

# Creative

wealth maximization strategies\*

 John Driscoll & Company, Inc.

5080 N. 40<sup>th</sup> Street, Suite 400

Phoenix, AZ 85018

Phone 602.957.7155 • Fax 602.956.7711

www.JDriscollCo.com

JUNE 2017



Both the English and Metric systems provide accurate measurements of distances, weights and volumes, but most Americans find it difficult to convert from one system to the other. For example, how far is a 26.2-mile marathon in kilometers? Even if you know that a mile equals 1.6 kilometers (and many Americans don't), and that a 5k race is the equivalent of 3.1 miles, the ratio of 1:1.6 just doesn't lend itself to quick conversion. (The answer is 42.2km).

It's the same with other English-Metric equivalents: Is 32 degrees Celsius hot or cold on the Fahrenheit scale? What about a person who weighs 130 kilos – is that light or heavy? If we knew the conversions, 89.6° F would be rather warm, and a 286-pound person would be quite heavy. But most of us are not fluent in both systems – we can't easily translate English to Metric, or Metric to English.

There can be a similar challenge with different financial calculations for retirement. On one hand, it may be represented as a lump sum. On the other, a monthly income. While both numbers are easily calculated, many individuals find it far more difficult to assess their relative value.

For example, look at the results from this 2016 study by Microsoft Research:

Respondents were sequentially presented (i.e., one at a time) seven retirement scenarios in which a lump sum was shown, followed by another seven using a monthly income.

The choices were as follows:

	<u>Lump Sum</u>	<u>Monthly Income</u>
1.	\$25,000	\$160/mo.
2.	\$50,000	\$319/mo.
3.	\$100,000	\$639/mo.
4.	\$200,000	\$1,277/mo.
5.	\$400,000	\$2,554/mo.
6.	\$800,000	\$5,108/mo.
7.	\$1,600,000	\$10,217/mo.

With each scenario, the respondents were asked to evaluate how adequate this amount would be for retirement, using a seven-point scale, with one being "totally adequate" and seven being "totally inadequate."

The title of the study, "The Illusion of Wealth and its Reversal," suggests an explanation for these results. When one option among two financially equivalent choices is seen as more adequate, this is an "illusion of wealth." Like our struggle to make English-Metric conversions, we over- or under-value one option because we lack the ability to easily think of one in terms of the other.

Two important facts: First, the lump sums and their corresponding monthly incomes are *financially equivalent*; the monthly income is derived from the purchase of a lifetime annuity using the lump sum as principal. Second, because each scenario was presented separately, respondents couldn't see the side-by-side progressions as listed above.

As expected, the lower amounts, as lump sums or monthly incomes, were considered least adequate; \$25,000, or \$160/mo., isn't much of a retirement. However, at the lower numbers, lump sums were seen as "more adequate" than the equivalent monthly income. But as the amounts increased, the monthly income choice became more desirable.

## In This Issue...

### THE SAME RETIREMENT IN FEET AND METERS

Page 1

### FOR OWNERS, IT'S DIFFERENT

Page 3

### FROM STICK HOUSE TO BRICK HOUSE

Page 4

### LESS DEBT IS BETTER FOR YOU

Page 5

\* 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.

This not only explains the illusion of wealth, but also its “reversal,” where monthly incomes have the illusion of wealth at higher numbers. Most households have a much greater financial sensitivity to monthly expenses; it’s their “English” way of measuring money. Even at higher monthly incomes, like \$5,000 or \$10,000, we still have a strong sense of their value.

At the same time, we have a less sure feel for lump sums. From our “English” perspective, we *know* \$160 a month is not adequate for retirement, but \$25,000? As a bonus check, that could *feel* substantial for many households, and convince us that it’s worth more than a measly \$160/mo. Except it’s not.

And as the numbers get bigger, most people lose all lump-sum fluency. They know \$1 million is a lot of money, but so is \$2 million, or \$4 million. But how it translates to monthly income, they’re not so sure. Consequently, the illusion of wealth tips toward monthly income.

### The Perils of Inaccurate Conversions

While a majority of respondents saw monthly incomes as more adequate at higher levels, some did not. And that speaks to another finding from the study: how you view lump sums-vs-monthly incomes likely impacts both your saving and spending.

In a March 27, 2017, Wealth Management feature produced by the *Wall Street Journal*, two of the researchers involved in the Microsoft study commented on these ramifications, using a retirement example of \$1 million vs \$5,000/mo., beginning at age 65. (In the Microsoft study, retirement started at 68, which resulted in higher monthly incomes per lump sum.)

Shlomo Benartzi and Hal Herschfield stated that people who see \$1 million as more adequate than \$5,000 a month might overestimate their wealth, and under-save for retirement. Conversely, people who favor \$5,000 a month over a \$1 million lump sum may suffer from an “illusion of poverty.” Because they incorrectly assume that \$1 million equates to less than \$5,000 a month, they may be reluctant to spend, even when they can afford to.

### Another Odd Piece of the Annuity Puzzle

In the Microsoft study, the monthly option is a lifetime income, i.e., an annuity, which means the retiree receives a monthly check as long as they live. That’s different than selecting a lump sum, where there’s a chance of outliving your accumulation.

This preference for monthly income is another twist on the psychology of what’s called the Annuity Puzzle. Since at least the mid-1960s, economists have produced analyses showing that retirees should convert more of their assets to annuities at retirement because the strategy eliminates the risk of running out of money while offering comparable income. Bob Seawright, in a February 2012 *ThinkAdvisor* article, says annuities are 25-40 percent cheaper than do-it-yourself options (like drawing from a lump sum). Richard Thaler, a noted financial behaviorist, is another annuity advocate: “You increase consumption and eliminate risk at the same time... Who says there’s no such thing as a free lunch?”

But despite clear evidence of the value of annuities, relatively few retirees choose them. They are reluctant to make the irrevocable decision of handing a lump sum to an insurance company, then possibly dying before life expectancy and perhaps not receiving full value from their deposit.

The irony here is that people in the Microsoft study *preferred annuities* at higher income levels – perhaps because they weren’t identified as annuities, but defined by their income benefit. It’s another case of the financial language getting in the way of understanding the value.

### One Language for Accumulation, Another Language for Distribution

Is one way of representing retirement information superior to the other? From experts, there is a distinct bias toward framing retirement in terms of monthly income. In “The Crisis in Retirement Planning,” a July-August 2014 *Harvard Business Review* article, Robert Merton puts it succinctly:

**“Our approach to saving is all wrong: We need to think about monthly income, not net worth.”**

The Microsoft study is a little less strident, but agrees: “We speculate that perceptions of wealth as an annuity are more likely to lead to satisfactory choices because it is easier to estimate a month’s expenses than to estimate expenses over all of retirement.”

That said, retirement planning today consists of two distinct phases, accumulation and distribution, with

prevalent measurement languages for each phase. Accumulations are typically presented as lump sums. This is arguably the most accurate format, because the lump sum will not become income until retirement. When retirement begins, and how accumulations will be affected during the time between now and then (by investment losses, extra deposits, early withdrawals) is impossible to predict.

But since retirement planning is the process of providing regular income from accumulated assets, it is essential to have the ability to translate lump sums to projected income. Individuals need fluency in both formats.

The Microsoft study offers a simple rule of thumb for converting lump-sum accumulations into monthly income: **1/200**. Assuming they begin at 65, monthly annuity payments are roughly 1/200<sup>th</sup> of a corresponding lump sum. Thus, a \$100,000 lump sum yields \$500 of lifetime monthly income. Or, to flip it, \$10,000 of monthly retirement income requires a \$2 million lump sum. The actual numbers will vary, depending on a multitude of factors, but pre-retirement, this rule of thumb offers a simple way to convert the numbers and assess your progress.



**What Language Are You Using for Your Retirement Plans? ❖**

1. 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 a financial professional for guidance and information specific to your individual situation.



If you were asked to list the fundamentals of personal finance, you might include the following:

- live within your means,
- control debt,
- manage risks, and
- save for the future.

These are fairly universal actions; they apply to everyone's personal finances. But execution of these basics can vary significantly – in priority, timing and proportion – depending on the source of your income, and your status as an employee or owner.

Much of the generic advice in personal finance is intended for employees, i.e., people with regular paychecks, simply because they represent the majority of economic households. In the employee paradigm, wealth management consists of allocating income on a monthly basis (often using automatic withdrawals) to build savings, pay for insurance, or fund retirement. For employees, the only intersection between their work and personal finances is the income they earn; when they get a paycheck, that money immediately becomes part of their personal finances.

In contrast, the distinction between work and personal finance for self-employed entrepreneurs and small business owners is fluid; what's "business" and what's "personal" often changes. And while the lifetime earnings from a successful business may exceed a typical employee's wages, this income will fluctuate, and perhaps include times where there isn't enough to meet current expenses. These factors mean entrepreneurs and small business owners can't "do" personal finance like employees.

### A Different Mindset

Every time an entrepreneur or small business owner realizes a profit, they have a decision: to move the money to their personal finances, or re-invest it in their business, with the hope of increasing profits and equity.

This ever-present question of whether to re-invest profits impacts long-term planning as well. Where employees are focused on saving enough to fund a future retirement, an entrepreneur or business owner knows a prosperous company is also a potential retirement asset. An owner can sell the business, and use the proceeds for retirement. Or he/she can hire management, and "retire *in* the business," continuing to collect the profits, while keeping many of the tax advantages that come with ownership.

This business-centric perspective doesn't always mesh with personal financial programs that attempt to project a steady progression of accumulation leading to retirement. As Garrett Gunderson, founder of a consulting firm that works exclusively with businesses, puts it:

(F)inancial planners look at where your finances will be when you hit age 65, whether that's in 10, 20, 30 years or more. Entrepreneurs, by contrast, focus on cash flow over the next few weeks, months and a handful of years at most.

Gunderson offers another interesting, perhaps counter-intuitive observation about entrepreneurs and small business owners: they may be *more risk-averse* in their personal finances than employees:

(E)ntrepreneurs wonder why anyone would take the risk of putting money into the stock of companies you don't know, understand or control. It is difficult enough to keep up with everything going on in the boardroom of one company, let alone a diversified portfolio with hundreds of companies.

### Different Priorities, Different Strategies

A sampling of commentary from consultants who work extensively with entrepreneurs and small business owners suggests three areas where personal finance has to be done differently.

**Get Risk Management Right – For Business and Personal.** Because business and personal finances are often inseparable for an entrepreneur or small business owner, risk management needs to address both sides.

For the business, this could mean legal structures, like a corporation or LLC, to segregate the business from one's personal affairs. It certainly means insurance, particularly liability protection, as an unfavorable legal judgment can end a business. (A 2015 report by specialty insurer Hiscox found that one in five small to mid-sized businesses will face legal actions from employees, with an average defense cost of \$125,000 for attorney's fees or settlement costs.)

Risk management on the personal side is just as important. Nelly Alkalp, in a November 2015 *Forbes* article, understands the reluctance to take money out of the business for personal insurance "but it's a huge mistake to neglect your personal needs," especially since the owner is the company's most important asset.

This means health insurance, disability coverage...and life insurance. "The younger you buy life insurance, the better," says Alkalp, citing lower premiums and the possibility that future health conditions might make you uninsurable. And since life insurance may often be required as collateral for business loans, having it before you need it is simply good planning.

**Make Cash Reserves a Priority.** Adequate cash reserves are critical for both the business and personal finances of entrepreneurs. In terms of "financial planning," the first use of profits that are not reinvested is to build cash reserves. Per Matt Lloyd, of MOBE.com (MyOwnBusinessEducation):

As a business owner, liquidity is your strongest ally. (T)ake that excess cash and start building a war chest for when your business needs it most, or when that perfect opportunity arises, such as acquiring a competitor that complements your operation.

A "war chest" means a \$1,000 emergency fund isn't going to cut it. The 3-6 months of living expenses often recommended for



employees? Probably not. Jason Papier, president of a Silicon Valley financial management firm, told *Entrepreneur* in an April 2013 article that he recommends entrepreneurs “have one year’s worth of personal expenses set aside in a liquid account for an emergency.” That’s a sizable amount. But as Gunderson notes, “If your business hits hard times, you won’t have to finance payroll on your American Express card at 18 percent interest.”

**Delay Retirement Plan Contributions.** Some of the strongest and most consistent advice to entrepreneurs and small business owners relates to contributing to retirement plans. Or rather, not contributing to them until later in the life of the business. In the same April 2013 *Entrepreneur* article, Peter Dunn, another small business consultant, estimated that 95 percent of his clients “paused retirement saving,” while reinvesting in their business. Some additional commentary that reflects this point of view:

- **Lloyd:** Every dollar you sock away is a dollar that could have funded your business’ growth...(E)very time your 401(k) balance drops, it’ll feel like a slap in the face. This feeling will only be compounded by the realization that your account’s overall health is largely out of your control, at least compared to the ongoing investments you make in your business, which fall completely under your control.
- **Capterra Finance Blog:** Investing business cash into stocks, bonds or mutual funds uses up your cash flow. Instead, save your profits to build up a reserve for rainy days, and, if you do decide to invest your business profits, invest in yourself and your company.
- **Gunderson:** Businesses are where true wealth is built, not in 401(k)s or IRAs. For most entrepreneurs, it’s best to reinvest and keep money inside of your business.

(To be fair, a few articles suggested diversification into retirement plans. But guess what? They are written by investment professionals recommending the products and services they provide. So the adage “When all you have is a hammer, everything looks like a nail,” might apply.)

**When it comes to their personal finances, entrepreneurs and small business owners shouldn’t try to act like employees. The basics are the same, but the circumstances of ownership often necessitate different strategies and priorities. ❖**



Whatever your financial condition, cash reserves are valuable; there is never a point where you can say you won’t need them.

But while cash reserves are desirable and necessary, the safety and liquidity they require have opportunity costs; this cash could perhaps yield better returns if placed in other investments. The perceived impact of these opportunity costs is magnified by the current low-interest rate environment. When many safe, liquid financial instruments credit less than one percent interest, it’s hard to be excited about keeping money in them.

It prompts the question: Are there alternatives? There are. Under the right circumstances, and with thoughtful planning, life insurance cash values could be an attractive destination for long-term cash reserves.

**Characteristics of Cash Values**

If you were looking for a good place to hold cash reserves, you would certainly want these features: security, liquidity, tax advantages, and higher returns. Here’s how cash values fit that criteria:

- Although cash value accumulations are not backed by the Federal Deposit Insurance Corporation (FDIC), the financial stability of insurance companies is in many ways comparable to, and some might argue, even exceeds that of banks. (More on this later.)
- In conventional whole life insurance policies, there are guaranteed accumulations<sup>1</sup>, as well as a history of consistent dividend<sup>2</sup> payments.
- Cash value policies from highly-rated life insurance companies have current annualized dividend rates in excess of 5 percent.
- Cash value increases are not subject to taxation while they remain in the policy.
- Policy owners may access cash values either as withdrawals or loans.<sup>3</sup> Taxation applies only if the amounts withdrawn exceed the total premiums paid.

If a cash value account existed as a separate financial instrument, everyone would consider it for cash reserves. But you can’t have the benefits of cash values unless you own a whole life insurance policy. And that means paying for a life insurance benefit.

With a permanent life insurance policy, premiums purchase life insurance protection and build cash reserves. In a typical premium schedule, these cash values accumulate slowly in a

policy's early years because a larger percentage of premiums are allocated to insurance costs, reflecting the insurance company's risk from an insured dying well before life expectancy. Consequently, a \$500 monthly premium will not result in \$6,000 of cash value at the end of the first year. (For some policies, there may be no available cash value until several years of premiums have been paid.)

Thus, life insurance cash values are not a good *starting point* for accumulating cash reserves. However, once you have cash accumulated, you may want to consider a *gradual transition* of these reserves into life insurance cash values. Two strategic elements to facilitate this transition: Paid-up additions and convertible term insurance.

#### Paid-Up Additions Rider<sup>4</sup>

Besides accumulating cash values through regular premium payments, the process can also be accelerated with additional premiums. In what might be considered analogous to extra principal payments on a mortgage, "extra" premiums are used to buy chunks of paid-up insurance and cash value, which is added to the existing policy. Paid-up additions can significantly increase cash values, even in a policy's first year.

However, to maintain its status as a life insurance policy and preserve some of the tax advantages, there are restrictions on how many paid-up additions can be purchased in a policy year, and how quickly the policy can be paid up. A primary factor in these restrictions is the size of the insurance benefit. And that's where convertible term life insurance may play a part.

#### Convertible Term

If you can't have cash values without having life insurance, and the size of the insurance benefit determines how much cash value can be added, how much permanent life insurance will you need for your long-term cash reserves? Nobody knows. But you can secure options to add permanent life insurance in the future with a large term insurance policy that has conversion privileges. This feature allows a policy owner to incrementally exchange portions of the term coverage for a permanent policy (or policies).

To illustrate: A 35-year-old male buys a \$2 million convertible term policy, which represents his current economic value. Over the next two years, he accumulates \$20,000 of cash reserves in a savings account (safe, but earning less than one percent). At 37, he converts \$200,000 of the term policy to a whole life contract (while keeping the remaining \$1.8 million term benefit in force), and systematically transitions his cash reserves into the policy, both as premiums and paid-up additions. He continues to accumulate additional cash reserves in the savings account, and at a later date, converts another \$200,000 to transfer these funds to cash values.

This approach delivers several important benefits:

- There is a high level of immediate life insurance protection at an affordable premium.
- By accumulating first in a bank account, there is enough total liquidity to manage the low cash values during a permanent policy's early years.
- At the same time, paid-up additions can accelerate cash value growth.
- Cash values currently have higher rates of return than savings accounts, plus tax advantages.
- The policy owner has flexibility to manage life insurance protection, determine premium allocations, and select future conversion amounts.

#### So... "Stick House, Brick House?"

Are life insurance cash values really a viable alternative for cash reserves? In an October 2012 article "*Banks Versus Insurance Companies, Which is Safer for Your Money?*" authored by the financial analysis company FSFG, there is a comparison between a stick-built home and a brick one:

Banks, the stick house, are good for storing liquid cash for short term needs due to their accessibility. Insurance companies, the brick houses, are the strongholds that best protect your savings from the many dangers that exist within the financial industry.

Do you have cash reserves that could be transitioned to whole life insurance with cash values? You'll always have a need for cash, and there may be real benefit in keeping some of it in a "brick house."

It might be worth your time to meet with a financial professional and see if the details of your personal finances are a good fit for this strategy. ❖

- 1 Guarantees are based on the payment of required premium and the claims paying ability of the issuer.
- 2 Dividends are not guaranteed. They are declared annually by the insurance company's board of directors.
- 3 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 loan 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 59½, any taxable withdrawal may also be subject to a 10% federal tax penalty.
- 4 Riders may incur an additional cost or premium. Rider benefits may not be available in all states.



**M**oney packs a tremendous physiological wallop. In general, the better our personal finances, the healthier we are, emotionally and physically. But when personal finances are out of balance, it can affect our productivity, relationships and personal well-being. And, right now a lot of American households – even those with high incomes – are out of balance. And stressed.

Consider these numbers provided by consulting firm PwC in their 2016 Employee Financial Wellness Survey, released in early 2017, regarding employees *earning \$100,000 or more*:

- 20% find it difficult to meet household expenses on time each month.
- 43% consistently carry balances on their credit cards (as compared to 32% last year).
- 27% find it difficult to make their minimum credit card payments on time each month.
- 22% use credit cards to pay for monthly necessities they can't afford otherwise.

Remember, these numbers aren't for low-income households. A sizable percentage of those with upper-middle class incomes are under financial pressure. What is the source of this pressure?

If you dig deeper into the PwC report, a big stressor is debt. Particularly, debt that was acquired at the beginning of their financial lives: student loans.



### The Burden of Student Loan Debt

PwC asked respondents with student loan debt about the impact it had on their ability to meet their other financial goals. For Baby Boomers and Millennials, four out of five said student loans had either a “significant” or “moderate” impact. (The percentage for Gen-Xers was a little lower, but still two out of three.) For those who said student loans affected their lives, the ripple effect was both financial and physiological:

- 65% found it difficult to meet household expenses on time each month, and 41% were using credit cards to pay for monthly necessities.
- 72% were carrying credit card balances, with 55% struggling to make minimum credit card payments.
- 81% reported being stressed about finances, and 32% said financial worries affected their productivity at work.

The report's summary statement: **Employees impacted by student loans are in worse financial shape than other employees.**

To which you might say, “Well, duh.” But is this awareness going to change American's borrowing behaviors? Actually, it may be happening.

### A Hidden Blessing from the Last Recession?

In some ways, the stress-inducing debt that American households carry today is a result of several generations of prosperity. While those who grew up in the Great Depression of the 1930s were reluctant borrowers, successive generations have become accustomed to borrowing; debt service has always been a budget fixture. But just like those who came of age during the Depression were cautious about debt, a similar reaction may be percolating among Millennials.

Citing studies by two University of California Berkeley economists, an April 1, 2017 *Wall Street Journal* article said households that “have lived through a high-unemployment environment spend significantly less over their lifetimes than those that haven't.” This behavioral change was particularly strong for people who were young when unemployment was high. In the same vein, the *WSJ* noted that even though unemployment is down and personal incomes are beginning to rise, inflation-adjusted spending declined. But saving is up.

### You May Be Able to Carry Debt, but It Weighs on You

For many American households, their first and most significant wealth management action should be getting their debt under control, then systematically paying it off. As the study shows, the benefits are more than financial. If this is your situation, be proactive about seeking assistance from a financial professional. ❖

This newsletter is prepared by an independent third party for distribution by your Representative(s). Material discussed is meant for general illustration and/or informational purposes only and it is not to be construed as tax, legal or investment advice. Although the information has been gathered from sources believed reliable, please note that individual situations can vary, therefore the information should be relied upon when coordinated with individual professional advice. Links to other sites are for your convenience in locating related information and services. The Representative(s) does not maintain these other sites and has no control over the organizations that maintain the sites or the information, products or services these organizations provide. The Representative(s) expressly disclaims any responsibility for the content, the accuracy of the information or the quality of products or services provided by the organizations that maintain these sites. The Representative(s) does not recommend or endorse these organizations or their products or services in any way. We have not reviewed or approved the above referenced publications nor recommend or endorse them in any way.

## John Driscoll & Company, Inc.

5080 N. 40<sup>th</sup> Street, Suite 400  
Phoenix, AZ 85018

Phone 602.957.7155

Fax 602.956.7711

www.JDriscollCo.com

Registered Representatives and Financial Advisors of Park Avenue Securities LLC (PAS), OSJ: 5080 N. 40th St., Suite 400, Phoenix, AZ 85018, ph: 602-957-7155. Securities products and advisory services offered through PAS, member FINRA, SIPC. Financial Representatives of The Guardian Life Insurance Company of America® (Guardian), New York, NY. PAS is an indirect, wholly-owned subsidiary of Guardian. John Driscoll & Company, Inc. is not an affiliate or subsidiary of PAS or Guardian.