751,702
26	$15,000	$38,335	$805,037
27	$15,000	$41,002	$861,039
28	$15,000	$43,802	$919,841
29	$15,000	$46,742	$981,583
30	**$15,000**	**$49,829**	**$1,046,412**

A small tweak of conservative assumptions makes a big difference; it means an additional $6,500/yr. – for 30 years. (Going the other direction: If the assumed rate of return was 12 percent, only $4,000/yr. would be required.)

It's just math, but the resulting disparity in projections could significantly impact real-world decisions. Your rate of return assumption could be the difference between deciding to just save for retirement, or to also pursue other financial objectives, like your kids' college education or a second home.

Should Rate of Return Assumptions Be Taken Out of Retirement Planning?

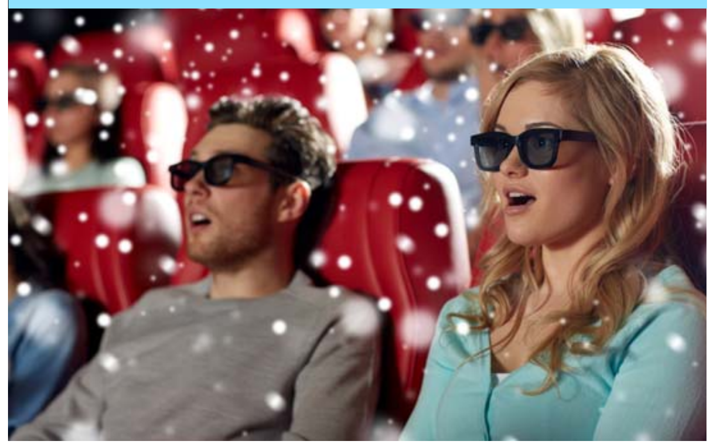
There's a simple argument that says because rate of return assumptions can skew current decisions and have outsized long-term consequences if the assumptions are wrong, they shouldn't be used. This idea has merit; who wants to find out after three or four decades of saving that, because actual rates of return did not match assumptions, they should have been saving more?

On the other hand, the annual rate of return, whatever it is, will make a big difference in the final accumulation balance. You simply can't ignore the impact of compounding, especially when considering opportunities to reallocate savings to other financial objectives.

Like many other debates, there's usually a middle ground. Rate assumptions are good short-term markers to guide adjustments, but have less utility for projecting long-term outcomes. Most households don't need rate of return assumptions; they can arrive at a satisfactory retirement outcome by consistently saving a percentage of income, then allocating it to financial instruments that are appropriate for their time horizon and risk tolerance. Calculations of return are really for historical rather than predictive purposes.

Mathematical assumptions can give us the illusion of financial certainty. But the only way to assure good financial outcomes is regular review and adjustment. Assume nothing, because even small deviations can have a big impact. ❖

Do You Have December in 3D?



Besides being the end of the calendar year, December 31 is also the deadline for executing many financial transactions, particularly those that are reported on individual tax returns. Because alliteration helps some people remember things, here are "three-D" categories of year-end transactions that you may want to review.

Donations: This applies to charitable contributions, which are reported on Schedule A for those who itemize deductions. Per the IRS at www.irs.gov, donations are deductible in the year made. However, different types of donations have different transaction dates. For example…

- Donations charged to a credit card before the end of 2015 count for 2015, even if the credit card bill isn't paid until 2016.
- Donations paid by checks count for 2015 as long as they are mailed in 2015. However, there are two exceptions: A postdated check is not an immediately payable contribution, but a promise to pay on the date shown. And if a check bounces because of insufficient funds, the gift will not be deemed to have been made when it was mailed or delivered.
- The date of donation for stocks, bonds, real estate, or other financial assets varies. If you need to include the donation in this year's tax return, be sure to seek professional assistance.

Deposits: Many government-regulated savings and retirement plans have annual limits on deposits, with the plan year ending on December 31st. This applies to most employer-sponsored qualified retirement plans, such as 401(k)s, TSAs and SEPs (but not IRAs, where deposits for this year can be deferred until April 15, 2016).

While most retirement plans require regular deposits throughout the year from each paycheck, some employees may qualify for additional lump-sum deposits at the end of the year. A plan can permit participants who are age 50 or over at the end of the calendar year to make catch-up contributions in addition to their regular deposits. Employees who receive year-end bonuses can usually specify a higher or lower percentage of the bonus to be deposited to their accounts.

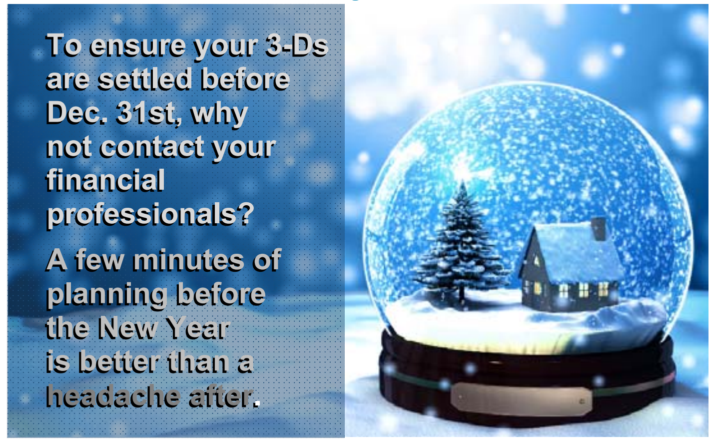
December 31 is also the cutoff date for annual contributions to 529 college saving accounts. Deposits to a 529 are limited by donor; the amount given by one person cannot exceed the annual gift tax exclusion, currently $14,000. However, under some conditions, 529 rules also allow donors to make lump-sum deposits in advance, equal to five years of deposits.

Distributions: Many government-authorized savings plans require annual documentation of distributions as well as deposits. For retirees over 70½, this applies to Required Minimum Distributions (RMDs) from qualified retirement plans. Participants may withdraw more than the RMD, but failure to withdraw the minimum by December 31st can result in tax penalties.

Retirees who are just starting RMDs do not have to make their first withdrawal until April 1, following the calendar year in which they are 70½. However, waiting results in two RMDs that year, one due on April 1st, the other on December 31st. To avoid having both of these amounts included in your income for the same year, you can make your first withdrawal by December 31st of the year you turn 70½ instead of waiting until April 1st of the following year.

Participants in 529 saving accounts may encounter an interesting year-end twist. Many colleges send bills in December for tuition due in January for a new semester. When owners choose to pay this bill from a 529, they must be able to match distributions with expenses – on a yearly basis. A December 2015 distribution for a January 2016 expense can, in some instances, have an income tax or financial aid impact. ❖

Decembers are busy.



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