Creative

wealth maximization strategies*

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There's a fundamental dilemma at the core of our financial planning processes: it's our inability to prepare for unknown, random events that can undo everything. No matter how much we know, how many alternate outcomes we consider, or how much money we save, there is always something that could devastate our best-laid plans. From a planning perspective, how do you handle that?

"The Game Plan" is a recurring column in the *Wall Street Journal*. which relates the financial back stories and challenges of a real-life family, then asks selected financial professionals for advice. A March 28, 2016, entry offers an example of the disruption from an event that couldn't have been foreseen or avoided.

Three years ago, Stephen and Ida, a couple in their late thirties with four children, had a combined annual income of $270,000 and a comfortable home in the suburbs. With a partner, Stephen was about to launch a flooring and janitorial services business. Less than a year later, their world was turned upside down: "Their youngest son Mikey, then 7, was diagnosed with brain cancer."

For a parent, there is perhaps no greater trauma than the suffering of one of your children. You will do whatever is necessary to ease their pain and help them get better. This includes exhausting your financial resources.

Ida, a registered nurse, quit her job to take care of Mikey and his three siblings. Stephen neglected building his business to be with Mikey as he underwent two surgeries and a series of chemo treatments. In 2014, their family income dropped to $48,000. To keep the family afloat, Stephen and Ida used up their savings, and restructured their mortgage and home equity line to longer terms with lower payments. They relied on assistance from friends and charities.

Mikey is now home, and part of a promising clinical trial. Refocused on work, Stephen's business is growing, and he expects new contracts will bring his income back to $200,000/yr. After two traumatic years, the couple is trying to get back on their feet financially. But they have no savings, and minimal income insurance (a $250,000 life insurance policy and small disability policy, both on Stephen). So what should they do now?

The experts, a New York City husband-and-wife financial advisory team, offered fairly straightforward advice:

- Up Stephen's life insurance to $2.5 million, more accurately reflecting his economic value for the family.
- Maximize Stephen's disability insurance, to equal 60% to 70% of his after-tax income. The policy should also have an own-occupation provision, meaning he will receive benefits if he cannot perform the duties of his current occupation, instead of any occupation.
- Add key-man insurance to the business arrangement. Stephen has a partner. If one partner dies unexpectedly, the coverage allows a surviving spouse to receive a cash payout, instead of inheriting the business and its attendant responsibilities.
- Focus on saving for emergencies. The advisers recommend an amount equal to six months of living expenses (currently around $60,000, total for 6 months).

In This Issue…

The advice isn't earth-shaking or innovative. Maximizing insurance and building an emergency reserve are what you do when you're at Square One financially. But looking beyond the recommendations, there are several valuable insights from Stephen and Ida's experiences.

1. They could not have prepared for this.

What parent puts "my son is diagnosed with cancer" on a list of things to plan for? And even if you did, what would be your preparation? Given all the other, more likely, financial challenges (like accumulating for retirement or helping your kids pay for a college education), would cancer insurance on your children be a priority? Probably not.

We like to believe that the right preparation can prevent bad events (if I don't smoke, I won't get cancer) and guarantee good ones (If I save 15 percent of my income, I will be able to retire at 65). But this isn't true. Random events really are random. And sometimes they are not avoidable.

2. There is a way to survive the unknown.

Health care, especially for complex cancer treatment protocols, is expensive. And the opportunity costs from using one's income, savings, and productivity to pay for this care can be monumental. But despite the magnitude of these challenges, many households find ways to survive, and eventually thrive. If it is unsettling to recognize that an unknown event could upend your financial life, there is also comfort in knowing that many people regain their financial footing. And just as there are unknowns that can knock us down, there may be unknown sources of support. If you do a little digging on the Internet, you can see that a number of organizations sponsored benefit events to help Stephen and Ida pay some of Mikey's medical expenses. Unknowns can be challenging, but defeat is not inevitable.

3. The "fixes" recommended by the financial professionals probably should have been in place already.

The recommendation of a ten-fold increase in Stephen's life insurance isn't because his economic value increased that much since Mikey's cancer. Even before the diagnosis, he was underinsured. And, even at $2.5 million, some might say his income potential is still under-represented.

The proposed improvements to Stephen's disability insurance plan reflect a similar concern. The family may be more receptive to a better insurance plan because their precarious financial condition means they can't afford to lose Stephen's income, but is that really much different today than it was three years ago?

Waiting to insure one's income is never a good idea, especially since our insurability comes with an expiration date; at some point, diminishing health will disqualify us for life and/or disability insurance. Before or after Mikey's cancer, the family's financial fortunes were dependent on Stephen continuing as the primary income earner.

Maximize What You Can, When You Can

In light of Mikey's condition, it's interesting to note the financial pros' recommendations were primarily directed at ***strengthening the household's life insurance and disability program.*** There was no recommendation to establish a medical fund for possible cancer issues in the future. Mikey's condition, and the subsequent financial fallout, simply highlighted how important income protection is for the family's long-term financial well-being.

It can be discouraging to realize how fragile our financial security really is in the face of the unknown. And trying to adequately prepare for every unknown can be an emotional and financial drain, wasting time and resources. Further, being distracted by the unknowns may prevent us from doing a good job with the things we can manage. Addressing known financial risks is the only way to prepare for the events that can't be prepared for. But quite often, even high-income households under-insure their incomes and future financial value. Better to accept there are some things that can't be planned for, and pay attention to the ones that can. ❖

Among his many memorable quotes, Hall of Fame baseball player Yogi Berra once said, "In theory there is no difference between theory and practice. In practice there is."

If he hadn't made it in baseball, Yogi could have been a fine behavioral economist. A longer explanation follows, but Berra's quote neatly summarizes a recent finding that many current retirees have a "retirement consumption gap," which means their ***actual*** spending is less than their ***available*** spending. What's more, the study found the consumption gap is greatest for those have accumulated the most.

"Spending in Retirement: The Consumption Gap," a February 2016 report by four Texas Tech professors started with the assumption that "retirees draw down their wealth in order to fund retirement spending. The economic rationale is that people save money during their working years so that they can eventually spend it." This assumption reflects a prevailing paradigm for retirement income planning; the objective is to develop strategies and withdrawal sequences to provide maximum spending potential from a retiree's savings.

But the Texas Tech report found, "(R)etirees seem to spend much less than theory would predict. Rather than spending down savings during retirement, many studies have found that the value

of retirees' financial assets hold steady or even increase over time."

The consumption gaps even affects required minimum distributions (RMD) from qualified retirement plans; retirees take distributions only to reinvest them. Furthermore, this unwillingness to spend was found to be greatest among those who had saved the most. Even when accounting for a desire to leave an inheritance and thus reduce their spendable assets, the authors calculated the wealthiest 20 percent of retirees had consumption gaps of over 40 percent, i.e., they could safely spend 40 percent more each year.

Why such a large difference between theory and practice? A combination of mathematical and psychological factors seems to be at work.

Calculating a Safe Withdrawal Rate

As more workers enter retirement without a pension, they face the challenge of finding safe and effective ways to turn existing accumulations into a stream of retirement income.

In 1994, financial advisor William Bengen first articulated a 4% withdrawal rate as a yardstick for delivering a consistent retirement income with minimal risk of running out of money. Bengen's historical research showed that retirees who drew down no more than 4.2 percent of their portfolio in the initial year, and adjusted that amount each year for inflation, had a great chance their money would outlive them. In the ensuing two decades, there have been ever-more sophisticated iterations of Bengen's idea, but every projection of a safe withdrawal rate includes the following four items:

- A lump-sum for producing retirement income, both through earnings and drawdown of principal.
- A first-year income that serves as a baseline for future withdrawals.
- An assumed average annual rate of return.
- An assumed average annual inflation rate.

Here's a simple retirement income withdrawal scenario using these ingredients:

- A 65-year-old retiree has $1 million in retirement assets.
- The first-year retirement income withdrawal will be $40,000, equal to 4% of the beginning balance.
- Each year, the amount withdrawn will increase by 3%, reflecting the assumed average annual rate of inflation.
- A 5% average annual rate of return on the lump sum is assumed, compounded annually.

Table 1 shows the retirement income projection.

TABLE 1

YEAR	BEGINNING BALANCE	ANNUAL WITHDRAWAL	ANN. INV EARNINGS
1	$1,000,000	$40,000	$48,000
2	$1,008,000	$41,200	$48,340
3	$1,015,140	$42,436	$48,635
4	$1,021,339	$43,709	$48,882
5	$1,026,512	$45,020	$49,075
	...	...	...
10	$1,033,563	$52,191	$49,069
	...	...	...
15	$998,514	$60,504	$46,901
	...	...	...
20	$902,717	$70,140	$41,629
	...	...	...
25	$721,258	$81,312	$31,997
	...	...	...
30	$421,038	$94,263	$16,339
	...	...	...
34	$66,397	$106,093	$(1,985)

The plan doesn't run out of money until the 34th year, when the retiree would be 99 (and receiving an annual income over $100,000). Superficially, this projection validates Bengen's 4% rule. However, a closer look reveals some interesting mathematical quirks, and those quirks matter.

Even though withdrawals increase annually, the retiree's accumulation balance continues to grow for nine years, and doesn't drop below $1 million until the 15th year. This is because most spend-down projections require the account balance to grow, at least a little, in the early years of retirement to cover the inflation-adjusted income needs later on.

In order for this growth during early retirement to occur, the assumed annual rate of return must exceed the initial withdrawal rate (in this example, average annual returns must be greater than 4 percent).

There's another twist: even if the average annual rate of return exceeds the withdrawal rate, ***this model only works if retirees experience positive investment returns in the early years of retirement***. If they don't, the inflation-adjusted withdrawals devour the accumulation in a hurry.

To illustrate: Take all of the assumptions from the first projection, except for two years – the first, where the portfolio loses 2%, and Year 3, with a zero return. From Year 4 on, returns stay at 5% annually. Look at the difference in **Table 2**.

TABLE 2

YEAR	BEGINNING BALANCE	ANNUAL WITHDRAWAL	ANNUAL EARNINGS
1	$1,000,000	$40,000	$(19,200)
2	$940,800	$41,200	$44,980
3	$944,580	$42,436	$0
4	$902,144	$43,709	$42,922
5	$901,357	$45,020	$42,817
6	$899,153	$46,371	$42,639
7	$895,421	$47,762	$42,383
8	$890,042	$49,195	$42,042
9	$882,890	$50,671	$41,611
10	$873,830	$52,191	$41,082
11	$862,721	$53,757	$40,448
12	$849,412	$55,369	$39,702
13	$833,745	$57,030	$38,836
14	$815,550	$58,741	$37,840
15	$794,649	$60,504	$36,707
16	$770,853	$62,319	$35,427
17	$743,961	$64,188	$33,989
18	$713,762	$66,114	$32,382
19	$680,030	$68,097	$30,597
20	$642,529	$70,140	$28,619
21	$601,009	$72,244	$26,438
22	$555,202	$74,412	$24,040
23	$504,830	$76,644	$21,409
24	$449,595	$78,943	$18,533
25	$389,184	$81,312	$15,394
26	$323,266	$83,751	$11,976
27	$251,491	$86,264	$8,261
28	$173,489	$88,852	$4,232
29	$88,869	$91,517	$(132)

The money will still last for 29 years, to age 94, which should be sufficient for most life expectancies. But note that the account balance drops below $1 Million the first year, and except for a $4,000 increase in Year 2, ***keeps falling.***

The above examples are very crude projections. More sophisticated spend-down calculators can process multiple return periods to generate best- and worst-case scenarios, and the probabilities for variance from historical averages. But when just two years of minimal losses in a simple illustration have this kind of long-term impact, and recognizing that actual inflation and return rates will be anything but stable, it's easy to see that retirees might feel a bit uneasy about spending down principal, even if the math tells them they can. This would seem particularly true for a retiree who experiences lower-than-expected returns at the beginning, and sees the balance decline right away.

The Consumption Gap Exists Because There is No Insurance

The difference between safe withdrawal rate theory and retirement consumption gap practices is probably due to a lack of financial certainty. With no lifetime guarantees like those provided by a pension or annuity, many retirees seem to intuitively recognize their management limitations. The Texas Tech professors concluded "It appears, in the absence of annuitized wealth, retirees have little confidence in their ability to decumulate effectively."

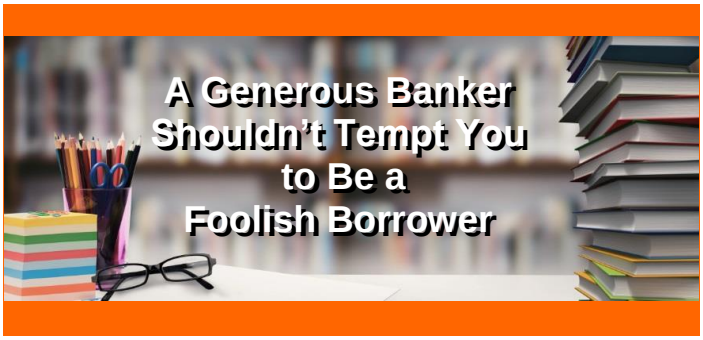
Yet retirement advisor Michael Kitces doesn't think the problem is a lack of confidence on the part of retirees. Per a July 6, 2016, blog post, Kitces feels that a reluctance to draw down principal "isn't a sign of inefficient portfolio spending or a consumption gap, but merely the prudent reality of dealing with an uncertain future!" When you don't have financial guarantees, you have to be more cautious. Or you have to consider adding some insurance into your retirement income plan.

Can Guarantees Close the Consumption Gap?*

While detailed math formulas may indicate retirees can probably spend more, a *probable* outcome is not the same as a *guaranteed* one. When some income is guaranteed – regardless of market conditions, inflation or personal circumstance – other assets can be spent more freely. This is the purpose of annuities, which are insurance contracts to guarantee a lifetime income. And the guaranteed death benefits from permanent life insurance policies can be used as a "permission slip" to spend other assets, knowing this end-of-life financial payment is waiting. ❖

Your decision on a safe retirement withdrawal rate might be a little easier if you find ways to integrate insurance into your retirement income calculations. Guarantees can make practice match theory.

* Annuity and life insurance policy guarantees are subject to the timely payment of all required premiums and the claims paying ability of the issuing insurance company.



A loan officer has a simple job description: lend money to individuals who can reasonably be expected to repay, with interest. But determining who is likely to repay is not simple. Loan officers must consider potential borrowers' financial vitals, such as income and net worth, as well as other more subjective issues, including their type of work, the larger economy, and the personal character of the borrower. Even with a wealth of information and meticulous assessment, some loans will default.

However, it shouldn't take much insight to see that some loans aren't as likely to be repaid. Like, maybe, this one:

Loan Officer: I understand you are here to see about a business loan. Tell me about your plans.

Would-be Business Owner: Well, I want to start a business.

Loan Officer: I see. What type of business?

Would-be Business Owner: I don't know. That's one of the reasons I want a loan. To start, I need somewhere between $20,000 and $40,000 to pay for a four- to five-year period of research and development. Then I may need another $200,000 or so, just to get me through the start-up phase to where I'm turning a profit.

Loan Officer: This is rather unusual. Most start-ups have decided on the type of business they want to go into, and they typically present a business plan that projects an eventual profit. What are your qualifications, in terms of education and experience, that would make you a good candidate for a research and development loan, plus additional financing?

Would-be Business Owner: I have a high school diploma, a couple of promising test scores, and no significant work experience.

Loan Officer: Hmm. This is an unusual business loan request. Have you considered the terms under which you would be willing to borrow this kind of money?

Would-be Business Owner: Yes. I would like to defer all payments on an interest-free basis until six months after I finish my R & D. I'll want my payments adjusted to a reasonable percentage of what I actually earn, and a below-market interest rate.

Loan Officer: Well, that's great! You are exactly the type of borrower we are looking for! I'll have the paperwork prepared today.

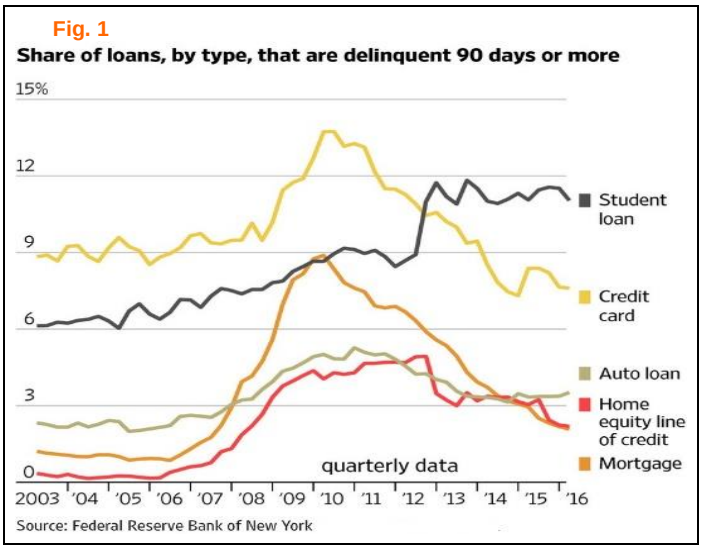
Would-be Business Owner: Uh, cool.

If you haven't guessed, this imaginary conversation parallels the student loan application process. When viewed as a loan to a prospective entrepreneur, approval would seem to be less than prudent. But although some might quibble on the details, these are essentially the loans the U.S. Government makes to 18-year-olds with a very limited idea of what they want to do to earn a living. And it's not surprising that many of these loans turn sour – for both the lender and the borrower.

Good Intentions, Not-so-good Results

By some measures, student loans have become the worst-performing class of consumer debt. Just under 12% of all student loans are delinquent 90 days or more, higher than credit cards, home mortgages, or auto loans. And while delinquency rates for other types of consumer debt have declined in the recovery

following the 2008 recession, the student loan rate has climbed and remained elevated. (see Fig. 1)



Lenders usually compensate for high delinquency rates by charging more interest; higher risk borrowers pay higher rates. The Federal Reserve's May 2016 Consumer Credit report found the average interest rate for unsecured credit cards was 13.35 percent, and many credit cards charge more than 20 percent. But student loan interest rates are tied to US Treasury rates, with no adjustment for students who are greater default risks. As of July 1, 2016, the rate for undergraduate student loans was fixed at 3.76 percent – for everyone.

A February 2016 U.S. Treasury report showed student loans now make up 37 percent of the total assets of the U.S. government, and in the words of blogger Mike Flynn, "In some ways, a major business of the U.S. government now is getting students to take out loans to pay for college." But why would a lender – even the U.S. government – offer low rates to high-risk borrowers?

Because policymakers have decided that increasing the opportunities for more citizens to attend college is an investment in the future, even if it is a financial "loss leader." On this basis, there might a case for defending student loans as an investment in human capital that will yield long-term dividends even if the loans don't make sense financially. But as Josh Mitchell asserts in a June 6, 2016, *Wall Street Journal* article, "New research shows a significant chunk of that investment backfired, with millions of students worse off for having gone to school." Here's why:

A May 2016 report from the think tank Third Way showed that among students who enrolled in 2005, on average only half graduated from such institutions within six years. The others drop out; they find school isn't for them, encounter other life events, or can't afford to continue, even with student loans.

Here's where it really gets sticky: Approximately 40 percent of college dropouts have student loan debt. Statistics show that the income levels for college dropouts are about the same as high-school graduates. But because many dropouts have student loan debt to service, their discretionary income is less than a high-school graduate's! "Along with weak job prospects," says Mitchell, "most of these students are now severely behind on payments, damaging their credit and limiting their ability to borrow for homes and cars." In short, borrowing for college and dropping out is worse than not going at all.

The Education Source of Last Resort?

If it's misguided for the government to offer easy money, it's also problematic for young adults to take it unless they have a clear plan for becoming profitable enough to pay it back without delaying or derailing their future. In a perfect world, everyone that wanted to attend college could save for it, and not borrow. In the real world, the pragmatic approach is to make student loans the last source of funds, and apply for them only after the student is firmly committed to a degree and career track that makes repayment a reasonable possibility. This results in a more plausible imaginary conversation:

Loan Officer: I understand you are here to see about a business loan. Tell me about your plans.

Would-be Business Owner: Well, I'm three years into an apprenticeship program, and need some money to finish out. I've done some work in my chosen field, and have some prospective customers lined up for when I can go on my own. If I earn what others have made, I can easily repay this loan.

Loan Officer: Wow. That's different from a lot of would-be business owners that come in my office. I think we can do something that works for both of us. ❖

Many individuals approaching retirement are facing an interesting decision: ***Should we liquidate our largest asset or continue to live in it?***

Even those with significant savings may find as they near retirement that the equity in their home (or homes) is equal to, or greater than their 401(k) balances. In these situations, selling a home and either downsizing or renting could dramatically increase one's retirement assets. But any decision to sell requires careful consideration of other financial, emotional and practical issues; the question of whether to "age in place" or select a new living arrangement is perhaps one of the most important decisions retirees must make.

The argument for selling is fairly straightforward. For long-time homeowners in desirable real estate markets, it would not be uncommon for a home purchased for $200,000 in the 1980s to sell for more than $1 million. Even if the property still carries a mortgage, a sale would likely net a substantial profit. Who couldn't use an additional $700,000 added to their retirement portfolio?

The Ripple Effects

A decision to sell your home triggers another decision: **Where are you going to live – and how are you going to pay for it?**

Whatever you decide, there can be far-reaching consequences.

- You could pay cash for a smaller, less-expensive home, while banking the rest of your sale proceeds. But whether the existing home or new one is owned free and clear, there are still overhead expenses, such as property taxes, utilities, insurance and maintenance & repair costs. Charles Farrell, a Denver financial planner, and author of the 2009 book *Your Money Ratios*, says homeowners should expect to pay about 3% of the home's value toward taxes, insurance, utilities and maintenance. That means the owner of a $1 million home should plan on paying $30,000 a year to stay put. That's $2,500 a month, which might be more than renting.
- Renting eliminates taxes and maintenance from your housing overhead, but it introduces another financial variable: the prospect of future rent increases. A home sale may add to your retirement pile, but over time, that "extra" could be consumed by rising rents. In select markets, steep rent increases have priced many long-term tenants out of their housing.
- The "location, location, location" mantra of every real estate agent also applies to the decision to sell at retirement, but in a different way. Renters typically enjoy a wider range of housing options and flexibility. It's much easier to relocate in response to a health issue, or a need to be closer to family. How much is this location flexibility worth?
- Not that most retirees want to be nomads. A 2014 survey from Harvard's Joint Center for Housing Studies found that "even among individuals aged 80 and over, more than three-quarters live in their own homes. Indeed, 'aging in place' is the preference of most people." A 2010 AARP survey found 70 percent of retirees want to remain in their own homes and/or their current communities.
- A reverse mortgage is a way to monetize one's home equity while continuing to live in it. Because reverse mortgages are considered loan advances and not retirement income, the payments you receive are not taxable. Moreover, they usually don't affect your Social Security or Medicare benefits.

Regardless of the financial and location factors, and also personal preferences, a housing decision ultimately hinges on one's ability to live independently. Remaining in one's home may be financially feasible if one is healthy, but what happens if advancing age requires increased care? A decision at 70 to remain in a home could be problematic at 85, especially if the decision to stay substantially reduces liquidity.

A personal residence is a unique financial asset, and often comprises a significant portion of one's net worth. Especially if you are nearing retirement, you should consider how your home fits your retirement objectives. These objectives are not just financial, and selling is not always the best choice. ❖

The best housing decision is one where you have enough time and input to carefully weigh your options.

Is this something to discuss with your financial professionals?

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