
**First Financial Group** 

# Financial Times

September 2014

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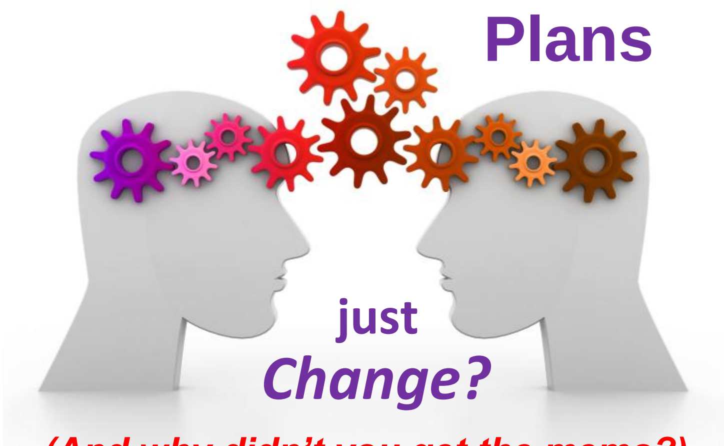
# Did Conventional Wisdom about Retirement Plans just Change?



**(And why didn't you get the memo?)**

**It's interesting to consider how and why conventional wisdom stops being conventional.**

There's not a clock that expires, telling everyone "your time is up," or a formal announcement that declares a new idea has been installed as the accepted truth. Usually, "old" conventional wisdom just slowly fades away, losing adherents one by one, until one day someone says "Well, who believes that anymore?" If you're not paying attention, you might not even notice the movement toward a new understanding.

Retirement planning may be in the midst of such a gradual, yet game-changing transformation. After almost four decades as the recommended and predominant form of retirement saving, pre-tax qualified plans, such as IRAs and 401(k)s, appear to be losing their favor with both experts and consumers. Instead, Roth accounts featuring after-tax deposits and tax-free withdrawals are increasingly the option of choice, particularly with younger Americans. This shift is so pronounced that *Wall Street Journal* reporter Anne Tergesen began a June 23, 2014, article with this declaration:

**"You probably know the conventional wisdom: Tax-free Roth IRAs and 401(k)s –a relatively new and fast-growing breed of retirement account – make the most sense for young investors."**

Yep, that's right. For at least one observer, regarding a particular segment of the population, Roth accounts are now "conventional wisdom." *(But you "probably knew that" didn't you?)* But wait, there's more…

Stuart Ritter, a senior financial planner for a large mutual fund company, recently released a report with the conclusion that **"Roths should be the rule and traditional 401(k)s the exception"** – even for many in their 40s, 50s and 60s.

Not that everyone is on board, but it appears a new retirement paradigm has been declared. How and why did this turn-about occur? Mostly, it took this long to unravel the assumptions that prompted the establishment of pre-tax retirement plans.

### It was supposed to go like this…

The late 20th-century American retirement model assumed three financial components – Social Security, an employer pension, and personal savings. The first two items provided a stable monthly income, with personal savings intended as a supplement to cover occasional expenses, discretionary purchases, and to leave an inheritance. In this format, Social Security and pensions made retirement possible, but additional savings made retirement worthwhile.

To encourage long-term personal saving, lawmakers embraced the idea of granting tax deductions for deposits to qualified retirement plans, with tax incurred only when the money was withdrawn in retirement. For savers, the rationale for setting the money (and income taxes) aside was simple: as retirees, they would be in a lower marginal tax bracket. Thus, the

## In This Issue…

tax paid to withdraw the money would be less than the deduction received when the money was deposited.

This assumption about the future of retirement had merit. For most workers, Social Security and pension payments would be a fraction of their working incomes, and might also be partially tax-free. Under the prevailing tax structure (which consisted of upwards of 20 marginal tax brackets), any additional retirement distributions would incur minimal taxation, probably at lower rates compared to one's working years.

## Except…

As Yogi Berra aptly put it, "It's tough to make predictions, especially about the future." In four decades, a lot of things can change. And they have.

**Pensions have disappeared.** For a variety of reasons, company pensions became liabilities for businesses. With the exception of some governmental agencies, most employers have shifted the retirement income responsibility to their employees. Initiated as supplemental income sources, qualified plans are now the *primary* retirement accumulation vehicles – with greater funding requirements.

**Tax rates have decreased (sort of).** In 1975, the highest marginal tax rate was 70%, and there were 25 tax brackets. In 2013, there were seven brackets, with a top rate of 39.6 percent. Thus, many contributions to pre-tax qualified plans receive a smaller deduction today than 40 years ago.

**Deductions have diminished.** The trade-off for lower marginal tax rates has been a concurrent decrease in deductions. Four decades ago, personal interest on credit cards was deductible, along with a host of other personal expenses. Today, the principal deductions for most Americans are their dependents and mortgage interest.

**Do you follow conventional wisdom?**

## Consequently…

**At lower income levels, there is less incentive to save in pre-tax plans.** Young households responsible enough to save, may also have mortgages and children – two factors that reduce current taxable income. If the combination of lower income and maximum deductions puts households in one of the lower marginal tax brackets (such as 15%), what is the likelihood they will pay more to withdraw the funds in retirement, especially if they reach age 65 debt-free and have no dependents?

**At all income levels, the pre-tax contribution format directly and indirectly penalizes proficient savers.** The more they save, the greater their future tax liability. And because of required minimum distributions that begin at age 70½, there's not a lot of wiggle room to manage the taxation on distributions. Even if these assets aren't needed, they must be withdrawn so a tax can be collected. The larger the distribution, the greater the likelihood of bumping ***up*** to a higher tax bracket.

**The looming tax obligation in pre-tax plans adds uncertainty to estate planning.** If you want to leave remaining balances from pre-tax retirement accounts to heirs, you might unintentionally pass the tax liability to them as well. The taxation will depend on their financial circumstances, not yours, and the terms for distribution may not be as favorable.

## Perceived Roth Advantages

Roth accounts promise a higher level of financial certainty, at least in regard to tax treatment. Once an after-tax contribution has been made, there is no further tax on gains or withdrawals, provided the account has been in existence for five years and the account owner is over 59½. Under special circumstances, withdrawals can be made prior to 59½ without penalty. There is no requirement to begin minimum distributions – at 70½ or any time. At death, any unspent Roth balances may be transferred to heirs and generally will retain their tax-free status (although non-spousal beneficiaries are subject to required minimum distributions or full liquidation within five years of receiving the proceeds).

Do these features make Roths better retirement accumulation vehicles? *The answer isn't clear-cut.* For example, some pre-tax advocates argue that an after-tax $5,000 annual contribution to a Roth 401(k) is equivalent to a $7,142 pre-tax contribution to a regular 401(k)for someone in a 30% marginal tax bracket. Yes, there's more tax to pay at the end, but the accumulation will be larger as well. In rebuttal, Ritter produced a chart showing tax rates in retirement would have to be about 10% lower to favor a pre-tax plan.

But both calculations are guesses, and it is almost inevitable that tax laws will change – they always have. Personal circumstances impact the decision as well. Higher tax rates at lower income levels could tip the balance toward pre-tax plans, especially for those who are closer to retirement and haven't accumulated as much. Apart from projections, the principal current advantage for the Roth format is knowing the tax is paid, and that accumulations and future withdrawals can be tax-free.

## Ahead of the Curve – Is This the "Next" Conventional Wisdom?

At the moment, an increasing number of Americans are inclined toward the Roth format. According to Aon Hewitt's report, *2013 Trends & Experience in Defined Contribution Plans*, "50% of employers currently allow employees to make Roth contributions, an increase from just 11% in 2007. Offering Roth accounts within a defined contribution plan has become increasingly common and is expected soon to become the norm—not the exception."

But the tax treatment on ***all savings*** is important, not just retirement accounts. Some financial experts have advanced the idea that an integrated blend of pre-tax and post-tax retirement contributions, along with tax-favored "pre-retirement" savings (i.e., long-term savings meant to be available before age 59½) can deliver a blend of immediate tax savings and flexible tax management in retirement, as well as a high degree of financial certainty in estate planning. In this format, an optimal savings plan is often an artful mix of "all of the above."

There is certainly merit in a broader integration of all saving, instead of restricting the discussion to traditional pre-tax and Roth formats. And who knows? A few years from now, this approach just might be "conventional wisdom." ❖

## ARE YOU READY FOR A WIDER VIEW OF YOUR SAVINGS, ONE THAT INTEGRATES YOUR RETIREMENT AND PRE-RETIREMENT ACCOUNTS?


Isaiah Austin is now 20 years old; he is over seven feet tall, and athletic. As an elite college basketball player at Baylor University, Austin expected to be selected in the National Basketball Association's June 2014 draft, an event that would quite likely lead to a multi-million dollar contract to play professionally.

However, a genetic test in a physical examination just days before the draft revealed Austin has Marfan syndrome, a disorder that affects the body's connective tissue. The most serious complications from Marfan syndrome are defects to the aorta and heart valves, such that strenuous exercise may fatally overtax the heart. The condition immediately and completely ended Austin's athletic career.

Austin's story was heart-wrenching, particularly in light of other challenges he had overcome during his childhood, including a detached retina that left him blind in one eye. But the story also has a satisfying alternative ending.

**Most adults would be well-served to value their own economic potential and insure it appropriately.**

A year ago, in consideration of his professional potential, Austin had taken out an Exceptional Student-Athlete disability insurance policy through the National Collegiate Athletic Association (NCAA), which agreed to pay him if he suffered a career-ending injury or illness. Austin's agent confirmed the policy's benefits were in excess of $1 million, and since the diagnosis of Marfan syndrome left little debate over Austin's ability to ever return to basketball, a claim would be filed shortly after the draft. Instead, Austin plans to finish his degree studies, and has started a foundation to raise awareness about Marfan syndrome. (In a nice personal touch, the NBA also invited Austin to New York for its draft festivities and made him a ceremonial first-round draft choice.)

## Elite-Athlete Insurance: A Little Different, Mostly the Same

While some of the insurance details are unique to Austin's circumstances, his case contains basic elements common to all individual disability insurance contracts.

Among the unique items: Amateur athletes can secure protection even before they begin playing professionally, but only for their time as an amateur; coverage is usually only one year. Coverage can be obtained from an NCAA-sponsored insurance company, or other private insurers (such as Lloyd's of London). The NCAA, which oversees amateur collegiate athletics, allows athletes to borrow to pay the premiums, and even offers in-house financing, with the premium loan to be repaid from the athlete's first contract. Depending on the sport, annual premiums can range from $3,500 to $14,000 for $1 million in coverage.

Beyond these peculiarities, the essential factors for determining disability coverage are the same.

**The health of the applicant matters, and pre-existing conditions may be excluded.** Because of his health history, Austin's policy would not have paid if he suffered a career-ending eye or shoulder injury.

**Income must be verified.** An applicant must be able to substantiate his earnings through independent documentation, like check stubs or tax returns. For not-yet-professional athletes, verification came from multiple scouting services and talent evaluators, who considered Austin among the top 64 basketball prospects in the world.

**The definition of disability and elimination period determines the payment of benefits.** In any disability insurance policy, the definition is critical. The NCAA's coverage only pays if the athlete suffers a "career-ending injury" or illness while enrolled in college, and has a 12-month waiting period before a claim can be filed.

But athletes may suffer career-diminishing injuries, ones that result in a loss of speed, explosiveness, or skill. While they may recover, they can no longer perform at an elite level and make a living from their athletic abilities. This prompts the question: At what point can the injury be considered career-ending? In Austin's case, the answer is clear-cut: he shouldn't be playing basketball at all. But if the athlete can play pick-up basketball at the local YMCA has there really been a career-ending injury?

Other insurance companies offer elite-athlete policies that pay benefits for injuries that result in diminished earning potential. (One version: slot insurance. If a projected first-round draft choice is selected in a lower round because of an injury, the insurance company pays a benefit based on what the player's contract would have been had he/she been drafted higher.)

## Seeing Your Future, and Protecting It

Athletes perhaps have a greater appreciation for the possibility of injury, and how it impacts their ability to perform. **But most adults would be well-served to similarly value their own economic potential and insure it appropriately.**

Isaiah Austin isn't going to play professional basketball, but his decision – as a 19-year-old – to protect his financial future gives him the resources to adjust his dreams and succeed in another avenue of life. Whether he initiated the process on his own, or followed the advice of someone else, he acted prudently to preserve the economic potential he had already created. ❖

The value of insurance isn't that it guarantees happy endings, but that it can prevent tragic ones.

# Red Herrings

## & The "Anti-Procrastination" Function

The term "red herring" is used to refer to something that misleads or distracts from the relevant or important issue. In discussions of whole life insurance by mainstream financial media outlets, a common red herring for consumers is the "excessive" commissions earned by life insurance agents for providing these products.

According to these pundits, the prospect of large commissions harms consumers in two ways: it skews agents' recommendations toward more expensive policies, and diminishes policy performance because the commissions paid to the agent result in lower cash values and higher surrender charges.

As an alternative, some recommend "no-load" whole life policies in which no commissions are paid for the placement of a policy. Prospective insureds can purchase these policies directly from the insurance company, or they may be recommended by a fee-based planner (who typically charges the buyer a fee for assisting in the procurement of coverage).

Theoretically, by themselves, these assertions seem reasonable, and may grab the attention of readers and viewers. But other real-world factors are part of the equation, and **a closer look suggests that a focus on commissions distracts consumers from the relevant issues in a life insurance decision.**

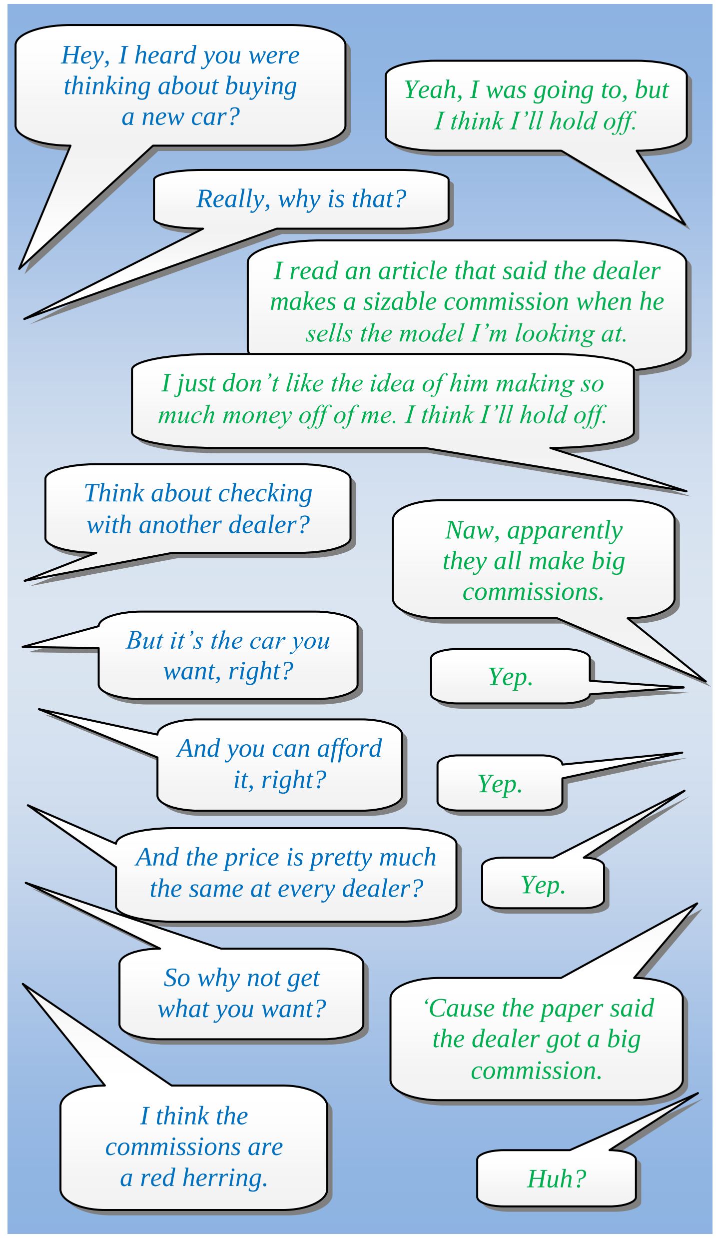
### Same Metrics, Different Business Models

Insurance only works when financial risks can be spread across large numbers of people. A critical issue for all insurance companies is how they will structure their "acquisition costs," i.e., what they must spend to acquire and retain premium-paying customers.

For a traditional life insurance policy delivered through agents, the primary customer acquisition and retention method is to compensate the agents for recommending their products and continuing to service policyholders. For a no-load insurance company, the cost is direct advertising, and providing a customer service system to replace the non-existent agent.

Since all life insurers work from the same set of statistics (i.e., the mortality rates for different segments of the population), their ability to deliver promised benefits is highly dependent on their business model. And for both insurance companies and policyholders, commission-based insurance is a market-proven solution, for several reasons.

**Long-term, the "savings" from no-load whole life policies may be insignificant.** In his 2010 book, *Questions and Answers on Life Insurance*, insurance expert Tony Steur stated that "While cash value of a no-load/low-load policy for the first few years is significantly higher than with a traditional product, over the long term the cash values become similar." Since whole life




is designed as a long-term financial instrument, the important performance numbers are at the end, not the beginning of the contract.

**Professional assistance with the details of life insurance makes a difference.** Several consumer-driven websites on life insurance note far less customer service and consultation with no-load companies. On easyretirementknowhow.com, in a 2013 post, financial educator Shane Flait says "Competently buying no-load insurance products requires you to have a somewhat sophisticated level of understanding of what you're buying and what you need now and possibly in the future. Lacking that knowledge may cost you more money in the long run."

**Commissions reward positive action.** Joseph Belth is an emeritus professor of insurance, long respected for his industry commentary. In a November 2013 blog post he related:

> "(A) reader asked whether I am opposed to commissions. I said I am not. I have often said commissions are essential in situations where financial services are sold rather than bought. The consumer's tendency is to procrastinate, and someone must perform

what I call the "anti-procrastination function." A person has to be paid to perform that function, and commissions are a reasonable form of compensation. I have often said many people die without wills because no one is paid to perform the anti-procrastination function."

In addition, most insurance companies structure their commission schedules to reward good business. They offer persistency bonuses for business that stays on the books, and impose charge-backs when consumers change their minds or drop coverage. Agents have strong financial incentives to recommend suitable products, and to be reasonably certain their clients can maintain them.

### The Anti-Procrastination Function

Commissions encourage financial professionals to assist consumers in following through on what is often a non-urgent, but important aspect of their long-term financial well-being. Consumers should know agents are compensated by commissions, but determining the utility of a whole life insurance plan depends on many factors unique to your circumstances. If the product matches your objectives and fits your budget, and the insurance company is willing to pay a commission that the agent deems reasonable compensation, this transaction personifies a free-market decision. Buyers can go elsewhere, and insurance companies and agents can adjust their terms and affiliations. ❖

**The fact that someone else may think a commission might be too high is a red herring – it has almost nothing to do with how well a whole life insurance policy will fit in your financial program.**

## *Detail Déjà Vu:* A $400,000 Beneficiary Mistake

**(and some possible solutions)**

Over and over, stories pop up in the media about overlooked beneficiary details that end up disrupting finances and dashing dreams. Most unfortunate, the harm often falls on those who expected to receive the most benefit. Like this one:

**Assets with beneficiary designations can bypass the probate process, allowing heirs to receive funds in a timely manner.**

Newly married, battling cancer, and wanting to make sure his adult children received an inheritance, Leonard Smith met with his financial advisors and attorneys to make sure his children would inherit the balance of his IRA retirement account. Two months later, Smith died.

Smith's intentions were clearly known by his children and his advisors. But somehow, incorrectly completed paperwork negated his well-defined plans. On the beneficiary line for his IRA, Smith had written "To be distributed pursuant to my last will and testament," instead of specifically listing the names of his children along with the percentages designated to each. The custodian for the account refused to release the funds. Instead, the institution prepared to distribute the funds to the default beneficiary, Smith's surviving spouse (of two months).

A court battle ensued. Five years later, the court awarded $400,000 to Smith's wife. And the children received nothing.

"I had no idea that a will could be trumped by an IRA beneficiary form," said Deborah Smith-Marez, 50, Leonard's daughter, in a June 27, 2014, interview with *Yahoo Finance*.

### The Priority & Importance of Beneficiary Designations

Retirement accounts, life insurance policies, bank accounts, certificates of deposit, stocks, annuity contracts, bonds, and mutual funds have beneficiary designations. **Assets with beneficiary designations can bypass the probate process, allowing heirs to receive funds in a timely manner.** To ensure the speedy distribution of funds, beneficiary designations take precedence over similar stipulations in a will.

The challenge for households is that it is impossible to consolidate beneficiary designations. Each insurance policy, retirement account, or annuity has its own beneficiary designation, and if life events (a birth, death, divorce) necessitate a change in beneficiaries, the correction must be made to each account. And the responsibility to update beneficiaries falls squarely on the individual; it is impossible for financial institutions to be aware of all the life events that might require beneficiary changes.

### How to Consolidate the Beneficiary Process

Even if you can't consolidate your beneficiaries onto one statement, you can consolidate the process, and minimize the possibility of a beneficiary error. Here are several options:

**Get all your documents in one place.** It seems self-evident, but unless you've established a specific location for your financial documents, it's easy to forget, misplace or overlook an account with beneficiary designations. An ideal arrangement includes digital archiving options, both online and portable physical storage (like an external hard drive).

**Plan to update beneficiary forms at least once a year – or whenever a "life event" occurs.** Some of this is awareness, some of it is planning. A birth, death, marriage, or divorce in your family should immediately trigger the question: "Do we need to re-evaluate our beneficiaries?" And every annual financial review should include a recap of beneficiaries. These aren't hard tasks, but honestly, when is the last time you checked the beneficiaries on all your accounts?

**Use expert assistance, especially if you're designating multiple beneficiaries.** It's not enough to know who you want to inherit the assets; you have to do it the right way. Do the phrases "per stirpes" and "per capita" mean anything to you? They should, especially if you want to leave different amounts to different generations of heirs. Fractional divisions of assets, particularly those that are not equal, must be properly defined.

## Protect Your Beneficiaries

Recent data estimates that more than $12 trillion is held in IRAs and 401(k) plans. As the Baby Boom generation begins to pass away, more and more of these accounts are going to become estate assets, with beneficiary designations. If you care about transferring these assets to loved ones, charities, or other special causes, it is absolutely essential to get the paperwork correct. While you are alive, you may get by with haphazard organization and sloppy record-keeping. The problem comes when you die, because it's almost impossible to undo your mistakes. ❖

**PROTECT YOUR BENEFICIARIES.**
**GET ORGANIZED, GET PROFESSIONAL COUNSEL, AND GET ON A SCHEDULE FOR REVIEWS.**

## Helpful Checklist

- ☐ Keep documents in one place.
- ☐ Update beneficiaries annually, and when a life event occurs.
- ☐ Get expert assistance.
- ☐ Store copies of important documents in a secure electronic "vault" for digital archiving.



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