WESTPAC
WEALTH PARTNERS
PROTECT • INVEST • ACHIEVE

wealth maximization strategies*

FEBRUARY 2020

"The test of a first-rate intelligence is the ability to hold two opposed ideas in mind at the same time and still retain the ability to function."
– F. Scott Fitzgerald

Let's begin with a couple of broad assertions.

1. **Efficient and rational markets arise from the collective irrational decisions of individuals.**
2. **Success in personal finance comes to those who can consistently make rational decisions.**

Without going too deep into the weeds of economic theories, these generalities explain the challenge of the personal finance industry: trying to persuade irrational individuals to make rational financial decisions. But what if irrational behavior is the catalyst that makes rational behavior possible? There's an idea to test a first-rate intelligence.

The Condescending Righteousness of Numbers

Carl Richards, a certified financial planner and author of the "The Behavior Gap," writes personal finance articles for the *New York Times.* In a recent column, Richards imagines a situation where a large group has assembled to listen to a presentation on personal finance from a famous speaker. Who is this speaker? **Numbers**.

> **"You know Numbers, right? Numbers is that really smart person who is always right and always rational and whose suggestions fit nicely into a calculator or spreadsheet. Numbers is the gatekeeper for truth. And when Numbers speaks, all of your other friends — Feelings, Emotions and Intuition — must shut up and listen. Those are just the rules."**

Yeah, well, despite being "always right and always rational," not everyone is inclined to listen to Numbers; Feelings, Emotions and Intuition also hold sway for a lot of people. Financial behaviorism recognizes these "irrational" aspects of our relationship with money and attempts to channel these impulses, nudging us toward more rational decisions. Default enrollment in retirement plans, automatic withdrawals for savings, and the framing language used to describe investments are examples of behavioral strategies intended to move us to better financial choices.

But even while giving a nod to feelings, emotions, and intuition, these nudges are based on the same assumption: Numbers are the benchmarks for good decision-making.

In This Issue…

A SOPHISTICATED PERSPECTIVE ON CASH
Page 1

THE TRUSTEE FOR YOUR ESTATE PLAN: CHOOSE WISELY
Page 3

SHOULD YOU PAY OFF YOUR MORTGAGE BEFORE RETIREMENT?
Page 4

WHY YOU'LL SELECT THE AARDVARK ACCOUNT
Page 5

And while Numbers wants to believe it can make a strong argument *("I've got the numbers right here to prove it!")*, some financial behaviorists are beginning to think there may be other benchmarks, ones that validate the importance of feelings, emotions and intuition.

Looking Beyond Rational to What's Real

Here's a good example: the percentage of cash reserves in a person's financial plan. Michael Kitces, a Virginia-based financial planner whose commentary is often featured in industry publications, articulates the numbers-driven, rational approach to cash reserves:

"The classic view of cash in the world of investing is that it's something to avoid, or at least minimize. To the extent cash is truly needed for immediate or near-term liquidity, holding some may be a necessity. But the investment goal is always to hold as little cash as possible, and put the rest to work on your long-term behalf."

The rationality of this approach is unassailable. Given the choice between a safe, liquid account that earns 1 percent annually, or a fund with a track record of 6 percent per year over the past 10 years, the numbers say commit as much money as possible to the high-return alternative and allocate a minimum to the 1 percent option. This approach produces more money, and rationally, more money is better. Except…

A recent research study *("How Your Bank Balance Buys Happiness: The Importance of 'Cash on Hand' to Life Satisfaction."*by Ruberton, Gladstone and Lyumbomirksy*)* arrives at a different conclusion. It seems that "Individuals with higher liquid wealth were found to have more positive perceptions of their financial well-being, which, in turn, predicted higher life satisfaction, suggesting that liquid wealth is indirectly associated with life satisfaction."

Even controlling for other factors, Kitces says this finding remains consistent: ***"People are happier when they have a pile of readily available cash."*** Which begs the question: What is the goal of personal finance, more money (very rational and measurable), or happy people (not exactly irrational, but very fuzzy)?

At first reading, this implies that irrational financial behavior makes people happier, which is just, well, irrational. But a more sophisticated take is that this information could be a key to making more rational financial decisions.

Accommodating Emotions = Acting More Rational?

One of the tenets of contemporary personal finance is that investments which have historically produced higher returns require longer holding periods. But studies of investor behavior repeatedly find a large percentage of individual investors do not stay invested; they jump in and out, usually to their financial detriment.

It's plausible to conclude that erratic investor behavior might be a result of forgoing the higher life satisfaction suggested by having cash on hand. It's hard to do the rational thing if you're neglecting the other aspects of your relationship with money – specifically your feelings, emotions, and intuitions, which seem to feel better when there is cash on hand.

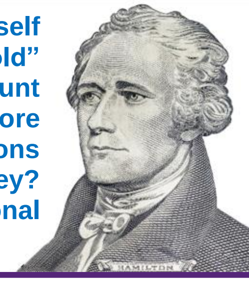
If you address your "irrational" desire for cash, you might actually be able to do what the numbers recommend with the rest of your money. It may seem irrational but more cash on hand might lead to better returns on the money you invest.

How Much Cash on Hand Will Make You Happy?

An excessively rational approach to personal finance may overlook factors that impact your financial well-being – like the satisfaction many people get from "a pile of readily available cash" – simply because these elements don't measure up to an arbitrary numerical standard. You can be more sophisticated in your thinking.

Cash on hand is important, and so are other financial products that reinforce your sense of financial security. And when your subjective issues with money are satisfied, you are better equipped to make rational money decisions and stick with them. ❖

Have you ever asked yourself what your "happiness threshold" is for cash on hand, an amount that would allow you to make more rational and profitable decisions with the rest of your money? Has a financial professional ever asked you?



An Out-Of-The-Box Afterthought:

An internet search "best places for cash reserves" will bring up lists of financial instruments with three essential characteristics. They will be:

1. Safe, usually with guarantees for both principal and earnings.

2. Liquid, in that funds that can be accessed quickly (from immediately to a few business days) and with minimal costs (such as withdrawal penalties, or taxes).

These cash reserve vehicles will ***not***:

3. Have high rates of return, relative to the historical, long-term performance of other investments.

Point #3 is not a negative. It's just the cost of making Points #1 and #2 certain. But with a little sophisticated thinking about cash on hand, there may be ways to improve returns as well.

The underlying assumption is that these instruments are short-term waystations for cash. As soon as possible, money will be transferred to longer-term investments with opportunities for higher returns. But what if you treated "cash on hand" as a long-term holding instead of a temporary one?

This perspective opens the door to other possibilities, like life insurance cash values*. Cash values are safe, liquid, and compared to other cash reserve instruments, often provide higher returns. But because cash values are part of a life insurance policy, they accumulate gradually, with the best returns realized as the policy matures. If you see the value in having a long-term repository of readily available cash, there are sophisticated ways to incorporate cash value life insurance in your financial plans. ❖

The Trustee for Your Estate Plan: Choose Wisely

You probably already know a trust is an essential document in estate planning. Properly configured and funded, a trust protects the privacy of your estate, ensures that its assets avoid probate, and provides the grantors with a legally binding framework for distributing assets according to their wishes. But a well-designed trust still requires human management to ensure its execution.

While the grantors (i.e., the creators) of the trust are alive, they usually also serve as its trustees, managing the assets placed in it. When the grantors die, a successor trustee steps in to continue these administrative responsibilities. The successor trustee is the critical human factor in an estate plan.

Responsibilities of a Trustee

A competent successor trustee must:

- Confirm their authority as trustee, and act as the liaison between both financial institutions and beneficiaries. This often requires documentation or registration with appropriate entities.
- Manage and preserve trust assets to fulfill the objectives of the trust.
- Administer distributions according to the terms of the trust.
- Maintain financial records so that tax returns are filed promptly, and beneficiaries have accurate and timely information regarding trust assets and anticipated distributions.
- Communicate regularly with beneficiaries, addressing questions and concerns.

Trustee Options

Typical candidates for successor trustees are family members, financial professionals, or institutions.

The most common reasons for designating a family member (an adult child, a sibling, or other family relative) are cost and trust. Family member trustees often serve as volunteers, and typically have a strong familial interest in ensuring the wishes of the grantors are honored.

Appointing a relative – even a trusted one – has risks. The trustee might not have the knowledge or expertise to properly manage the trust assets, which could lead to losses, decreasing the amounts intended for beneficiaries. If family members are beneficiaries, prickly personal relationships may become full-fledged conflicts once money is involved.

These potential pitfalls may prompt grantors to name a financial professional as a third-party trustee. These trustees usually charge fees for their services. In some cases, the grantors may choose a business, such as a bank or trust company, to be the successor trustee. These institutional trustees provide management services for many trusts; different members of the trust company may fulfill the trustee's duties; an investment manager for the assets, a tax preparer for returns, etc.

In theory, institutional trustees have the advantage of expertise and impartiality. In estate plans where a family member is the trustee and also a beneficiary, this duality might create conflicts of interest. Institutional trustees are not beneficiaries; they earn their fees by following the dictates of the trust.

On the other hand, beneficiaries may believe the fees charged by the institutional trustee eat away trust assets that should rightly be distributed. One option to resolve this tension: naming co-trustees, such as a family member and a trust company, to be checks and balances for each other.

Qualifications of Your Trustee

As mentioned earlier, the decision regarding a successor trustee is critical to the trust performing as intended by the grantors. While each estate plan is different, grantors should consider some of the following factors when deciding on a trustee.

Availability of the trustee. It might not be a full-time job, but a trustee's responsibilities are numerous, and may have deadlines. A family member or individual financial professional might be well-suited for the task, but not have the time.

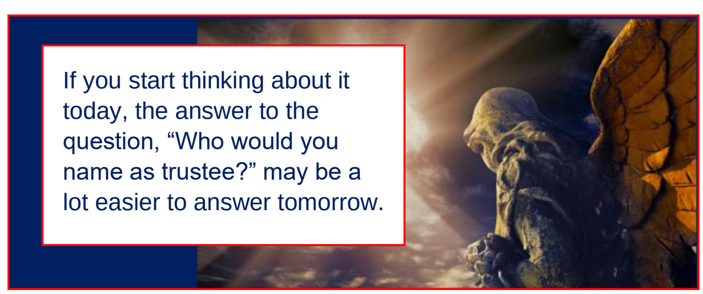
Size of the estate, and the types of assets. If there's a lot to manage, you may need a lot of managers. Real estate, business interests, or investments may require expert guidance. If the trustee isn't competent in these areas, it is imperative that he/she can delegate these management responsibilities to other professionals.

The number and makeup of the beneficiaries. Trust beneficiaries could be a surviving spouse, children, siblings, charitable organizations, private foundations, or other special entities. A trustee should be someone who can interact effectively with the beneficiaries and manage tensions that may arise among competing interests.

An important note: Each state has different rules and each situation is unique, so you should always consult with an attorney or tax advisor when establishing a trust and naming a trustee.

Who would you name as trustee?

Estate planning may not be on your horizon right now. Even if it's a long way off, it can be helpful to consider what you might hope to accomplish with an estate plan, including the people, institutions or causes you'd want as beneficiaries, and who you would appoint to act on your behalf. ❖



Should You Pay Off Your Mortgage Before Retirement?

For generations of American homeowners, the final payment on a mortgage has been a financial milestone, often commemorated with a big celebration. Financially, no more interest charges and no more monthly payments are big wins. And owning your home free and clear is another piece of retirement security; even if you eventually sell the home, your monthly housing costs can remain affordable, because the proceeds from the sale are often enough to pay cash for another residence.

In the past, paying off a mortgage has often been part of a pre-retirement checklist; homeowners might even commit to extra principal payments or refinance to a shorter term.

The thought of not having a monthly house payment is certainly appealing – at any age. But should paying off your mortgage before retirement be a financial priority? Depends on who you ask.

There is the option of saving ***outside*** the mortgage to ***pay it off early.***

Some Experts Say No…

In “3 Retirement Myths Debunked,” an August 2019 article posted on barrons.com, “paying off your mortgage before you retire” was the first “myth” on the list. Columnist Cheryl Munk presented the opinions of several experts who argued against it:

- The money required to clear the mortgage, either in a lump sum or through increased monthly payments, might be more productive if it were invested instead of used to pay down debt. For example: If the mortgage interest rate is 4 percent, and your investments are earning 6 percent, paying off the mortgage incurs a lost opportunity cost; 6 percent gains are forfeited to clear a 4 percent debt.
- Allocating more money to reduce a mortgage is also a reduction in liquidity. Additional principal payments do increase home equity, but this equity can only be accessed through a loan (such as a line of credit or a cash-out refinance) or at the sale of the property.
- Rather than paying down the mortgage, one expert recommended going in the ***other*** direction, by refinancing for a ***longer*** period, like a new 30-year mortgage. This strategy lowers monthly housing costs ***today***, immediately increasing the amount that can be invested in higher-yielding assets. Larger accumulations and greater liquidity would presumably provide more options at retirement.

Some People Disagree…

One of the benefits of Internet journalism is the immediacy of debate. The “Comments” section that often follows an article puts the arguments and rebuttals side-by-side, giving readers a broader perspective on the topic. In this case, many of the commenters were homeowners who had paid off their mortgage, and they were decidedly opposed to Munk’s myth-busting.

Several commenters emphasized the financial freedom and decreased stress that resulted from an early payoff:

– “Paying off your mortgage as quickly and as young as possible is the best decision you can make. It’s freedom from debt.”

– “I paid off my mortgage when I was 43, and this enabled me to accelerate my savings enormously during the last 18 years I worked.”

Another commenter directly rebutted the loss of liquidity, recommending that homeowners “Pay off the house and establish a home equity line of credit…I've never touched it but if, God forbid, one of the children or grandchildren has a horrific and expensive event it is there.” He also saw home equity as less volatile than market-based investments: “What happens when I go to tap the money I gave to (investment companies) and the market is down 35%?”

Is There a Third Way?

Both arguments (for and against paying off a mortgage) are based on hindsight. Munk writes from a perspective of what could have been better choices, given the actual returns, interest rates and housing prices of the past several decades. The readers counter with their personal experiences, concluding that their stories validate their approach. But neither side addresses what could have happened, or more importantly, what might happen in the future. And neither mentions another possible strategy.

Instead of a binary choice between paying off the mortgage or investing, there is the option of saving ***outside*** the mortgage to ***pay it off early.*** To illustrate:

Suppose a pay-off-the-mortgage-plan requires $500/mo. in extra principal payments. Instead of sending this extra cash to the lender, deposit the $500 into a separate account. When the balance equals the mortgage payoff amount, make a lump-sum payment to clear the debt.

This approach has the potential to satisfy both sides. There can be opportunities for returns higher than the interest rate, liquidity, and a payoff which still occurs before retirement. Sort of win-win, right?

Some diehards in the pay-off-the-mortgage camp might insist that the only way to ***guarantee*** an early payoff is to commit the $500 to extra principal payments. This is true.

But if you consult with a financial professional and run some projections based on reasonable assumptions about rates of return and taxes, you might be surprised how minor the difference is in payoff dates – even if the returns from the outside account are ***less*** than the mortgage interest rate. Especially for shorter time periods, the extra money – either for extra principal payments or deposits to an outside account – is the difference-maker, not the rate of return. (And if the returns from the outside account should exceed the mortgage interest rate, you could pay off the mortgage even sooner.) ❖

There is no one-size-fits-all answer, but if you're in the pre-retirement phase of life, it might be time to consider various strategies for paying off your mortgage.

Why You'll Select the Aardvark Account

The Yellow Pages and Alphabeticity Bias

If you're of a certain age, you remember when Yellow Pages directories were the analog versions of Google. If you wanted information on businesses, professional services, or retail outlets within a specific geographic area, you flipped through the local Yellow Pages book to find addresses, hours of operation, and business descriptions.

In its heyday, having a Yellow Pages ad was a big deal. It was an indication of your legitimacy in the business community, and for many, a primary marketing and advertising platform. When entrepreneurs chose the name for their business, one consideration was where it would be seen in the Yellow Pages.

The Yellow Pages grouped businesses or services by category (i.e., Automotive Repair, Dentists, Grocery Stores, etc.), then listed the businesses in each category in alphabetical order. To be the first name potential customers would see, new businesses (especially in retail and personal services) often strategically chose names that began with "A," or even better, several As, so that they were listed first. (A great example is two nationwide rent-to-own franchises: Aaron's Rental and ABC Rental.)

This strategy was based on alphabeticity bias, a documented phenomenon in which early alphabet options are chosen more frequently than others. Alphabeticity bias has been found in a wide range of circumstances. Politicians with last names early in the alphabet are more likely to be elected; scholars with such names are invited to review papers more often; and alumni with such names donate more than others because they are solicited more.

Alphabeticity bias is strongest when people are looking for a product or service about which they have little prior knowledge, or are making a decision under duress, like an emergency or time deadline. If your sink is clogged and you don't have a preferred plumber in your smartphone, you will probably select the first plumber who is available. Which means if the list of plumbers is alphabetical, you'll probably never call Zebra Plumbing. In research terms, you are looking to "satisfice," to find the first acceptable solution as soon as possible – even if continued searching might yield a better result.

Early Search Engine?
We used to "let our fingers do the walking" through the Yellow Pages.

Interesting, but how does this relate to personal finance?

Investment choices presented to participants in employer-sponsored retirement plans (such as 401(k)s and other defined-contribution plans) are often organized by asset class (e.g., equities, bonds, balanced), with the funds in each class then listed in alphabetical order – much like the Yellow Pages of old.

A recent study published in *Financial Review ("Alphabeticity Bias in 401(k) Investing")*, found that participants are biased toward selecting among the options at the top of the list. This bias occurs even if the list is as short as five choices.

"On average, each of the top four funds on such a list receives 10% more money than it would receive if money was allocated equally among the investment options," Jesse Itzkowitz, one of the paper's authors, told the *Wall Street Journal*. "It's absolutely amazing how powerful this effect is and how much it is really distorting what's being invested in."

This is not a finding exclusive to 401(k) allocations. In an earlier study, Itzkowitz found that stocks of companies whose names would place them early in any alphabetic listing have higher trading volumes than those that come later.

Negating Alphabeticity

What can be done to negate alphabeticity bias? The study suggested that lists could be based on different criteria, like expenses or volatility. Yes, people in a hurry or not confident in their expertise might still choose the items from the beginning of the list, but at least their decision wouldn't be based on something as random as the first letter in the item's name.

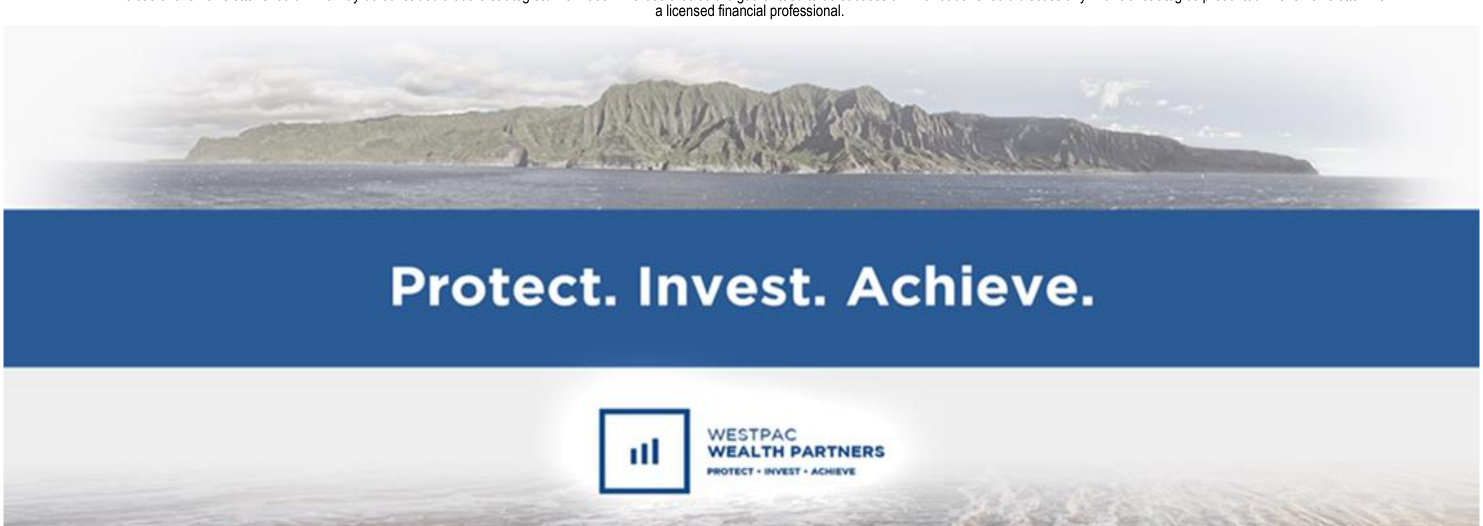
But remember, alphabeticity bias is a result of two things: ignorance about the issue at hand, and the necessity of deciding quickly. For many employees, those are precisely the circumstances under which they make allocation decisions in employer-sponsored retirement plans. It doesn't matter whether the list is organized alphabetically, by lowest costs, or highest volatility; these conditions are not conducive to making an informed decision.

The next time a financial decision includes a list of options, you might notice if the choices are in alphabetical order. And if the first choice is Aaron's Aardvark Account, you'll know why. You can also remember that you have three decision-making strategies for alphabeticity.

1. You can satisfice and simply pick the first one that seems appropriate.
2. You can take your time, review the information, become better informed.
3. You can seek professional input. Let someone else go through the list, do the research, and give you feedback.

The first option relies on luck. The second requires more work on your part. The third? Well, isn't that what financial professionals are for? Alphabeticity bias occurs because it provides a shortcut, but if someone with expertise will do your homework, you don't need a shortcut. ❖

*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.



P 619.684.6400 • F 619.684.6410 | 4275 Executive Square Suite 800, La Jolla, CA 92037 | WestPacWealth.com