Maximizing Your Good Fortune…

…through Financial Intelligence

> **“Everything is amazing and no one is happy.”**
> – Comedian Louis C.K.

The research has been done. The numbers have been crunched. The conclusions are clear, and they are discouraging. Americans are in bad shape: we don’t save enough; we have too much debt; we aren’t adequately prepared for retirement. And, oh yeah…we’re fat, too. At least that’s what can be concluded from surveys about the “average” American. But what does “average” really mean? And does it apply to you?

“Average” compared to what?

By definition, calculating an average means some data points in the analysis must be above- and below-average, regardless of what other measurements might indicate. For example, if you surveyed 500 millionaires, and averaged their net worth, some of the 500 would be “below average” millionaires, at least statistically. But does being a “below-average millionaire” mean you are an under-achiever? After all, you’re a millionaire! By itself, being above or below average may not be an accurate assessment of success or failure. Context matters.

In a January 29, 2014 article from themotleyfool.com, ***“50 Reasons We’re Living Through the Greatest Period in World History”*** economics and finance columnist Morgan Housel compares statistical samples from the past to make a persuasive case that the average American’s life has never been better than right now. All 50 reasons are worth reading (search: “morgan housel 50 reasons”), but here are a few that relate to personal finance:

#5. The average American now retires at age 62. One hundred years ago, the average American died at age 51. Enjoy your golden years – your ancestors didn’t get any of them.

#12. According to the Federal Reserve, the number of lifetime years spent in leisure – retirement plus time off during your working years – rose from 11 years in 1870 to 35 years by 1990. Given the rise in life expectancy, it’s probably close to 40 years today. Which is amazing: The average American spends nearly half his life in leisure. If you had told this to the average American 100 years ago, that person would have considered you wealthy beyond imagination.

#32. Incomes have grown so much faster than food prices that the average American household now spends less than half as much of its income on food as it did in the 1950s. Relative to wages, the price of food has declined more than 90% since the 19th century, according to the Bureau of Labor and Statistics.

#42. Adjusted for inflation, the average monthly Social Security benefit for retirees has increased from $378 in 1940 to $1,277 by 2010. What used to be a safety net is now a proper pension.

#43. If you think Americans aren’t prepared for retirement today, you should have seen what it was like a century ago. In 1900, 65% of men over 65 were still in the labor force. By 2010, that figure was down to 22%. The entire concept of retirement is unique to the past few decades. Half a century ago, most Americans worked until they died.

#49. You need an annual income of $34,000 a year to be in the richest 1% of the world, according to World Bank economist Branko Milanovic’s 2010 book *The Haves and the Have-Nots*.

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.

This non-statistical observation from Housel is perhaps the most profound:

#26. Google Maps is free. If you think about this for a few moments, it's really astounding. It's probably the single most useful piece of software ever invented, and it's free for anyone to use.

Compared to any time in recorded history, "average" Americans live longer, healthier lives, earn more money, have more leisure time, pay less for food and transportation, are safer, and better connected to the world around them **– and they can get free directions to anywhere in the world!** Housel's final reason summarizes this good fortune:

#50. Only 4% of humans get to live in America. Odds are you're one of them. We've got it made. Be thankful.

Overcoming Average with Uncommon Intelligence

Housel's data is a strong argument that it has never been easier for the average American to achieve a comfortable, secure material existence. Empirical observation supports this view. On a smart phone, the average American can access more financial information, buy more products, and obtain more technical assistance than a millionaire with a team of advisers from 1950. So why do so many other economic surveys paint a different picture, one which shows average Americans are stressed, in debt, unprepared for retirement, and 30-60 days away from bankruptcy if household income is disrupted?

It's not a lack of resources, but rather a lack of knowledge about how to use the plentiful resources available to us. **True financial intelligence is uncommon.**

More than 90% of the wealth in the world is held by less than 10% of the people. Sift through history, and while the exact percentages may move a bit, it has more or less always been this way: there is a wealthy minority and everyone else. Financial success isn't "average," but uncommon.

In the past, this 10-90 proportion might have indicated an "income inequality" problem, where a privileged elite exercised undue control over society, and perpetuated a monopoly on wealth to successive generations. There was no social mobility, no way for the poor to rise, or the rich to fall. But this is not the case in 21st century America.

Contrary to the cries of some politicians and social activists, upward social mobility today is not only possible, but the norm. The most recent "Billionaire Survey" by Wealth-X and UBS found that 65% of Ultra-High Net Worth individuals were "self-made," i.e., they didn't inherit their wealth but accumulated it during their lifetime. And conversely, much inherited wealth is dissipated within one or two generations.

The vast majority of Americans don't make money decisions like the 10% who hold the most wealth. The 90% have the tools, but lack the knowledge to maximize their productivity. For Americans who desire better financial outcomes, the solution starts with thinking differently, learning the perspectives and attitudes of the 10% instead of following the common financial myths that circulate among the 90 percent. Set aside the headline-grabbing exceptions involving greed and corruption; the wealthy achieve their success because of financial intelligence and lose their wealth when they get financially stupid.

Financial success – for anyone – can never be guaranteed. Unforeseen events can disrupt the best of plans. But there are time-tested actions that greatly increase the likelihood of achieving a comfortable level of financial satisfaction and security. The principal catalysts for upward financial mobility are: knowing these financial truths, and consistently applying them. And these steps are easier to achieve today than ever before.

Housel is right: "We are actually living through the greatest period in history." And there is no gatekeeper preventing you from accessing the financial intelligence you need to maximize your good fortune. Statistics may say the average American is struggling, but you don't have to be average. ❖

The wealthy achieve success because of financial intelligence. True financial intelligence is uncommon.

Retirement Income from Whole Life Insurance

If one of the certainties of life is change, it is prudent to consider financial products that can adjust to meet a variety of future circumstances.

The main purpose of life insurance is to provide a cash benefit to designated beneficiaries upon the death of the insured. However, permanent life insurance is a prime example of a financial "multi-tool" that can be reconfigured for different phases of life; perhaps for purposes other than anticipated when the policy was first established. One of these adjustments gaining attention in the financial media: using permanent life insurance as a source of retirement income.

In a May 12, 2013, *InvestmentNews.com* article, columnist Darla Mercado reported that "clients are jumping to talk to advisors about how to structure life insurance for retirement income." Why?

- Mercado mentions a "stringent income-tax environment," with limited options for tax-favored accumulation and tax-free distribution.
- A March 29, 2013, *Wall Street Journal* Wealth Adviser article cites "guaranteed tax-free growth and the ability to withdraw from the account as needed."
- Planning scenarios from a 2009 study commissioned by a large mutual life insurance company found that "a retirement income strategy incorporating whole life insurance…can **tame** a bear market by creating the flexibility to respond to changing economic conditions."

Income Options

Most of the recent attention from the financial press focuses on managed distributions from cash values, but owners of permanent life insurance should know several income options exist.

- Using a transaction known as a **1035 exchange**, life insurance policy cash values may be transferred tax-free to an immediate or deferred annuity. The life insurance policy's cost basis (i.e., the total premiums paid) becomes the annuity's basis. Taxation will depend on the difference between the basis and the amount transferred, and the format of distributions.

- **Managed Distributions** usually entail a combination of withdrawals and loans. These distributions may be systematic or irregular and, if executed according to regulations, income tax-free. However, most tax-free managed distribution scenarios require the policy to remain in force until death. If total distributions exceed premiums paid (quite typical for policies structured to deliver retirement income), income tax will be applied retroactively against the gain if the policy lapses or surrendered.

- **Collateral Assignments, Viatical Settlements**, and **Terminal Illness Benefits** may permit policy owners to access additional sources of income, based not on the policy's cash value but its death benefit. These amounts will depend significantly on the insured's age and health, and how the bank, broker, or insurance company values the death benefit.

Designing a Life Insurance Policy for Future Income

The typical schedule for a "whole life"[1] policy assumes premiums will be paid for the insured's lifetime. Some permanent policies can be fully "paid up" in shorter time periods (such as 10 years, or "by age 65"). This will accelerate cash value accumulation, and may also eliminate the need for premium payments in retirement.

Policy owners must be careful not to "overpay" premiums, either annually or in aggregate. If too much cash is deposited too quickly, the policy will be considered a Modified Endowment Contract (MEC) under IRS regulations. This status changes the tax treatment of distributions from the policy, and negates many of its tax advantages.

In these scenarios, a policy's design is often "reverse engineered," in that the insurance benefit is determined by the amount available for deposit, with an eye toward maximizing the cash value.

Taking Distributions

Distributions from a whole life policy can be taken either as withdrawals, loans, or both. A typical distribution strategy from a non-MEC policy begins with withdrawals up to the cost basis, and loans taken thereafter. This type of distribution does not incur taxation as long as the policy stays in force. Any distribution plan requires regular review to ensure the policy stays in force[2].

Some whole life contracts reduce their loan interest rates if these transactions take place after the policy has been in force for a specified period (such as 10 years), or if the insured is a certain age (like 65). Reduced loan costs can significantly increase the amount that can be distributed from a whole life policy designed for retirement income.

Permanent life insurance is **a financial "multi-tool"**:
- that can be reconfigured for different phases of life
- perhaps for purposes other than anticipated when the policy was first established.

Applications

Flexible, tax-free[3] distributions from life insurance cash values can have several uses in retirement income planning.

- Retirees can manage their tax obligations by blending income from taxable accounts with tax-free cash value distributions from a whole life policy.
- By using cash values as an occasional income supplement, retirees may avoid having to liquidate market-based assets at a loss; this approach can level out negative market cycles, and give market-based assets time to rebound in value.
- For those wanting income before age 59½, cash values can be a tax- and penalty-free option.

A Balanced Perspective

Most of the above examples employ cash values as an income supplement, used in conjunction with other retirement resources. This use exemplifies the multi-tool nature of whole life insurance: You decide when and how it will work in your financial program. When first established, the policy offers immediate protection against an untimely death. Over time, it can also offer tax-favored accumulation with favorable terms of access, guarantees and the expectation of steady dividends[4]. Positioned to remain in force for one's entire life, the policy may be used to address some long-term care and other end-of-life health situations, as well as provide certainty in estate planning.

The key to maximizing the benefits of a whole life insurance program is intelligently integrating it with the rest of your financial assets. For some, the accumulation features of a "cash-rich" policy may not be as important as maximizing life insurance protection, or securing an inheritance. The *WSJ* article mentioned above concluded with this comment from a financial professional who recently helped a doctor establish a new whole life policy as a place for savings in addition to his business' 401(k):

"There's still so much misinformation about using cash value whole life insurance as an asset class.

The key is that clients need to work with someone who is really going to help guide and advise them on how to best position this asset in their financial foundation." ❖

[1]Whole Life Insurance is intended to provide death benefit protection for an individual's entire life. With payment of the required guaranteed premiums you receive a guaranteed death benefit and guaranteed cash values inside the policy. Guarantees are also based on the claims paying ability of the company. Cash values may not appear and dividends may not be paid until the third policy year. Dividends are not guaranteed and are declared annually by the company's board of directors. Any loans or withdrawals reduce the policy's death benefits, cash values, and affects its dividend and guarantees. Whole life cash accumulation is reduced by insurance costs and company expenses and should be considered for its long term values.

[2]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 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 59½, any taxable withdrawal is also subject to a 10% tax penalty.

[3]Guardian, its subsidiaries, agents, and employees do not give tax or legal advice. You should consult your tax or legal advisor regarding your individual situation.

[4]Dividends are not guaranteed. They are declared annually by Guardian's Board of Directors.

A Primer on Progressive Taxation

Taxing the "seed" vs. taxing the "harvest"

One of the ongoing discussions regarding tax-favored accumulation is whether it is better for savers to incur taxes on the "seed" or the "harvest." Some tax-favored vehicles, such as Roth IRAs, require after-tax deposits (the seed), in exchange for tax-free growth and distributions. Other qualified retirement plans (like IRAs and 401(k)s) offer pre-tax deposits but impose tax on the distribution (the harvest). Which approach is better? Understanding of the history and dynamics of the progressive income tax in the United States can be helpful in making a decision.

Understanding Progressive Taxation

The basic idea is simple: As taxable income increases, a progressively higher tax is imposed. From its inception in 1913, the US income tax has followed this format. In theory, this arrangement means a greater tax burden is imposed on those who can most afford to pay it. In practice, the format has also included a slew of regularly adjusted exemptions and deductions, which can significantly increase or decrease one's individual tax liability. See the chart of The Current Progressive Income Tax Format from the IRS.

THE CURRENT PROGRESSIVE INCOME TAX FORMAT

2014 Taxable Income Brackets and Rates

Rate	Single Filers	Married Joint Filers	Head of Household Filers
10%	$0 to $9,075	$0 to $18,150	$0 to $12,950
15%	$9,076 to $36,900	$18,151 to $73,800	$12,951 to $49,400
25%	$36,901 to $89,350	$73,801 to $148,850	$49,401 to $127,550
28%	$89,351 to $186,350	$148,851 to $226,850	$127,551 to $206,600
33%	$186,351 to $405,100	$226,851 to $405,100	$206,601 to $405,100
35%	$405,101 to 406,750	$405,101 to 457,600	$405,101 to $432,200
39.6%	$406,751+	$457,601+	$432,201+

Keep in mind the difference between gross income and taxable income. As mentioned, most taxpayers will have a variety of deductions, such as dependents, mortgage interest, and charitable deductions that reduces their taxable income. But for a single filer with $200,000 in ***taxable income***, the total tax calculation would be as follows. This calculation produces two numbers that savers need to understand: the **Marginal Tax Rate** and the **Effective Tax Rate.**

Income	TaxRate	Tax
$9,075	10%	$907.50
$27,825	15%	$4,173.75
$52,450	25%	$13,612.50
$97,000	28%	$27,160.00
$13,650	33%	$4,504.50
$200,000		$49,858.25

Marginal Tax Rate: This is the tax rate for each *additional dollar earned*. In this example, the marginal tax rate is 33%. If additional income exceeds $405,100, the marginal tax rate would increase to 35%.

Effective Tax Rate: This number is derived by dividing the tax assessed by total income ($49,858.25/$200,000). In this example, the *effective tax rate* is 24.92%. Because the effective tax rate combines several different tax brackets, it will always be lower than the marginal tax rate.

The marginal tax rate gives savers an idea of the value of the deduction for pre-tax deposits. In the above example, a maximum contribution of $17,500 to a 401(k) results in a tax reduction of $5,582.50 ($13,650 of the deposit reduces tax at 33%, while the remaining $3,850 results in a 28% deduction).

Historical Perspectives

The following chart shows the number of tax brackets and the range of tax rates since 1963. It is a curious record. Both the number of tax brackets and the rates have increased ***and*** decreased over the past five decades. Although the top marginal tax bracket has dropped significantly since 1963 (can you imagine a scenario where 91 cents of every additional dollar earned was taken by taxes?), many of the deductions available to higher income earners have also been phased out.

Adjustments must also be made for inflation. The top bracket of 77% in 1964, if in force today, would apply only to the portion of income exceeding $2.9 million. However, today's top threshold of $406,750, which results in a 39.6% rate, would have correlated to a 56% tax bracket in 1964.

Year	# of Tax Brackets	Range of Tax Rates
1963	24	20 – 91%
1964	26	16 – 77%
1978	25	14 – 70%
1979	15	14 – 70%
1982	12	12 – 50%
1984	14	11 – 50%
1987	5	11 – 38.5%
1988	2	15 – 28%
1991	3	15 – 31%
1993	5	15 – 39.6%
2001	5	15 – 39.1%
2002	6	10 – 38.6%
2003	6	10 – 35%
2013	7	10 – 39.6%

Implications for Savers

The primary reason for using accumulation vehicles with pre-tax deposits is the assumption that the individual will be in a lower marginal tax bracket in retirement. Thus, the tax on distribution will be less than the tax savings received for the deposit.

So…**"What will my marginal tax rate be in retirement?"**

It's a challenging question. Any speculation about the future is iffy, especially since the rules will likely change. Since 1988, when taxes "bottomed out" with two brackets and a top marginal tax rate of 28%, there has been a move to more tax brackets, and higher marginal tax rates. Yet, adjusted for inflation, there is an argument that even those in the highest brackets today are paying less than in the past.

Other factors impact your answer. Households with dependents and mortgages may find their current marginal tax rate is lower because of these deductions. What happens 20 years later, when the kids are grown up and the house is paid off? Fewer deductions could mean a higher marginal tax rate, even with lower gross income.

If you are a prodigious saver, a possible result under current regulations is sizable mandatory distributions from pre-tax accounts at age 70½. This provision could push you into a higher marginal tax rate even if you don't want or need the income. The flip side is those with lower retirement accumulations will quite likely experience lower taxes in retirement, simply because they don't have much to withdraw.

The younger you are, the longer the period between deposit and distribution, and the greater the uncertainty about how taxes will be calculated. What would happen if a national sales tax replaced the income tax? How would these pre-tax deposits be treated?

The more proficient you become in accumulating wealth, the more taxes will factor in your financial decisions. History shows tax rates are not static, which implies your decisions about how and where to save should be flexible as well. ❖

Like most Americans, you recently filed your 2013 individual tax returns. Do you know your marginal and effective tax rates? Do your accumulation plans consider future tax scenarios?

TEST YOUR FINANCIAL IQ

One definition of myth is a "widely held but false belief or idea." The statements below reflect ideas often expressed in financial conversations, by experts and the general public. Each statement has a logical premise, but is in some way misleading, incorrect, or incomplete. Can you identify the flaws in these comments?

Some Common Financial Myths

"My money only needs to keep pace with inflation."
"I will be in a lower tax bracket in retirement."
"My 401(k) plan creates a tax savings, which can be spent or invested."
"Compounding interest creates a financial miracle."
"I won't need life insurance when I retire."
"A 15-year mortgage costs less than a 30-year mortgage."
"Disinvesting is the same as investing."
"Rate of return on my assets is more important than regular savings habits."
"To increase protection, my cash flow will suffer."

Assessing Risk:

When billionaire investor Warren Buffett announced he would co-sponsor a $1 billion prize to anyone who could pick the winning teams for all 63 games of the NCAA Men's Basketball Tournament, he knew the chances of it happening were infinitesimally close to zero. In fact, the website hosting the contest indicated the odds of winning were calculated to be 1 in 9.2 quintillion (a quintillion is 1 with 18 zeros).

By the end of the 25th game on the second day of the three-weekend tournament, all contestants had been eliminated. Considering the odds, this outcome was no surprise. But the incident revealed several insights about risk management.

It didn't happen, it won't happen – but it could

Even though the odds in Buffett's contest were incomprehensively high, a winner was theoretically possible. The contest's sponsors didn't provide details, but they did take out an "event insurance" policy (from one of Buffett's companies). So if someone did win, the payout would come from the insurance company's pocket, not the contest sponsors.

This prompted speculation on the premium. How do you price the likelihood of a correct NCAA Tournament bracket? In a January 2014 interview with CNN, Buffett acknowledged "There is no perfect math...There are no true odds, no one really knows."

One college statistics professor said the premium should be zero, because there was no realistic chance of a winner. When a reporter asked the president from one of the sponsoring companies if the premium was $10 million, his response was "It's in the ballpark."

Whoa…if the estimated premium is theoretically between $0 and $10 million, the possibility of over-paying for coverage seems likely.

Why you aren't overpaying (or underpaying) for insurance

An accurate assessment of risk – both the probability of a claim and its cost – is absolutely essential to the integrity of insurance. Because who would pay premiums if they didn't believe the insurance company would make good on its promises to pay?

In the standard types of insurance, actuaries are not evaluating long-shot events like an NCAA bracket contest. They have large amounts of very specific data about things that happen regularly (like thefts, fires, accidents, and deaths), from which to design and price policies. For some insurance, a lot of marketing to the public may focus on price ("a 15-minute call could save you 15 percent or more"), but the "savings" are primarily based on whether the insurance company sees you (or your health, driving habits, zip code, etc.) as a preferred risk. Market competition compels insurance companies to offer the lowest possible premium, but the necessity of being able to pay claims keeps them from having "sales." As Norm Baker, a developer of software for the life insurance industry, once said, "There are no deals in insurance."

If consumers accept that insurance companies correctly price their offerings, it sheds some light on products that may at first glance seem either "cheap" or "expensive." For example, a 35-year-old non-smoking male might pay $55/mo. or $1,083/mo. for $1 million in life insurance protection. The first premium covers a 10-year period; the second is for lifetime protection plus a guaranteed accumulation account. The difference may at first seem extreme, but it reflects the realities of risk. The likelihood of a healthy 35-year-old dying in the next 10 years is very low. The likelihood of dying at some point is 100%. Similar conclusions apply to almost any comparison of "minimal" and "comprehensive" insurance policies. The difference in premium is a reflection of the risk assumed by the insurance company.

In exchange for a modest premium, insurance offers some financial certainty. Remember, the sponsors paid the premium, even though the odds were overwhelmingly in their favor. As Garrett Gunderson says in his book *Killing Sacred Cows:*

> **"Producers love insurance because it transfers their risks, and they know it saves them money in the long run."**

If financially savvy business owners, including Warren Buffett, are willing to perhaps overpay for comprehensive insurance when the odds are overwhelmingly in their favor, consumers should seriously consider the value of doing the same thing – especially when they know the price is right.

How accurate is your assessment of whether, *or when* you may need insurance coverage?

Like other insurance coverage, you can only be covered before you need it.

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