February 2017

Capital Management:

Your *Economic Edge* over Automation

Whatever you're doing right now to earn a living, there's a good chance much of your work could eventually be done by a machine. In fact, some futurists predict machines will do *all* our work. On first exposure, this may seem ridiculous. But both history and current developments make a reasonable, perhaps compelling, argument that work will be a much smaller part of our future. If this is true, it portends some dramatic changes for personal finance as well.

The Uneasy Tension Between Labor and Capital

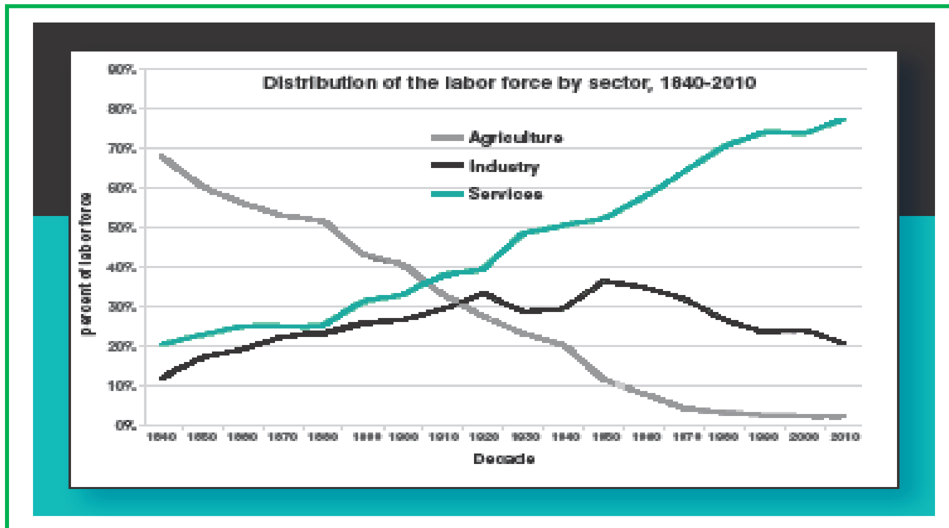
In economic terms, people are born with an "endowment of human capital;" they have the potential to work, to learn, and to earn money. Human capital is often referred to as "labor," which distinguishes it from other capital assets, such as land, equipment, or money.

Wealth creation occurs when human labor is applied to capital – to grow food, manufacture products or provide services. Labor is the catalyst for all wealth, because capital can't develop on its own. F rom labor. Over time, labor tends to get smarter, more sophisticated in it essential; once profitable ways of earning a living disappear, the man is replaced by a machine.

The logical conclusion of this trend of capital replacing labor is that, eventually, the need for labor will almost cease to exist. In academic circles, this is called "capital-biased technological change." In the past, this displacement of labor by capital has swept through specific sectors, completely changing the economic landscape.

The History of Capital Replacing Labor in the United States

One of the ways economists analyze an economy is by the distribution of the labor force – who works where. Historically, labor has been divided into three categories: those working in Agriculture, Industry and Services. The following chart, derived from academic



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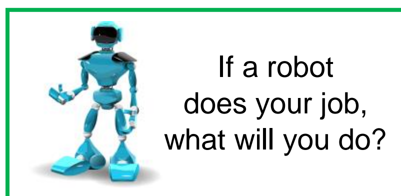
* The title of this newsletter should in no way be construed that the strategies/information in these articles are guaranteed to be successful. The reader should discuss any financial strategies presented in this newsletter with a licensed financial professional.

research and government statistics, shows the changes in the US labor force from 1840 to 2010.

The Agricultural and Industrial segments of the labor force are easily defined: these are people whose work produces food or manufactures goods. The Service sector encompasses a much broader range of labor: retail, transportation, management, education, medicine, finance, information technology, etc.

In less than two centuries, the labor force distribution has flipped dramatically, due almost entirely to capital replacing labor.

- In 1900, most Americans still lived in rural areas and 40 percent of them worked on a farm. Today, only two percent of Americans list farming as an occupation, yet these few mechanized farmers produce much more food than their predecessors.
- A similar pattern is occurring in Industry. In the early 1950s, manufacturing represented almost 40 percent of the nation's workforce. But since then, automation has steadily eroded this sector of labor. Citing a January 2016 Federal Reserve report, Rex Nutting wrote in a March 28, 2016, *MarketWatch* column that "US factories produce twice as much stuff as they did in 1984, but with one-third fewer workers." Today, Industry comprises under 20 percent of the US work force. But like Agriculture, it is plausible that eventually only two percent of the work force will be needed by Industry, as machines can handle the entire process, from design to manufacture.
- Historically, as both agricultural and industrial labor opportunities diminished, the service sector has taken up the slack. And until now, the service industry has been the most machine-resistant. But machines are beginning to replace low-end service labor (think of the automated phone systems that keep you from talking to a real person). And as they integrate with artificial intelligence platforms, automation is moving up the service food chain. In a November 2016 interview in *Vox*, Andy Stern, a past president of one of the nation's largest unions, notes the most common job in 29 states is driving a truck. Yet driverless vehicles (projected to hit the road within the next five years) could make that occupation obsolete, perhaps overnight.



No Work, or No Need to Work?

While many see capital-biased technological change as inevitable, there is no consensus on whether the economic consequences will be beneficial or disruptive. An August 8, 2014, *Wired* article by Marcus Wohlsen captures the ambivalence:

"Optimists say that more robots will lead to greater productivity and economic growth, while pessimists complain that huge swaths of the labor force will see their employment options automated out of existence.

"Each has a point, but there's another way to look at this seemingly inevitable trend. What if both are right? As robots start doing more and more of the work humans used to do, and doing it so much more efficiently than we ever did, what if the need for jobs disappears altogether? What if the robots end up producing more than enough of everything that everyone needs?"

Labor is the catalyst for all wealth, because capital can't develop on its own.

Hypothetically, an economy without human labor at the center threatens to unravel the social and financial systems under which we operate, which is sort of scary and unnerving. If almost no one earns a living, what happens to buying and selling, lending and borrowing, income taxes, retirement planning?

One response put forward by some economists to the possible end of work is a Universal Basic Income (UBI), where each adult citizen receives a monthly stipend, with no regard for employment status or income. Stern, the ex-union president, sees UBI as a way to ease the transition away from dependence on wages by providing an economic base that gives people a sense of security, as well as the freedom to be entrepreneurial. A large-scale experiment involving UBI for 2,000 people in Finland began in January, and two cities in Scotland are also considering UBI on a test basis. Last year, a Swiss referendum proposed giving every adult citizen a guaranteed income of $2,500 a month, but the plan was soundly defeated; centuries of working for a living make people resistant to the idea of giving money to everyone for doing nothing.

Some more pragmatic thinkers simply want to get more capital in the hands of workers. Noah Smith, in a January 2013 *Atlantic* article titled "The End of Labor: How to Protect Workers from the Rise of Robots," says it should be "easier for the common people to own their own capital – their own private army of robots. That will mean making 'small business owner' a much more common occupation than it is today."

Taking the idea one step further, Smith proposes giving every citizen "an endowment of capital" when they turn 18, consisting of a diversified portfolio of investments. "This portfolio of capital ownership would act as an insurance policy for each human worker; if technological improvements reduced the value of that person's labor, he or she would reap compensating benefits through increased dividends and capital gains."

Your Next Job: Capital Management

You might dismiss the end of work as dystopian pessimism. You could discount the replacement of agricultural and industrial labor, ignore the academic papers, and scoff at experiments with universal income. But recall the phrase repeatedly used to describe the aftermath of the Great Recession: The Jobless Recovery. Productivity is up, but wages and employment are not. Capital is replacing labor.

It is reasonable to assume this change will not impact all sectors equally; some careers and professions may endure and even benefit from this displacement. And there will still be farmers and industrial workers (just not as many) and it might be possible for these select few to successfully continue in a work-and-save personal finance model.

But if your anticipated retirement is more than 10 years in the future, relying exclusively on your labor for present income and future retirement is a financial strategy with potentially

seismic fault lines. A labor displacement in your field could precipitate a financial earthquake.

These conditions present two profound and inter-connected philosophical shifts in personal finances. First, the potential wealth accumulation from work alone (and saving) will be much lower. Second, when capital replaces labor, the only "job" left for human labor is managing/owning capital. In this paradigm, capital management – i.e., the active control of assets for both short- and long-term income – is an essential wealth-building activity.

In most careers, there is little integration between labor and capital; people are either workers (labor) or owners (capital). Workers are focused on compensation; their only "capital management" usually consists of designating a money manager at retirement. Many, if not most, workers are ill-equipped to be owners.

But when capital-biased technological change and universal incomes threaten to cap or drastically limit earnings from one's labor, the only practical response is to consider capital management – and not only for retirement, but perhaps to supplement or replace current income. If automation takes your job, owning and managing a fleet of driverless cars could be a lucrative and necessary application of your endowed human capital. And monthly income from rental properties might be a steady retirement income.

The value of your labor may not be immediately threatened. But your financial life isn't just about today; most of your financial objectives won't be realized until a future date. What happens if capital-biased technological change has re-ordered the economics of daily life?

No matter where your human capital is currently working, considering capital management strategies for your personal finances is good advice, because even if it's wrong, it's right. You can't make a mistake by becoming a better capital manager.

COULD YOUR FINANCIAL PLANS ADJUST TO AN END OF WORK? ❖

"The American estate tax turned 100 this year. It probably won't live to see 101."

That's the lead sentence in a December 9, 2016, *Wall Street Journal* article commenting on the likelihood the incoming administration will introduce legislation to repeal the estate tax. But while it's a nifty turn of the phrase, and might be an interesting topic for debate ("Should the government tax someone *again* after they're dead?"), the estate tax is really a non-issue for most American households.

The Tax Policy Center estimates that only 0.2% of Americans who die in 2017 will leave an estate large enough to incur federal estate taxes. That's roughly 5,200 people, a number so small that the impact of the current estate tax on government revenues and social inequality is already miniscule.

However, depending on what might be repealed, there could be new tax regulations regarding the transfer of assets at death, and these might apply to a broader segment of the populace. Thus, permanent life insurance – i.e., life insurance intended to be in force for one's lifetime – is still one of the best estate planning solutions for the unknowns and uncertainties that come with generational asset transfers.

The essential advantage of life insurance in estate planning is the guaranteed liquidity it provides for a future event (death), ***whenever it happens***.

Guaranteed Money, Precisely When Needed

The essential advantage of life insurance in estate planning is the guaranteed liquidity it provides for a future event (death), ***whenever it happens***. In the past, large estates may have earmarked the proceeds from an insurance benefit to pay taxes, ensuring that other, more valued assets (such as homes or businesses) did not have to be sold to satisfy the bill. But apart from federal estate taxes, a permanent life insurance program can be used in a variety of ways to optimize the transfer of valuable assets to future generations. For example, permanent life insurance can…

- **Protect and preserve the most valuable assets.** A family home with a mortgage becomes an obligation of the estate at the death of the owner. Similarly, outstanding business and personal loans must be settled. From a balance sheet perspective, an estate may have enough assets to meet these monthly obligations or make a payoff. But liquidation of these other assets may occur at inopportune times, or require the estate to accept discounted valuations. Life insurance is an economically efficient strategy to provide instant liquidity precisely when needed, and allow valuable assets to remain in the estate or be liquidated for full value.

- **Provide equitable treatment for heirs with disparate interests.** Because of circumstances, some heirs may not value estate assets, like real property or ownership of a business, in the same way. An heir may prefer to sell his percentage of ownership rather than continue as a partner with other beneficiaries. In these situations, the disinterested heir can force a sale or compel other beneficiaries to borrow against estate assets to receive his share. The immediate liquidity from a life insurance benefit can eliminate these costly options, while providing equitable treatment for those who want out.

- **Serve as an escrow account for other estate-related taxes.** The elimination of the federal estate tax does not affect the levies states may charge. As of 2016, fifteen states have estate taxes and six impose inheritance taxes, with the top brackets taking a 20 percent cut of assets over specific thresholds.

In addition, the repeal of the federal estate tax may give rise to higher capital gains taxes. One of the unique features in current estate tax law is the "step-up" in basis that heirs receive when inheriting financial assets. This means a beneficiary's basis for tax purposes is the value on the date of transfer, not the original purchase price.

Some proposals concurrent with the elimination of the estate tax eliminate this step-up, meaning that a beneficiary could incur significant capital gains taxes when liquidating an asset from the estate. A 15 or 20 percent tax on capital gains calculated on the original share price could be just as substantial as an estate tax assessment.

To add to the complexity, tax laws change frequently. Life insurance is a "pop-up" escrow account for these taxes, whatever they may be.

When a financial professional says "Let's look at ways to increase the return on your savings," what comes to mind?

- **A. Considering financial instruments with longer holding periods?**
- **B. Increasing your investment risk?**
- **C. Committing to a more active allocation strategy?**

Or…

- **D. Getting a financial efficiency review?**

The setup gives it away. You should choose D every time. Improving your financial efficiency to "find" more dollars to save is almost always the best way to increase your returns (at least until you've built a sizable accumulation).

While you may conceptually assent to the superior results from a financial efficiency review, a mathematical analysis really hammers home the value. You just have to see the numbers.

	SCENARIO #1: **4% RETURN**			*SCENARIO #2:* **6% RETURN**		
MONTH	**MONTHLY DEPOSIT: $1,500**	**4% RETURN MONTHLY EARNINGS**	**4% RETURN ENDING BALANCE**	**MONTHLY DEPOSIT: $1,500**	**6% RETURN MONTHLY EARNINGS**	**6% RETURN ENDING BALANCE**
JAN	$1,500	$5.00	$1,505.00	$1,500	$7.50	$1,507.50
FEB	$1,500	$10.02	$3,015.02	$1,500	$15.04	$3,022.54
MAR	$1,500	$15.05	$4,530.07	$1,500	$22.61	$4,545.15
APR	$1,500	$20.10	$6,050.17	$1,500	$30.23	$6,075.38
MAY	$1,500	$25.17	$7,575.33	$1,500	$37.88	$7,613.25
JUN	$1,500	$30.25	$9,105.59	$1,500	$45.57	$9,158.82
JUL	$1,500	$35.35	$10,640.94	$1,500	$53.29	$10,712.11
AUG	$1,500	$40.47	$12,181.41	$1,500	$61.06	$12,273.17
SEP	$1,500	$45.60	$13,727.01	$1,500	$68.87	$13,842.04
OCT	$1,500	$50.76	$15,277.77	$1,500	$76.71	$15,418.75
NOV	$1,500	$55.93	$16,833.69	$1,500	$84.59	$17,003.34
DEC	$1,500	$61.11	**$18,394.81**	$1,500	$92.52	**$18,595.86**

	SCENARIO #3: **4% RETURN**			*SCENARIO #4:* **15.84% RETURN**		
MONTH	**MONTHLY DEPOSIT: $1,600**	**4% RETURN MONTHLY EARNINGS**	**4% RETURN ENDING BALANCE**	**MONTHLY DEPOSIT: $1,500**	**15.84% RETURN MONTHLY EARNINGS**	**15.84% RETURN ENDING BALANCE**
JAN	$1,600.00	$5.33	$1,605.33	$1,500.00	$19.80	$1,519.80
FEB	$1,600.00	$10.68	$3,216.02	$1,500.00	$39.86	$3,059.66
MAR	$1,600.00	$16.05	$4,832.07	$1,500.00	$60.19	$4,619.85
APR	$1,600.00	$21.44	$6,453.51	$1,500.00	$80.78	$6,200.63
MAY	$1,600.00	$26.85	$8,080.36	$1,500.00	$101.65	$7,802.28
JUN	$1,600.00	$32.27	$9,712.62	$1,500.00	$122.79	$9,425.07
JUL	$1,600.00	$37.71	$11,350.33	$1,500.00	$144.21	$11,069.28
AUG	$1,600.00	$43.17	$12,993.50	$1,500.00	$165.91	$12,735.19
SEP	$1,600.00	$48.65	$14,642.15	$1,500.00	$187.90	$14,423.10
OCT	$1,600.00	$54.14	$16,296.29	$1,500.00	$210.18	$16,133.28
NOV	$1,600.00	$59.65	$17,955.94	$1,500.00	$232.76	$17,866.04
DEC	$1,600.00	$65.19	**$19,621.13**	$1,500.00	$255.63	**$19,621.68**

The Math *(Oh My!)*

Scenario 1: Suppose you are currently saving $1,500 each month. Suppose also that your annual return on your savings is 4%, compounded monthly. (Standard disclaimer: This is a hypothetical situation, and the illustration does not assume the use of a specific financial instrument. It's just a numerical comparison; real-life results would likely vary.) This is a month-by-month progression of deposits and earnings.

Scenario 2: You make an adjustment to your allocation strategies that results in a 6% annual return; the earnings obviously increase. A 50% increase in return (from 4 to 6%) seems significant, but actual numbers are less impressive.

Over a year, the difference in return is slightly more than $200. That's about $17 a month (also known as the price of an extra-large pizza with three toppings).

Scenario 3: What results might come from a review that cleans up some of your financial inefficiencies and "finds" additional savings? Could it be $50 a month, or maybe $100? Using the original 4% rate of return, let's *add $100 each month*. Obviously, bigger deposits will produce a higher ending balance.

Scenario 4: The difference between Scenario 1 and 3 is due almost entirely to adding $100 each month. But to illustrate the significance of bigger deposits, let's conclude with this calculation: What is the rate of return needed on $1,500/mo. deposits to equal the ending balance of $1,600/mo. earning 4%? Look at the return variable at the top of the table in Scenario 4. This is the mind-blower: Scenario 2 would have to earn ***15.84%*** to equal the results of Scenario 3!

Between pursuing higher returns (Scenario 2) and increasing financial efficiency (Scenario 3), here are two relevant questions:

1. Which strategy is easier to execute?
2. Which strategy entails the least financial risk?

It is theoretically possible for either strategy to be the best answer to both questions. But for most households, the default choice should be to look first at becoming more financially efficient.

Can You Achieve Similar Results?

Financial efficiency in personal finance seeks to eliminate or minimize costly or overlapping expenses, and put more money under your control. Possible actions to accomplish this objective might include:

- Transferring credit card balances
- Consolidating loans
- Restructuring personal debt
- Re-financing a mortgage
- Adjusting deductibles on property and casualty insurance
- Evaluating allocations and employer matches in retirement plans
- Re-directing dividends or interest payments instead of compounding

Not all efficiency options may fit your situation, but it often takes only one or two to add up. In the example above, an extra $100 added to existing savings of $1,500 each month is an increase of less than 7%, which isn't much. So it's reasonable to think an assessment of your financial efficiency might yield similar results. And as the numbers show, increasing returns (usually through increased investment risk) to match finding an additional 7% to save, is usually a tougher challenge.

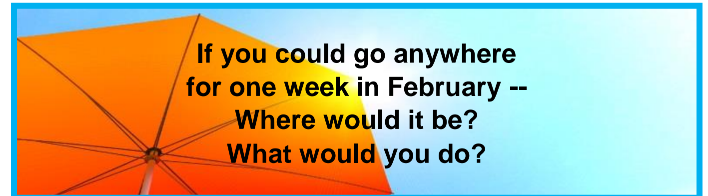
Granted, the returns from efficiency diminish as your accumulations get bigger. If you have $100,000 earning 4%, an increase to 6% is a $2,000 boost in earnings. Accomplishing the same increase with financial efficiency requires finding almost $200 each month, which might be a little harder (especially if you've already done a few financial "house-cleanings").

Having said this, finding ways to increase deposits remains a proven method for maximizing long-term accumulations while minimizing risk. And done right, a financial efficiency review should be painless; the extra money that is saved doesn't diminish your lifestyle. It's money redeemed from waste. ❖

If you're someone living across the northern tier of the continental US, February can be miserable. Read these comments from Keith Ecker, a blogger who lives in Chicago:

T.S. Eliot got it wrong. February is the cruelest month. It is cold. It is gray. It is four months into Chicago's winter with no jubilant holidays like Christmas or New Years to look forward to. It's just a month of depression and death and bone-chilling awfulness, icy tears and frosty beards made frostier by my icy tears.

Even if you're living in a warmer clime, February can be a grind. For many of us, it would be the perfect time for a vacation. So why not start planning one? No kidding…



You know what? This might an ideal "starter project" for you and a financial professional.

The Perils of Long-Term Planning

Planning for any future event can be daunting, but especially when it's in an area where you don't have much knowledge or experience. If you know almost nothing about physical training, are 20 pounds overweight, and don't run any further than the distance from your couch to your kitchen to keep a pot of nacho cheese from burning on the stove, is it a good idea to a start a fitness plan by completing an entry form for a triathlon scheduled five years from now?

Maybe. For some, the magnitude of the goal, and their current lack of fitness, could be a sufficient motivator. But it might, just as likely, lead to discouragement and defeat if the goal is too big, too distant, and without enough psychological reinforcement to maintain training.

Sometimes it's better to progress through a series of smaller projects. Each little achievement builds experience and confidence, and lays the foundation for more ambitious efforts.

A Fun Financial Idea?

There's a parallel in the experience many households, particularly young ones, have with personal financial planning services. When they first meet with a financial professional, one of the first topics for discussion is usually retirement. Which, if you think about it, is sort of a triathlon-level personal finance project.

Here's the all-too familiar scenario: You're in your thirties, just getting established in your career, finally making a little more than your expenses, perhaps with a young family, but still dealing with student loans, weighing whether to make a 30-year commitment for a home of your own, and someone says, "You ought to meet with ___________; he/she is helping me plan for retirement."

Retirement? You mean that thing that happens when you're about 70? The thing you have to save so much money for because inflation will make everything so much more expensive 40 years from now? Do you know how discouraging it is to reach this point of finally getting your head above water, only to be told you need to start swimming upstream in order to have any chance of reaching the dry ground where you can finally enjoy life?

Whole bunch of metaphors there. But seriously:

What if your first "project" with a financial professional was a little less daunting? Wouldn't it be *fun* (who uses *that* word when discussing personal finance?) to earn some sort of short-term reward for successful completion?

> There's significant psychological value in experiencing regular pre-retirement financial rewards from your management plans.

And whether the objective is an ideal retirement or a dream vacation, successfully accomplishing your goals is going to look pretty much the same, and require many of the same actions. You're going to want to know you have enough money to spend freely, instead of doing without, skimping on the experience, or borrowing to make it happen. That will mean putting together a savings plan and finding the money, either by committing to delayed gratification or by eliminating the inefficiency and waste in your transactions.

The difference with planning for a vacation is the payoff could occur in one, two or three years instead of thirty. Not to diminish the necessity of saving for a long time to produce a comfortable retirement, but there's significant psychological value in experiencing regular pre-retirement financial rewards from your management plans.

Planning for a dream vacation might seem disconnected from "long-term" and "important" financial objectives, but maybe not.

Suppose the dream vacation is a 10-day river cruise in Europe. Estimated price for two, including airfare: easily $7,000, probably closer to $10,000.

If you've saved that much money in the past two years, you probably have a true appreciation for what it took to accumulate it. It might even prompt you to consider what it would feel like if things changed – like your job, or your health – and you couldn't continue to save – for vacations or retirement. Having begun to master your personal finances, you might place a higher value on those instruments of income protection, like disability and life insurance, to ensure you can keep on saving to provide great experiences in the future, including retirement. ❖

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