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How would you pay \$50,000 in medical bills, due over the next six months?

Much of the planning in personal finance is focused on the future, like how much needs to be saved to retire, and how much of what's saved can actually be spent. But the future has a slim chance of coming to fruition if the financial challenges of the present aren't adequately addressed. If today cannot be managed, any dreams for tomorrow will always be in jeopardy.

Today, there is perhaps no greater personal finance challenge than the spiraling cost of healthcare, and the drag it imposes on individual economies. Even worse is the financial damage to a household unfortunate enough to experience a major health incident, such as an accident or illness. Of all the costs of living that must be managed so long-term accumulation can occur, healthcare is the hardest to effectively address.

Healthcare costs have consistently risen at a pace greater than both personal income and inflation, and consume an ever-larger percentage of the economy. In 2015, U.S. health care costs equaled 17.8 percent of the country's gross domestic product. In 1960, these costs were 5 percent of GDP.

It's not just higher prices for healthcare services and procedures. Employees are getting less assistance from their employers in the way of subsidized benefits. An October 24, 2016, *Money* article declared "Americans today face higher health insurance premiums, vastly higher deductibles in health plans, and higher prescription drug costs than ever."

The vastly higher deductibles are the result of employers switching to high-deductible health plans (HDHPs), which require an individual to pay an annual deductible of at least \$1,300 (or \$2,600 for a family), before the plan covers any medical expenses. Per the same *Money* article: "51% of all covered workers, and 65% of workers in small firms, face deductibles of at least \$1,000."

HDHPs may offer more affordable insurance premiums, but affordability also means greater financial exposure should the employee have a significant medical incident. In many HDHPs, individual deductibles may be \$6,500, and \$13,000 for a family. This is a significant transfer of financial risk to the individual.

Further, even the best insurance plans don't cover everything. After the deductible is met, some individuals may be responsible for coinsurance and co-pays for prescriptions, as well as special procedures that insurance may not cover. Some expenses (such as ambulance transport, lost wages, homecare and childcare, travel and lodging), while incurred because of the incident, are "non-medical," and not eligible for reimbursement.

What's worse, it can be difficult to ascertain out-of-pocket costs in advance. There are few price tags on healthcare services, and rarely an answer to "What will this cost?" until the bills arrive. And with healthcare, you usually can't say, "Well, I'll just wait until they're having a special on knee replacements."

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* 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.



Medical Emergency	Out-of-Pocket Medical Expense	Non-Medical Expenses	Total Financial Impact* (what you will owe)
Heart Attack	\$9,290	\$13,266	\$22,556
Stroke	\$9,010	\$24,775	\$33,793
Cancer	\$11,702	\$6,833	\$15,868
End Stage Renal Failure	\$11,702	\$16,319	\$28,021
Major Organ Transplant	\$18,432	\$26,946	\$45,378
Coma	\$14,958	\$30,953	\$45,911
Paralysis	\$34,690	\$51,474	\$86,164
Blindness	\$5,843	\$12,845	\$18,294

*The "total financial impact" in this table is for the first six months following the medical emergency.

Could you handle this much financial disruption?

Emerge, an insurance brokerage specializing in cash benefits for medical emergencies, culled data from government agencies and research studies to illustrate the actual out-of-pocket costs of specific medical events for those with high-deductible health plans. The numbers are sobering.

Remember, these numbers are *out-of-pocket expenses* for *households with health insurance*. Then consider that most of the incidents listed would probably also include at least a temporary disruption in earnings, and it's no surprise that a 2016 *Insurance News Net* report found that "just over half of all the debt that appears on credit reports is related to medical expenses."

As you look at the real costs of a medical emergency, several things stand out:

- The **three to six months of living expenses** that many experts say should be sufficient emergency reserves probably **aren't enough to weather this type of financial storm**.
- While a Health Savings Account may help offset these out-of-pocket medical expenses on a tax-favored basis, **it's unlikely there will be enough accumulated in an HSA to meet all costs**. The annual contribution limit of \$3,400 for an individual and \$6,750 for a family, combined with the likelihood of other regular, non-emergency healthcare expenditures makes it difficult to accumulate a large enough reserve.
- **Tapping retirement plans gets complicated**. You might consider a hardship distribution from your retirement plan. But this option is available only if your plan permits it, and if your request meets the administrator's approval. A distribution adds to your taxable income, and should you return to work, you won't be able to resume contributions for at least six months following the hardship distribution.
- A home equity loan might be a possibility. **But if you're not able to work for the foreseeable future, how likely is it that a bank will authorize the loan?**

It's time to change the metrics for cash reserves

The shift to HDHPs necessitates a change in strategies for managing today's risks: Individuals either must build larger liquid reserves, or find other ways to transfer these risks to insurance companies.

In this context, maintaining emergency cash reserves equal

to 3-6 months' expenses is inadequate; a better reserve target is a year's worth of **income**. The larger amount gives you a better chance to manage the out-of-pocket expenses from a significant medical incident, including what may be a transition to disability benefits in the aftermath.

Those with higher incomes may be understandably reluctant to hold \$100,000 or more in low-yielding savings accounts. It is prudent to keep some reserves in the bank, but other options are suitable, such as life insurance cash values¹ and some equity instruments where it is easy for shareholders to sell their positions. As long as the funds can be readily liquidated, they count toward the one-year reserve number.

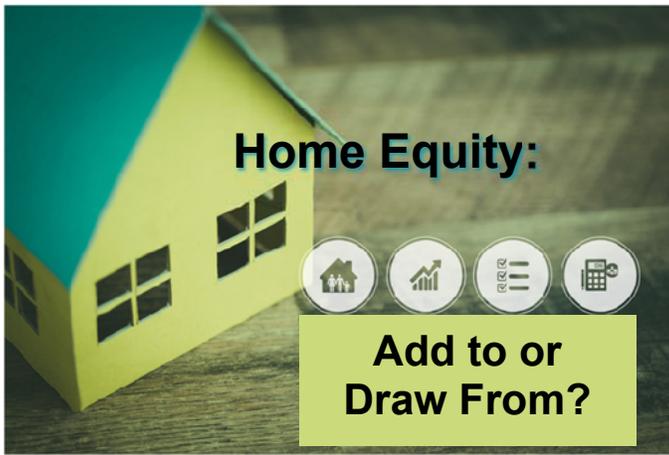
In this definition of cash reserves, some assets have volatility and investment risk. But until the one-year's-earnings threshold has been crossed, individuals should think long and hard before making substantial allocations to illiquid, long-term vehicles, particularly qualified retirement plans, where withdrawals will be subject to administrative approval, taxes and penalties.

Whenever individuals are bearing too much financial risk, there is an insurance opportunity. The medical insurance marketplace is responding to HDHPs with supplemental coverage for critical illness or physical injuries. Individuals will have to weigh the cost of protection against accumulating more savings, which can be allocated to other financial objectives if not needed for medical expenses. ❖

"Tomorrows Come Next, Todays Come First"

Fifty years ago, lower healthcare costs and employer-paid insurance made three to six months of living expenses a plausible benchmark for cash reserves. Today, HDHPs and fast-rising medical costs require a larger reserve; an amount equal to one year's income.

There is a tendency for both consumers and financial professionals to shortcut liquidity and focus on long-term investments and objectives. But as personal finance veteran Bob Ball puts it, "Tomorrows come next, todays come first." Building substantial liquid reserves needs to be a foundational priority. Failing to address today's economic risks from healthcare costs can keep tomorrow's financial dreams out of reach.



The phrase “financial wisdom” is not an oxymoron like “deafening silence” or “jumbo shrimp.” But there are times when generic financial advice can seem almost as contradictory. For example, persistently low interest rates have experts urging homeowners to ponder two diametrically opposed strategies:

- Add to home equity by using cash reserves to pay off a mortgage, or...
- Withdraw home equity, using either a home-equity line of credit or cash-out refinancing.

You can’t get much more opposite than that. But is it possible that both options could be right – or wrong – at the same time?

Maybe. The approaches are similar in their attempt to reallocate assets to be more efficient and profitable. Each strategy has merit, and depending on your circumstances, might seem workable.

The Logic for Adding to Home Equity

You could use savings to make home improvements (by updating a kitchen, building an addition, etc.), and these improvements might increase your home’s value. But the simplest way to increase home equity is using cash reserves to pay off a mortgage or home-equity line of credit. In this asset transfer, the payoff may be construed as producing a return equal to the interest costs that are “saved” by retiring the debt. Thus, paying off a \$100,000 balance on a mortgage at 5% interest, with savings earning less than 1 percent represents a more efficient use of those funds.

It is important to understand that a loan payoff does not increase overall net worth, or the value of the home. But paying off a loan decreases monthly obligations and increases cash flow. Money once allocated to a mortgage can be redirected to alternative investments, or spent. Even though net worth doesn’t change, the freedom of a paid-off property may accrue additional benefits, both financial and psychological.

The Logic for Drawing from Home Equity

Like rates on savings, loan interest rates also remain near all-time lows. With housing values returning to pre-recession levels in many parts of the country, homeowners may consider tapping their home equity to pursue investments that produce returns greater than the costs of borrowing.

The typical arrangements for accessing real estate equity are either a home-equity line of credit (HELOC), or a cash-out re-

finance. An August 28, 2017, *Wall Street Journal* article aptly characterizes a HELOC as “similar to a credit card, where a borrower can spend as much or as little of the available credit as they wish – but with the house as collateral.” In a cash-out re-fi, borrowers refinance an existing mortgage into a new one with a higher principal balance, giving them a chunk of cash to spend or invest.

A simple application of this strategy: borrowing \$100,000 of home equity at 5 percent, to earn 8 percent. But other cash-out strategies could include a leverage play, where the lump sum is the down payment on the purchase of a rental property, or business, etc.

Cash-out re-fi transactions may also reduce monthly obligations and increase cash flow. If the existing mortgage is well along the amortization schedule (say, a 30-year mortgage in its 15th year), homeowners may be able to re-finance an existing balance and receive a lump-sum, while reducing their monthly payment and increasing their tax deductions. These benefits can be accomplished through a combination of lower interest rates, smaller loan amounts (even with a cash-out), longer payoff periods, and a higher percentage of deductible interest because the new loan is at the beginning of its amortization schedule.

So...Add to, or Draw From?

Both approaches to home equity have advantages. Retiring mortgage debt eliminates interest costs, reduces monthly obligations, and increases discretionary cash flow. Withdrawing home equity frees up cash for more profitable opportunities, while in some circumstances also reducing monthly payments and increasing tax advantages.



But an evaluation of either approach should be more than an isolated comparison of home equity and an alternative. A decision to transfer in or out of home equity impacts other aspects of your financial eco-system. Among the considerations: how adding to, or withdrawing from, home equity will affect cash reserves and cash flow.

Paying off a mortgage depletes cash reserves. If you have \$40,000 in liquid assets and it takes \$35,000 to retire a mortgage with \$1,500/mo. payments, this transaction leaves almost no protection against a financial emergency. This exposure makes it almost imperative that the improved cash flow from the payoff be used to replenish the reserves – which probably means depositing \$1,500/mo. in the same low-yield account that the payoff came from.

Also, while it’s easy to add equity, it’s much harder to withdraw it. A decision to build home equity through a cash transfer incurs an opportunity cost: you may not be able to pursue other financial opportunities without selling the property or getting the permission of a lender to borrow against the equity.

For those withdrawing home equity, a cash-out re-fi or a HELOC often comes with additional interest costs, higher monthly obligations, and a longer amortization schedule. If debt service increases \$100/mo., but the transaction yields an additional \$150/mo. in income, these borrowing costs may be an acceptable trade-off. But what if you’re five to ten years from

retirement? Will higher payments still be affordable when you're no longer working, but relying on savings for income?

Some financial professionals advocate paying off a mortgage and becoming debt-free as soon as possible. But eliminating debt at the expense of adequate cash reserves actually adds financial risk. In the event of an emergency, the illiquidity of home equity may aggravate an already challenging situation.

Advocates for drawing from home equity may tout profitable opportunities for arbitrage or leverage. But if these transactions add to monthly obligations and are used to acquire additional illiquid assets, there should be an assessment of the impact to current cash flow, and whether the liquidity risks require additional cash reserves. ❖



If you have substantial savings and home equity, it is worth exploring your options to reposition these assets to your advantage.

But any decision on home equity should also include an assessment of what happens to cash flow and reserves. Even if the math of an equity transaction makes sense – either to add to or draw from – the foundational elements of your personal finances should not be compromised.



Getting
Lucky
in Retirement

A chorus of financial experts have declared that Americans face a “retirement crisis.” Their long-standing warning: individuals are not saving enough. Their more recent concern: Financial ignorance and diminished mental capacity in old age leaves many retirees poorly-equipped to manage their retirement savings, and susceptible to all sorts of financial pitfalls, from unnecessary frugality to being scammed out of their life savings.

When they observe this crisis, some experts have a tendency toward nostalgia, to look backward to “the good old days.” For retirement, that means longing for an employer-sponsored, defined-benefit pension plan. Check these headlines or lead sentences from recent blog articles:

- ♣ **Understanding Your Pension - If you're lucky enough to have one!**
- ♣ **Pensions are becoming a thing of the past — so if you're still entitled to one, consider yourself lucky.**
- ♣ **If you're lucky enough to have a pension plan at work, be thankful— it may be one of your greatest financial assets.**
- ♣ **Pensions are terrific, if you're lucky enough to still have one.**

You no doubt sense a theme. But what's so great about a pension that makes you “lucky” if you have one? From the perspective of these personal finance experts, a defined-benefit pension resolves the biggest issues in retirement: An employer funds the plan, and guarantees a lifetime income (typically based on average annual earnings and years of service). The weak link – the individual who hasn't saved or can't manage money – is removed from the equation.

Ah, the good old days. If only the present could be as we remember the past. Unfortunately, the financial behavior of pension plans isn't much different than that of individuals.

If You Thought Individuals Didn't Save...

To make good on their financial promises to retirees, employers must make ongoing deposits to fund the plan. But like many American households, most employers haven't saved enough to meet their retirement obligations. To use the jargon of the industry, their pensions are “underfunded.” According to 2016 data analyzed by Wilshire Consulting, “Large pension plans currently have just 70% of what they need to pay future benefits to their retirees.”

This underfunding is true of both private and public pension accounts. Even after a year in which many pensions experienced above-average investment returns, the August 8, 2017, *Wall Street Journal* reported that “Many of America's public pensions remain severely underfunded, meaning they don't have enough assets on hand to fulfill all promises made to their workers.” A June 2017 *Bloomberg News* report found that “New Jersey, Kentucky and Illinois continue to lose ground and now have only about one third of the money they need to pay retirement benefits.”

And Pensions Compensate for Under-Saving Just Like Individuals, Too...

Just like individuals, pensions can make up for under-saving by assuming a higher rate of return on the savings they do have. For years, pension administrators have used optimistic return assumptions to cover their funding shortfalls. In 2017, Illinois' state pension system estimates a \$127 billion funding deficit while Moody's Investor Service says it's closer to \$250 billion. The difference: “a function of the state using more optimistic investment assumptions than used by the rating agency.”

But this issue goes deeper than unrealistic investment assumptions. Pursuing higher returns almost always comes with greater risk, which means a greater likelihood of plan failure. Yet a September 8, 2017, *Wall Street Journal* report found that “As the developed world's population ages rapidly, pension funds are pushing into riskier assets.”

Given these realities, it is hard to think pensions are really the cure-all. In fact, when retirees rely on plans that don't save

enough and take on more risk, it puts a whole new spin on the idea of “getting lucky with a pension.”

What Happens to Under-Funded Pensions?

Historically, many pensions are either discontinued or diminished. The typical endings:

The plan is frozen. Current retirees and some not-yet-retired employees will continue to receive benefits. But the plan will not accept new participants, and some current employees may receive lump-sum payouts representing a present value calculation of their pension benefit (most likely using an optimistic return assumption) that can be rolled into another retirement plan.

The plan is terminated, and the employer pays an insurance company to assume responsibility for future payments. General Motors and several other large corporations have done this with blocs of employees. The cost of transferring the risk to an insurance company is usually more than the assets in the pension (because it was underfunded), but the additional cost to the employer is worth it because it eliminates future liabilities.

The plan is terminated, and taken over by the Pension Benefit Guaranty Corporation (PBGC). The PBGC is a federal insurance agency funded by premiums from pension plans to protect participants in private-sector defined benefit plans. If a pension does not have sufficient funds to pay retirees, the PBGC uses its reserves to cover the difference, up to certain limits. The PBGC says “Most people receive the full benefit they had earned before the plan terminated.” However, highly-compensated retirees with benefits in excess of the agency’s limits will experience a reduction in monthly payments.

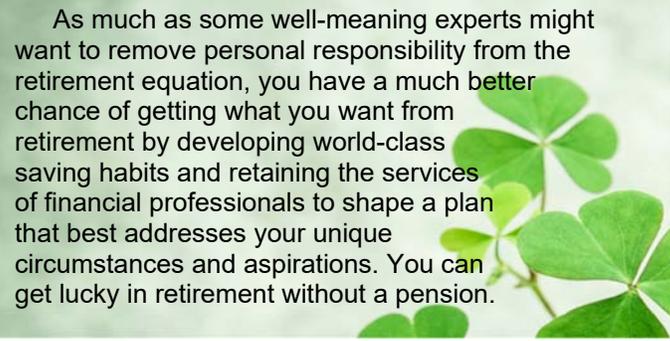
The plan reduces benefits. For federal, state and local government pensions, underfunding eventually leads to reduced benefits. In March 2017, the California Public Employees Retirement System (CalPERS) approved a reduction in benefits for a small group of retirees from a defunct public agency because the plan failed to meet its contribution requirements. This action resulted in a 63 percent reduction in benefits for 62 retirees.

Of the possible endings for struggling pensions, paying an insurance company to guarantee the payments is the outcome that provides the most certainty for retirees. The plan is fully funded, the incomes are guaranteed, and no additional action is required by the retiree – no additional deposits, no management responsibility. Any hiccups that might arise, such as poor investment returns, or off-base actuarial assumptions, are covered by the insurance company’s reserves.

No Pension? You Can Still Get Lucky

Transferring the funding and investment risks in a retirement plan to an insurance company is also an attractive option for those without a pension. When individual retirees allocate a portion of their retirement savings to buy a lifetime annuity, they receive the same benefits: Their funding is complete, their income is guaranteed, and they are relieved of ongoing investment management responsibilities.²

There are significant challenges to managing your own retirement and providing an income from savings. But those challenges have practical insurance and management solutions that don’t require a reliance on an underfunded pension plan that takes excessive investment risks.³ ❖



As much as some well-meaning experts might want to remove personal responsibility from the retirement equation, you have a much better chance of getting what you want from retirement by developing world-class saving habits and retaining the services of financial professionals to shape a plan that best addresses your unique circumstances and aspirations. You can get lucky in retirement without a pension.



Ever heard someone say, “It’s not just business, it’s personal?” That sentiment is often at the heart of personal finance. It’s about us, our needs, our dreams, our money. We aren’t planning for someone else’s retirement, or making investment decisions for someone else’s gain. It’s **personal**.

This egocentric financial focus is understandable, but such a narrow view of “our” money may blind us to the satisfaction that can come when some of our finances have an “other” dimension. Consequently, we may miss out on moments of eudaimonia.

Literally translated as happiness or welfare, “Eudaimonia” is a Greek word used by Aristotle to define the goal of human existence. Often paraphrased as “human flourishing,” eudaimonia is more than hedonic happiness, i.e., the experience of pleasure or avoidance of pain. Rather, eudaimonia is “a state in which an individual experiences happiness from the successful performance of their moral duties.”

The quote is part of a 2009 Harvard Business Review white paper titled, “*From Feeling Good about Giving: The Benefits (and Costs) of Self-Interested Charitable Behavior.*” And a growing body of research supports the idea that giving is one of the ways we experience eudaimonia.

Any discussion that includes the phrase “moral duties” is certainly ripe for debate about virtues and standards – except when it comes to giving. Generosity is a universally valued human attribute. When we voluntarily give of our time, talents or finances to individuals, organizations, or worthy causes, Aristotle says we strengthen our connections and communities. In the process, we sense our own human flourishing, and this is one of the great satisfactions of life.

Family Giving Traditions: How to Make Eudaimonia Contagious

Behavior experts believe generosity is an innate human attribute that is greatly influenced by one's environment. In other words, generosity is both a product of nature and nurture. If parents want to encourage generosity in their children, one of the strongest positive influences comes from family giving traditions.

Mark Ottoni-Wilhelm is a professor of philanthropic studies at Indiana University. In a March 2017 *Wall Street Journal* panel discussion, the professor shared a puzzling finding from a recent research project:

The most surprising finding from our study of American families is that parental giving doesn't seem to have a causal effect on their children's giving. How can that be, when we know from developmental psychology experiments that adult modeling of giving increases children's giving?

Ottoni-Wilhelm went on to suggest that while parents may be regular givers, children often don't understand the activity or the reasons behind it. To effectively model generosity, "Parents should make sure their children see giving as a regular part of their life, and engage children in conversations about why they (the parents) give."



Family giving traditions, often centered around holidays or family events, provide a framework for parents to demonstrate their own giving, and the opportunity to explain and reinforce their reasons for doing it. Over time, children can progress from observers to participants in giving, eventually making the habit of generosity their own.

Thanksgiving is an opportune time for establishing and maintaining a family giving tradition. For school age children and grandchildren, it's part of a holiday weekend. For those in college or living outside the home, the holiday is often an occasion to return home. And the day itself is intended for thanks – and giving. Making charitable giving a Thanksgiving tradition is a great way to embed your philanthropic values in the next generation.

And encouraging your children and grandchildren to practice generosity is more than setting an example. It is also a moment of Eudaimonia, of happy flourishing, for you. ❖

**"We make a living by what we get.
We make a life by what we give."**

– Winston Churchill

¹ (Page 2) 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.

² (Page 5) Insurance company guarantees are subject to the claims paying ability of the issuing insurance company.

³ (Page 5) This Material is Intended For General Public Use. By providing this material, we are not undertaking to provide investment advice for any specific individual or situation, or to otherwise act in a fiduciary capacity. Please contact one of our financial professionals for guidance and information specific to your individual situation.

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