Creative

wealth maximization strategies*

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Ridin' with Rube Goldberg

Reuben "Rube" Goldberg (1883–1970) was an American cartoonist, engineer, and inventor best known for humorous illustrations of complicated gadgets performing simple tasks in convoluted ways. Goldberg's cartoons made people laugh because they could relate to the almost irresistible human impulse to tinker, and how the results are often no better, just more complex or difficult to operate.

The dictionary defines tinkering as "an attempt to repair or improve something in a casual or desultory way, often to no useful effect." But is tinkering really of no useful effect?

Consider this anecdote:

> 30 years ago, my neighbor bought a new motor home, and almost immediately began "fixing it," making all sorts of homemade modifications. In the cab area alone, I counted over 20 gadgets. He placed stick-on levels on the dashboard and doors, put a retractable chain on the driver's seat for the gas cap key, jerry-rigged extensions to the sun visors, installed a drop-down map case from the ceiling, suction-cupped a compass to the windshield, expanded the side and rearview mirrors, attached a pull-down shade to the passenger window, glued a kitchen timer on the console next to the radio, and wired an indoor-outdoor temperature gauge into the console. There was a checklist that explained the functions of these modifications, and when I borrowed his RV for a family vacation, I couldn't operate the vehicle until he'd given me a tutorial on how to use all these extras.
>
> And the tinkering never stopped. It was a running joke between us for me to ask him what new "improvements" he had made to his RV.
>
> But in retrospect, it's interesting to note how many of my neighbor's "fixes" have become standard items in today's cars and motor homes. Most RVs have level indicators embedded in their interiors to assist in settling the vehicle on a campsite. Visor extensions, to cover the space between the rear view mirror, are commonplace. Temperature, compass and GPS functions are standard components for just about every auto.
>
> In a way, my neighbor was a visionary; he had good ideas. But his "improvements" were awkward, and sometimes were more of an inconvenience than a benefit – you had to be a contortionist just to get into the driver's seat.

Empirical evidence suggests that tinkering eventually produces worthwhile improvements. But progress only comes when good ideas are paired with workable designs. The difference between a Rube Goldberg motor home and a well-designed, functional vehicle isn't the ideas, but the engineering. Tinkering may uncover some interesting possibilities, but most of the benefits will never be realized because of haphazard applications. **Success requires an integrated design process**.

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Tinkering in Personal Finance: It's Everywhere!

The neighbor puttering with his motor home reflects many American households and their personal finances: a lot of tinkering, with a notable absence of a coherent plan. Their financial actions are arguably good ideas, motivated by good intentions to improve their current situation, save for retirement, pay for their children's education, etc. Yet, in discussions relating to personal finance, you often hear the word "dabble," as in "he dabbles in real estate" or "she dabbles in the market." Dabble, tinker, it's the same thing: casual attempts at improvement or success. And it's no surprise that many of these financial decisions end up falling short of hopes and expectations.

For those who see the management of their personal finances as a hobby, tinkering may be acceptable, enjoyable, accidentally profitable – and your inalienable right. For the neighbor, the motor home was his property, his money and his time, for him to use as he saw fit. And his gadgets didn't disable the vehicle, they just customized it to his (funky) personal preferences. However…

The motor home owner was comfortable tinkering with the non-essential features of his vehicle because he relied on the manufacturer's design and production process to deliver a functioning vehicle. Even if he didn't have a coherent design, someone else did. Can individual households have the same confidence that someone else is delivering well-designed programs that take care of the financial necessities so they can afford to dabble/tinker? Probably not. Rather, when it comes to personal finance, it appears that businesses and governments are also primarily tinkerers.

Financial institutions make their money by offering vehicles and services for lending, insuring, saving, and investing. In a competitive marketplace, these institutions constantly seek to differentiate themselves, and one of the easiest ways is to tinker with their product offerings, typically to produce a price or benefit advantage. Adjustable-rate mortgages and universal life insurance policies are two examples of how tinkering with a standard financial instrument (a fixed 30-year mortgage and a whole life insurance contract) can hypothetically deliver many of the same benefits, but at lower entry price points. But ARMs and UL policies aren't necessarily "better" products, and financial institutions typically offer minimal advice or perspective on how to determine whether these products are appropriate for your personal circumstances.

Because of the power to tax, government decisions have a significant impact on personal finances. But the logistics of government – bills by committee, the need to build consensus, majority votes etc. – often make it difficult to implement comprehensive and integrated changes. Instead, it's easier to tinker with existing policies, by amending regulations or introducing variations to current plans. Contribution limits are indexed to inflation, or Roth IRAs are added (followed by rules on how to re-characterize existing IRAs to Roth accounts), and new exemptions allow first-time homebuyers penalty-free access to their accounts before 59½. The result is a multitude of plans, with additional exemptions, that, in true Goldberg fashion, turn a simple objective (saving for the future) into a confusing, convoluted process.

Unfortunately, the typical response to tinkering gone awry is often more tinkering. An example: Aware that higher life expectancies combined with current required minimum distributions rules for pre-tax retirement plans might result in individuals using up their retirement savings before they die, Congress created an exemption for qualifying longevity annuity contracts, or QLACs. In response, financial institutions are scrambling to develop new annuity products to conform to the legislation. Theoretically, this tinkering solves a problem. In reality, the complexity of the solution makes it harder to succeed; if someone tried to map the history of a household's retirement contributions, their flow chart would look like a Rube Goldberg cartoon. There may be a lot of activity, but what has been accomplished?

Design Principles for Personal Finance

Governments and financial institutions don't provide design frameworks to integrate and maximize your individual financial potential. So how does an individual break free from the tinkering mindset that is so prevalent in the world of personal finance? Because everyone's situation is unique, the details will vary, but there are some timeless, proven design principles and processes that apply to everyone.

Get all the facts, and get them in order. If you've never prepared detailed net worth and cash flow statements, you don't have the basis for designing a viable personal financial plan. The designers, whether it's you or financial professionals working on your behalf, must understand the pieces they have to work with.

Identify Your Resources. An essential ingredient in designing a financial program is revenue. What are your revenue sources, and how can they be allocated to products and programs you might use? Great plans fail for lack of funding.

Establish Priorities. A vacation home on the Riviera might be a wonderful experience and a great opportunity, but is it more important than funding your kids' college education? Is it more important than insuring your income against a disability or premature death? These are hard questions, but they need to be asked – and answered honestly. A solid foundation is essential for a long-standing, profitable financial life.

Incorporate Flexibility. Many "tinkered" solutions assume today's conditions – income, tax rates, investment returns – will be the same in the future, and make commitments accordingly. These assumptions become problematic when money is needed before age 59½, a spouse is down-sized out of a job, or someone gets sick. The combination of inflexible commitments and unforeseen changes can disrupt current designs and limit future opportunities.

Reassess Frequently. Life's only constant is change. New circumstances may necessitate new strategies, new programs, and new products. An effective design for your personal finances will never be a "set-it-and-forget-it" model; the design process is ongoing.

Integrate, don't segregate. Much financial tinkering produces stand-alone ideas or products. A "perfect" college funding plan for honor students who want to attend an in-state public university may indeed be a great idea – if your child fits that profile. Better to maintain several sources for college that can also be applied elsewhere than committing to a plan that precludes uses other than college expenses. Rigidly compartmentalizing your financial commitments in a series of

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stand-alone projects is risky. If (and when) changes come, this approach often results in loss of capital and significant opportunity costs.

Managing your personal finances is a lifelong journey. How you travel depends on the design approach you choose.

Tinkering can be productive, and hobbies can be relaxing. But do your financial plans reflect an intelligent coherent design, or have the pieces been assembled in a slap-dash manner that more closely resembles a Rube Goldberg contraption? ❖

The (Quantitative and Qualitative) Costs of Education Debt

Most of the reporting on the burgeoning generational problem of unpaid and outstanding student loan debt attempts to convey the impact through numbers. For example, a March 2014 Gallup survey of 30,000 college graduates of all ages found that:

- Approximately 70 percent of all college graduates still have student loans to repay.
- The average balance is more than $33,000 (up from $18,600 10 years ago).

Sounds ominous, right? Well, how about these factoids, from a January 2014 *Huffington Post* article by Kyle McCarthy:

- Currently, more than 40 million Americans hold student debt. The population with student loans is actually greater than the entire population of Canada, Poland, North Korea, Australia and more than 200 other countries. It's also about four times greater than the population of Sweden.
- Out of the nearly 40 million borrowers, about seven million have defaulted on these student debts.

Those numbers are stunning. And many economists believe the student loan burden has grown so large it is impacting sectors of the national economy, like new housing construction – graduates can't afford to buy a home because a significant percentage of their earnings is servicing debt.

The Unseen Costs

Beyond the numbers, and calculations of wider economic impact, there are perhaps even greater concerns. For 30 years, the Gallup organization has used a series of questions to ask respondents how satisfied they are with their quality of life. The questions identify five areas of well-being: purpose, financial, community, physical, and social. When these questions were put to graduates in the most recent survey, **those with high student loan debt self-reported significantly lower quality-of-life assessments.**

The finding that excess student debt impacts quality of life isn't surprising. What does raise an eyebrow is how long the condition lasts. Per Gallup:

> Even 24 years after graduation, students who borrowed more than $25,000 are less likely to enjoy their work and less financially and physically fit than their counterparts who graduated without debt. For more recent college grads, the discrepancy is even more pronounced.

With the exception of the social category, graduates with student debt saw themselves as less successful (or thriving) in comparison to their peers who had no debt. The difference was most pronounced in regard to assessments of physical and financial well-being.

Since the responses were subjective, it's not clear that the high-debt/lower-quality-of-life connection is causal or correlational – i.e., does high debt lead to poor health, or do unhealthy people also happen to have a lot of debt? But the implications are sobering: assuming too much debt early in adulthood has a long-term and wide-spread negative impact. As Gallup executive director Brandon Busteed told the *Wall Street Journal* in an August 7, 2014 article, it seems clear that student debt is "bad for all aspects of your life."

Dropping Anchor Before Leaving Shore?

For several generations, the decision to finance a college education has been relatively easy: getting a degree is so valuable, it's worth borrowing for. The financial anchor of debt could usually be overcome by the increased earnings expected from a higher level of education. But in the last decade, the decision to borrow has become less certain. Student debt has a tipping point; the costs can be too steep, and the consequences can seep into other aspects of life.

These factors should prompt serious discussions for parents and prospective students. For parents with younger children, it increases the urgency to establish or increase savings allocations. For those on the cusp of attending college, the conversation may be more difficult. At what point does a parent or a young adult say "I/we can't – or won't – borrow any more money to go to school?"

Often, this is the first critical financial decision a young adult will make: Even if my parents are willing to co-sign, how much debt should I have before I've even begun a career? As the reports suggests, this is not purely a financial decision. A debt incurred today can be a determining factor for a long time after – in all areas of life.

Do you know your tipping point for a college education? Want to change it? "Now" is the best time to reduce the need to borrow. ❖

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Picture flickering campfires, breathtaking sunsets, lazy days on the water or in the woods, gorgeous weather, wonderful family gatherings.

According to Elizabeth Dunn and Michael Norton, authors of the book *Happy Money*, **one of the best things money can buy is experiences**, and the long-lasting memories that result. So it's no surprise that many Americans aspire to own a vacation home. To borrow a phrase from an imported Mexican beer, it's a place where they can find their own beach.

In addition to being great venues for wonderful experiences, vacation homes can often be profitable investments. An April 6, 2014, cnnmoney.com article reported that annual sales of vacation properties rose nearly 30% in 2013, and sale prices were up 12.5%, numbers not seen since before the recession.

Increases in demand and price also make acquiring a vacation home a higher financial hurdle. "Few people have enough cash to buy one on their own, let alone enough vacation time to justify the purchase," declares *Wall Street Journal* reporter Peter Green in a June 16, 2014 article. One solution: make a vacation home a group project. Friends, siblings, parents and their children, can pool resources to own an asset they can all enjoy.

While shared ownership may answer the funding question, such an arrangement also creates additional logistical issues. How do you apportion use? Who is going to pay for repairs? What happens if one owner wants to sell? Can ownership be transferred to heirs? Shared ownership in a vacation home is doable, but to successfully navigate the additional issues that are almost certain to arise, thoughtful planning is required.

Multiple Owners and Multi-Generational Ownership

Even when vacation properties are originally purchased by a single party, there is a strong likelihood that shared ownership will eventually occur; if a property is valued for its emotional connection and multi-generational legacy, heirs may have a strong interest in keeping it in the family rather than selling it. This typically means several adult children and their families will become the successor owners. But different family circumstances (place of residence, number of children, marital status, employment, financial standing, etc.) could lead to different perspectives on how to best use the property. Move out to the third generation, and the number of owners – and competing interests – expands geometrically.

When assets are jointly owned, the actions or circumstances of individual owners may imperil the collective interests in the property. A civil judgment, divorce decree or bankruptcy settlement against one owner could compel a sale to satisfy a financial judgment, or result in unwanted partners. Thus, when multiple owners are involved, either in the original purchase, or on transfer at the death of a sole owner, the parties may find it beneficial to place the vacation home in a trust or similar legal arrangement.

Properly implemented, the trust segregates an asset (in this case, the vacation home) from the owners' personal liabilities and also provides a governance model for equitable distribution of privileges and obligations among the several owners. There are clearly defined management responsibilities for the trustees, delineating who will pay the bills, maintain the property, determine policies for use, and regularly report on the financial and physical condition of the home.

It's impossible to anticipate all of the scenarios that might arise from shared ownership in a vacation property. But if the partnership privileges and responsibilities are thoughtfully considered in a trust or other shared ownership agreement, there is a road map for resolving most issues with minimal discord. The only practical challenge: making sure there's enough money to execute the terms of the agreement.

Even for a property unencumbered by a mortgage, ongoing expenses will likely increase. And as more heirs inherit a smaller percentage of the property, the greater the odds that some will want to exercise an option to sell their interest. These situations, as well as several others, require cash, on either a regular or unscheduled basis. Typically, the owners have two options for these cash obligations: borrow against the equity in the property or require the shareholders to contribute additional capital. Both options stress the viability of the partnership. Loans against the property reduce its net value for all partners, and create a new cash obligation. Capital calls decrease individual wealth, and may force some to terminate their ownership interest.

A simple solution to the liquidity challenge in shared real estate may be an integrated life insurance program, beginning with the first owner(s).

Why Life Insurance?

Consider a couple in their 60s, with three adult children, who borrow to acquire a lakefront property, and die before paying off the loan. When the owners pass, the children, as heirs, inherit the property. They also inherit the obligation to pay the mortgage and property taxes, and cover the costs of maintenance and improvements. Assuming the heirs want to keep the property, they face several financial decisions, such as…

- If the parents' estate doesn't have the cash to remove the mortgage, the heirs will be compelled to make the mortgage payments, pay taxes and cover other overhead expenses from their own cash flows.
- If the parents' estate has substantial liquid assets, the heirs could agree to use some of the cash to pay the outstanding balance on the mortgage. This frees the heirs of a monthly mortgage obligation, but also diminishes their liquidity, as a greater percentage of the estate is now held as equity in the vacation home. The heirs are still responsible for ongoing expenses and taxes, and must determine how to divide these costs among themselves.
- If one or more children decide they don't want, or can't afford, the ongoing costs of vacation home ownership, the other siblings may buy out the reluctant heirs, perhaps by exchanging assets from the estate, or by arranging alternative financing to produce a cash payment.

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Any one of these issues could be a financial challenge for the heirs. But what if the parents had life insurance policies with the property trust named as beneficiary?

By delivering a guaranteed and liquid benefit at the time of transfer, many, if not all, of the cash flow issues in a multi-generational legacy property can be resolved. Proceeds from the death claim may be used to clear the mortgage, establish a cash reserve for ongoing expenses, and even buy out an heir who doesn't want to inherit an ownership interest. And if successive generations continue to fund the property trust with life insurance, it's very possible a precious legacy asset can remain in the family for a long time.

The structuring of the legal agreement and the positioning of life insurance for a property with multiple owners requires professional assistance. If any of these issues are on your radar, a consultation with an expert might prove invaluable. But whatever you do, be slow to terminate your life insurance policies.

Sometimes when people project their financial futures, they conclude, "Well, when I retire, I don't think I'll need life insurance." But one of the advantages of permanent life insurance, i.e., insurance designed to last one's entire life, is the flexibility to re-purpose benefits at a later date. What was once intended to provide immediate relief for dependents can be transformed to preserve an asset for future generations. Once acquired, life insurance benefits should be relinquished only after careful consideration. ❖

Acronym Alert:

A common-sense saying known as Murphy's Law says "If anything can go wrong, it will." If there was a Murphy's Law for financial legislation, it would probably go something like this:

The more complex the rules, the more they will have to be modified – and the modifications will be complex.

The details of a new provision regarding Required Minimum Distributions from IRAs and other similarly configured qualified retirement plans approved by Congress in 2012 were finally defined by the Internal Revenue Service in July 2014. And while it seems like two years is a long time to determine how to tweak existing tax policy on retirement accounts, remember: it's going to be complicated.

Longevity Annuities

In a standard immediate annuity contract, an individual makes a deposit to an insurance company in exchange for a guaranteed stream of payments, with payments commencing shortly after the transaction. A twist to this arrangement is a longevity annuity, where the individual makes a lump sum deposit today, but must wait for a designated future date before receiving a guaranteed lifetime income. For example, a 65-year-old man deposits $100,000, with benefits to begin when the man reaches age 85.

In its basic form, a longevity contract is pure insurance; it only pays benefits if the insured lives to the scheduled age. If the insured dies before payments commence, the premium (the lump sum deposit) is not refunded to the purchaser's estate. In contrast, a deferred annuity contract gives the owner the option of initiating lifetime payments at any time, withdrawing his accumulated balance (both principal and subsequent earnings), or passing the unused balance to heirs.

The combination of a lump sum deposited today and the statistical certainty that some purchasers will not live long enough to collect benefits makes it possible for the insurance company to offer attractive guaranteed rates of return for longevity contracts. In a July 9, 2014 blog commentary at kitces.org, the $100,000 example mentioned above would guarantee lifetime payments of $31,874/yr.

The actual rate of return from a longevity annuity is dependent on how long the annuitant lives, and there is a chance the individual may never see a dime from this contract. But the relatively low purchase price for the certainty of a guaranteed income in old age gives retirees greater freedom to spend other assets in earlier years. They don't have to "hold back" on spending out of concern that a long life might exhaust their savings.

As life expectancy increases and more individuals rely on their own savings instead of a company pension to provide a stream of retirement income, longevity annuities are projected to play a larger role in personal finance. However, regulations in another aspect of personal saving have been a stumbling block for expanded use of longevity contracts.

The RMD Dilemma

Americans have placed a significant portion of their retirement savings in qualified retirement accounts, such as IRAs, 401(k)s, and TSAs. These plans require account holders to make annual minimum distributions of their tax-deferred savings after they reach age 70½. The amount of the required minimum distribution (RMD) is determined by formulas based on the retiree's age and the retirement account balance.

What happens to these calculations if the retiree wants to use retirement plan funds to purchase a longevity annuity? Using the previous example, how would a $100,000 longevity annuity purchase be classified, for RMD purposes, when the owner reaches 70½?

According to a July 18, 2014, article by Jeffrey Levine in the trade publication *LifeHealthPro*, previous tax rulings for RMDs made it almost impossible to purchase longevity contracts with qualified plan money, primarily because the fair market value of the longevity contract had to be included in the amount used to calculate the annual RMD. Referring to the earlier example, what is the fair market value of a $100,000 longevity annuity in the years between its purchase and when claims are made against it? If the individual doesn't live to 85, the value is zero. To include it in an RMD calculation means being taxed on something the individual – or the individual's heirs – may never receive. As a result, individuals willing to forgo current income to ensure their long-term financial security are being punished for their responsibility.

The Modifications

To rectify the situation, Congress established a new type of longevity annuity, called a Qualified Longevity Annuity Contract (QLAC). QLACs can be purchased with funds from IRAs, but are excluded from RMD calculations, and distributions (and the associated income taxes) can be deferred until the target date of the contract. Sounds relatively simple, right?

But when complex rules are modified, the changes can't be simple! Levine describes the new regulations as "a complicated mash-up of IRA and annuity rules, and clients may need substantial help in understanding their key provisions." A few "simple" details, with modifying comments:

- **The simple fix:** An individual may place up to 25 percent of their total qualified plan assets in a QLAC, with a $125,000 limit on total QLAC purchases. QLAC funds are exempt from RMD calculations.

The modified reality: The 25 percent calculation is based on qualifying assets as of December 31st in the year prior to the year the QLAC is purchased. The 25 percent limit is applied in a slightly different manner for 401(k)s and IRAs. The 25 percent number may also be modified by deposits and/or withdrawals from the account during the previous year. In other words, determining the QLAC limit is complicated.

Despite the complexity, the QLAC provisions will offer retirees some intriguing new options for managing their retirement income. And "will" is a key word, because while insurance companies currently offer longevity annuities, they have not yet introduced products that conform to the specific QLAC guidelines. It may take some expert guidance to work through the calculations and restrictions, but some retirees may find substantial benefits from a longevity annuity in their retirement income planning. ❖

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