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*wealth maximization strategies**

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# A Blast From the Past
(as in 1999)

## *"Plus ça change, plus c'est la même chose."*

This phrase, attributed to Jean-Baptiste Alphonse Karr, a 19th-century French literary critic and novelist, literally translates to "The more that changes, the more it's the same thing." Or, in plain English, "The more things change, the more they stay the same."

Jean-Baptiste probably didn't have 21st-century retirement planning in mind when he wrote those words, but they fit. Because despite what seems like constant changes in the financial services industry, things are pretty much the same. Here's some commentary from 1999, that appeared in this publication, about the planning process:

**"To help you plan (and attract you as a customer), a financial institution produces a brochure promising to show how much you need to save for retirement, or a college education for your kids, or a new home, etc. Inside are worksheets and charts to help you arrive at dollar amounts. Maybe there's even a software program you can install on your computer. After you 'do the math,' you will know exactly what's needed."**

Doesn't sound much different than today, does it? Banks, investment companies and financial professionals are still offering to help you find "your number." Only instead of software to download, it's an app on your smartphone.

And today, just like 20 years ago, it all sounds ***so precise***, so mathematical, so 2+2=4.

But why does one app say you need to set aside $500 a month for retirement, and another says $650? If it was a few bucks, no big deal. But that's a big difference! What's going on? Again, let's refer to that 20-year-old article:

**"Here's what's up. Even though everyone can say they "have the numbers to prove it", they are all guessing! The "number" is a mathematical projection, based on a series of premises… The program asks you to make projections about inflation, investment rate of return, your earnings, tax bracket, future costs, and whatever else can have a numerical guess attached to it. The end result? A number. One that most likely doesn't mean a lot. Or if it is an accurate number today, it will probably change tomorrow.**

**There's nothing wrong with guessing. The problem is that somewhere along the way, some of these guesses start being treated as facts because they have numbers associated with them. And sometimes, the guesses are wrong."**

***Hmmm…*** Sounds sort of "Plus ça change…" doesn't it? Guesses are still being treated as facts.

## 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.

### Projection-as-Fact: A Problem Then, and Now

In its critique of the problems with "projection-as-fact" in retirement planning, the 1999 article cited a list from Jonathan Clements of hard-to-project variables that could have an enormous impact on retirement. (At that time, Clements was five years into a 24-year run as the *Wall Street Journal's* personal finance columnist.) He mentioned:

- the irregular expenses of maintaining a home and replacing automobiles,
- the inexorable increase in medical expenses as one gets older,
- the desire to travel and have experiences before declining health makes those dreams impossible,
- and the need for paid assistance with daily living in one's old age.

That list is still relevant today. Hard-to-project variables will definitely impact your retirement. While a retirement plan built on guesses and projections might be better than no plan at all, consumers should be aware of their limitations.

Mr. Clements' proposal for resolving the dilemma with projections? It was simple:

**"You may want to save a tad more each year, or work a little longer, so your retirement portfolio is larger and thus can generate more income."**

Wow. Another insight from 1999 with that still holds true today. "Plus ça change," indeed.

### An Alternative Approach – Straight from 1999

Instead of relying on guesses and projections, the 1999 article offered an alternative, which began with a short fable:

***"Every morning in Africa, a gazelle wakes up. It knows it must outrun the fastest lion or it will be killed. Every morning in Africa, a lion wakes up. It knows it must outrun the slowest gazelle, or it will starve. It doesn't matter whether you're a lion or a gazelle… when the sun comes up, you'd better be running."***

What's the point? The only way either the lion or the gazelle can truly prepare is to *plan to run as fast as possible*. There are too many unknowns to think otherwise. From a planning standpoint, there's no telling what might happen with taxes, interest rates, inflation, technology, currencies, or political and civil unrest. You must plan to make as much as possible from every financial transaction.

This maximizing-the-present philosophy is applicable to every facet of retirement planning. For instance:

- **The primary goal is to accumulate as much as possible, not as much as is thought to be needed.** Don't be fooled into thinking that a projection made arbitrarily today will still be valid in the future. As long as you continue to earn money, you should be concerned about saving a part of it for your future.
- **It is also necessary to plan to spend as much as possible.** A financial program that concentrates only on *accumulating* overlooks an essential financial truth: Money only reveals its value for us when we spend it. Maximum spending is as important as maximum accumulation. Too many fortunes are wasted because of ill-planned spending.
- If all of your wealth is not consumed, **it becomes crucial to control the transfer of assets.** Often the major recipients of your "left-over" wealth end up being governments, financial institutions, and opportunistic people, instead of heirs or charities. Don't disperse it needlessly – know where the money will go if you don't spend it.
- Finally, **plan to succeed under all circumstances.** One of the weaknesses of the "projection-as-fact" method is the difficulty in adjusting to unforeseen problems. Risk management, using guaranteed accounts, insurance, tax strategies and legal documents, should also be part of your financial plan.

It may seem counter-intuitive, but maximizing your current financial transactions is the only valid long-term financial philosophy. Anything less runs the risk of having some unknown factor "outrun" you and eat up your finances. ❖

**ARE YOU RELYING ON SOME "PROJECTIONS" TO TELL YOU EVERYTHING IS "OKAY"? OR ARE YOU MAXIMIZING TODAY'S OPPORTUNITIES?**

## "The Bank of Mom and Dad" vs. Retirement

The Federal Housing Administration recently published data showing that, for the fiscal year ending September 2018, 26% of first-time home buyers received financial assistance from relatives, usually parents, to come up with the down payment. This compares to 22% of first-time buyers who had help from their families in 2011.

Some analysts see this increase in family support as indicative of a larger trend: Young adults are more reliant on their parents for financial support, and for longer periods. While the desire to help their adult children get a financial leg up is understandable, some experts think it might be time to pull the plug on what is often referred to as "The Bank of Mom and Dad."

"We love our kids, but they can ruin retirement," says Theresa Ghilarducci in a July 2018 forbes.com article. Ms. Ghilarducci is an economics professor who has often appeared before Congress to discuss the poor state of retirement saving in the United States. To buttress her reluctance to provide financial assistance for adult children, Ghilarducci cites a report from NerdWallet which finds that "A parent's retirement savings could be $227,000 higher if they chose to save the money that would otherwise go to their child's living expenses and tuition."

The same study reports that a significant number of parents are providing more than a down payment for their adult children:

- 28% have paid tuition or student loans
- 56% have bought groceries
- 40% are paying for their children's health insurance
- 21% are paying rent for children living outside of home

Ghilarducci isn't saying parents shouldn't offer financial assistance to their children. But some parents are "sacrificing their finances in old age by giving money to their adult kids," and from her perspective (which is admittedly focused on retirement), "One of the best things you can do for your kids is take care of yourself."

For Ghilarducci, taking care of yourself equates to having "$2-3 million saved for retirement" before offering to help with a down payment. Since the professor also notes that the median retirement savings for upper middle class Americans between the ages of 55 and 64 is around $100,000, her conclusion is clear: Many Americans would be better off closing their Bank of Mom and Dad.

How do you prioritize your children's financial well-being against your own? It can be tough.

## Thinking About the Bank of Mom and Dad

Be proactive about the topic of financial assistance to adult children. Don't wait until Junior comes to you with a financial "emergency/opportunity" that only you can solve. Decide in advance what you will or will not do.

A bit of Internet research finds the Bank of Mom and Dad is an interesting subculture in personal finance. It has its own acronym (BOMAD), several distinct philosophies, and a variety of strategies. Some things to consider:

## Is Your BOMAD a Charity or a Business?

A pivotal division in BOMAD thinking is whether intra-family financial assistance is an act of charity or a business transaction. As an example, consider a down payment on a home.

**Sometimes, the assistance must be charity.** A lender may require any down payment assistance to be classified as a gift, because a loan would further increase the adult child's indebtedness and perhaps make them ineligible for a mortgage.

**Money affects the relationship dynamics.** King Solomon noted in his Proverbs that "just as the rich rules over the poor, the borrower is slave to the lender." How many parents or adult children want a loan in the relationship, especially one that emphasizes an imbalance of financial power? If you don't want your children financially obligated to you, better perhaps to give them money instead of loaning it.

**Conversely, a family might see a loan as a familial and financial "win-win,"** a way to help a son or daughter while also improving the parent's finances. Suppose the parent liquidates some low-yield savings to make a loan to a child, perhaps at a rate less than an institutional lender. For the parent, this rate might be better than the earnings from savings. This transaction allows the money to be used today for the children, but also eventually replaces it, with a profit in the parent's portfolio, and decreases or eliminates the lost opportunity costs that would have occurred if the money was simply a gift.

## Planning for the Bank of Mom and Dad

Depending on your decision to operate as a charity or a business, here are some specific recommendations, culled from a number of websites and white papers.

### *If your BOMAD is a charity…*

- **Determine what you can afford to give.** It's easy to get parental, and just say yes to every request and, for the moment, feel good about helping out. A better approach: consult with your financial professionals and determine a dollar amount that can be given away without jeopardizing your other financial objectives.
- **Clarify your objectives for helping.** Identify items for which you would give (a down payment on a house) and wouldn't (a trip to Disney World). Hopefully, your gifts are catalysts for a better future, not just band-aids on unresolved issues.

### *If your BOMAD is a business…*

- **Have your children first seek institutional assistance.** Going through the loan application process can make them appreciate your willingness to help, and inform you of their ability to repay.
- **Put the loan in writing and keep good records.** Treat this like a business transaction, with the terms clearly defined. This is essential for resolving legal issues, settling estate and inheritance distributions, and clarifying tax consequences for both the parent and child.
- **Secure the loan.** Especially if the loan is for a home purchase, the agreement should confirm the lender's interest in the property should the child default.
- **Understand the tax consequences.** Intra-family loans are not exempt from tax laws. A parent may charge a below-market rate of interest, but must be aware of the "applicable federal interest rate," and how it may trigger imputed interest or gift taxes. If at some point the loan balance is forgiven, the IRS may consider the forgiven amount a gift, and subject to gift taxes. ***(Conclusion: it is best to seek professional tax assistance.)***

### *In addition…*

**A BOMAD could change how much you save and where you save.** Because of the penalties for early withdrawal, 401(k)s and other qualified retirement plans may be sub-optimal places for BOMAD saving. Look to your financial professionals for other options, ones that have better tax treatment on withdrawals, and favorable liquidity characteristics. ❖

The Bank of Mom and Dad has long been an essential resource for young adults to transition to financial self-sufficiency (a 2015 white paper called it "a source of comfort for everyone"). But well-meaning parents can unnecessarily disrupt their own finances by imprudent disbursements to adult children. If you're going to be the Bank of Mom and Dad, make sure your plans for operation are in place well before you open for business (or charity).


The personal-finance principle of "**Protection First**" is frequently referenced in this publication; preserving the value of assets you already have is one of the most effective ways to achieve long-term financial security.

Among those assets, arguably the most important is one's Lifetime Economic Value, the potential to produce income through one's work. For most of us, for most of our lives, our Lifetime Economic Value is our primary engine for wealth creation. Among all our assets, it is the one we most need to protect.

Insurance, where small amounts of money are collected from many policyholders to pay for the few losses that might occur in a given period, is an efficient method to provide this protection. Specifically, life insurance and disability income insurance are two ways individuals can protect their Lifetime Economic Value.

The logic of Protection First and Lifetime Economic Value is fairly simple and straightforward. But when it comes to execution, the details of insurance can sometimes distract consumers from adhering to a Protection First approach. This is particularly true with life insurance, where protecting Lifetime Economic Value is often derailed by a discussion of whether you should use term or whole life insurance. A more relevant first conversation is how to determine Lifetime Economic Value, and how to insure it.

### Lifetime Economic Value and Life Insurance

Insurance companies have underwriting parameters for how much life insurance they will consider offering an individual, and these guidelines can be used as a rough estimate of one's Lifetime Economic Value. This table, from a highly-rated American life insurance company, "reflects general life insurance guidelines equal to the present value of potential future earnings which would be lost at the death of the insured."

| Age | Maximum Life Insurance |
|---|---|
| 18-40 | 30 times income |
| 41-50 | 20 times income |
| 51-60 | 15 times income |
| 61-65 | 10 times income |
| 66-70 | 1 times net worth |
| 71-80 | 1/2 times net worth |
| 81+ | case by case |

The declining multiples as applicants get older reflect shorter time periods; a 51-year-old has 20 fewer earning years than a 31-year-old counterpart. And as people move into retirement, the criteria switches from their future economic value as earners to the future economic value of the assets they have accumulated.

Using this table as an estimate of Lifetime Economic Value,

- A 35-year-old with an annual income of $50,000 qualifies for $1.5 million of life insurance ($50k x 30).
- A 40-year-old with an annual income of $150,000 qualifies for $4.5 million ($150k x 30)
- A 45-year-old with an annual income of $250,000 qualifies for $5.0 million ($150k x 20)

### "Do I Really Need That Much Life Insurance?"

For some consumers, seeing their maximum life insurance number can be unnerving. "Do I really need that much life insurance?" they ask. "After all, I'm *(fill in the blank)*, and I don't have *(fill in the blank)*."

Regardless of how you fill in the blanks, the answer is the same: the maximum amount represents an insurance company's estimation of your Lifetime Economic Value. And the question that follows is: do you want to insure your full economic value, or just a fraction of it?

It's interesting to note that while some financial experts recommend obtaining the smallest amount of life insurance that will keep a spouse and children from poverty, insuring other assets for full value is the norm. We insure our homes for their replacement value, as opposed to what it would cost to buy a pop-up camper *("because I just need a place to live, right?")*. Same thing with our cars; even as their value declines with use (sort of like how maximum life insurance goes down with age), most of us continue to insure our vehicles for their current replacement value.

If you're going to do Protection-First, you ought to look at ways to insure your full Lifetime Economic Value today.

## Buy Lifetime Economic Value Protection Now

If you understand and agree with the Protection-First approach, you should consider securing maximum life insurance protection ***now.*** That statement may seem like hyperbole, but there are two compelling reasons to see it as true.

First, future insurability is not guaranteed. Second, insurability tends to decline with age. For healthy individuals, there may be significant advantages to obtaining the maximum amount of life insurance as soon as possible.

Consider the 35-year-old with an annual income of $50,000 from the previous list. Using rates from the insurance company whose maximum life insurance guidelines were shown above, a 35-year-old male no-tobacco user with a health profile that merits a "Preferred NT" rating could secure a 20-year level term policy for $1,410/yr. This policy includes a conversion privilege, which allows the insured to change some or all of the insurance benefit to a whole life policy at any time during the term. However, if the same individual is in excellent health, (defined as "Elite" by the insurance company), the annual premium drops to $975/yr. – a 30% reduction – for all 20 years. A 35-year-old female with an Elite risk profile would realize an even greater discount of 34%. (see chart below).

**PREMIUM COMPARISON***

| SEX | RISK STATUS | ANNUAL PREMIUM |
|---|---|---|
| M | PREF NT | $1,410 |
| M | ELITE | $ 975 |
| F | PREF NT | $1,290 |
| F | ELITE | $ 855 |

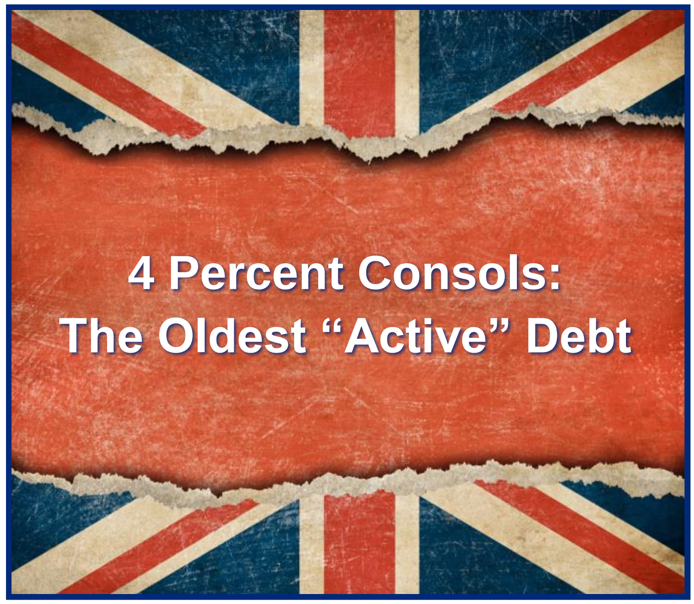
* Applicant is 35 years old, no tobacco use. $1.5 million life insurance benefit. 20-yr level term, with full conversion privilege, and premium waiver for disability.

A convertible term policy for the maximum amount of life insurance locks in a Lifetime Economic Value benefit today, with options to change the coverage in the future, including the ability to keep the protection in-force for a lifetime. And many insurance companies offer convertible ***30-year*** level term policies, which is not only a longer period of protection with fixed premiums, but plenty of time to determine how to best integrate a permanent life insurance benefit with the rest of your financial plans. The key is having protection equal to your Lifetime Economic Value ***now***, when you are most insurable.

## Protection-First Makes Sense

Is this more life insurance than you need? Maybe, probably not, who knows? Both you and the life insurance company believe your death is a long way off. Because you can't anticipate how much life insurance will be needed in the future, it's prudent to apply for the maximum today, then take as much as your budget will allow.

**A Protection-First approach to personal finance doesn't dismiss or de-emphasize the accumulation aspect of wealth building. It just recognizes the importance of protecting the asset that makes all accumulation possible: your Lifetime Economic Value.** ❖




Studying extremes can often bring great clarity to a topic. For example, to better comprehend the impact of the Earth tilting on its axis, look at how long or short the days are at the North Pole in summer or winter. And for greater insight into the principles of debt and borrowing, you might read up on 4 Percent Consols, thought to be the oldest debt still being paid.

### Issued in 1927, for debt going back to…?

"4 Percent Consols" is the financial term for 4-Percent Consolidated Loans, a series of bonds issued by Great Britain in 1927. As the name indicates, these bonds were a consolidation and re-financing of existing government debt. Much of this debt replaced war bonds issued by the government in World War I, which started in 1914. The 4 Percent Consols were to pay 4 percent interest until maturity, when the principal would be returned to the bondholders.

The Great Depression, which began in 1929, prompted the British government to engage in another round of re-financing, in which investors were allowed to exchange their 4 Percent Consols for perpetual bonds paying 3.5 percent. Perpetual bonds give the debtor the right to never repay the principal as long as the interest is paid.

A small portion of these converted 4 Percent Consols were retired in 1947, after World War II. In 2014, a century after the war that precipitated the debt, the government announced it would pay $349 million to retire about 10 percent of the outstanding bonds. The rest of the 4 Percent Consols continue to pay 3.5 percent interest, year after year, forever, or until the government decides to pay the principal.

As mentioned above, most of the debt re-refinanced with 4 Percent Consols was from World War I. But some was much older. In the 2014 pay-off, the British Treasury noted that some of the debt consolidated in the 4 Percent Consols is from borrowing initiated in **1720** and **1752**.

## A Different View of Debt

You aren't a national government; you can't consolidate and refinance for three centuries. But the British government's history of debt management might be instructive in shaping some alternative strategies for borrowing.

- **Choose the longest terms, and lowest payment.** Borrowing is leverage, where paying a small amount each month can control a larger sum immediately. To maximize this leverage, you want payment terms that require the least amount of your monthly cash flow.

- **Consolidate and re-finance as many times as necessary.** You should always be open to restructuring your indebtedness to improve cash flow or reduce interest costs. Yes, the long-term objective is to be debt-free, but financial stability (manageable debt, adequate reserves, and cost efficiency) makes the journey possible.

- **Absolutely, positively, under all circumstances, pay what you owe.** The long-term credit-worthiness of the British government is the only reason lenders have been willing to continually re-finance debt over three centuries. If your credit isn't good, you won't get the best terms, and you won't be able to consolidate or re-finance.

Beyond the curiosity of 300-year-old debt, it's thought-provoking to compare and contrast these observations with the exhortation by some financial experts that consumers should opt for shorter mortgages and/or make extra principal payments to pay off housing debt as soon as possible. Clearly, there are diverging opinions about how to use debt. ❖


**What debt strategies will work best for you? That's a great question to ask your financial professionals the next time you meet!**

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