Creative

wealth maximization strategies*

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Just because you have a plan doesn't mean it will work.

An integral feature in many personal financial programs is a projection of future accumulations, and the retirement income this accumulation could provide. This projection is derived from a combination of the number of years (to accumulate and decumulate), the amount of money (either deposited or withdrawn), and the rate(s) of return that will be applied to those amounts.

A change to any one of these variables impacts the projection. Of the three (time, money, rate of return), the rate of return is the easiest to tweak, and the easiest to abuse. A person's current age and life expectancy put parameters on the time aspect of the projection, and amounts that have been accumulated or can be added reflect your financial history. But projecting a rate of return? There's an Alice-in-Wonderland aspect to it. To para-phrase Humpty Dumpty: "When I select a rate of return, it is as realistic as I say it is."

Rate of return is a projection bail-out. If you're not saving enough, assuming a higher rate of return can make up the difference. If you haven't accumulated enough, a higher rate of return can produce more income from a smaller balance, or make it last longer. But in real life, pursuing a higher rate of return typically entails more risk, which also increases the potential for plan failure.

To prevent a Humpty Dumpty use of rates of return in projections, financial professionals have compiled comprehensive studies of historical returns to determine "realistic" rates of return. When you restrict rates of return to a narrow range of realistic possibilities, you can derive some benchmarks for what individuals need to accomplish in their financial plans, and what they can expect from their efforts.

The Safe Withdrawal Rate

In 1994, using research on historical returns and retirement scenarios from the previous 75 years, California financial planner William Bengen determined that retirees who drew down no more than 4.2% of their portfolio in their first year of retirement, and adjusted that amount for inflation in subsequent years, would, under almost all circumstances, not outlive their money. Further studies have reaffirmed Bengen's initial analysis, and the "4% rule" has become a benchmark frequently used for the distribution phase of the planning process.

The Safe Minimum Saving Rate Matrix

While the 4% rule can suggest how much an individual might safely spend each year from accumulated savings, it is arguably more important to arrive at an adequate rate of annual savings.

In the preface to a 2011 white paper, Wade D. Pfau, Ph.D., a Tokyo professor with a doctorate in economics from Princeton University, articulated the importance of determining, and maintaining, a rate of saving that would deliver enough money at retirement under all scenarios:

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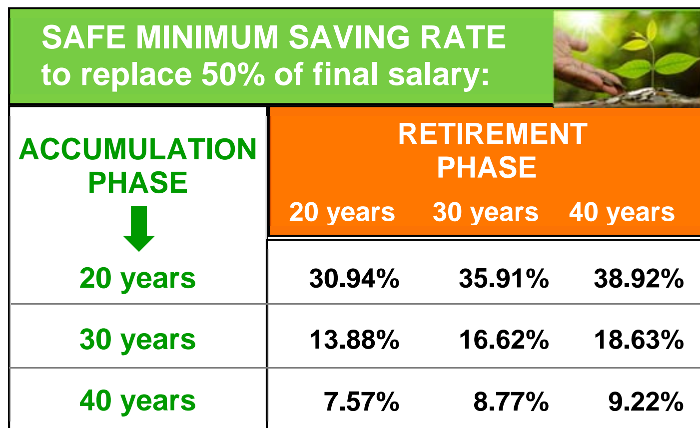
"The focus of retirement planning should be on the savings rate rather than the withdrawal rate… Starting to save early and consistently for retirement at a reasonable savings rate will provide the best chance to meet retirement expenditure goals. Actual withdrawal rates and wealth accumulations at retirement may be treated as almost an afterthought in this framework. **The savings plan should be adhered to regardless of whether it seems one is accumulating either more or less wealth than is needed based on traditional criteria.**" *(emphasis added)*

In an analysis of investment returns from 1871 to 2009, Pfau calculated a "safe savings rate." This was the percentage of one's income that would need to be saved each year to provide a sufficient retirement income (using the 4% safe withdrawal rule) across every historical period.

Pfau assumed a "sufficient" annual retirement income to be **50 percent of an individual's last year of earnings while working**. He also assumed the individual would begin saving at 35, save for 30 years, and live 30 years in retirement. Thus, a 65-year-old earning $150,000 in the year before retirement would need to accumulate $1.875 million to provide a $75,000 base retirement income.

Pfau concluded **a savings rate of 16.62 percent of annual income was the minimum percentage** that could be expected to deliver satisfactory results over every 30-year accumulation period.

Because not everyone retires at 65, or begins saving at 35, Pfau also produced a matrix of "safe saving rates" for different accumulation and retirement periods.



SAFE MINIMUM SAVING RATE to replace 50% of final salary:

ACCUMULATION PHASE	RETIREMENT PHASE		
	20 years	30 years	40 years
20 years	30.94%	35.91%	38.92%
30 years	13.88%	16.62%	18.63%
40 years	7.57%	8.77%	9.22%

The matrix brings several conclusions into stark focus. First, a delay in saving creates a huge challenge to a successful retirement; those who don't begin saving until their late 40s and 50s have a daunting annual savings requirement to secure sufficient retirement income. And second, if savings are deficient, the most realistic adjustment (as opposed to increasing the rate of return) is to plan on working longer.

A deeper dig into Pfau's study reveals two additional nuggets:

1. **Taking more or less investment risk has limited impact compared to an increased saving rate.** Pfau's matrix used historical rates of return from a mixed portfolio of investments. But he also developed similar matrices for riskier and more conservative investment mixes. Using the same 30-30 scenario, a more conservative portfolio required a safe saving rate of 19.33% while a riskier portfolio needed a 15.14% annual saving rate.
2. To be consistent with other research, **Pfau did not take into account any fees that might be incurred as a result of owning particular types of assets**, "but simply introducing a fee of 1 percent of assets deducted at the end of each year would increase the baseline scenario's safe savings rate significantly from 16.62 percent to 22.15 percent."

Facing Retirement Reality

Essentially, Pfau's numbers say that if you're not saving at least 15 percent of income by age 35, your retirement prospects will be delayed, diminished or uncertain. You can try to craft a different narrative using Humpty Dumpty rates of return, but imaginary numbers aren't a recipe for realistic results.

In light of this sobering perspective, ***establishing a healthy saving plan should be the number one priority in almost every financial program***. Waiting to save – until student loans are paid, until you have a house, until the kids are in school – makes the catch-up percentages almost impossible.

- ***If you're under 30***, you should make 35 the absolute latest date for getting your saving rate where it needs to be, and making sure it can stay there for a long time. If you can get there sooner, all the better.
- ***If you're over 50***, catching up is a daunting task, but not impossible. You're most likely to be in your peak earning years, and if you're willing to tweak your current standard of living, it may be possible to save 30-35 percent of income from now until retirement.
- ***In between 30 and 50?*** You probably have a good idea whether you need to aim for a higher percentage or just continue with what you've been doing. And consider whether working longer would be beneficial or possible.

The Right-Now Importance of Cash Flow Management

Cash flow management, the ability to arrange your personal finances so that robust saving is possible, is a fundamental that must be mastered to achieve your financial objectives.

Yet advertising from most financial institutions says very little about the critical role of saving. Instead, there's encouragement to find your "number," the amount you'll supposedly need to retire. Or a blurb touting a superior return on savings in a particular strategy or product.

But realistically, the most valuable financial professionals are those who can help you manage cash flow and save more. Whether it's tax deductions, lower insurance costs, reduced interest rates, discounted fees, refinanced debt, or simply pointing out "you need to save more," any guidance or transaction that re-directs current cash flow to savings will be your most profitable financial activity – at any age. ❖

Saving is the fuel for financial success, and cash flow management is the process for getting it. In realistic planning scenarios, world-class savers have the advantage.

When the 401(k) was introduced a little over three decades ago, it was intended to *supplement* monthly checks from Social Security and employer-sponsored pension plans. Today, many pensions are gone, Social Security has a funding problem, and the primary responsibility for providing a steady retirement income falls to individuals and their 401(k) accounts. For the thousands of Americans retiring each day, there's a growing sense that the task of turning their savings into monthly checks is one they either don't want, or for which they are not well-suited. As Jennie Phipps puts it in a December 2016 bankrate.com article:

> It is becoming increasingly clear that getting through retirement by living off investments is too difficult and unpredictable for most of us. This uncomfortable conclusion has been driving the government, employers and particularly insurers to seek out an alternative — something that functions a lot like an old-fashioned defined benefit pension plan.

This nostalgia for an "old-fashioned defined benefit pension" plan is because it promised a lifetime income for the retiree (and in most instances, a surviving spouse) from a formula based on a worker's earnings and years of service. In contrast, 401(k)s and other defined contribution plans deliver a lump-sum at retirement (with the amount dependent on contributions and investment performance), then leave distribution to the discretion of the retiree. Many retirees adopt one of two prevalent income-producing strategies for lump-sum accumulations:

1. Taking earnings (interest, dividends, capital gains) as income while preserving principal.
2. Systematically drawing-down earnings and principal, based on an annually adjusted percentage of assets.

Both approaches require ongoing management by the retiree, and neither has the guarantee of a lifetime income. These shortcomings become greater concerns as one ages; retirees feel less competent about managing their affairs and more troubled by the prospect of running out of money. No surprise that a recent LIMRA survey (Life Insurance and Market Research Association) found eight in 10 U.S. workers favor employers providing direction on how to convert savings into a retirement income – like the pensions they remember their parents receiving.

But as attractive as a pension might seem, there are good reasons for their demise.

Pensions: Too Many Ingredients

Pension plans are like sausage; we may like the taste, but most of us don't know (or want to know) the ingredients. A pension is a constantly changing mix of past, current and future participants that requires regular reassessments of life expectancies, obligations, projected returns, and on-going capital contributions.

These complexities, with their uncertain costs and the attendant liabilities, explain why many employers have jettisoned pensions. And of the pensions still in existence, many are in poor financial condition (including Social Security, the nation's biggest pension). A Wilshire Consulting report found that "87 percent of the 92 state retirement systems that reported data for the 2014 fiscal year were underfunded." Historically, the destiny of most pension plans is either suspension or implosion, with the risk that some retirees will not receive what they were promised.

Annuities: Fewer Ingredients, Better Results

A better option for a guaranteed retirement income could be an individual life annuity. In this arrangement, an insurance company promises a lifetime stream of payments in exchange for a lump-sum premium. Annuity contracts offer a range of payment options, but to replicate a pension, an individual would typically select a life and joint survivor format, which guarantees monthly payments for an individual and a surviving beneficiary for as long as one of them is alive.

Similar to a pension plan, a life annuity insures against three significant retirement risks:

- *Longevity risk* — the risk of outliving one's assets.
- *Market risk* — the risk that fluctuating asset values might decrease income.
- *Management risk* — the risk that mismanagement, whether due to ignorance or diminishing mental capacity, could result in loss of principal and income.

A life annuity is similar to a pension plan in that the insurance company provides lifetime incomes for all participants by averaging out the costs of those who live past life expectancy against those who die early. By pooling resources, everyone's risk is diminished, and every annuitant can expect a guaranteed income.

You might say the annuity's ingredients for providing a lifetime income are of better quality. Unlike a pension, the insurance company doesn't have to plan for an unknown number of future participants; it only provides income for those who buy an annuity. And the plans are fully-funded up front; no future payments are required to maintain benefits. Because the mechanics are simpler (and the financial regulation is stricter), insurance companies have a stellar track record for keeping their lifetime income promises. What's more, in many scenarios, an annuity may provide a higher monthly income than either principal-conserving or draw-down strategies – while guaranteeing it for life.

Pension Ignorance Impacts Annuity Utilization

In consideration of these advantages in both income and guarantees, economists have long recommended annuities as being the optimum instrument for turning accumulated assets into streams of guaranteed income. But retirees have been slow to embrace individual annuities, in large part because of their "mis-remembered" perspective on pension plans.

A decision to buy a life annuity is usually irrevocable. If annuitants die before life expectancy, there is no "refund" of the unused premium; the excess is used to ensure those who live beyond life expectancy will get their checks as promised.

This arrangement is not different than a pension. The difference is a pension is funded by an employer. In theory, the cost of providing a pension comes from a reduction in an employee's compensation, but this cost is hidden. It's not a deduction on a pay stub, and it doesn't show up on a W-2.

With a pension, employees didn't see how the sausage was made, and psychologically, they didn't pay for it. With an annuity, retirees see the costs, and perceive a possible "loss" if they die early. Yet this is the same loss they experienced with a pension in exchange for guaranteed lifetime benefits.

Other Ingredients – And Help to Put Them Together

If you are retiring with a lump-sum, your income-generating options are not restricted to choosing between a draw-down schedule or a life annuity. There are almost infinite ways to combine guaranteed insurance products with other financial assets to deliver a mix of reliable income, sufficient liquidity, and minimized management responsibility. Every situation is different, but it is worth exploring these options with a financial professional. ❖

You may be pleasantly surprised as how easy it is to turn a lump-sum into a monthly pay-check when you add some insurance and don't have to do all the work.

Do the Right Thing: Insure Your Economic Value

A fundamental purpose of life insurance is to replace an individual's economic value should they die earlier than anticipated. Considering that the ability to earn an income is one's greatest financial asset, it is logical to select an amount of life insurance that reflects this lifetime earning potential. Yet this logic is sometimes skewed by a misguided emphasis on reducing costs. Instead of fully insuring one's economic value, some consumers and financial professionals focus on determining the *minimum* amount of life insurance needed for the economic survival of beneficiaries.

A simple illustration highlights both the ethical and practical shortcomings of obtaining the least amount of life insurance.

The Example

A 35-year-old husband is killed by an intoxicated motorist. The event is devastating to his family, both emotionally and financially. Beyond any criminal prosecution, the family of the deceased will almost certainly pursue a civil action to secure a financial judgment against the drunk driver.

In court, representatives for the family will establish the lifetime economic value of the deceased. This will be an assumption of future lifetime earnings, reflecting the victim's vocation, anticipated raises, professional advancement, remaining working years, the impact of inflation, etc. Projected future earnings will then be reconfigured as a present-value amount, i.e., a lump sum needed today to replicate this projected stream of income. This present-value number would be the baseline for determining financial compensation due to surviving family members.

The logic and justice of seeking financial compensation equal to the lifetime economic value of the victim should be easy to comprehend. Two follow-up questions, and their answers, should make it apparent that this rationale applies to other circumstances.

Question 1: Is there any reason the family should consider asking for an amount ***less*** than the husband's full lifetime economic value? For example, if the family already had enough assets to survive, and didn't "need" a judgment for the full economic value of the deceased, would it be advisable to seek a lower amount, or perhaps nothing at all?

Question 2: If this death occurred in a one-car accident, where the husband lost control of his vehicle due to weather conditions, would the lifetime economic loss be any less than if another party was responsible?

The correct answers, and their implications, should be obvious. Regardless of the level of financial well-being of the survivors, they deserve to be fully compensated. There is no moral justification for seeking a lower settlement amount by arguing the survivors "don't need it." And the magnitude of the economic damage does not change if there is no one to blame for the husband's death; a drunk driver, a one-car accident or a sudden illness all cause the same financial loss.

Insuring for full value is the only way to effectively address any financial needs that might result from an untimely death.

Lifetime Economic Value: The Only Logical Approach

If it is reasonable to pursue legal action to have someone else pay your full economic value in the event of a wrongful death, how can you justify using a different standard for insuring an untimely death that can't be blamed on anyone? "Well dear, if a drunk driver kills me, you'll receive two million dollars, but if I slip and fall, it will be $200,000 – because that's all you really need to survive without me."

Making a life insurance decision based only on what is thought to be needed by survivors may appeal to cost-focused consumers, but the premise is wrong. It is impossible to accurately calculate the costs that might result from an untimely death today, and those costs would surely be different if a death occurs two years, five years or twenty years later. Since

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tomorrow's financial "needs" will be different than today's (and might be far greater), any needs-based calculation is flawed the day it is made.

There may be occasions when a household cannot presently afford to fully insure one's full economic value, but the standard should be a factor in any life insurance discussion. Insuring for full value is the only way to effectively address any financial needs that might result from an untimely death.

Who Determines Lifetime Economic Value?

In a legal action, arriving at your lifetime economic value is a detailed process. You could probably replicate the calculations, but there's an easier way: Simply ask a life insurance company.

All insurers have underwriting parameters for how much life insurance they will consider offering an individual, and these guidelines roughly reflect lifetime economic value. Here's the verbiage and amounts from a highly-rated American life insurance company:

The following information reflects general life insurance guidelines equal to the present value of potential future earnings which would be lost at the death of the insured.

Age	Maximum Life Insurance
18-40	30 times income
41-50	20 times income
51-60	15 times income
61-65	10 times income
66-70	1 times net worth
71-80	1/2 times net worth
81+	case by case

As applicants get older, the declining income multiples reflect shorter time periods; a 51-year-old has 20 less earning years than a 31-year-old counterpart. And as people move into retirement, the criteria switches from their future economic value as earners to the future economic value of the assets they have accumulated.

Don't Under-Estimate Your Value (or What You Can Afford)

Many consumers are surprised when they see an insurance company's assessment of their lifetime economic value, especially in light of the amount of insurance they actually have. *("You mean to tell me I'm worth $3 million? I only have $250,000!")*. And shortly thereafter comes the thought: *"That's a big number. How could I afford to insure my lifetime economic value?"*

In reality, securing life insurance equal to lifetime economic value today may be quite doable, especially for younger applicants. Term insurance, graduated premiums, even financing options, can all be used to maximize current life insurance protection. A life insurance professional can not only provide the policies, but also offer guidance on how to pay the premiums. Instead of thinking you can't afford to insure your lifetime economic value, you should ***find out how much you can insure.***

Buying as much life insurance as the insurance company will offer is a sound risk management strategy because obtaining individual life insurance is dependent on one's health. Insuring for full economic value today means not having to re-apply later, and avoids the risk of being declined because of health conditions that were not apparent decades earlier. ❖

Have you tried to insure your lifetime economic value? It's the logical basis for deciding how much life insurance you should own. ❖

Accountability in Personal Finance

"Should I ask why you're doing that?"

There is genius in the phrasing of that question. A respondent can say as little or as much as they want, yet whatever they do or don't say will be revealing. It's a question that shows both respect and concern, that prompts accountability while withholding immediate judgment.

When it comes to your personal finances, who can ask you that kind of question – and have you answer it honestly?

Mastering your personal finances is a self-improvement project. You don't *have* to do it, and intentional change, where you attempt to take control of some aspect of your life, is often difficult. This is especially true if your self-improvement project is really just you, by yourself. Most of us need support, motivation – and accountability – to succeed.

Permitting Accountability

Robert Farrington, who has the title "America's Millennial Money Expert," makes this provocative assertion in a May 2016 blog:

> **"The single most important trait that defines personal finance success is accountability. Personal accountability… will define whether you're successful with your money or not."**

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Farrington's message is intended for Millennials, but it really applies to everyone. Voluntary accountability dramatically improves the odds of mastering your finances.

But where to find accountability? The only consistent outside accountability many people have in their financial lives is from the IRS and creditors – but they only make sure you pay *them* on time, not whether you "pay yourself first" by saving.

A spouse can often provide accountability. They know you, love you, and have a stake in the outcome. And if a spouse gets behind personal finance as a self-improvement project, it's no longer a go-it-alone thing. The only limitation is that neither one of you may have the experience or knowledge to intelligently ask "Why are we doing this?"

People who want to succeed in personal finance often make themselves accountable to their financial professionals. A financial professional is not a boss; you don't have to listen to their opinions or recommendations. But they can provide invaluable input, not just about the products and strategies, but also with principles and processes that keep you on track toward your stated financial objectives.

Who has permission to say *"Should I ask why you're doing this?"*

And while they don't have the emotional investment on the level of a spouse or family member, financial professionals do have a vested interest in your success. When your personal finances improve because of their assistance, it enhances their professional reputation, and usually results in positive word-of-mouth.

If you really want to make progress with your personal finances, you should consider which financial professionals you want to hold you accountable. ❖

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