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*wealth maximization strategies**

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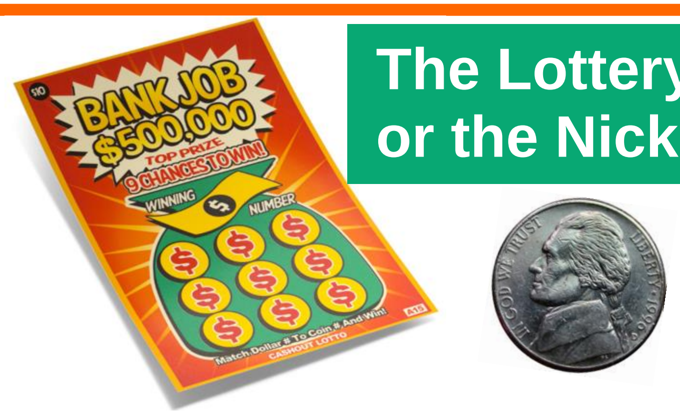
The Lottery or the Nickel



"Investing is not the study of finance. It's the study of how humans behave with money."
– Morgan Housel

It is fascinating to observe how humans behave with money. For example…

Who Passes Up a 400 Percent Return?

A current series of $1 scratch-off state lottery tickets gives players six chances to win cash prizes between $1 and $5,000. According to the lottery's website, the odds of winning a cash prize are 4.71 to 1. But of the 3,334,954 prizes in this pre-printed series, only six tickets have the $5,000 grand prize, while there are 1,885,686 $1 winners and 864,292 $3 winners.

That's the "finance" part of this particular lottery. Let's consider the way humans behave.

With six scratch-offs on each card, there's a decent chance that someone who buys five tickets will have at least one winner. But because $1 winners comprise 56 percent of all prizes, there's an even greater likelihood the prize will be just a buck. And 99.99 percent of $1 winners will use their winnings to buy another ticket. Because who plays a dollar lottery just to get their money back? So, the odds of taking home some cash are much longer than 4.71 to 1.

How big does a prize have to be for a player to take cash instead of using it to buy more tickets? Here's a fascinating real-life situation:

At the end of a night of Christmas shopping, a father buys four one-dollar tickets for his adult children. One ticket has no winners, two show $1 prizes. The fourth ticket uncovers a $20 prize, which is rare (only 1.4 percent of all winners are for $20).

At this point, a $4 lottery "investment" has yielded $22, a return of ***450 percent!*** But that's "finance." What do the winners actually do?

For the two $1 winners, it's a no-brainer. They each buy another ticket, which produces one more $1 winner – which is used to buy another ticket, which is a bust. But even giving back $2 for more tickets, the rate of return is still 400 percent.

The three "losing" siblings turn to their sister holding the $20 winner. They implore her to buy 20 more tickets, with this logic: "You got $20 from one ticket. If you buy 20 tickets, that's 20 chances to not only win $20 again, but really get lucky and win $50 or $100! Let it ride!"

The sister caves to peer pressure. And about 27 tickets later (there are a few more $1 winners, used to buy a few more tickets), all the winnings are gone, and the family has an amusing story to retell at future holiday gatherings.

But Change the Amounts…

Considering the backstory (it's the holidays, it's family, Dad's buying), this outcome isn't surprising. The tickets weren't really an "investment" in anything but a few moments of entertainment. But would these lottery players do the same thing if a single ticket cost $100 and delivered a payoff of $2,000? Probably not.

Even though the odds and returns would be the same, the difference in the amounts, both at risk and won, would change behavior. Because for a lot of people, $100 a play and $2,000 in winnings is real money. And who would be foolish enough to give up a 400 percent return on real money?

In This Issue…

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Take this discussion in a different direction. Instead of buying a lottery ticket, suppose a friend asks you to invest $1 in his business. In exchange, the friend promises, in writing, to return the dollar in a year, along with a nickel. What do you choose, the lottery ticket, or $1.05 a year later?

If we're talking about a dollar, the lottery probably still wins out, doesn't it? Despite the high likelihood of losing all of your investment with a lottery ticket, and even though the other option is guaranteed, the amount at risk with a lottery ticket is so small and the possible gain is so proportionally large that earning a nickel a year later just doesn't have much appeal.

But what if we're talking about $1 million instead of $1? Now the "nickel" is worth $50,000. Again, the finance aspect hasn't changed, but larger numbers change one's perspective, and behavior.

The Tension between Opportunities and Guarantees

The lottery-or-the-nickel example is exaggerated but instructive, because it highlights two contrasting appeals that influence financial behavior: Opportunities and Guarantees.

Opportunities are chances to achieve higher returns. These higher returns may be possible, perhaps even likely, but not guaranteed. Investors in these products are buying the opportunity; the actual outcome is unknown, and may even include financial losses.

Guarantees are products that promise certain financial outcomes. Usually, the price for certainty is lower returns, particularly when compared to the historical returns achieved by some non-guaranteed Opportunities.

The spread in returns between Opportunities and Guarantees is much narrower than the lottery-or-the-nickel example, but over time, the difference could be substantial. For instance:

Many guaranteed financial instruments currently promise annual returns around 2.0%. Some investment Opportunities may be able to claim a 9.4% annual rate of return over some 30-year periods. These numbers, which could be argued as a plausible representation of the differences, produce the following numbers.

Guarantee: $500/mo. invested at a 2.0% annual rate of return for 30 years grows to $248,599.

Opportunity: $500/mo. invested at a 9.4% annual rate of return for 30 years grows to $1,003,127.

When you look at the difference in final accumulations, it's easy to treat the Guarantee like the nickel, because how can you settle for 75 percent less than what ***might*** come from choosing the Opportunity?

Except many of the Opportunities with stellar 30-year numbers may also include stretches of 10 years or more with average annual returns close to zero. That's the equivalent of a decade of lottery tickets that only yield $1 winners. And because of this volatility, and how it impacts financial behavior, studies repeatedly show that individual results often fall short of historical numbers. In real life, many Guaranteed scenarios outperform those based on Opportunities; the nickel beats the lottery.

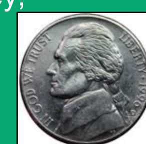
The Best of Both Worlds

Evaluating Opportunities-versus-Guarantees is probably the biggest behavioral challenge in personal finance. Because even when the amounts are larger than a dollar, the opportunity for the big prize often causes us to over-estimate the odds for success with Opportunities and undervalue Guarantees – just like the lottery and nickel.

Some personal finance programs try to address this dilemma by asking prospective investors to complete a risk-tolerance questionnaire. A survey can ask an investor to imagine their response to a possible under-performance or loss, but nobody really knows their risk tolerance until they lose real money.

What most consumers really need are financial professionals who can articulate both Opportunities and Guarantees, who don't see them as either-or, but understand the tension between them, and can show how they can be combined to maximize financial success.

When we're talking about real money, the nickel is just as valuable as the big prize. You want to work with financial professionals who understand this distinction. ❖



TAX LAW CHANGES:
ANOTHER REASON FOR LIQUIDITY

It's an odd situation where people want to pay their taxes early, and government officials have to enact new laws to accommodate them.

In the last days of 2017, in response to federal income tax changes passed just the week before, many homeowners across the United States rushed to prepay their property taxes for the upcoming year.

The legislation, which became effective on January 1, 2018, increases the standard deduction for all taxpayers, but puts a $10,000 cap on state and local taxes that can be deducted from taxable income on the federal return if filers still itemize. The

$10,000 limit includes property tax payments, which had previously been fully deductible, no matter how large the amount.

Data from the Tax Policy Center showed that “about a quarter of taxpayers deducted their real estate taxes in 2015, the latest year available, shaving roughly $5,000 on average from their adjusted gross income,” so the limit could effectively increase taxable income for many homeowners.

From December 22, when the change was officially enacted, to December 26, when the Christmas holiday weekend ended, many homeowners realized that they could benefit by prepaying their 2018 property taxes before December 31, 2017, thus taking the full deduction on their 2017 income taxes.

Provided their property taxes had been assessed, that is. The IRS said property taxes that had been actually assessed – i.e., there was a specific amount due on a specific date – could be pre-paid; payments made based on estimated tax due would not be deductible. This distinction compelled several municipalities to hold special sessions to officially assess property taxes before year-end so that residents would be allowed to prepay them.

Wait, there’s more…

Besides the limit on the deductibility of state and local taxes, the bill features several other changes that will increase taxable income by decreasing deductions for many affluent and upper-middle class taxpayers. Among them:

A lower limit on deductible mortgage interest. Taxpayers with existing mortgages may continue to deduct interest on a total of $1 million of debt for a first and second home, which was the previous limit. However, for new mortgages, the limit is $750,000 for a first and second home.

This means that if Dick and Jane already have a $750,000 mortgage on a first home and a mortgage of $200,000 on a second one, they can continue to deduct the interest on both.

But if the couple had one home with a $750,000 mortgage and wanted to buy a second one next year using a mortgage of $200,000, the mortgage interest on the second property would not be deductible because the new amount is above the $750,000 threshold.

Home equity loans will no longer be tax deductible. Previously, borrowers could deduct home equity interest on loans up to $100,000 ($50,000 for married people filing separately). The new law does away with this deduction, for both new and existing borrowers; there is no “grandfather” provision. Although home equity loan interest rates are generally lower than credit cards or other unsecured loans, the loss of the deduction for interest effectively increases the cost of using home equity-backed lines of credit.

Deductions for charitable contributions may diminish or disappear. For many households that itemized under the previous rules, their largest deductions were typically state and local taxes (including property taxes), mortgage interest, and charitable contributions. With the new standard deduction ($24,000 for a married couple filing jointly), more households will not see an advantage by itemizing, which means charitable contributions will not be deductible unless the sum total of allowable deductions exceed the higher thresholds.

Some analysts of the tax bill have already begun to formulate new strategies in response to the changes. Such as:

- Instead of using a home equity line of credit to monetize the equity in their homes, homeowners may consider second mortgages, or re-financing an existing mortgage for a larger amount, as the interest from both transactions will still be deductible (provided the refinanced mortgages don’t exceed either $1 million or $750,000).
- Conversely, the elimination of deductible interest on home equity loans may prompt some to pay off or begin paying down these debts instead of making interest-only payments.
- As for charitable contributions: If your annual itemizations will not exceed the new standard deduction, you might consider combining two or three years of charitable contributions in one tax year. This “bunching” strategy could result in additional tax deductions in some years, while taking the standard deduction the rest of the time.

Other new tax strategies may not become apparent for several years; it will take a while for taxpayers to recognize which changes affect them most, and what innovative approaches might make a difference.

Tax Management Can Be a Financial Emergency

For those who determined on Christmas Day that they could save several thousand dollars by prepaying their taxes in the next week, the next thought was: “Do I have the cash to make this happen?” It’s one thing to see how re-arranging your finances could result in tax savings. It’s another thing to have the cash reserves to do it.

Think about the new tax-saving strategies mentioned above. Every one of them needs cash to be done efficiently.

Refinancing usually includes transaction fees, which if not paid up-front, will be rolled into the new loan, adding principal and interest. Better to use cash reserves.

Paying off a home equity line of credit by liquidating long-term assets risks selling at a loss or forfeiting future appreciation. Better to use cash reserves.

A decision to bunch charitable contributions will likely require some end-of-the-year gifts. Where will those funds come from? Better to use cash reserves.

Tax management probably doesn’t come to mind as a “financial emergency” that requires liquidity. But considering the inevitability of tax law changes, cash reserves can be an invaluable asset for maximizing your chances to minimize taxes. ❖

Most financial advice reflects a cautious, balanced perspective. You’ll hear statements like:

- Don’t put all your eggs in one basket. Diversify.
- Borrow, but don’t take on too much debt.
- Take risks, but have some guarantees as well.
- Think long-term. And short-term, too.

You get the idea. So, when someone comes along with an approach that seems, well, unbalanced, there will be a few raised eyebrows, usually followed by “I don’t know…that sounds pretty drastic.” And for many, the conversation ends right there.

But some people, when they take the time to get to the whole story, end up saying, “Y’know, that isn’t as crazy as I thought.”

The following example illustrates just this type of approach. And if you can get past the initial raised eyebrow, it’s not as outrageous as it sounds.

A Strategy for Financial “Adults”

A 40-year-old dentist earning $150,000 a year has accumulated $200,000 in several saving and investment accounts, primarily through a plan of systematic monthly saving (currently $1,500 a month). Looking for a second financial opinion, and on the recommendation of a friend, the dentist meets with a financial professional to discuss his current situation and perhaps consider some new approaches.

The financial professional reviews other aspects of the dentist’s financial life, such as debt, insurance protection, and cash reserves, as well as personal objectives besides retirement. A week later, they meet to discuss possible alternatives. After a brief intro, the financial professional says,

“You know, you might consider putting all your ‘new money’ into a whole life insurance policy.”

And the dentist, who is married, has three children, and already has $3 million in term life insurance, says, “I don’t know…that sounds pretty drastic.” And the conversation ends right there.

No wait! There’s more to the story. And as you dig into the details, there are good reasons to give this idea a closer look.

Reason #1: The Dentist Is a Financial Adult. An all-in commitment to funding a whole life insurance policy is probably not suitable for someone just starting a career and beginning to save and invest for the future. But the dentist isn’t a financial newbie. His professional and financial success make him eligible for this recommendation.

First, the dentist has an established career, and can reasonably anticipate another two decades of steady, and perhaps increasing income. Unless something catastrophic happens, he is going to accumulate a substantial fortune.

Second, he has demonstrated the discipline to save. It is reasonable to assume he will continue to save in larger amounts as income increases and/or obligations decrease.

Third, a financial foundation is in place. He has assets other than his income, and doesn’t need to build an emergency fund.

Reason #2: It’s Not All Money, Just “New Money.” The recommendation involves only “new money,” that is, the $1,500 of additional saving that is set aside each month. Existing accumulations (“old money”) will not be touched; they will remain invested as before, to presumably grow as before.

Also, any new money in excess of $1,500/mo. can be allocated to new or established accumulation accounts. In other words, the term “all new money” really applies only to this year.

Reason #3:[1] It’s Not Forever. This commitment of all new money to funding a whole life policy doesn’t have to continue forever. Details will vary depending on the structure of the policy, but once cash values reach specific levels, the dentist may exercise options to reduce or suspend premiums, while maintaining the benefits.

Reason #4: The Benefits are Substantial. Here are some of the long-term benefits the dentist achieves by adding a substantial, fully-funded whole life policy to his financial program:

- **A Permanent Death Benefit.[2]** Especially for those with substantial assets, a life insurance benefit guaranteed to be in force at death – at whatever age that might occur – can be a tremendous complementary asset. The certainty of an insurance benefit may allow other assets to be spent/enjoyed, protect legacy assets from liquidation, provide funding for inheritance, or defray long-term care and/or end-of-life expenses. Some individuals wait until retirement to obtain permanent life insurance, but this is a gamble, contingent on continuing good health. Better to secure the benefit now than hope to still be insurable later.
- **A Disability Waiver of Premium Rider.[3]** This ensures that $1,500/mo. in premiums will continue to be paid in the event of a qualifying disability. This waiver preserves both the insurance benefit and cash value accumulations. While a good disability income insurance program can replace a high percentage of one’s earnings, and maintain one’s present standard-of-living, Waiver of Premium is a way to ensure that saving for the future continues as well.
- **Lawsuit Protection.[4]** People with assets have the greatest risk of losing them through legal proceedings. In many states, cash values inside a life insurance policy are protected from creditors, particularly if a spouse or children are named beneficiaries, and the policies have been in force well before litigation is initiated.
- **Tax Advantages.** Cash values accumulate tax-free, and can be withdrawn tax-free up to the policy’s basis, or taken as loans with liberal repayment terms.[5] Death benefits are usually tax-free to beneficiaries, which may be used to maximize inheritance and estate planning distributions.

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- **Liquidity.** Cash values accumulate according to a pre-determined schedule, and are typically enhanced by dividends.[6] The result is a steadily growing liquid accumulation - which can be accessed through loans/withdrawals[5] - that, as one life insurance professional puts it, "never has a bad day." Over longer holding periods, the historical rates of return on cash values are competitive with other conservative asset classes, while arguably less volatile.
- **Removes the Almost-Certain Financial Loss in Term Life Insurance.** The only "win" in term insurance occurs if the insured dies well before life expectancy; the far more likely outcome is several decades of premiums for a benefit that will be surrendered. The financial impact is not only the premiums paid, but the opportunity costs, as well as the forfeiture of a death benefit that could have added many of the advantages listed above.

Are You a Financial Adult Who Could Use a "Time Out"?

In this example, a decision to commit all new money to a whole life policy is a brief "time out" from other saving to ensure improved financial protection, balance and options going forward. The strategy isn't as unbalanced as it may have first seemed. Rather, it's a way to maintain financial equilibrium at a higher level. If you're a financial adult with an established career path, discipline, and existing accumulation, having a financial professional prepare a personalized evaluation of how whole life could protect your future and enhance your results could be enlightening. ❖

1 The premium offset year is not guaranteed and relies on the payment of non-guaranteed dividends and the amount of paid-up additions in the policy in order to pay for the policy's required premium.

2 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.

3 Disability Waiver of Premium rider will incur an additional premiums.

4 State creditor protection for life insurance policies varies by state. Contact your state's insurance department or consult your legal advisor regarding your individual situation.

5 Policy benefits are reduced by any outstanding loan or loan interest and/or withdrawals. Dividends, if any, are affected by policy loans and loan interest. Withdrawals above the cost basis may result in taxable ordinary income. If the policy lapses, or is surrendered, any outstanding loans considered gain in the policy may be subject to ordinary income taxes. If the policy is a Modified Endowment Contract (MEC), loans are treated like withdrawals, but as gain first, subject to ordinary income taxes. If the policy owner is under 59 ½, any taxable withdrawal may also be subject to a 10% federal tax penalty.

6 Dividends are not guaranteed. They are declared annually by the company's Board of Directors.

Could You Be "Orphaned" in Retirement?

Are your financial professionals older than you? How much older?

What would happen to your financial programs if they retired? (What if they don't retire, but simply make a career change?)

If you lose one of your financial professionals, who can step up to help you?

Citing a report from Cerulli Associates, a July 2017 *Forbes* article reported that "Today the average age of a financial advisor is 51, with 38% of advisors expecting to retire in the next 10 years." These numbers aren't expected to change dramatically: 43 percent of financial representatives are over the age of 55, while just 10 percent are under 35.

Two key considerations in choosing a financial professional are perceived competence and a relationship connection. People want to work with a professional who has the qualifications and experience to get the job done right. They also appreciate someone who understands and relates to their values, concerns and aspirations.

Statistics show this desire for a combination of experience and affinity means financial professionals tend to be close in age to most of their clients. Thus, it's quite likely that just about the time the client is ready to retire, so is the financial professional.

For those who will soon be dependent on their savings to live in retirement, the possibility of losing trusted financial assistance can be disconcerting. After sorting through the options, the consensus says there are two effective responses:

1. Plead with the financial professional to put off retirement so he/she can continue working with you.
2. Plan for a transition.

Option #1 might work, but you are better off working on Option #2. Here are several thoughts about ways to make a transition as smooth as possible.

1. Identify possible successors. Does your financial professional have a successor in place? If so, you should begin evaluating his/her suitability for working with you in the future. Beginning this evaluation now gives you time to know the successor's philosophies and perspectives – and gives them time to know you as well.

If there is not an appointed successor, inquire about your professional's future plans. Is he/she planning to sell the business? What will happen to your accounts? If the professional is a part of a larger firm, will your account be absorbed by the firm and reassigned to another professional in the company?

In the industry, accounts that are unassigned after a financial professional's departure are often classified as "orphans." Their reassignment may be random, sometimes to newly hired representatives, whose abilities may or may not meet your needs.

2. Establish other connections within the firm. Most professionals whose work includes providing insurance and other financial products have an affiliation with a general agency and/or a broker-dealer. In the event your agent/broker either retires or leaves the business, most of your information and service needs can be addressed by the firm. It might be to your advantage to make connections with some of the staff and management. In fact, ask your current financial professional to introduce you.

3. Use technology. Toll-free numbers and on-line access are poor substitutes for personal contact. But there are ways that technology can make a transition much smoother. Secure on-line "data vaults," like The Living Balance Sheet®* and other similar programs, make it simple for you (and whoever succeeds as your financial professional) to access and track your important financial information. There are no paper files to copy and physically transfer, no statements to forward to a new address – and most important, nothing that can be lost or inadvertently thrown out when a retiring representative boxes up and leaves.

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In a perfect world, you'll work with one group of financial professionals for the rest of your life, and the relationships will be profitable for both parties. But even the best financial professionals will eventually pass on. Just in case you outlast them, take some time to consider how you'll choose a successor instead of becoming a financial orphan. ❖

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