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Wealth Design Group, LLC
3040 Post Oak Blvd. Suite 400
Houston, Texas 77056
Phone number 280.220.2700 • Fax number 713.622.1440

Rick Ray
rickray@wealthdesigngroup.net

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A CYBORG SOLUTION TO PERSONAL FINANCE

"Behave rationally – you know, like economists say you should!" - Steven Horwitz

In theory, informed parties engaged in honest exchanges achieve optimal financial results. This is a basic assumption of standard economic theory. But one thing that aggravates economists is that parties in these exchanges are human. They make irrational decisions, even with good information. They have conflicting interests, and sometimes deceive or cheat one another.

Economists have a term for human imperfections: agent failure. Markets simply can't function efficiently because people (agents) keep messing them up!

Financial behaviorists attempt to provide strategies or incentives that minimize or eliminate agent failure. These fixes can be procedures, like automatic enrollment in retirement plans. They might be laws, such as licensing requirements, or mandated disclosures for certain products or services. And governments can offer tax advantages for desired behaviors, like deductions for saving or credits for the purchase of favored products or services.

In some instances, a fix attempts to remove the human element altogether. An interesting trend along these lines is the development of "robo-advisors." Per Investopedia, a robo-advisor is an "online wealth management service that provides automated, algorithm-based management advice without the use of human financial planners." For a fee, these services promise to deliver superior results, largely because they eliminate some of the human factors that can disrupt efficient financial management.

Remove the Failing Agent, Solve the Problem?

At first glance, there are obvious perceived advantages to removing humans from the personal finance equation. A robo-advisory service is generally less expensive because a computer program doesn't have a family to feed, want to own a home, or have to save for retirement. And computers are "honest." A machine with a pre-determined program has no conflicts of interest. As Steven McCarty puts it in an April 17, 2015, article, "Since computers standardize procedures, content and interactions, they effectively banish promissory language, unapproved sales techniques and materials, and misrepresentation."

From their introduction about a decade ago, several robo-advisory services have gained traction with consumers, enough for some observers to think that human advisors may go the way of dinosaurs. But as the concept has matured, some drawbacks have emerged. In some cases, eliminating a human advisor may actually magnify other agent failures in personal financial planning.

On the Other Hand…

Most robo-advisory programs require the individual to complete a self-assessment of their current financial condition, such as assets and liabilities, salary, tax bracket, etc. The robo-advisor also asks subjective questions about risk tolerance, financial priorities, and allocation preferences. Unfortunately, a common agent failure in personal finance is that people may not accurately assess their financial condition; they don't know the details, they guess, or they lie. A program built on customer inputs can't ascertain the veracity of the information. When a consumer becomes his/her own advisor in a do-it-yourself program, it goes against another basic economic principle: the benefits from the division of labor. Many of us, given the motivation, might have the ability to be a physician, account-

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tant, attorney, financier or landscaper. But most of us can't effectively do ***all*** of these things, and trying to do something better than an expert is an agent failure waiting to happen.

Another source of human agent failure is a tendency to believe the future will be like the past. Computer-generated recommendations are based on historical data; they can't account for innovations or never-seen-before events.

And in a counter-intuitive way, there's a greater likelihood of accepting underperformance from a robo-advisor. An unbiased program tells you – and everyone like you – to allocate your finances in a particular manner. If the results are less than satisfactory, you can't blame the program, and you probably won't blame yourself. Since others are in the same boat, it's almost a confirmation that there wasn't much you could have changed.

McCarty frames these robo-advisor shortcomings as the difference between compliance and ethics. Ethics is the "domain of thought that defines the right way to act (or invest)…and while robo-advisors may be great at compliance and transparency, they may fall short regarding ethics." His example:

"(A) robo-advisor is ill-equipped to encourage clients to forego investing online until they augment their emergency fund, reduce credit-card balances, or set up a college savings 529 account. And they lack the ability to keep clients accountable by sticking with budgets and other financial commitments."

In essence, some positive aspects of human behavior, like discernment, collaboration, and integrative thinking are often effective antidotes for agent failure. As aggravating as it might be for economists, humans are both the problem and the solution.

Combining Man and Machine

In an August 27, 2015, blog post, financial commentator Michael Kitces noted that one of the nation's largest personal financial management firms recently purchased the third-largest "pure" robo-advisor company. Interestingly, the reason for this acquisition was not to move the parent company into the direct-to-consumer, no-human-interaction marketplace. Rather, it was to offer "a robo-advisor-*for*-advisors solution, and license/offer the technology platform to a wide range of broker-dealers, insurance companies, banks, and custodians to turn their human advisors into tech-augmented 'cyborg' advisors."

This "cyborg" model combines ethical human input with compliant technological support. The "robo" platform records meetings, organizes and updates data, distributes appropriate documentation, completes transactions, and schedules reviews. This frees the human advisor to provide relevant insight, creative strategies and personal accountability. Used correctly, this model gives all parties the best chance to avoid agent failure, either as an advisor or customer.

While some robo-services focus primarily on investments, other programs, such as The Living Balance Sheet®*, offer a comprehensive, integrated platform for personal finance, including insurance, cash flow, and spending analyses. For consumers who are serious about maximizing their financial potential, the capability of these personal finance platforms to facilitate better outcomes is breathtaking.

But while technology can do a lot of heavy lifting, the human element remains essential. It takes wisdom to make sure those piles of analysis and communication are properly interpreted and rightly applied to individual circumstances.

You can minimize agent failures in personal finance by taking advantage of the division of labor, and engaging the services of both humans and machines. Are your financial professionals *cyborgs*?

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An often-overlooked risk in government-sponsored benefits, including tax-favored savings and retirement plans, is the possibility that the rules will change. In practice, the "possibility" is more likely an "inevitability": the rules ***will*** change.

A recent example of government "moving the goalposts" involved options for receiving Social Security retirement benefits. On November 2, 2015, President Obama signed off on legislation that eliminated three methods of payment permitted under rules passed in 2000. The most significant change was the elimination of the "file-and-suspend" strategy.

How File-and-Suspend Used to Work

File-and-suspend allowed someone, upon reaching full retirement age (FRA), to file for Social Security retirement benefits, then immediately suspend them. For each year a retiree deferred benefits, they were credited with an 8 percent increase in retirement income. At the same time, a benefits-eligible spouse could immediately begin receiving a spousal benefit (defined as one-half of the retiree's monthly benefit).

File-and-suspend was a key component in many retirement plans. Financial institutions even developed software and built marketing campaigns around integrating other assets to best implement this approach. In instances where one spouse had a higher earnings history and was still working, while the other was not working or had lower lifetime earnings, the file-and-suspend option could result in thousands of dollars in additional benefits. A website posting for a law firm specializing in file-

and-suspend said, "We often saw couples who could receive over $70,000 in additional benefits."

But in one swift act, these strategies have been eliminated. Under the new provisions, individuals can still file-and-suspend their personal benefits. But spouses can no longer receive a spousal benefit from an individual who is suspending benefits.

The government claimed that closing this loophole will save the Social Security retirement fund $9.5 billion each year. Bob Rosenblatt, in a November 3, 2015, *Huffington Post* article said some government officials felt file-and-suspend "gave upper-income retirees a chance to game the system." Yet Rosenblatt quoted experts who said file-and-suspend was used by "lower-middle-class families with disabled children" and that "women with low and moderate incomes were also important beneficiaries of the strategy."

As part of a comprehensive budget bill, these changes were apparently hastily inserted, and caught almost everyone by surprise. The first version, approved by the House of Representatives, generated so much negative outcry that the Senate immediately revised or modified some of the provisions, and added a six-month transition period, through May 2016, before the changes will take full effect.

"We're throwing out the old rules."

Unintended Consequences Already Apparent

Even with the re-writes, Lawrence Kotlikoff, a professor of economics at Penn University, and expert on Social Security, quickly found several perverse incentives in the new laws. Writing in a November 2, 2015, article for PBS, Kotlikoff observed that some couples would be better off if they got divorced:

> The budget deal provides a huge incentive, up to $120,000 in some cases, for married couples to get divorced, "live in sin" and then get remarried at 70. Take a couple in which each spouse is now 63. Neither can file and suspend over the next six months because neither will reach full retirement age by then. But if they get divorced, they will be able, at full retirement age, to each collect a full spousal benefit based on each other's work records while waiting until 70 to collect their own retirement benefit. You need to be divorced for two years before you can collect on an ex, so this couple would have to get divorced by 64 in order to start collecting their full spousal benefit at 66. Can working couples under age 62 do the same? No, because they will be deemed to be filing for their own retirement benefit at full retirement age if they file for their divorcee spousal benefit and will end up with the larger of the two amounts.

A financial incentive for divorce is problematic. Even worse, the changes give bitter exes a chance to punish a divorced spouse by withholding benefits. Again, from Kotlikoff:

> (A) nasty ex-spouse can cancel the spousal benefits of his ex by filing and suspending even though doing so provides no advantage to himself. Take Sue who was unhappily married to John for decades before Sue called it quits. John earned a lot of money. Sue earned very little. Sue and John are now both 66. John plans on waiting until 70 to collect his retirement benefit. Sue files for her divorcee spousal benefit. John, who is a nasty person and hates Sue, chooses to file and suspend his retirement benefit, and poof, there go Sue's benefits for four long years.

Kotlikoff concluded with this stinging critique:

> No retiree will ever again be able to feel their Social Security benefits are safe from some backroom, midnight, rushed change in rules that are designed to meet some budget target or accommodate some politician's whims.

While we might be sympathetic to Kotlikoff's outrage, these changes shouldn't come as a surprise. This is how the system works. Based on current exigencies, the government reserves the right to change the rules.

The Prudence of Personal Planning and Private Contracts

These changes underscore the desirability of financial instruments and strategies whose benefits are not so dependent on legislative approval. Many of these "non-governmental" options are contracts with guarantees (such as **annuities, life insurance policies, or fixed mortgages**) that have clearly specified conditions. Changing the terms of the agreement is difficult, and not something one party can impose unilaterally on the other. And if a financial institution fails to honor its agreement, a consumer can seek legal remedies.

There are some personal finance models that emphasize qualified retirement plans in long-term accumulation strategies. This perspective often assumes tax treatment and participation rules for retirement plans will remain essentially the same for the next 30 or 40 years. Given past history, this is a risky assumption, and not just because of the recent changes to Social Security. Congress has made numerous "adjustments" to qualified retirement plans over the past four decades, concerning things like loan provisions, contribution limits, and required withdrawals.

Government-endorsed benefits are certainly part of the personal finance landscape, and their use and impact must be part of any planning conversation. But relying on their stability just isn't rational, considering legislators have the authority to change the terms of the deal at any time – and have shown they will. ❖

HOW MUCH IS YOUR PERSONAL FINANCE PROGRAM SUBJECT TO GOVERNMENTAL CHANGE?

DOES YOUR FINANCIAL COURSE HAVE THE FLEXIBILITY TO CHANGE WHEN THE RULES DO?

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Life insurance programs are not immune to the challenges of life; unfortunate and unforeseen events can undermine the best-laid plans. What can consumers do if events have put this important financial protection at risk?

With a term life insurance policy, the arrangement is pretty straightforward: the only way to maintain coverage is to continue paying premiums. In contrast, a permanent life insurance policy includes an equity component in the form of cash values, giving policy owners options in regard to maintaining the policy and eventually receiving a benefit. But to slightly paraphrase Peter Parker/Spiderman, "With greater flexibility comes greater responsibility."

Among the options owners may have with a cash value policy (i.e., whole life, universal life, adjustable life, etc.) are:

- taking loans[1] against cash values
- using cash values to pay premiums
- allocating dividends[2] (if and when they are paid) to reduce premiums
- surrendering a portion of cash values with a proportional reduction in the life insurance benefit

These options may be a valuable resource to address other needs or opportunities. Sometimes, they simply allow the policy to remain in force in spite of difficult financial circumstances.

However, exercising these options can impact the performance of the policy, both in terms of cash value accumulation and total insurance benefit. And occasionally, policy owners may find that previous decisions to take loans or stop paying premiums have jeopardized the long-term stability of their policies. If this occurs, policy owners have some decisions to make, usually falling into two categories: to unwind the policy, or preserve it.

Unwinding a Policy

Unwinding a permanent life insurance policy typically involves two options: surrendering the policy, or suspending premiums and converting to extended term insurance.

In a surrender, the policy owner receives any remaining cash values and the policy is terminated. If the distribution exceeds total premiums paid, the owner may incur income tax on the excess.

Extended term insurance is a provision that allows the policy owner to use cash values to purchase paid-up term insurance equal to the existing benefit for a limited period. The length of the term depends on the cash value, and will usually be calculated to the day (i.e., "the extended term lasts for seven months, five days"). If the insured dies during the extended term period, the benefit will be paid. When the term ends, so does the protection.

Rejuvenating a Policy

Neglected insurance policies can be preserved or rejuvenated in a variety of ways. The simplest is to re-start premiums and/or repay outstanding loans.

If a policy has been kept in force with automatic premium loans (a typical contract provision that takes loans from cash values to cover unpaid premiums and maintain the benefit), paying premiums again is usually as simple as sending a check or re-establishing automatic withdrawals.

Accrued interest on proportionately large loan balances can cause a policy to collapse, because ongoing premiums and remaining cash values may not be sufficient to cover both insurance and interest costs. Before repaying loans, policy owners should have an agent prepare a projection of policy performance that includes the anticipated repayments. This can determine if the repayment schedule will restore a policy to healthy status or merely extend the date of its eventual lapse.

Some other restoration options vary by company and contract provisions. Restoring policies using these approaches will typically require an in-depth consultation with a life insurance professional. Some common options:

- **Elimination or reconciliation of a loan**, often accompanied by a reduction of cash values or insurance benefits. In effect, a policy owner sells off a portion of the policy to satisfy the loan.
- **Reinstatement.** Before submitting new premiums, the insured has to re-establish insurability, either by reporting updated medical information or submitting to a new underwriting exam. If medically approved, the insurance company may also require the payment of missed premiums to restore the policy to good standing.
- **A 1035 exchange to a new policy.** It may be desirable to update a life insurance program via a 1035 exchange. This process transfers both the cash values and cost basis of the original policy into a new policy. But this option is also dependent on current insurability, and new premiums will be priced at the insured's current age.

Protect Insurability, Maximize Insurance Investment

Your insurability is an asset, one that should not be forfeited casually, especially since there are no guarantees you will be able to obtain additional coverage at a later date. Life insurance benefits should never be surrendered without careful consideration of the consequences.

If you have stopped paying premiums, accumulated additional interest, or deferred loan payments on a cash value life insurance policy, now might be an ideal time to review its status and consider options to revitalize it. ❖

YOU MIGHT BE SURPRISED AT THE OPTIONS YOU HAVE, AND HOW A REJUVENATED POLICY CAN BRING EXTRA VALUE TO YOUR FINANCIAL ROADMAP.

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You've probably heard someone say "How can we do it so cheap? Because we eliminate the middleman!" It's an enduring model for attracting customers: a claim that one's product or service is better because it eliminates intermediaries that add cost.

Intermediaries are businesses or individuals who assist in connecting interested parties. For example, banks act as intermediaries between depositors seeking interest income and borrowers seeking capital. Intermediaries are necessary due to the imperfect nature of markets; some parties need assistance to transact an exchange of goods or services. In banking, most individual depositors are not well-equipped to assess the creditworthiness of prospective borrowers. And most borrowers don't have an extensive network of individuals with money from whom they can solicit funds. A bank serves as an intermediary, not only by bringing both groups together, but also by providing expertise in determining suitable borrowers, and appropriate rates of interest.

Intermediation is valuable, but comes with a price; depositors don't receive all the interest that borrowers pay, because banks have to be paid for their services. But to the extent the services of these "middlemen" can be streamlined or eliminated, transaction costs can diminish.

In the past decade, technology and the Internet have dramatically disrupted intermediary structures in various sectors of the economy. For example, since its 2009 introduction of a smartphone application to connect riders with drivers, the transportation network company Uber has dramatically disrupted the taxi business. According to Zachary Karabell in a November 7, 2015, *Wall Street Journal* article, "Uber is a high-tech middleman that is making the intermediaries of the past obsolete."

Zachary, a money manager for a global investment company, sees a similar sea change ready to occur in banking and investing, particularly for retail customers: "The financial world is one of the most mediated industries on the planet, and that is precisely what is about to change."

Expanding on this trend toward "Uberization" in finance, Zachary says:

"The most immediate change will be an explosion in peer-to-peer lending. Just as Uber returns us to a world where anyone with a car could offer a ride to anyone with a thumb, peer-to-peer lending is both new and old. Before there was a robust retail and commercial banking system, there were people with money to lend and people who wanted to borrow it."

Zachary isn't the only one who foresees an increase in peer-to-peer (P2P) lending. There has been a proliferation of financial commentary on P2P lending as a resource for student loan consolidation, home improvements, small business loans, credit card balance transfers, and other unsecured borrowing. In a July 2015 white paper from the Data & Society research institute, Alexandra Mateescu describes P2P lending as an "eBay for credit," that makes everyone potential lenders and borrowers.

P2P lending technology gives prospective borrowers access to literally millions of potential lenders – often at rates and terms more favorable than might be offered by a traditional lending institution. One P2P lending company reports its borrowers realize, on average, an interest reduction of seven percentage points. (This magnitude of savings is primarily because most P2P loans are used to refinance other unsecured, high-interest debt, like credit cards.)

On the other side of the equation, individuals have the opportunity for higher returns – albeit without the guarantees bank depositors receive. Reviewing the financial information of potential borrowers provided by the P2P lending platform, individual lenders set their own criteria for participation. They decide to whom they will lend, in what amount, and at what rate.

From this simple overview, it's easy to see how online P2P businesses could streamline several layers of intermediation, and theoretically provide better value for both borrowers and lenders. However, a streamlining technology also often generates new conflicts with existing mediating functions, particularly those overseen by governing agencies. Uber has encountered several regulatory challenges regarding the employment status of its drivers, and whether their operation requires them to be licensed. Similarly, the ability of borrowers and lenders to participate in P2P lending currently varies from state to state, depending on regulations that govern the types of loans that may be offered and the qualifications for lender participation.

Ironically, some new intermediaries have already arisen in the P2P arena. Mateescu notes that even though online P2P lending is barely a decade old, it really isn't peer-to-peer anymore. It's really an expanded marketplace for institutions and investors.

(T)oday, the majority of peer-to-peer loans are purchased by large investors like banks, hedge funds, and wealth management firms. The entry of these investors has motivated a growth of startups and other actors dedicated to advising investors, performing loan data analysis, and automating the investment process. The promise of disintermediation, or removing the banks from the equation, has given way to a wide array of intermediaries, including but not limited to banks.

Before Considering P2P, What About the Alternatives?

Some commentators see P2P lending as an attractive financial "entry point" for Millennials because they often have limited assets and minimal credit histories. This makes sense, since the predominant transaction in the P2P marketplace is an unsecured loan, payable in three to five years, usually for the purposes of consolidating or refinancing other unsecured debt.

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Compared to conventional options, the spread on these types of loans are attractive, for both borrowers and lenders.

But if your personal finances have progressed beyond the start-up phase, and you think you should clean up your unsecured debt, you may want to check other options that often have lower rates, and better repayment terms. Some possibilities:

Home equity loans. Because the loan is collateralized by the house, the interest rate will be lower. Many lenders permit interest-only payments for several years, and the interest may be tax-deductible.

Life insurance cash values. Cash value loans[1] are available at any time, and not subject to an approval process. Repayment terms are flexible, and interest costs can be partially offset by dividends[2] credited to the account.

Retirement account balances. The IRS permits loans from some retirement accounts as follows: (1) the greater of $10,000 or 50% of your vested account balance, or (2) $50,000, whichever is less. Loans must be repaid with substantially equal payments over five years, but the interest rate will usually be much less than an unsecured loan, even from a P2P lender.

Your unique circumstances may also present some other possibilities, such as borrowing from a friend or family member (the original peer-to-peer lending arrangement) or monetizing some other financial asset.

Instead of entering the P2P marketplace as individuals, prospective borrowers might do better to find an intermediary who can direct them to their best options.

Eliminating the middleman has appeal, but intermediaries exist because they help consumers make profitable financial decisions. Finding a trusted intermediary is often better than getting rid of one. ❖

[1] Policy benefits are reduced by any outstanding loans and loan interest. Dividends, if any, are affected by policy loans and loan interest. If the policy lapses, or is surrendered, any 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 distribution from the policy may also be subject to a 10% federal tax penalty.

[2] Dividends are not guaranteed. They are declared annually by the issuing company's board of directors.

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Rick Ray
Wealth Design Group
3040 Post Oak Blvd. Suite 400
Houston, Texas 77056
281.220.2700
rickray@wealthdesigngroup.net

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