Creative

wealth maximization strategies*

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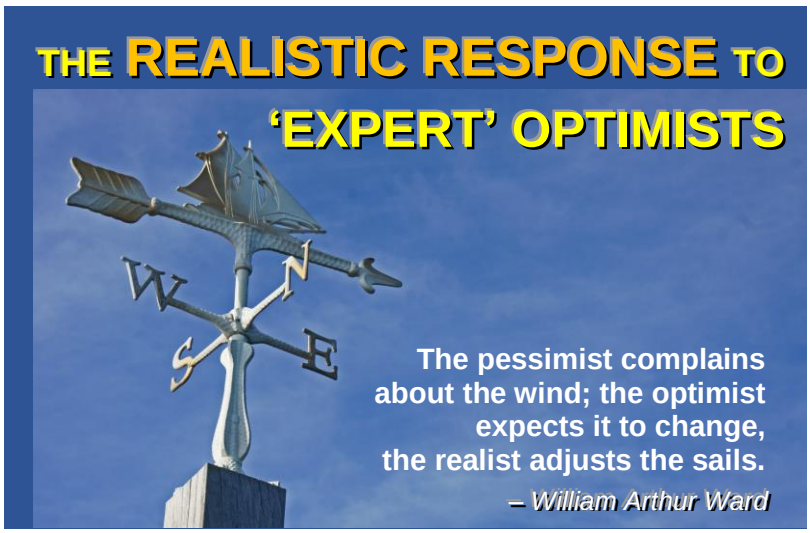
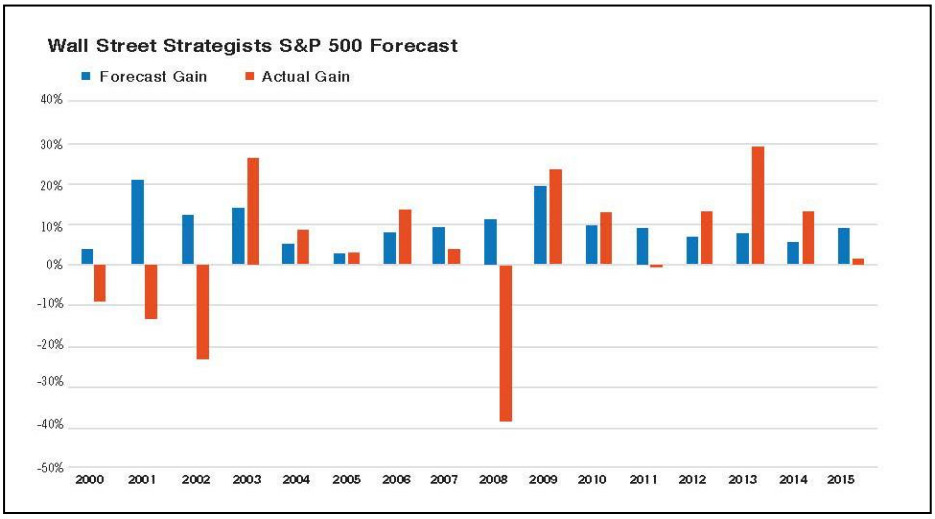


Mark Twain said that an optimist is a day dreamer more elegantly spelled. If Twain were alive today, he might add that an optimist is a financial expert who can't see trouble, even though it regularly shows up.

Since 2000, Birinyi Associates, a financial research firm, has tracked the yearly forecasts of 22 financial experts at Wall Street's biggest banks and investment firms. Every January 1st, these experts, called "chief market strategists", offer opinions on where the S&P 500 stock index will close on December 31st. In addition to recording their individual predictions, Birinyi also calculates the average expectations of the group, as a way of assessing the general sentiment of professional investors.

Considering the variables that can impact the economy, no one expects the chief market strategists, even as a group, to have a perfect track record. But as economics and finance columnist Morgan Housel notes in a February 2015 article, "You might be surprised at how disastrously bad it is."

The chart below shows the difference between the experts' average forecasted gain and the S&P 500's actual results for the past 16 years.



Several items stand out. Among the experts, optimism prevails. As a group, they anticipated positive returns ***every*** year. And it's not a case of two or three exuberant optimists skewing the group average; in 2015, every one of the 22 strategists was bullish. Yet four of the 16 years produced negative returns, and two posted results close to zero. Down or flat years aren't the majority, but they have occurred frequently enough that it would seem experts should occasionally predict down years.

The experts missed on the upside as well; positive returns significantly exceeded expectations in eight years, sometimes by 100 or 200 percent. In all, Housel calculates that the strategists' forecasts were off by an average of 14.7 percentage points per year. Depending on where you live, your local meteorologist might be more accurate.

In This Issue…

To hammer home the point that predictions from individuals with impeccable credentials and superior resources aren't worth much, Housel compares their record to what he calls the Blind Forecaster: "He's a brainless idiot who assumes the market goes up 9% – its long-term historic average – every year regardless of circumstances." And guess what? By a narrow margin, the Blind Forecaster is more accurate; his degree of error is only 14.1 percent.

Poor economic prognostication isn't limited to Wall Street and the stock market. Bankers and government economists follow the same pattern: they are relentlessly optimistic about the economy, and regularly surprised by downturns.

The Federal Open Market Committee (FOMC) is a Federal Reserve committee that determines monetary policy based on its assessment of the economy's future prospects. On a quarterly basis, they issue a "Summary of Economic Projections" to elaborate. But much like the Wall Street market strategists, this group of bankers struggles to accurately anticipate the future. And they admit as much.

A research report published in February 2015 by the San Francisco branch of the Federal Reserve titled "Persistent Overoptimism About Economic Growth," found that: "Federal Open Market Committee participants have been persistently too optimistic about future U.S. economic growth. Real GDP growth forecasts have typically started high, but then are revised down over time as the incoming data continue to disappoint." Further, the report confirmed previous studies which showed "the record of failure to predict recessions is virtually unblemished." Bad stuff happens, but optimistic experts never see it coming.

Government experts at the Congressional Budget Office (CBO) also acknowledge their shortcomings as predictors of future economic trends. However, they take some comfort in believing their errors are in line with everyone else's. In their 2015 Economic Forecasting Record Update, using sophisticated statistical analysis, the office concludes:

> CBO's forecasts generally have been comparable in quality with those of the Administration and the *Blue Chip* consensus. When CBO's projections have proved inaccurate by large margins, the errors have tended to reflect difficulties shared by other forecasters.

Their math might be accurate, but there isn't much comfort in hearing, "Hey, we might never get it right, but at least we aren't more wrong." The overwhelming conclusion remains: financial experts are irrationally optimistic and ill-equipped to spot trouble before it occurs. Which prompts two questions…

1. Why do people listen to forecasters who are so consistently wrong?

Housel weighs in: "I think there's a burning desire to think of finance as a science like physics or engineering. We want to think it can be measured cleanly, with precision, in ways that make sense. If you think finance is like physics, you assume there are smart people out there who can read the data, crunch the numbers, and tell us exactly where the S&P 500 will be on Dec. 31, just as a physicist can tell us exactly how bright the moon will be on the last day of the year. The belief that finance is something precise and measurable is why we listen to strategists."

How Strong is Your "FINANCIAL INSURANCE" Program?

John Mauldin, a finance and economics columnist who regularly appears on the cable business channels, says people want to believe strategists because "the idea that markets are inherently messy and disorderly frightens them. It's much more comforting to think that someone out there has a crystal ball that you just haven't found yet."

Mauldin adds another reason people listen to forecasters - they want a scapegoat: "The only thing worse than being wrong is being wrong with no one to blame but yourself." Forecasters keep their jobs despite their manifest cluelessness because they are willing to be the fall guy."

2. Why don't people make financial insurance a higher priority?

Think about it. These chief strategists, Federal Reserve committee members, and CBO economists aren't poorly-educated con artists trying to fleece ignorant consumers. They have high levels of education, access to the best information, and they want to do a good job. **But if the smartest financial minds in the world can't foresee economic peril, the only reasonable response is to obtain insurance.**

This practical response seems to resonate when considering real assets like homes and automobiles. Nobody says "auto insurance is a waste of money" or "just skip it, you'll probably never need it." But the odds of the S & P 500 having a down year might be higher than your having a vehicular accident. In light of the inability of experts to avoid losses, doesn't financial insurance make sense?

For most of us, financial insurance is about guaranteeing time and money. Remember the Blind Forecaster? His accumulation formula is simple: predict 9 percent each year, and make regular deposits, through ups and downs, until personal experience matches the long-term average. Over the long haul, this steady approach can overcome the uncertainties that even the smartest people can't see coming. But the problem for most people is their ability to stay in the game.

They don't have the financial insurance that makes it possible to implement this incremental approach. They don't have the "insurance" of safe or guaranteed assets, so they can't withstand the losses from the inevitable down periods. They don't have income insurance that would allow them to remain invested during a job loss, disability, or even death. These financial instruments are available, yet often undervalued or ignored. You

may not impress your friends with your "financial insurance plan," but if you want the best chance to succeed in a world where even the best and brightest can't see what's coming, **risk management is essential.**

Optimism is a healthy, even necessary, character trait; negative people rarely achieve their dreams. But believing that someone really does have an economic crystal ball – and that they are willing to share it with you – isn't optimism. It's delusion. If you want to be optimistic about your long-term financial prospects, base it on a foundation of financial insurance. ❖

HOW STRONG IS YOUR "FINANCIAL INSURANCE" PROGRAM?

NOTE: S&P 500 Index is a market index generally considered representative of the stock market as a whole. The index focuses on the large-cap segment of the U.S. equities market. Indices are unmanaged and one cannot invest directly in an index. Past performance is not a guarantee of future results.

How Two Health Care Laws Uncovered A "Bulked Up" Retirement Account

The moment a new law is enacted, someone is wondering if there is a way to take advantage of it. This dynamic is frequently seen in financial regulation. Lawmakers use taxes and incentives to generate revenues and influence group behaviors, but since there is rarely full knowledge beforehand as to how the populace will respond, every new regulation comes with the prospect of unknown consequences – and sometimes, opportunities.

A current example of uncovering unexpected opportunities can be found in Health Savings Accounts, and changes resulting from the Patient Protection and Affordable Care Act (PPACA).

Introduced in 2003, Health Savings Accounts currently permit individuals with qualifying high-deductible health insurance plans to contribute up to $3,350 annually on a pre-tax basis for anticipated out-of-pocket medical expenses (the threshold is $6,750 for a family, with an additional $1,000 if over age 55). Any earnings on the deposits are tax-free, as are withdrawals – as long as the money is used for qualified medical expenses. In addition, unused balances are allowed to accumulate. After age 65, HSA funds can also be used to pay insurance premiums, including Medicare and long-term care insurance.

Similar to an IRA or other qualified retirement plan, withdrawals for other purposes are taxable as regular income. However, if funds are withdrawn before age 65 for non-medical reasons, a 20% penalty is applied.

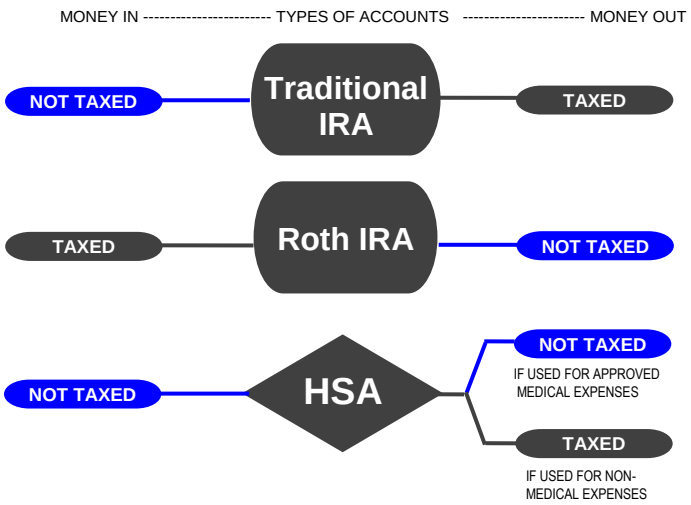
On introduction, the HSA was sort of a "niche" program, intended to defray medical expenses for households without comprehensive coverage, usually the self-employed or those working for smaller companies that didn't provide employer-sponsored health insurance. That changed with the passage of PPACA.

Although PPACA was signed into law in 2010, several provisions did not take effect until January 2014, including the mandate that all individuals not covered by an employer sponsored health plan, Medicaid, Medicare or other public insurance programs had to secure an approved private-insurance policy or pay a penalty. Combined with a provision that insurers could not decline applicants based on pre-existing conditions, many more Americans found themselves either maintaining or buying health insurance at significantly higher rates compared to previous years. Faced with rising premiums, some opted for higher-deductible plans. This approach reduced premiums (although most were still higher than before) but left individuals with greater financial exposure; potential out-of-pocket costs were higher.

Almost immediately, the HSA received increased attention as the affordable complement to high-deductible insurance coverage. This increased awareness also sparked some other *non-health insurance observations*: a few financial experts came to the conclusion that an HSA could be a better retirement vehicle than an IRA. In a March 2014 article, Retirement Management Analyst Dana Anspach called the HSA an "IRA on steroids," explaining:

> "Where else do you get to contribute tax-deductible dollars and withdraw them tax-free? Health insurance premiums and medical expenses of some kind are a certainty. Why not pay for them with tax-free dollars? I can think of almost no downside to funding an HSA instead of an IRA. If you don't need your HSA funds for medical expenses or insurance premiums then after age 65, you can use the money just like funds in your IRA or 401k."

Tax benefits of HSAs vs. retirement



Besides the increase in households buying individual high-deductible health insurance, HSA eligibility got another boost. Premium increases prompted some larger companies to manage costs by replacing comprehensive medical coverage with high-deductible health plans for their employees, sometimes including an allocation to fund an accompanying HSA. And that got some creative thinkers wondering…

Could an HSA be better than a 401(k) – *even with an employer match?*

In the January 2016 *Journal of Financial Planning*, University of Missouri professor of accounting Greg Giesler published an article titled "Could a Health Savings Account Be Better than an Employer-Matched 401(k)?" The professor's answer: Yes, most definitely.

Because of its substantial tax savings at contribution, and no tax cost at distribution, Giesler calculates an HSA has a much higher after tax future value (ATFV) in comparison to a 401(k), where contributions are deductible but distributions are taxable. Even when an employer matches a portion of a worker's 401(k) contributions, the ATFV of an HSA is still higher under most circumstances. A 401(k)'s advantage is greater only if the employer makes a 100% match on employee contributions. In all other circumstances, in every marginal tax bracket, the HSA prevailed.

Giesler also observes that the comparative tax savings between a 401(k) and a Roth 401(k) are primarily dependent on whether the tax rate at distribution is higher or lower than the rate when the funds were deposited. A higher future tax rate favors the Roth account, where deposits are made with after-tax dollars, with growth and distribution tax-free. A lower future tax rate makes a 401(k) attractive because of the deduction on deposits.

Mainstream personal finance commentators may still see the 401(k) as a default funding priority, but a number of experts who have run the numbers say things have changed. As Geisler says near the end of his article:

> "The emergence of HSAs requires reexamining the traditional financial planning advice to first take advantage of the maximum employer-matching contribution to an employee's 401(k)."

During the debate over PPACA, Nancy Pelosi, the Speaker of the House, said "We have to pass the bill so that you can find out what's in it." She probably wasn't thinking that one of the "finds" would be a tax-free "super account" that might be more attractive than an employer's 401(k). But then again, you never know what might come from new financial legislation, especially after some inquisitive, outside-the-box thinkers have a chance to dig into the details. ❖

WHO IS YOUR "GO-TO" FINANCIAL PROFESSIONAL FOR UNCOVERING UNIQUE OPPORTUNITIES IN FINANCIAL REGULATIONS?

There are words and phrases that we hear and read so often, we sometimes forget their original definitions. For the sake of clarity, here is a glossary of terms – with their appropriate definitions – relevant to this conversation.

An **asset** is something that can be used, either now or in the future, to generate income. By this definition, assets are more than financial instruments such as stocks and bonds; a business is an asset, and so is one's ability to earn income. (And while real properties can be assets, a personal residence is not an asset for many households. If their home is sold, the proceeds won't generate income, but will be used to acquire new living accommodations.)

An **asset class** is a group of assets with common financial characteristics, including the tendency to perform similarly in changing market conditions. There are many ways to classify assets, but some commonly used categories are Equities, Fixed-income, Cash Equivalents, Real Estate, Guaranteed Accounts, and Commodities.

Correlation is an assessment of how different asset classes respond to changing economic circumstances. Assets classes that respond to a change in similar ways are said to have a ***positive correlation***, while asset classes that move in opposite directions from the same change have a ***negative correlation***. If one asset class is not affected by an event, relative to other asset classes, it is considered to have a zero correlation, and is sometimes referred to as an ***uncorrelated asset class***.

Diversification is a financial strategy of combining asset classes with different correlations to reduce the overall risk of loss. Instead of trying to select "winning" asset classes in an ever-changing world, diversification attempts to moderate loss; when some asset classes are down, the hope is that others will be up.

Some experts argue that diversification also reduces overall returns, but a financial model known as **Modern Portfolio Theory** (MPT) has shown that a prudently blended mix of asset classes not only reduces risk but delivers maximum returns. MPT was first articulated in the 1950s, and in 1990 the originators of the concept received a Nobel Prize in Economics for its importance in financial planning.

Because the value is not contingent on market conditions or timing, **life insurance** can be a significant uncorrelated asset.

The Uncorrelations in Life Insurance

One of the key elements for successful application of the MPT strategy is identifying uncorrelated asset classes, i.e., those whose performance doesn't zig or zag in relation to others, but remains stable. In this paradigm, a number of economists have begun to reconsider the place of life insurance, particularly whole life insurance, in a diversified portfolio.

In 2008, insurance expert Richard Weber and actuary Chris Hause produced a lengthy (109 pages) white paper titled "Life Insurance as an Asset Class: A Value-Added Component of an Asset Allocation." In it, the authors explained, in detail, why life insurance could be a valuable uncorrelated asset class in an individual's portfolio when there is an underlying lifetime need for life insurance.

Two aspects of a whole life insurance policy can be considered uncorrelated assets: The insurance benefit and the cash values. A May 2011 article from Reuters ("Insurance: The New Asset Class?") characterized the insurance benefit as an "options contract," because there is an agreement between the policy owner and the insurance company that a guaranteed asset – the proceeds paid to beneficiaries – will be delivered if and when the insured dies. Because the value of this asset is not contingent on market conditions or timing, it can be a significant uncorrelated asset.

In addition, Weber and Hause find the "living benefits" of the cash values have "the dominant characteristic of a fixed account with a minimum guaranteed return." These guaranteed values, along with potential dividends*, accrue systematically and are minimally impacted by the volatility of other asset classes. While an insurance company's investment returns are a component in declared dividends, other internal factors, such as administrative expenses and mortality costs, also factor in these distributions. A life insurance company doesn't need a rising market to deliver a healthy dividend.

True to the MPT model, including life insurance as a distinct uncorrelated asset class can not only reduce risk, but also produce better returns. Weber and Hause provide a detailed mathematical analysis in which a combination of life insurance and bonds delivers superior long-term accumulation results compared to a bond-only account while decreasing investment risk. Weber and Hause conclude:

"Permanent life insurance intended for a lifetime can produce at least as favorable a long-term return with less risk within a portfolio of equity and fixed components than a portfolio without life insurance."

For a variety of reasons, from financial globalization to central bank interventions in national economies, it's become harder to find truly uncorrelated assets, ones whose performance is minimally impacted by external events. This realization has coincided with recognition of the unique asset class features in life insurance. While it cannot tout the opportunity for high returns, within the context of Modern Portfolio Theory, life insurance can be a foundational uncorrelated asset that reduces risk and enhances financial health. ❖

IS YOUR LIFE INSURANCE AN UNCORRELATED ASSET, OR JUST AN EXPENSE? IS IT TIME TO FIND OUT?

Strategy: Pay Life Insurance Premiums with Portfolio Earnings

One of the psychological hurdles in deciding to include whole life insurance in your financial program is the requirement of regular premium payments, possibly for the rest of your life. (Which could be a long time.) It is possible to purchase lifetime insurance protection on shorter schedules or with a single premium, but some of these options greatly diminish the tax advantages on the cash value accumulations. **To maximize the living benefits of whole life, the policy must be capitalized with smaller payments over time.**

In many households, premium funding comes from budgeted income; i.e., the amount of earnings set aside for regular savings. But if you already have accumulated assets, there may be other ways to meet ongoing premium commitments. Earnings from existing assets (in the form of interest, dividends or capital gains) can be collected (instead of left to compound) and used for premium payments.

This strategy has several possible advantages. First, it requires **no additional out-of-pocket funding**. Second, the gradual **transfer of earnings** from one asset class to a whole life policy results in the establishment of another uncorrelated asset class (life insurance) in the portfolio. Third, regularly skimming earnings from non-qualified accounts effectively "**flattens the tax**" since earnings, while taxed annually, are no longer compounding into ever-larger tax bills each year. Fourth, the addition of a permanent insurance benefit to a portfolio may improve future "spend-ability," because the life insurance benefit can allow for a spend-down of other assets instead of keeping a large portion in reserve for surviving spouses or heirs.

Premium Sources

Before age 59½, a typical earnings-to-pay-premiums scenario will involve non-qualified accounts, i.e., those held outside of a qualified retirement plan such as a 401(k), IRA or Roth account. This is because the penalties on early withdrawals from qualified plans are often prohibitive. (However, in some circumstances, taking qualified funds in a systematic 72(t) distribution might prove workable. This option requires expert assistance.)

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Since interest, dividends and distributed capital gains will fluctuate, some provisional planning will be necessary; what happens if there aren't enough annual earnings to pay the premiums? This means selecting a premium well below anticipated earnings, adding outside funds to make up the difference, or liquidating some accumulated principal.

In some instances, it may be desirable to systematically liquidate an existing account to pay premiums. The effect is an **asset transfer**; over time, an old asset becomes a new life insurance asset.

After 59½, qualified retirement accounts may be a suitable premium source, especially if it appears a portion of the accumulation will not be needed to provide immediate retirement income. For those with taxable distributions (including the required minimum withdrawals that begin at 70½), sending a portion to a life insurance policy establishes a new tax-advantaged asset. Accumulated cash values can be a tax-favored source of supplemental income, and the tax-free death benefit can be valuable in estate planning.

Integrate to Innovate

There is a school of financial thought that insists on keeping life insurance separate from investments. It sees insurance only as an expense, and thus seeks to minimize its cost and use. But for those who understand how life insurance can function as an asset, the challenge is to properly integrate it with other asset classes, and pay for it.

Compounding is an impressive financial concept. But if you have existing assets, now might be a good time to consider ways to multiply your financial benefits by repositioning earnings.

A financial professional using this holistic approach can often find innovative ways to reposition or redirect existing assets to make the hurdle of regular premium payments just a simple step to a better future. ❖

* Dividends are not guaranteed, and are declared annually by the company's board of directors.

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