Creative

wealth maximization strategies*

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"Strategy is a route to achieving your objectives." - Simon Ramo

Simon Ramo truly meets the definition of a polymath – a person of wide-ranging knowledge or learning. Wikipedia identifies Ramo as "an American physicist, engineer, business leader and author" who pioneered microwave technology, is known as the father of the intercontinental ballistic missile, and was the "R" of TRW, a Fortune 500 technology company. Born in 1913 (and still living at the time of this writing), at age 100 he became the oldest person to ever receive a US patent, for a computer-based learning invention.

An example of the breadth of Ramo's interests was a 1973 book he wrote called *Extraordinary Tennis for the Ordinary Tennis Player*. Tennis was a lifelong passion for Ramo, although he was not a gifted player. And just like his scientific and business activities, he studied the sport intently. Over time, Ramo concluded that success on the court was determined by dramatically different factors, depending on the skill level of the participants. This was Ramo's insight:

Professionals win Points, Amateurs lose Points.

For professionals and a few gifted amateurs, tennis is about making excellent plays: scorching a service ace, finessing a well-placed drop shot, blasting a strong volley. Ramo found that 80 percent of points in high-level matches were the result of winning shots and only 20 percent the result of unforced errors by one's opponent.

In contrast, the dynamics of matches between amateurs were reversed. Eighty percent of points came from unforced errors. An amateur player seldom "beats" an opponent; rather, the player who makes the fewest mistakes, who simply continues to keep the ball in play, usually ends up winning.

From Ramo's perspective, if you want to win at tennis, you have to adjust your strategy to your abilities. For the "ordinary" tennis player, this means understanding that amateur tennis is a "loser's game" where success comes from avoiding losses.

Extraordinary Tennis and Investing

As you might have already imagined, the tennis strategy of avoiding losses could be applied to financial decisions. And indeed, once you get past the Amazon listing for "extraordinary tennis" the most prominent hits in an Internet search reference financial experts. Even more interesting is how many of these experts recommend playing the investing game as amateurs.

Charles D. Ellis, in his best-selling book, *Investment Policy: How to Win the Loser's Game*, (first published in 1977, with five subsequent updates) highlighted Ramo's *Extraordinary Tennis* philosophy. Ellis felt there were so many variables and unknowns associated with investing that it was almost impossible to consistently make "winning" decisions, and even the best financial managers were really "amateurs," who would be better served by adopting safer approaches that minimized loss as opposed to maximizing gain. Other investment pros who believe that investing is a "loser's game" also consistently reference Ramo in their blogs and commentaries, touting safe and loss-averse approaches.

Which leads to an interesting thought: If many investment "pros" see themselves as amateurs, how should those with far less financial acumen see themselves? And what strategies should they be using?

In This Issue…

Well…just how amateur are you?

For the past decade, Olivia S. Mitchell of the University of Pennsylvania's Wharton School and Annamaria Lusardi of the George Washington University School of Business, have administered a three-question financial literacy test to people in the US and around the world. The questions address the concepts of compound interest, inflation, and risk tolerance.

"When we first started, we thought these questions were way too simple and that the majority of respondents would get them correct without any question," Mitchell says in a newly-released update of their research. Wrong assumption: Only half of Americans over age 50 (theoretically, the ones who have made the most financial decisions) could get the first two questions right and only 34 percent could correctly answer all three. "Only half got the third question right — and that was a true or false question," Mitchell says. "You had a 50-50 chance, and one-third answered 'Don't know.' "

Here are the questions:

Financial Literacy Test

1. Suppose you had $100 in a savings account and the interest rate was 2% per year. After five years, how much do you think you would have in the account if you left the money to grow?
   a. More than $102
   b. Exactly $102
   c. Less than $102
2. Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After one year, how much would you be able to buy with the money in this account?
   a. More than today
   b. Exactly the same
   c. Less than today
3. Please tell me whether this statement is true or false: "Buying a single company's stock usually provides a safer return than a stock mutual fund."
   a. True
   b. False

The Correct Answers: 1. A. 2. C. 3. False

Okay, let's just say it. If most Americans had problems with these three questions, their financial skill level is in a category below amateur. But even if you aced the quiz, does that elevate your financial understanding to the professional level, especially when many of the pros admit to being amateurs? (Yes, it's a rhetorical question.)

"Amateur" Ways to Win the Money Game

Stunning financial success stories grab our attention, but most of those events cannot be duplicated, even by pros. We can't start another Microsoft in our garage just like Bill Gates, or win the Powerball by getting a ticket from the same convenience store; these successes are often singular moments of preparation and luck. If and when we encounter unique opportunities, we should certainly consider taking a chance and scoring big. But over the long haul, the best financial strategies are those that keep us from losing.

1. Save methodically. If there's any financial activity that equates to simply keeping the ball in play, it's saving on a regular basis – paycheck after paycheck, month after month. As long as you are saving, you're not losing the game. And the longer you can keep playing, the greater your odds of winning.

2. Look for ways to increase savings. Adding more to the pile is usually more productive than seeking a higher rate of return. Long-term financial objectives are defined as accumulation milestones, not annual performance numbers; when it comes time to pay for college, buy a vacation home, or retire, it's how much you have that matters, not the rate of return you've earned along the way. To illustrate:

Option A: Save $1,000/mo. at 0.5% annual interest

***or…*Option B:** Save $800/mo. at 5% interest.

The numbers:	Option A	Option B
After 1 year:	$12,032	$9,864
After 2 years:	$24,125	$20,232
After 5 years:	$60,768	$54,631
After 10 years:	$123,075	$124,743

Option B is earning 10 times Option A, but it isn't until 9 years and 8 months that Option B's balance exceeds Option A. Yet, which task would be harder to achieve, finding another $200 each month or guaranteeing a 5 percent return for 10 years? Cash flow management – even into accounts that earn almost nothing – is a superior strategy for financial amateurs.

3. Use insurance to protect against big losses. Amateurs must avoid losing, but some losses are unavoidable and unforeseeable. However, the financial impact of unexpected losses can be offset by prudent insurance decisions. Any insurance that preserves your ability to save is vital.

Some might characterize it as the amateur's way, but diligent saving, efficient cash flow management and comprehensive insurance coverage can deliver winning results. If even the pros have to acknowledge their amateur status, avoiding losses might be your best way to play to win. ❖

Have you had a cash flow analysis to increase your saving? What about an insurance review?

Life Insurance in Retirement: A Good Idea *for Everyone?*

Since at least the 1970s, there has been an on-going debate about the value of life insurance in retirement. The argument has focused on two issues: the need for life insurance in old age, and the financial performance of these policies.

The arguments were as follows: If life insurance is intended to replace earnings, then once you retire (and have no earnings), where's the need to continue coverage? And, during decades of high interest rates and soaring stock market values, many analysts concluded that the premiums allocated to life insurance cash value accounts would deliver better returns if placed in other financial instruments. These assessments resulted in a generation of financial experts extolling the benefits of "buying term and investing the difference," and condemning all forms of cash-value life insurance.

Despite this extreme perspective, both term and permanent life insurance (whole life, and other contracts designed to be in force for a lifetime) have a long history in the marketplace. And over time, many of the die-hard advocates of term insurance have, sometimes grudgingly, admitted that permanent life insurance has value for inheritance, estate planning, or supplemental retirement income. But these term insurance champions still tend to see whole life and other cash-value policies as "affluent" products, and continue to insist that permanent insurance is a "poor investment" in terms of accumulation for the "average" American.

However, as the Baby Boomer generation comes to understand that retirement planning is not only about accumulation but also distribution, a thread of financial commentary has arisen that says permanent life insurance might be a valuable retirement asset – for everyone. Because while other instruments may produce a larger amount for retirement, the cost to spend it may also be greater. As author and healthcare expert Dan McGrath puts it in an April 29, 2015, blog, having permanent life insurance might mean that retirees "will start retirement with less, but they will most likely end up with a lot more."

McGrath is not alone in this assessment. In the past year, several industry experts have articulated detailed scenarios where the accumulations and distributions from a permanent life insurance policy could be integrated with other retirement assets to deliver better results – even for less-affluent retirees.

Whole life insurance can play a critical role in helping to meet retirement goals.
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Integrating with Social Security and Medicare

For the average American, Social Security is, and will continue to be, a significant retirement asset. Tom Martin, CFP®, CLU®, ChFC® notes in a March 6, 2015 ProducersWeb.com commentary, "Fifty-five percent of Americans over age 65 rely on Social Security to provide more than half their income," and because Social Security benefits are indexed to inflation, he projects that a fully-vested worker who is 50 today could expect an annual benefit of $77,000 at age 67. A 2014 T. Rowe Price-sponsored survey of recent retirees with median household assets of $473,000, found that Social Security comprised 43 percent of their retirement income.

Social Security benefits are received income tax-free, unless income from other sources exceeds annually-adjusted thresholds. The first "provisional income" threshold is currently $25,000 on a single and $32,000 for a joint return. For each dollar above the threshold, 50 cents of Social Security also becomes taxable income. If provisional income is above $34,000 for individuals or $44,000 for couples, 85 cents of Social Security is taxable.

The income tax cost for earnings over the threshold can be steep. Because the provisional income calculation is complex, and because marginal income tax brackets will vary, it can be difficult to assess the real tax cost of exceeding these thresholds. But if a retiree in the 28% marginal tax bracket had provisional income right at the threshold, an additional $100 in income would increase their tax by $51.80 ($100 income x .28 + $85 Soc. Sec. benefit x .28). Some would characterize this as a 52% marginal tax rate.

Under most circumstances, withdrawals from life insurance cash values are not taxable as income until they exceed cumulative premiums, and once this threshold is met, policyholders may have the option to characterize additional withdrawals as loans, which are also not taxable. This unique feature can allow retirees to manage their retirement distributions, maximizing their Social Security benefits by reducing the amount that is taxed[1].

The Affordable Care Act requires all Americans to obtain health insurance. For most retirees, this means enrolling in Medicare Part A, which covers treatment provided in a hospital, a skilled nursing facility and hospice care, and has been pre-paid by taxes collected during your working years. But in order to be fully insured, retirees must also purchase Part B, D and the Part F Medigap coverage.

The premiums for these plans are also means-tested; if combined income exceeds certain thresholds, retirees pay more. How much more? McGrath estimates that a couple retiring at age 67 whose taxable income just crosses the Medicare threshold can expect to pay an additional $115,000 in Medicare premiums by age 85. For those in the highest income brackets, the projected "extra" is $1.16 million. And these premiums are increasing at a rate greater than the indexed increases in Social Security.

Similar to the threshold issues for Social Security, drawing retirement income on a tax-favored basis from life insurance cash values (instead of fully taxable accounts, like IRAs and 401(k)s) could result in substantially higher net income.

Couples receiving Social Security have another reason to consider whole life insurance. Social Security is an individual benefit – each person receives a benefit calculated on their age and work history. But Social Security also incorporates a spousal benefit. For any married couple, one spouse can elect to receive either their own benefit, or one-half of their spouse's benefit, whichever is higher[2].

At the death of a spouse, one Social Security check stops, and the survivor continues receiving the larger payment. Suppose a husband receives the current maximum benefit of $2,642 and his wife takes a spousal benefit of $1,321 (half of the husband's benefit). If either husband or wife dies, the survivor continues receiving the larger check ($2,642). Overall, this scenario results in a reduction of $1,321 in monthly retirement income.

In theory, this loss should be offset by a decrease in living expenses for the survivor. Reality suggests otherwise. It may be true that two can live as cheaply as one, but it does not follow that one can live on half of what two did. Whether one or two are living in the residence, housing costs will likely remain the same. Transportation costs may not diminish proportionately either.

To adjust, a surviving spouse will either draw additional retirement income from other sources or decrease his/her standard of living. And drawing more from other sources may expose the remaining Social Security benefits to higher taxation.

Life insurance could address this dilemma in two ways. As before, cash distributions from a survivor's whole life policy can be received tax-free, lowering or eliminating the tax impact on Social Security benefits. Additionally, if the policy was on the deceased, the insurance proceeds (received tax-free) may replace the second Social Security check.

Per Martin: "Life insurance can play a critical role in helping couples meet their retirement goals, whether it is through utilization of the policy's cash value or in having the death benefit replace the lost Social Security."

The Long-term Care Issue

McGrath cites a Health and Human Services statistic that roughly 70% of Baby Boomers are going to need some form of long-term care in retirement, and that the current annual cost for care in a facility is about $78,000. One of the ways a permanent life insurance policy may address long-term care costs is by collateral assignment. To secure a loan (perhaps to pay medical costs) a policy owner can appoint the lender as the primary beneficiary of the death benefit. These potential transactions are unique and vary according to individual circumstances, but they effectively allow the policy owner to "spend" a portion of the insurance benefit while living, preserving other assets.

If Properly Positioned, a Middle-Class Asset

These uses of whole life insurance are not strategies for the uber-rich; they have applications for the broader swath of Americans who will rely on Social Security and Medicare for a large portion of their retirement benefits. McGrath concludes "there is no such thing as a perfect solution or magic potion…" then asks: "What other financial instrument can help you…"

- √ Control and manage all your health costs in retirement?
- √ Help manage your Social Security benefit?
- √ Possibly lower your taxes, by providing income that is not recognized by the IRS and Medicare?
- √ Provide long-term care coverage?

One last thought: It can be problematic to add whole life insurance to your plans right before retirement. Your health may make you uninsurable, and cash accumulations[3] may not grow fast enough to maximize your income options. **A more practical approach is to consider how your current life insurance policies can be configured to not only provide protection today but also maximize your retirement tomorrow. Don't wait until it's too late.** ❖

Whole Life Insurance: what other financial instrument can help you do so many things?

[1] 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.

[2] Contact the Social Security Administration for complete details regarding eligibility for benefits.

[3] Dividends are not guaranteed. They are declared annually by the company's board of directors.

The Case Against
Extra Principal Payments

As interest rates stubbornly remain at historic lows, savers are looking for safe alternatives. An old strategy that's regained traction with some pundits: making extra principal payments on your mortgage.

The rationale: If your mortgage interest rate is 5%, every additional dollar paid to principal effectively "yields" a 5% return in reduced interest costs. When many savings accounts pay less than 1% on deposits, redirecting savings to produce a guaranteed return of 5% seems like a no-brainer.

But there's more to the story.

Saving and paying off debt are not the same thing. When you save, you increase assets under your control; the amount you can liquidate or reallocate gets larger. While the "savings" you realize from reduced mortgage interest costs may also increase your net worth by boosting the equity in your home, *this equity is not under your control*. If you make extra principal payments of $500/month for 12 months, you can't simply access this additional $6,000. It requires a home equity loan – which requires a lender's approval and monthly repayments. In most instances, debt reduction only reduces the length of an obligation, it does not increase "controlled" savings.

The control element is arguably more important than a rate of return. A decision to save – even in a low-interest-rate account – provides intangible, non-math benefits. Building a reserve of truly liquid cash could be security against losing a job or taking a pay cut; even with less income, there's still money to make the *regular* mortgage payments. But if several years of "extra" income has paid down principal and suddenly there isn't money to make next month's payment, you have a problem – and it's one that can't be solved with a home equity loan.

Even for those who have enough financial reserves to afford additional principal payments, doing so on a monthly basis is usually not optimal. If the goal is to pay off a 30-year mortgage in 15 years, a better approach might be to allocate the required additional principal payments to a separate account, allow them to accumulate, then make a lump-sum payment in the 15th year to clear the balance. This strategy offers several potential advantages:

- It allows for investment options that, over longer periods, may deliver returns that exceed the mortgage interest rate.
- Over the 15-year period, the mortgage interest tax deduction can be maximized.
- There is the flexibility to use some or all of this allocation for other financial opportunities that may arise.

Even in a worst-case scenario where 15 years of additional saving does not produce a return equal to the mortgage interest rate, the "cost" of not accumulating enough to pay off the mortgage at 15 years is minimal; a payoff might take an extra three or four months.

"Yeah, buts…"

Even though saving in a separate account to pre-pay a mortgage is logical and workable, some naysayers have objections. Two frequent quibbles concern human behavior. First, they will argue the certainty of having one's home paid for has emotional benefits. Second, they will assert that "most people" don't hae the discipline required to make deposits into a separate account. Thus, the "safer" approach – for your own good – is to authorize your lender to take an additional principal payment from every automatic withdrawal.

These objections are weak, and even a bit insulting. If someone understands the separate account concept, it is reasonable to believe that a constantly growing reserve will deliver as much – or more – emotional satisfaction as a dwindling mortgage balance during the 15 years of extra allocations. And if each method delivers the same outcome – a mortgage paid off early – the concluding satisfaction should be the same.

The assertion that extra principal should be out of your control, and immediately forwarded to your lender, strains credulity. Extra principal payments seem to immediately favor the lender more than the borrower; the lender gets its money back faster, and reduces its risk. The borrower still has a minimum monthly payment until the loan is retired.

Moreover, believing that money needs to be immediately sent to the lender is akin to saying most people are better off not controlling their finances. In some instances, this may be true. But shouldn't financial "experts" educate and encourage consumers to make better financial decisions, and develop the habits that make better decisions pay off? And shouldn't consumers have the choice to decide for themselves if they want to aspire to better financial management?

In a very narrow, mathematically focused argument, you might say that extra principal payments are better than additional deposits to a low-yield savings account. But once you consider the broader context of control and alternative approaches to debt reduction, the case for extra principal payments is far less attractive. ❖

Extra principal is out of your control and favors the lender, who gets the money back sooner and reduced its risk.

The borrower still has a minimum monthly payment until the loan is retired.

Conventional Retirement Wisdom

Needs More than the 80% Rule

Most Americans don't scrutinize their personal finances like a business. Deciphering the mix of revenue, debt, taxes, overhead, investment and entertainment doesn't seem worth the trouble. Instead, we often rely on rules of thumb, codified as "conventional wisdom," to make our assessments and decisions.

With conventional wisdom, financial questions can be quickly answered with a number, a percentage, or a simple calculation. These broad guidelines can be helpful; they give us concrete objectives, and prompt us to action. But it is also helpful to understand the thinking behind conventional wisdom, to see if it fits one's unique – and perhaps unconventional – circumstances. For example:

A long-standing bit of conventional wisdom says you will need a retirement income equal to 80% of your final salary. If you were earning $100,000/yr. at 64, you'll need enough assets and benefits to provide $80,000 of retirement income to maintain your lifestyle at 65.

The 80% figure is based primarily on two assumptions: As a retiree, you are no longer saving and no longer earning income. If you were saving 10% (another conventional wisdom standard) and paying 7.65% in payroll taxes while working, both of those items will disappear in retirement. And if some of your retirement income comes from Social Security, your overall income tax bill will probably also be slightly lower. These factors reduce the overall budget by 20%, and require no cost of living changes. That's the logic of the 80% rule. But are these reasonable assumptions?

Looking Beyond the Rule: Some Real Numbers

In February 2014, Brightwork Partners LLC surveyed the financial conditions of those recently retired or nearing retirement. Their report, *First Look: Assessing the New Retirement Experience*, found some interesting twists to the 80 percent rule.

- Retirees were living on an average of 66% of their preretirement income.
- 57% said they were living as well or better than when they were working.
- 85% agreed with the statement: "I don't need to spend as much as I did before I retired to be satisfied."
- Among those still working, 34% were contributing 14% or more of their earnings into a retirement plan.

It appears many retirees have decreased their lifestyle expenses in retirement with minimal distress. And if households are saving 15% of income instead of 10%, their current lifestyle standard is going to be lower in retirement than the 80% assumption. So should the 80 percent rule be adjusted or tossed? Personal finance author Jonathan Clements, in an April 11, 2015, column, has a more pragmatic assessment:

> Most of us don’t have a well-honed financial plan in which we set out to amass a specific sum and quit the workforce when we hit our target. Instead, we save what we can and then make do.

That statement probably gets closer to the truth of how most people handle their personal finances. The guidelines of conventional wisdom may say they should be doing more, and maybe they could have done better, but a lot of Americans are making do – and they’re okay with it. Meeting or missing an arbitrary target isn’t a great determinant of retirement satisfaction.

But if Today is Fine, It’s the Ending that Makes Us Nervous

In a way, a lot of personal financial advice is still first-generation. The Baby Boomers are the first Americans with a retirement paradigm that expects a long life and makes the individual primarily responsible to provide for it. Until now, the focus has been mostly on accumulation and less about specific expenses and distribution formats. In particular, most of the conventional wisdom doesn’t account for the two biggest challenges currently facing retirees: outliving one’s resources and/or having them wiped out by end-of-life medical expenses.

Annuities and long-term care insurance are financial instruments designed for these challenges, but a consensus on how to use them, or what percentage of one’s assets should be allocated to them, doesn’t exist. Yet at some point, retirees are going to have to consider these products. In a March 24, 2015, article for *ThinkAdvisor*, Jane Wollman Rusoff says, “Annuities are going to become the most important investment vehicle of the next decade.”

Instead of waiting for a “new” conventional wisdom to resolve end-of-life retirement issues, retirees and near-retirees would be well-served to “make do” by thoroughly examining their finances and enlisting some professional assistance. Personalized strategies that work today don’t need to wait for tomorrow’s rules of thumb. ❖