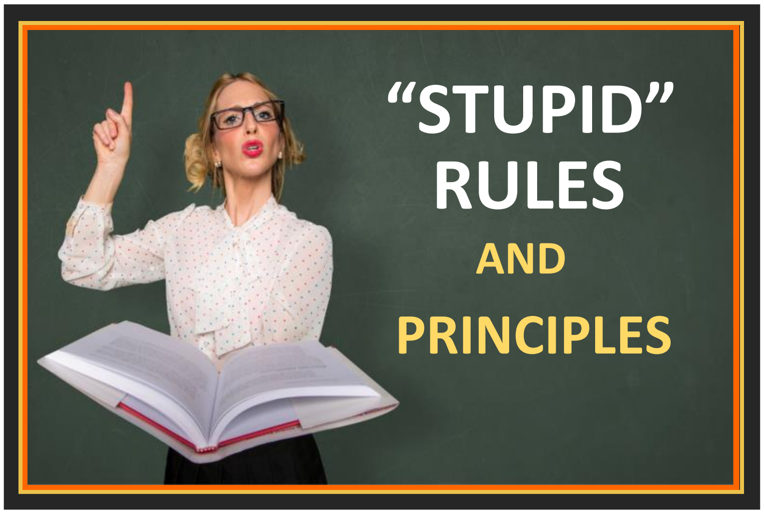
the SAFFER financial group

April 2019



An investment professional who publishes a daily newsletter of market commentary was asked by one of his readers ***"Do I need a budget?"***

The investment professional said, "Probably not." Rather, he said, the best way to become a successful investor was to first engage in "radical saving," to save as much as humanly possible, even to the point of mild discomfort. This means forgoing even small indulgences to build a financial safety net as fast as possible. "Only after you have established good saving habits should you start investing."

Then the publisher allowed that some people, because they have no fiscal discipline, must follow a budget:

"I am sorry that these people exist. As many others have observed before me, rules are for the stupid."

Whoa. Didn't see that coming, did ya?

Rules are for the stupid? And there are "others" who have arrived at this conclusion before he did? Time for fact-checking. An Internet search of "rules are for the stupid" doesn't generate a match. But it does bring up this quote:

**"Rules are for the guidance of the wise,
and the obedience of fools."**

This statement is attributed to Harry Day, a World War I ace in the British Royal Flying Corps. And although Day applied it to aerial combat decisions, the newsletter writer's mangled version reflects the same behavioral insight: some people can't function unless they have rules to follow.

The Difference Between Rules and Principles – and the Tension

In psychology, and particularly in behavioral economics, the distinction between rules and principles, and how people respond to them, is a hot topic. Sometimes it appears rules are more effective, and sometimes it's principles. The distinction between the two terms? Productivity consultant Francisco Saez offers the following definitions:

- **Rules** are standards "which must be complied with because it has been agreed within a community."
- **Principles** are "fundamental ideas that govern someone's thought or behavior."

Rules are specific instructions that clearly delineate "good" or "bad." Principles are broader statements, usually accompanied by supporting logic, but often without a specific course of action.

In This Issue…

* 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.

Rules and principles can also be seen as a distinction between external and internal motivation. Saez elaborates: "Although both things determine the way you act and make decisions, rules are imposed from the outside and must be obeyed to avoid incurring some kind of penalty, whereas principles are internal, and motivate you to do what you think is right or correct."

A budget is an external imposition, while radical saving usually arises from an internal drive to achieve.

RULES: Pros & Cons

The prevalence of numbers in personal finance makes it easy to establish rules, because mathematics is a rule-based discipline (2 + 2 = 4. Always. That's a rule.) It is possible to manage your personal finances exclusively by using rules – no principles required.

In 2010, Charles Farrell, an attorney and investment adviser, published *Your Money Ratios,* a book of formulas in which "readers need only to plug their income and age into Farrell's ratios to get an instant picture of their overall financial health, as well as a road map for the important choices they must make in the future." And it's easy. Says Farrell: "If you know how old you are and how much you make, you can master retirement planning."

Farrell's book is representative of the strengths and weaknesses of a rule-based approach.

Rules make clear distinctions; clarity helps people act. Rules, especially ones embraced by a large segment of the populace, are psychologically reassuring; there is comfort in knowing our decisions align with the majority. Adherence to rules can insulate us from public humiliation should our plans under-perform; after all, we were "just following the rules."

Rules have downsides, too. A failure to keep to a standard can be frustrating *("There's no way I can save 20 percent each year!")* and over time, lead to despair *("We'll never have enough to retire.")* Following rules might keep us from pursuing better options. If your rule for saving is 15 percent of annual income, you might not consider saving 25 or 35 percent in a prosperous year, even though that extra could be valuable if you have a few years of under-saving.

And, as one lawyer says, "Rules are things you get around by clever thinking." We have a tendency to shortcut rules, frequently to our detriment. Didn't save enough last year? Maybe you're clever enough to achieve a higher rate of return instead. (Usually accompanied by greater investment risk, i.e., a greater chance of not succeeding.)

PRINCIPLES: Pros & Cons

Rules are abundant in personal finance, but there are plenty of principles, too. Even though money can be quantified with numbers, there are diverse perspectives on financial success.

Some principles have broad consensus, like living within one's means and saving; no one argues against that. But others generate more debate: Is tax-deferral really the best format for retirement accumulations? Should a personal residence be considered an investment or an expense?

Unlike rules, principles leave room for flexible interpretations and creative solutions. For example, buying new equipment could be a "retirement investment" for a small business owner because of an anticipated increase in revenue. A permanent life insurance policy could be the liquidity for an estate plan, or supplemental retirement income* – and the decision might not be made until much later.

Principled decisions require a higher level of personal responsibility; you have to "own" the decision and formulate a plan of action. Principle-based decisions may be unconventional, which can be uncomfortable; if the results are less-than-favorable, you don't have the alibi of "Well, I was just following the rules."

What Works?

In theory, principle-driven decisions may be more desirable, but that doesn't make rules bad, or rule followers stupid. There are some interesting studies on how default enrollment (a "rule") affects employee participation in retirement plans. Automatic enrollment is found to increase participation, but the most aggressive savers are those who ***voluntarily*** exceed the default percentages. Those who entered under automatic enrollment tended to not initiate increases, but simply accept the default percentage.

A general observation is that rule-keepers may under-perform those with principle-driven motivation but out-perform those with no guiding principles; a rule-centric financial plan is better than having no plan.

Rules or Principles? Yes

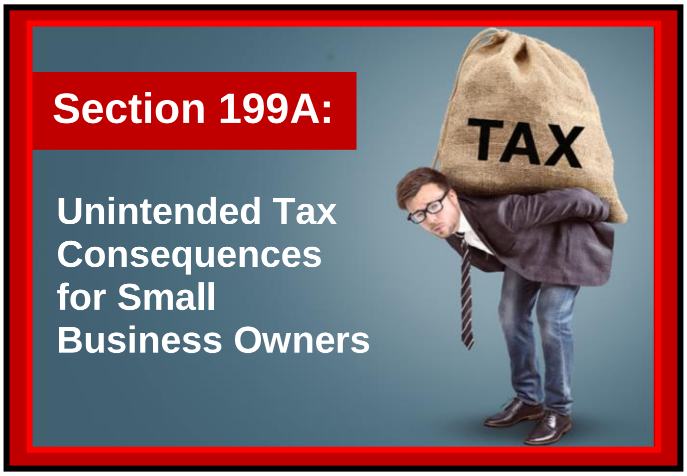
In an ideal world, simple rules derived from solid principles make for easy and wise decisions. Unfortunately, rules and principles often get disconnected: we may follow the rules while being ignorant of the principles behind them. Or we might agree with a principle, but not know how to translate it to a specific action. The best outcomes occur when we know our principles, and know that our actions are aligned with them.

But that level of engagement is a lot of work; you have to be deep into your financial plans to achieve this integration of rules and principles. Or you could collaborate with your financial professionals. They should be able to articulate the principles and recommend rules that fit. So…

- Do you know your financial principles?
- How well do you follow your own rules?
- Do you know the guiding principles of your financial professionals?
- Do your relationships with these professionals make it easier to act on your principles?

If you know your principles, rules aren't stupid. Rules make principles easier to live by. ❖

* 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.



In December 2017, Congress enacted "once-in-a-generation" income-tax changes, which took effect in 2018. Some changes were obvious: increases for standard deductions, elimination of personal exemptions, and caps on deductions for state and local taxes. For other changes, the consequences are just now coming into focus.

One of the reasons for the delayed understanding is the complexity. Take Section 199A. This new regulation, per taxadviser.com, "allows taxpayers other than corporations a deduction of 20% of qualified business income earned in a qualified trade or business, subject to certain limitations." Clarifying the limitations required 247 pages of guidance from the Internal Revenue Service, and it wasn't released until January 18, 2019 – more than a year after the law went into effect.

In a February 2019 article *("How the New QBI Deduction-Reduction Ruins the Value of Pre-Tax Retirement Plans for Small Business Owners")*, CPA Jeffrey Levine says the "New deduction (is) a powerful way for many business owners to reduce their tax liability, (but) it comes at a price…complexity." And business owners eligible for the Section 199A deduction may find an unpleasant surprise. Per Levine:

(T)he Section 199A deduction will dramatically reduce the value of tax-deductible retirement plan contributions. (F)or some S corporation owners, a contribution to an employer-sponsored retirement plan will effectively result in a *partial* deduction, but still subject the *entire* contribution, plus all future earnings, to income tax upon distribution."

This is a big deal. A business owner who makes contributions to a qualified retirement plan (like a SEP) does so under the assumption the deposits will be fully deductible from current income taxation, with the deposit and appreciation taxable as income on distribution. One of the possible consequences of Section 199A is that retirement contributions may in fact be only partially deductible when deposited (even though the tax return suggests otherwise).

Section 199A: The (Very) Short Version

In August 2018, *Forbes* issued an online review of Section 199A, based on what was known at that time. If you printed a copy, it ran 35 pages. Here is a summary of the most salient features.

1. The Section 199A deduction is available to any taxpayer "other than a corporation." This includes:

- Individual owners of sole proprietorships, rental properties, S corporations, or partnerships, and
- An S corporation, partnership, or trust that owns an interest in a pass-through entity.

But just because you are the owner of an entity "other than a corporation" doesn't mean Section 199A applies to you.

2. Section 199A then eliminates certain types of businesses and activities from eligibility for this deduction. Two broad restrictions: Some are disqualified if the business performs "services as an employee," others are excluded if they involve the performance of trades or services in select fields, (such as law, accounting, financial services, athletics, the performing arts), where the business's principal asset is the reputation or skill of one or more owners or employees. These exclusions are very specific and nuanced.

3. Once a business qualifies for Section 199A, it must determine its Qualified Business Income (QBI). A business may have taxable income from multiple sources, such as profits, rents, capital gains, etc., but not all taxable income is considered Qualified Business Income and eligible for a 20% deduction. And this is where the surprise comes.

A deduction taken from taxable income affects QBI. But depending on the specifics, the impact may be disproportional. Levine gives an example of a business owner named Robin who qualifies for a Section 199A deduction of $18,000. But if Robin decides to make a $20,000 contribution to her SEP, the 199A deduction will decrease to $14,000.

There are two ways to process this outcome. The first is to see a $20,000 deduction for the SEP contribution, and $14,000 for the Section 199A calculation, for a combined deduction of $34,000. This is how the transaction is reported on the tax return.

But from Levine's perspective (and other CPAs), a Section 199A deduction of $18,000 would have been available whether a SEP contribution was made or not. A $20,000 contribution to the SEP only produces $16,000 of additional deductions. However, because the $4,000 "difference" is deposited in the SEP, it will be taxed at distribution as if it had received a deduction when it was deposited – even though it did not.

Says Levine: "It's almost like Robin is making a $4,000 nondeductible contribution to a SEP IRA, but not getting any credit for basis for having made that nondeductible contribution!"

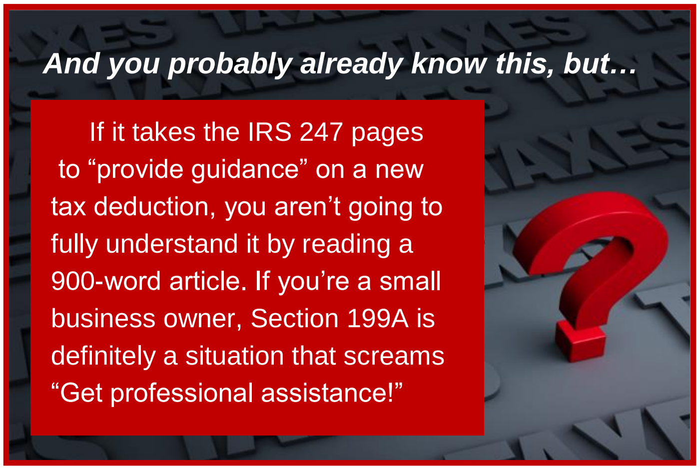
Levine concludes:

"The final regulations (for Section 199A) significantly expand the number of small business owners for whom there is now a reduced (yes reduced!) incentive to make tax-deductible contributions to employer plans.

(continued…)

"There are ripple effects which make it necessary to take a fresh look at every element of a business owner's tax plan, including which type of retirement plans will really provide maximum benefit in the future!"

Did Congress intend to decrease retirement plan deductions for small business owners? Probably not. But that's what can happen with new rules. If you're a small business owner, you might want to explore or revisit alternatives. ❖



"Who Knows Dad's Passwords?"

Ooh. That question makes you uneasy, doesn't it? Without any context, you know something is amiss. If no one knows the passwords, that uneasiness ticks up a notch.

Imagine the level of anxiety when employees at a crypto-currency exchange were asked "Who knows the CEO's passwords?"

In early February 2019, Quadriga CX, a Canadian exchange service and storage vault for encrypted digital currencies like Bitcoin, Litecoin and Ether, announced that almost $150 million held by the company could not be retrieved. The company's CEO – who died suddenly on December 9, 2018, at the age of 30 – was the only one who knew the password to the exchange's digital vault, and after two months of looking, it was still "lost."

Gerald Cotten, the CEO, was hyper-aware of the security risks in his business. To protect the virtual currencies from digital theft, he regularly moved them offline – into digital "cold storage." But Cotten apparently left no record – on- or offline – of the passwords for these accounts.

Most likely, you're not the keeper of a password that controls millions of dollars of other people's money. But you probably have something in common with Gerald Cotten: You may be the only person who knows the passwords for your financial accounts and personal data. If something happened to you, could anyone else access that critical information?

The Proliferation of Passwords

Digitalization certainly has advantages in storage, portability and access. But the security of digital information remains a thorny issue.

The starting point for most digital security is a password. Almost every online vendor, retailer or service provider who regulates access to their products or services uses passwords.

Because of their gatekeeper function, passwords are valuable to data thieves. As of March 1, 2019, the Pwned Passwords website reported ***550 million*** real-world passwords had been the subject of data breaches, making "them unsuitable for ongoing use as they're at much greater risk of being used to take over other accounts."

To mitigate against password theft, many institutions insist on frequent password resets, sometimes monthly. To further deter hackers, sites increase their password complexity, requiring numbers, symbols, upper- and lower-case letters. For consumers, these protocols produce an expanding list of ever-changing, increasingly-complex passwords, far more than most of us can memorize or recall without a written reference.

This torrent of passwords has prompted the development of password retrieval systems, usually in the form of password manager applications.

Password Managers

The specifics will vary with the application, but in general, password managers include the following features:

- **A master password** that, when accessed, can automatically call up the passwords for corresponding websites.
- **A storage center/vault** for other confidential information, such as credit cards and brokerage accounts, scanned legal documents and personal notes.
- **Connectivity across multiple authorized devices** – a desktop, laptop, smartphone, etc. Data entered in one device is instantly updated in all other connected devices.
- **Automatic generation of new, random passwords.** For sites that require lengthy, complex passwords or frequent resets, the application does the job, and remembers the new sequence.
- **The option to include another designated user.** Security consultant Roger Grimes relates his experience: "I'm growing older. My wife is worried about me unexpectedly dying and leaving her without appropriate access to my critical financial accounts. I installed another instance of the password manager on her computer, told her the master password, and showed her how easy it is to logon to any website I have."

(continued…)

Obviously, if Mr. Cotten had shared his master password with another employee, things might have been a lot easier for the crypto-currency exchange. But password managers are not a silver bullet for password retrieval.

Some do not interface with all devices or browsers. The password retrieval and entry feature usually only works with internet-based browser logons; you may not be able to log onto your computer, smartphone or corporate network from a password manager.

And a single point of access also creates a single point for disaster. Says Grimes: "If you lose your master password or other identifying info, you could lose access to all your passwords at once." In the same vein, the single-sign on (SSO) feature means that if an identity thief steals a master password, he most likely gains access to all other passwords.

Back to the Pirates?

Password security and retrieval presents a security challenge akin to 16th-century pirates trying to hide their looted treasure. They wanted to keep the cache a secret, yet make sure trusted confederates could find it in case they were incapable of retrieving it themselves. But who do you trust, and how do you preserve the information? The options available then, while not fool-proof, still work today.

Memorize and regularly recall. Here's the founder of a tech company, and what he requires: "All my guys use a password complexity of greater than 64 characters for a password, which is never written down. It's just something you remember. Mine, for example, is 72 characters. To keep your memory fresh, practice typing it into an offline computer on a regular basis."

Move passwords to a non-connected storage device, like an SSD card, or a flash drive. Password information cached in a physical location offline eliminates the threat of online hackers.

Use "analog encryption." Write the master password on a piece of paper, using a code or other obscuring formats (like riddles or inside jokes). Then put the document in a deposit box, or family safe.

Moving the master password to a single location, known only by select individuals, and encrypted in a format that only trusted individuals can easily decipher, provides a high level of personal security.

The last two options are very similar to a pirate's treasure map. As long as the map stays in the possession of the intended beneficiaries, and as long as someone can decipher the information, no one has to worry about losing access to your family's critical digitalized files. ❖

If something should happen to you – an unexpected absence, a disability, a premature death – do you have a password retrieval protocol that a spouse, a child, or another trusted person can use to access your important financial information?

As of mid-February 2019, the Internal Revenue Service reported that the average tax refund from 2018 returns was down 17 percent, compared to the previous year. Considering that tax refunds represent an over-collection of taxes due, financial experts see smaller refunds as an indication of more accurate assessments of tax liability, a rare moment where a government agency seems to have improved its performance.

But don't tell that to the average American, who has been conditioned to view a refund as a "bonus" from Uncle Sam. They equate smaller refunds with smaller bonuses, and for some, that's not playing so well – even as the vast majority of taxpayers (approximately 80 percent) have seen their income tax burden diminish.

Over-Paying Is OK? Yeah, If You Get a Refund!

This brouhaha over smaller refunds is a classic case of framing; the way that a topic is presented impacts its perception.

Almost no one is excited about paying taxes; just think of the typical worker's reaction when they see how withholding reduces their take-home pay by 20 to 30 percent. It's not just the withholding that aggravates. Most workers are skeptical that any of this money will eventually return to them; most often, they perceive their taxes are paying for someone else's government assistance.

A refund, especially a large one, tends to ameliorate both the frustration at withholding and the sense that government doesn't deliver a benefit. Since the 1960s, about 70 percent of American taxpayers have received tax refunds each year. For 2017, the average refund was $3,256. Which is apparently enough to make many people forget that they overpaid their taxes.

"(M)ost taxpayers use refunds as a type of forced savings," say writers Brian Faler and Aaron Lorenzo in a February 22, 2019, article for *Politico*. Taking the spin on over-payment a step further, "Some also misinterpret (refunds) as an indication of how well they're faring under the tax system, presuming that if their refund goes up, they must be doing better."

So instead of grousing about over-paying, a tax refund has become an annual happy moment. It is money that retroactively pays for holiday spending, funds this summer's vacation, or makes a down payment on a new car. Merchants market to this reality, suggesting ways to spend your refund, even making loans against anticipated refunds.

Because the public has become accustomed to tax refunds, most Americans respond to the practice with a shrug. Yeah, we're over-paying our taxes and giving the government a tax-free loan, but hey, we got a refund! What's the big deal? Well, suppose the story was framed differently.

Inside a Different Frame, the Picture Changes

Imagine an alternate scenario in which a company was found to be systematically overcharging its customers, then refunding the difference once a year, but only after individuals submitted extensive paperwork to prove the excess costs.

Cable news networks would produce documentaries on the "shameful" actions of the company, fanning the flames of public outrage. Indignant politicians would most likely rail at the company and enact industry-wide legislation to prevent other companies from trying the same thing.

With so much bad press, the company would acquiesce to all demands for change, and politicians would take credit for standing up for their constituents. And no one would be saying, "Well, yeah, they over-charged me, but I got a refund!"

What About Your Frame?

If you received a refund of more than $5,000 this year, that's more than $400 each month that didn't have to be withheld from your earnings. Instead of accepting a forced savings that takes the money out of your pocket for a year, and delivers no return, what could that money be doing in your personal economy? It's a question worth pondering. ❖

When you look at the picture of your personal finances, the **frame** can shape your perspective.

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