Creative
wealth maximization strategies*

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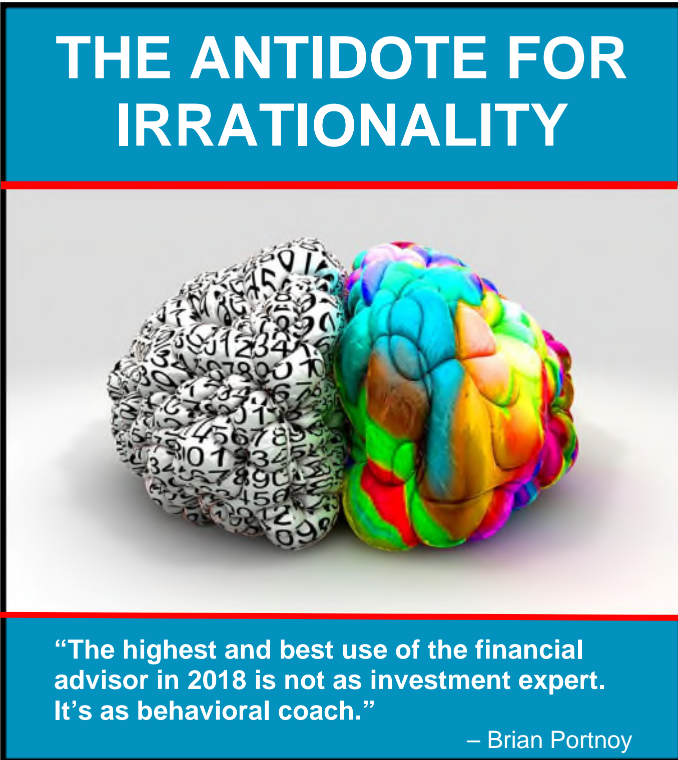
THE ANTIDOTE FOR IRRATIONALITY



"The highest and best use of the financial advisor in 2018 is not as investment expert. It's as behavioral coach."
– Brian Portnoy

Over and over, behavioral finance studies reach the same broad conclusion: When it comes to money, people often behave irrationally and make poor decisions, even when fully-informed. Some attribute these mistakes to the dissonance between our logical and emotional assessments of the choices put before us.

Studies in neuroscience suggest that the left hemisphere of the brain is more active when engaged in calculations, logical evaluations, and order, while the right hemisphere is dominant when dealing with images, music, emotions, and creative pursuits.

You can see how personal finance could challenge both hemispheres. On one hand, there are the left-brained details of money, things like comparative rates of return, portfolio allocation, and Monte Carlo simulations. There is also the huge emotional, right-brained impact money has on our daily lives – what we can do, whether we are satisfied and secure with what we have, and how we feel about the future.

Computers make the numbers – i.e., the left-brained stuff – easy to evaluate. There is no end to the ways a financial decision can be left-brain analyzed – for total return, tax consequences, volatility, etc. But the financial services industry often does a poor job of speaking to both sides of the brain; there is a tendency to provide left-brain arguments for right-brain concerns. Joseph Jordan, a behavioral finance expert and former senior vice president for MetLife, says, "This is a tragedy in the financial service business. We've developed a lot of left-brained analytic tools to solve right-brain emotional issues."

The Facts and Fears of Spend-Downs

Consider the left-brain/right-brain challenges to creating an income in retirement. Most retirement income models are built around some version of a spend-down, a plan that methodically draws income from both earnings and principal over the course of retirement. Financial professionals develop models to determine the maximum that can be withdrawn, with minimal risk of running out of money at some point in the future.

On paper (or a computer screen), the math of these models is legitimate. But financial behaviorists find that emotional right-brain concerns often get in the way of implementing these logical plans.

In the early years of a spend-down, it is common for investment earnings to exceed the initial income withdrawals, resulting in modestly increasing retirement account balances. But as withdrawals increase (to keep pace with inflation), account balances eventually decrease; that's the spend-down. Once principal begins to decline, many retirees get nervous; studies show they often decrease income to preserve principal instead of staying with the plan. Any period of poor investment returns only exacerbates their anxiety about not having enough income or running out of money – even though the numbers clearly show these fears are unfounded.

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Soothing Right-Brain Financial Anxiety

Harold Evensky and Deena Katz are husband-and-wife partners in a financial advisory firm and co-authors of several books about retirement. One of their signature ideas is the "cash-flow reserve strategy," an approach that seeks to ease the right-brain issues in a spend-down.

Their core idea, first formulated in the 1980s, is to allocate a percentage of assets to low-risk or guaranteed financial instruments, for the exclusive purpose of providing a secure income for a specified period (say 5 or 10 years). The remainder is invested for long-term growth. At regular intervals, this "safe account" is replenished with earnings from the long-term pool.

Over the years, the couple has fine-tuned their approach into three components: A checking account for living expenses, a low-risk portfolio with two years of reserves, with the remainder allocated to various long-term investments.

Theoretically, this compartmentalized approach, in which a significant percentage of assets may be allocated to safe investments with lower historical returns, gives retirees peace of mind about their present income, which means there is a greater likelihood that they will not make unprofitable, panic-driven decisions about their long-term assets.

The Logical Left-Brainers Disagree (And Can Prove It)

The cash-flow reserve idea is one of what are referred to as "buffer-zone" retirement income strategies. While buffer-zone plans might calm a retiree's nerves, critics say it's a false security, because the premise doesn't stand historical scrutiny.

Research compiled by two professors of investments at the American College of Financial Services in a 2011 study concluded that "use of a buffer zone strategy of any sort—one year, two years, three years, or four years—is more likely than not to leave the investor worse off than if he or she simply set up an investment portfolio with a static asset allocation."

Instead of accommodating their emotions, left-brain retirement planners urge better consumer education, believing the facts will persuade retirees that their fears of losing money are inaccurate or exaggerated. Which, from a left-brain perspective, is a perfectly logical idea. But, as financial behaviorists know, it probably won't alleviate emotional/right-brain concerns about a diminished or insecure retirement.

Or…You Could Buy an Annuity[1]

Another retirement income option which seems to satisfy both left- and right-brain demands? Using an immediate annuity.

An immediate annuity delivers a guaranteed income for a lifetime, no matter how long it lasts, which should effectively eliminate any worries about decreasing income or running out of money.

And from the logical side, historical studies have repeatedly shown that lifetime annuities outperform spend-down strategies. One of the reasons for the superior performance: An immediate annuity is "the only investment that provides a fourth potential return," according to Evensky. "Stocks, bonds and all other investments provide a return from a combination of interest, dividends and capital gains. An immediate annuity offers the possibility of a mortality return…," i.e., a return from living beyond life expectancy.

Yet very few retirees use annuities. Why? Even though they satisfy both the logical and emotional requirements for retirement income, annuities are thought to be under-utilized by retirees because they are usually irrevocable transactions. Once you give an insurance company a lump sum for a lifetime income, the agreement is locked in. There's no return of principal if you die before life expectancy, and once they begin, there's no changing the monthly benefits. Just like some people can't handle decreasing principal in a spend-down, others are stopped by the one-time decision that establishes an annuity.

Retirees hand over a significant chunk of their life savings, knowing they can't get it back, except as a monthly check (albeit, for the rest of their lives). Ten years from now, that exchange might seem like a great deal, but today, it might feel like handing over a lot to get a little. Those feelings, illogical or not, often stop many people from getting started.

For logical left-brainers, the guarantees in an annuity also preclude the selection of other investments. There will always be a hindsight scenario in which an alternative – probably not guaranteed, perhaps riskier – could have been a better choice. This compels some retirees to continually look for the next opportunity, instead of accepting the very good, guaranteed options available today.

A Meeting of the Minds

The under-utilization of annuities for retirement income is a prime example of how consumers can make sub-optimal financial decisions because of logical and emotional ignorance. As Brian Portnoy, a veteran investment analyst and behavioral finance author, succinctly puts it: "An investor's primary problem isn't figuring out the market – it's figuring out himself."

This "figuring out" requires both education and self-awareness, not only understanding products and strategies, but getting a sense of how risk of loss, guarantees, and opportunities impact your perspectives. One of the best ways to achieve this enlightenment is through engagement with financial professionals. Not only can professionals provide facts and interpretations, but they can offer insight into the emotional appeals and challenges that accompany these products and ideas.

We may never fully escape our irrational tendencies, but the odds are much better when we seek outside input. When you're faced with an important financial decision, do you have trusted sources who can challenge your assumptions and add perspective? It's a logical way to make better decisions – and feel better about them.

1 Contract guarantees are guaranteed solely by the claims paying ability and strength of the issuing insurance company. You should consider your liquidity needs before any money is used to purchase the annuity. You will not have access to the premium except through the future stream of fixed income payments created by your purchase payment. While the insurance company guarantees the future income payments based on the amount of monies used to purchase the annuity and a variety of other factors, there is no guarantee that the amount of monies used to purchase the annuity will be sufficient to provide you with a secure retirement. It is strongly recommended that you consult with your financial advisor when determining the amount and timing of purchases to this annuity. Product availability and features may vary by state.

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If you are disabled, what happens to your ability to save for the future?

If you are disabled, insurance – in the form of Social Security, Workers' Compensation, group or individual disability income policies – may provide financial assistance to keep you from poverty. But these programs will most likely not be enough to provide a healthy financial future.

Disability insurance programs, whether from government agencies or insurance companies, aren't intended to replace 100 percent of income, because doing so creates a moral hazard; individuals might find it more profitable to qualify for, and remain on, disability than to continue working. Consequently, most disability insurance programs limit benefits to a percentage of gross income, usually between 60 and 70 percent. These benefits are often tax-free and may be sufficient to meet current living expenses. But it's not a 100-percent replacement of income.

Consider also that the real costs of living with a disability can be significantly greater than the previous costs of living. And these extra expenses – for therapy, rehabilitation, medication, etc. – may be on-going for the rest of one's life.

Thus, while disability insurance, from any source, can prevent immediate financial ruin, an extended period of disability can derail lifelong financial objectives, particularly ones that require saving, like a down payment for a home, college education for children, or retirement. How can you protect your saving when disability insurance doesn't fully replace your income?

Incorporating Savings Protection into Disability Insurance Planning

If you are currently saving, you may be able to preserve your ability to ***continue*** saving, by adding riders to existing insurance protection. A rider is an amendment or addition to an existing insurance policy. Most riders add specialized benefits for an additional cost. Two examples are: Retirement Contribution Insurance, and Whole Life Waiver of Premium.

Retirement Contribution Insurance[2]

For those who have individual long-term disability insurance, your plan may offer a retirement protection rider. For an additional premium, the insurance company ensures that, in the event of a qualifying disability, contributions to a defined-contribution qualified retirement plan (such as a 401(k), IRA, ESOP or SEP) will continue at current levels. This amount may include an employer's matching contributions as well.

To be eligible for this benefit, the insurance company may require proof that you are currently contributing to a qualified plan. The amount of coverage is selected by the insured, but usually capped at the level of last year's contributions (although the rider may have cost-of-living provisions to increase contributions over time).

In group policies, these retirement contributions are deposited directly to the existing employer-sponsored plan. In contrast, benefits from a personally-owned individual policy are placed in an irrevocable trust. These funds are invested according to the individual's direction, in options provided by the insurer. Because these contributions are made to a trust instead of a qualified retirement plan, distributions of interest, income or capital gains are subject to taxation on an annual basis. Taxes can be paid out of the trust from the accumulated assets. This trust is not a pension; it is a personal accumulation account funded as a result of a disability.

This arrangement does not create a moral hazard, because while it increases the overall disability benefit, it does not allow the insured immediate access to the additional funds.

Whole Life Waiver of Premium

Not everyone has access to an employer-sponsored qualified plan. And even among those who do, not everyone chooses to place all their savings in them. For "non-qualified" savings, individuals may want to consider adding a whole life insurance waiver of premium rider to their policies.

With a whole life waiver of premium rider, the insurance company guarantees on-going premium payments in the event of a long-term disability. These payments not only keep the insurance benefit in-force, but also increase the cash values according to the terms of the policy.

An example: A 35-year-old male non-smoker has a whole life policy from a highly-rated mutual insurance company with an annual premium of $10,000. If he suffers a permanent disability at age 40, the insurance company will continue to credit 10,000 annually in premium to his policy. To age 65, this adds up to $250,000 in premiums paid by the insurance company, and, using current assumptions, projected cash values of almost $600,000. And these premiums would continue to be paid for the life of the insured.

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Wait, there's more…

Some insurance companies permit waiver of premium to be combined with conversion agreements on term policies. A conversion agreement gives the policyowner options to exchange some or all of the existing term protection for a cash-value policy without additional underwriting. In a qualifying period of disability, the policyowner could convert from term to whole life (or a similar permanent policy) and accumulate cash values – with the premiums paid by the insurance company.

Unlike disability income insurance, the accumulation benefits from whole life insurance waivers of premium are *not tied to earnings*. A disability accumulation amount with whole life insurance may be as large as one's budget and human life value will allow.

Waiver of premium benefits may be further maximized through additional purchase- or guaranteed-increase option riders. Once a policy is established, these riders give the policyowner options to obtain more coverage at specified times (such as every three years), or if "life change" events occur (marriage, birth or adoption of a child, a home purchase, etc.).

These policy configurations make it possible to secure the right to significant amounts of permanent life insurance (and the accompanying waiver of premium benefits), even if current finances will only allow for either term insurance or smaller amounts of permanent coverage. ❖

If you've established healthy saving habits, don't let a disability disrupt what you've started. Riders can ensure your saving plan stays healthy even if you don't.

2 Retirement contribution insurance is not a pension plan, qualified retirement plan or qualified individual retirement account or a substitute for one.

3 Waiver of Premium rider waives the obligation for the policyholder to pay further premiums should he or she become totally disabled continuously for at least six months. This rider will incur an additional cost. See policy contract for additional details and requirements.

The Backstory for "Buying the Farm"

In 1900, 38 percent of the American workforce was involved in farming. Today, it's about one percent. People still know what farmers do, but not very many have an intimate connection with the specifics of the work. This applies not only to the activities, but the language associated with it.

So, while many common idioms have their origins in farming, and while most of us know their contemporary meanings, we're a bit fuzzy about their original context. For example…

- We might understand that something that happens **"once in a blue moon"** is a rare occurrence.
- When someone says **"Don't have a cow!"** we know it means we should settle down.
- And when this information **"comes straight from the horse's mouth,"** the implication is the source is reliable.

But what are the backstories behind these idioms? Sometimes, even the experts aren't so sure. Two hundred years ago, the idea of an "urban dictionary" didn't exist in rural America, and in many cases, there simply isn't definitive documentation on the origins of many of these phrases.

Consider the phrase, "buy the farm."

Retiring a Farm Loan at Death

Today, to "buy the farm," is a euphemism for death, often used in the context of an accident *("He bought the farm yesterday in a car crash.")*, or military service *("The sergeant bought the farm when his vehicle hit an IED.")*. But how did buying the farm come to signify death?

If you research a variety of online sources, from the most popular (Wikipedia), to the authoritative (Merriam-Webster), to the skeptical (Snopes), then check personal blogs by word nerds and academics, there is no consensus. Among the possibilities:

- It's an expansion of "to buy it," which means to do something that leads to death. (This phrase appears in print as early as 1825.)
- It's a wry description of a cemetery plot as a very small farm.
- It represents an idealized final resting place for the deceased, returning to a beloved rural home.
- It relates to the deaths of early aviators, who often died attempting emergency landings in farm fields.
- It points to the result of an insurance settlement, either paid to a farmer whose crops were damaged by a plane crash, or used by the beneficiaries of the deceased pilot to buy some property.

Several sources admit their answers are speculative. As one put it: "These are charming tales filled with imagery and romance, but nothing other than our desire to believe supports any of them."

Since none of these answers are definitive, let's look at one more, provided by financial writer Jason Van Steenwyk, at nerdwallet.com:

Farmers have always struggled with extreme seasonality of cash flows. It is the nature of the business. Farmers would generally have to borrow money to buy farmland. Then they would have to borrow more money to plant, and to have money to live on while they paid their mortgage, paid their laborers, if any, and waited for the harvest. At harvest time, if crops were good, they took their crops to market, and used the money to pay off the debt on their seeds and labor expenses. Meanwhile, a portion of their mortgage was paid down.

…In those days, people frequently did not live beyond their mortgages. Instead, rather than risk losing the family farm, the family would buy life insurance. If the farmer died before the mortgage was paid off, the life insurance company would pay the death benefit, and the farmer finally 'bought the farm' from the bank – which is where the term comes from.

No other source affirms Steenwyk's explanation. But it makes sense. The history of American farmers and ranchers using life insurance to protect their property in the event of a premature death can be traced back to the Civil War.

What Life Insurance Can Do for Farmers and Ranchers

One of the unique financial characteristics of farmers and ranchers is that much of their wealth is tied to their land and equipment. Liquidity, the ability to turn a financial asset into spendable cash, can be a challenge. Life insurance, which guarantees[4] liquidity at the death of the insured, can be a particularly valuable complementary asset.

In the event of a premature death, a life insurance benefit can ensure that surviving family members stay on the farm (98 percent of American farms and ranches are family owned). The proceeds can provide income for a surviving spouse and family members, pay for the education of any children or grandchildren, and yes, buy the farm from the bank.

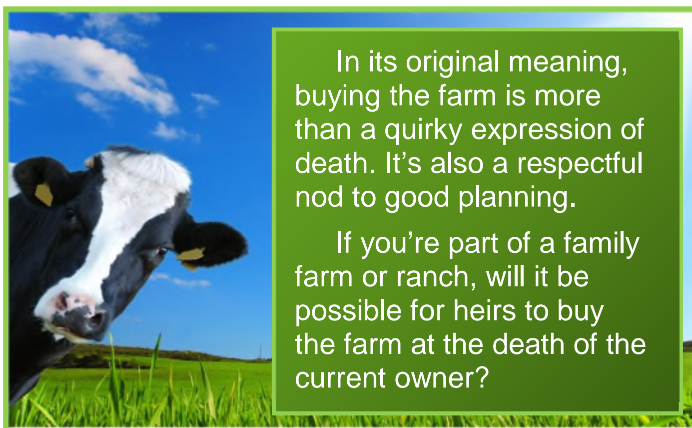
Even if a farmer lives a long and productive life, and owns his farm outright, the liquidity of life insurance can be useful, particularly in estate equalization for heirs. Even though most farms are family businesses, not all of a farmer's children may be active participants. Life insurance in an estate plan can ensure the transfer of the farm's ownership to active heirs while providing a cash inheritance to those who are not part of the business.

Another reason for farm and ranch owners to have life insurance is to fund buy-sell agreements. A buy-sell agreement is a legally binding agreement between two parties that governs the disposition of a business if an owner dies or leaves the business. These agreements may be part of a partnership or a succession plan, and can be particularly attractive in situations where none of the rancher's children will continue in the business.

Because the timing of some of the conditions under which the business may be sold cannot be anticipated, life insurance is often used as a funding vehicle.

The Virtue of Buying the Farm

Family farms and ranches are not just businesses, they are legacies, often with rich multi-generational histories. To preserve these precious assets, farm and ranch owners should take the time to establish succession plans and explore the ways life insurance can guarantee sufficient liquidity to fulfill these plans. ❖



4 All whole life insurance policy guarantees are subject to the timely payment of all required premiums and the claims paying ability of the issuing insurance company. Policy loans and withdrawals affect the guarantees by reducing the policy's death benefit and cash values.

You've heard of the "retirement crisis," the fact that many Americans aren't saving enough for the future? Well, it appears one source of the problem has been identified: Having children makes it hard to save. Here's the summary, from a July 2018 article in the *Wall Street Journal*:

> **When it comes to saving for retirement, conventional wisdom calls for starting early and saving 10% to 15% or so a year. But that can be difficult for parents who are spending on child-rearing while also saving for college.**

To which every parent, everywhere, says, ***"Well, duh!"***

Snarky remarks aside, the priority of children in your financial plans is a big issue in personal finance. An Internet search that starts with "retirement vs," has "college saving" as one of the top autofills. A sampling of the top hits:

- **"Should You Save for College or Retirement?"**
- **"Retirement or College Funding: Which Comes First?"**
- **"Saving for College vs. Saving for Retirement: Why the Conventional Wisdom Is Wrong"**
- **"First Things First: Save for Retirement or Save for College?"**

The either-or tone of these commentaries presents retirement and your children's education as a zero-sum game: for one to win, the other has to lose. Which is really a no-win situation. And, not so subtly, it implies the best financial option is to forego parenthood. This situation begs for better perspectives, and better strategies.

The numbers-crunching people who dominate the financial services field need to adjust their planning models for real-world circumstances. "The idea of saving a steady percentage of income throughout our working lives, when the expenses of raising children are anything but steady, has never been a reasonable approach," says Michael Kitces. a Maryland certified financial planner.

On the flip side, parents who today sacrifice retirement saving to provide for their children should be aware of the necessity of re-orienting their financial priorities, perhaps drastically, once their children are out of the house. Kitces contends: "The transition into the empty nest is the key moment for retirement savings."

You Can Wait to Save, but You Can't Be a Lightweight Saver

The math is actually pretty simple. If you haven't been able to save 10-15 percent of income during your parenting years, you'll need to save 25-30 percent for the last 15-20 years of your working lifetime to achieve the same retirement accumulation. A household saving 30 percent of annual income for 15 years might not catch someone who's been saving 10 percent for 35 years, but the gap narrows quickly.

Those percentages can seem daunting but may actually be quite doable. Remember, empty-nesters are now free from the expenses of raising children. According to a 2015 Department of Agriculture report, families with annual incomes between $59,200 and $107,400, spent $26,000 a year to raise two children under the age of 18 (and for families with higher incomes, the per child average is over $20,000). In theory, a large portion of those expenses could be transformed to saving when a child leaves home.

But unless households are intentional about increasing their savings as empty-nesters, it probably won't happen. The Center for Retirement Research's 2016 study, "Do Households Save More When the Kids Leave Home?" found that "households do increase their savings when the kids leave, but the increases are extremely small…" When the study says "extremely small," it's not an exaggeration:

On average, after the departure of the last child, empty-nesters raise their saving in tax-deferred retirement accounts by ***slightly less than one percentage point*** of income. *(emphasis added)*

Sliding or Deciding?

If an empty nest is on your horizon, now is an opportune time to assess your financial standing, and determine how best to re-allocate the funds that have been used to raise your children. The CRR's study found that many households on the cusp of an empty nest don't increase saving during this transition because of a lack of awareness and preparation. They simply slide into this new phase of their lives, with no plan other than to react to the needs and whims of the moment, perhaps slightly relieved that they have a bit more discretionary income.

An empty nest may represent the last best chance to upgrade your financial future, an inflection point where a few well-designed plans could make a big difference. Don't slide into an empty nest. Decide how best to seize the opportunity it affords. ❖

IS YOURS AN EMPTY-NEST HOUSEHOLD? HAVE YOU MADE POSITIVE SAVING ADJUSTMENTS TO REFLECT YOUR "IMPROVED" FINANCIAL STATUS?

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