

Creative

wealth maximization strategies*

August 2015

Big Engine vs. Engineering

F-4 Phantom



F-14 Tomcat



For every problem, there is often more than one solution. From the same fundamental principles, two engineers can produce dramatically different designs. In fields as diverse (and seemingly unrelated) as aeronautics and finance, it can be instructive to understand how different priorities affect the engineering that results.

The Flying Brick and the Swing-Wing

The **F-4 Phantom**, an American jet fighter plane introduced in the 1960s, was the aviation equivalent of a muscle car; it was big, heavy and fast. Over its 30 years in operation, F-4s set numerous speed records.

Engineering critics sneered at the F-4's less-than-sleek design – wind tunnel testing supposedly revealed the plane would actually be more aerodynamic if it were flown *backward* – and decried its over-emphasis on power. An oft-quoted comment: “The F-4 is proof that even a brick can fly if you put a big enough engine on it; and the F-4 takes two!”

But the F-4's overwhelming speed compensated for any of its weaknesses or inefficiencies. A Phantom's engines were so powerful that pilots could engage or disengage whenever they wanted, which meant most battles were fought on favorable terms. For F-4 pilots, speed solved almost all problems encountered in combat.

Beginning in the 1970s, the Navy started to replace the F-4 with the **F-14 Tomcat**. Continuing in service until 2006, the Tomcat was the plane featured in the popular 1986 movie “Top Gun.” While the F-4 was all about

power and speed, the F-14 was distinguished by its variable-sweep wing, commonly known as a “swing wing.” This feature allowed the pilot to adjust the position of the wings in flight, depending on the demands of the moment. A swept wing was more suitable for high speeds, while an unswept wing was optimal at lower speeds; the aircraft could carry more fuel or armaments, and had greater maneuverability. As noted in a Wikipedia commentary, a “variable-sweep wing is most useful for those aircraft that are expected to function at both low and high speed.”

Even though their designs emphasized different performance factors, both aircraft were in service for over 30 years, essentially in the same roles. Similarly, some financial “engineers” emphasize different components to build wealth. They don't have formal designations, but these perspectives on personal finance have interesting parallels to the F-4 and F-14.

The F-4 Money Model: Mo' Money, Mo' Money, Mo' Money

How do you enjoy a luxurious lifestyle, pay for your children's education, retire to a life of leisure, give generously to good causes, and have plenty left over for an inheritance? You simply have enough money to pay for it all. A surplus of money is like the engine in an F-4: with enough of it, you can “make bricks fly.” You can even overcome all manner of poor decisions, financial losses and inefficient transactions.

At first, the F-4 money model might come across as snarky or sarcastic, but its practicality is hard to deny. Centuries ago, a proverb attributed to King Solomon acknowledged “Bread is made for laughter, and wine gladdens life, and money answers everything.” The truth is, most of our financial options are dependent on the output of our “economic engine.”

Many personal financial programs are perpetually under-capitalized; in F-4 terms, they don't have the “financial thrust” to get airborne. In some instances, the best solution for poor financial performance is figuring out how to have more money to work with.

“Booster” Programs for the F-4 Model

For many Americans, finding new or additional income-producing options is constrained

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by a lack of time, limited skill sets, and other priorities; changing a career path or starting a business isn't a realistic option. But there are other ways to boost a deficient financial engine.

Financial instruments with the opportunity for higher returns can compensate for a lack of capital. These options are not guaranteed but, if things go well, might deliver increased performance. For example, \$400/mo. at 8 percent might equal or exceed \$500/mo. at 2 percent. A whole segment of the financial services industry is devoted to producing superior investment returns as a way to deliver F-4 results from an under-funded plan.

Government-sponsored initiatives designed to help Americans build wealth also operate on the F-4 model. By reducing taxes, IRAs, 401(k)s, 529 plans and similar programs are intended to produce more money. But the wealth boost from tax breaks has restrictions. Participants must adhere to limits on deposits and terms of distribution. Operating outside these limits often results in a loss of tax advantages, as well as additional financial penalties.

Ironically, the demographic that benefits most from these F-4 booster strategies are those who already have the most money. They can best afford the risks, occasional losses, and longer time horizons that typically are part of investment products with greater upside opportunities. Likewise, when it comes to tax breaks, those with the highest incomes are the ones getting the biggest benefit. A February 18, 2015, *Bloomberg News* article titled "The Rich Benefit the Most From Tax Breaks Designed to Help People Build Wealth" reported "households with less income have less to tuck away for a rainy day" and thus "are less able to take advantage of these tax breaks."

Boosting wealth by chasing higher returns or committing to tax-favored plans adds two stresses to undercapitalized savers: a greater likelihood of investment losses, and inflexibility in responding to future challenges. If you don't have enough money to operate in the F-4 model, any losses incurred will also be tougher to weather. Losses can be further exacerbated by the difficulty in reconfiguring government-sponsored plans. For example: You can't transfer unused 529 funds without incurring substantial penalties. If you lose your job before age 59½, and tap your 401(k) to cover living expenses during the transition, the taxes and penalties will be punitive – you may actually pay more taxes while unemployed.

These stresses create another dilemma: What to trim – or completely eliminate – from your financial plans. If your strategies are designed to produce more money, what do you do when you still don't have enough? Do you reduce your emergency funds to concentrate on retirement savings? Do you drop life insurance to save for college? These are hard choices.

The F-14 Money Model: Engineered to Adjust

The F-4 model works, but most Americans can't use it. They don't have the resources to simply overwhelm their financial challenges by throwing more money at them. So just like the swing-wing allowed an F-14 pilot to reconfigure his plane according to immediate circumstances, consumers might want to look for financial "engineering" features that allow for similar flexibility.

The F-14 money model still requires money – it won't fly on wishes and good intentions. But instead of trying to meet all challenges by simply adding more dollars to a specific objective, it focuses on flexible, multi-function instruments that can wait to be deployed as needed instead of committed to a single purpose. There's also the ability to maintain some financial stability at "lower speeds," such as a period of unemployment, a disability, or some other financial setback. Some examples:

- A life insurance benefit that could also be applied to long-term care expenses or inheritance.
- Accumulations for college tuition that can also be used for personal emergencies – while not negatively impacting eligibility for scholarships or financial assistance.
- Retirement savings that could be tapped for a pre-age-59½ business opportunity without incurring penalties for early withdrawal.



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Compared to strapping a bigger engine on a plane's frame, the engineering that goes into building an aircraft with a swing-wing is a bit more complex. Similarly, integrating financial products – perhaps in varying proportions at different times – requires more thought and effort than simply establishing a new account and adding deposits. And regular "maintenance" reviews are essential.

There is a tendency to evaluate financial programs based on rates of return or the size of the pile. But that's like evaluating an airplane only on its speed. Other performance characteristics matter as well. Engineering your personal finances to perform under a wide range of possibilities may not always produce the biggest balance, but overall performance and stability might be better.

Are there "swing-wing" elements in your personal finances, or are you just trying to build a bigger engine? ❖



When you first start working, retirement is a hazy idea far beyond the horizon. You know it will probably happen, and you know you should save for it. Beyond that, retirement is far from defined. But as your working years pile up, a sharper image should begin to take shape, for several reasons.

- You'll have a better idea of how long you will continue to work, and the income you can expect to earn.
- You should have a sense of how your health might impact your retirement lifestyle.
- And with an ever-shrinking period to save, you probably have a general sense of whether you've accumulated enough to retire comfortably, or whether you'll have to adjust to a lesser standard of living.

The years immediately preceding an anticipated retirement can be an opportune time to re-calibrate or fine-tune your financial plans, in light of both your past performance and current circumstances. In fact, the decisions made in the five to ten years prior to retirement can be the ones that have the greatest impact on your retirement satisfaction. If you're in this Pre-Retirement zone, here are some essential questions to answer:

□ When to take Social Security? As the Baby Boomers have surged into retirement, the decision about when to begin receiving Social Security has become a hot topic. A plethora of computer models can assess the pros and cons of starting benefits as early as 62, or deferring beyond your full retirement age to 70. These analyses can also project integrated scenarios for spouses, in which one partner begins receiving benefits early while the other elects to defer.

If a deferred option would be optimal, other savings may be required to "stand in" for postponed Social Security payments. Considering today which Social Security payouts you'll choose 5-10 years in the future gives you time to reallocate savings for this eventuality.

□ Should you emphasize pre- or post-tax saving programs?

The conventional logic of pre-tax retirement contributions is that retirees will be in a lower tax bracket after they stop working. If you haven't been able to save a lot, this logic might be correct, simply because your retirement income will be significantly less than your earnings while working. In this situation, maximizing pre-tax contributions to 401(k)s, IRAs, TSAs, etc. might be a priority, especially considering the catch-up provisions that give older savers higher contribution limits.

On the other hand, if you have done a good job accumulating for retirement, and have dwindling deductions (i.e., the house is paid for and the kids are gone), your taxes in retirement could go the other direction – your marginal tax rate might be *higher* than it was while you were working. Now might be the time to establish, maximize, or transfer to, a Roth account, or select other non-qualified accumulation vehicles that feature tax-favored distribution options.

Having a mix of assets gives retirees avenues to manage taxation on distributions. This flexibility could prove beneficial, particularly if circumstances result in large or irregular withdrawals (say, for an asset purchase or emergencies).

□ What role does life insurance play in your retirement?

If life insurance has been part of your financial program during

your working years, one of its primary functions was likely income replacement – if something happened to you, the insurance benefit was intended to replace your earnings. As you come to the end of your earning years, you might think this protection is no longer needed. **But a life insurance policy can be re-purposed to deliver other benefits.** Some possibilities include:

- replacing Social Security at the death of a spouse.
- assisting with long-term care expenses, should the need arise.
- allowing other assets to be spent down, knowing the insurance benefit can be collateralized in old age.
- providing an inheritance.

If you have life insurance, you've already paid premiums for an event that is certain to occur. Instead of letting go of the benefit (and taking a loss on those premiums), it might be worth exploring ways to maximize its value through coordination with other resources.

□ Will you include a self-funded "pension" component?

A July 2014 Transamerica Retirement Survey found that only 15% of employers offer a **defined benefit** (DB) retirement plan, i.e., a plan that pays retirees a monthly check as long as they live – and most of them were government employees. A 2014 study from the Employee Benefit Research Institute estimates only 3% of private-sector workers have a defined-benefit retirement plan.

The vast majority of employers offer a **defined contribution** (DC) retirement plan, like a 401(k), which means individual retirees will have to make decisions about how to create a retirement income from their accumulated assets, and do so in a way that ensures the money doesn't run out before they do.

The trend toward individual responsibility for retirement income has renewed interest in individual annuities. An **annuity** is an insurance contract that can guarantee an income for life, however long that may be. In these individual agreements, a

retiree places a lump sum with an insurance company in exchange for monthly payments.

The annuity payment depends on several factors, including the age of the retiree, when payments begin, and the terms of payment (for example: as long as the retiree lives, as long as both the retiree and a spouse live, a refund of principal if the retiree dies earlier than expected).

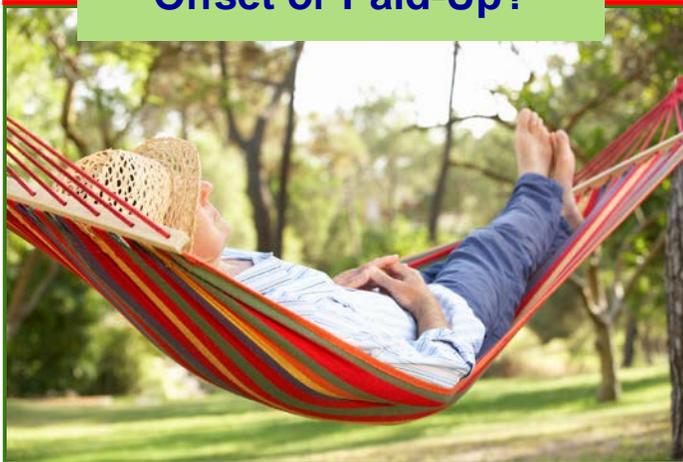
Insurance companies can provide competitive guaranteed returns for a lifetime because they have a lengthy period to hold and invest the lump sum while gradually distributing payments. Some insurers offer substantial crediting bonuses to individuals willing to make a deposit today, but defer taking income to a later date. For example, an insurer may commit to crediting 5% annually to the account balance for up to 10 years, provided the owner decides to receive funds as a lifetime series of payments. If a soon-to-be retiree wants a portion of their savings to provide a guaranteed income, these incentives may be an option to explore today, rather than waiting until retirement commences.



You may plan to work as long as possible, but if you are over 50, most of the above questions are relevant. Considering your options *before* retirement, gives you time and resources to optimize what you've accomplished thus far, and shore up areas of weakness.

**In the Pre-Retirement Zone?
Why not review these questions with your
Financial Professionals? ❖**

Offset or Paid-Up?



Dividend options give policy owners ways to adjust their life insurance program.

When actuaries construct an insurance policy, a primary concern is making sure the company can deliver the benefits promised by the contract. It's not insurance if the policy owners can't count on receiving a benefit. To ensure their ability to deliver promised benefits, insurance companies conservatively price their offerings, giving themselves a financial cushion against unexpected occurrences, such as higher-than-anticipated claims or lower-than-projected returns from their invested reserves.

This conservative pricing may result in excess capital for the insurance company; actual claims and expenses are less than projected, or investment returns are higher. Policy owners may receive a portion of this excess as dividends.¹ This is a common feature of whole life insurance policies, and while dividends are not guaranteed, most life insurers pay them regularly.

Policy owners may choose to receive a dividend as a cash payment, or apply it against current premiums, reducing out-of-pocket payments. To enhance policy benefits, they may elect to add the dividends to existing cash value accumulations, buy paid-up additional insurance, or obtain additional one-year term insurance.

Dividend options give policy owners ways to adjust their life insurance program. One possibility is called "premium offset". If a policy consistently exceeds its guarantees and pays dividends, it is possible that, at some point, accumulated dividends may be sufficient to keep the policy in force without requiring additional premiums (to "offset" the premiums).² Done correctly, this option could be a substantial benefit. But mismanaged, a

decision to offset premiums can lapse a policy and obliterate all benefits.

The Difference between Guaranteed, Projected and Actual Performance

When someone contemplates the purchase of a whole life insurance policy, an illustration of benefits and cash values will typically be presented. Since insurers have a long history of regular dividend payments, regulators allow them to publish projections of policy performance that include the payment of dividends, even though they are not guaranteed. An illustration will include both guaranteed and projected performance numbers for the anticipated life of the policy. These numbers, and the differences between them, are intended to give consumers some perspective on the minimum benefits they are guaranteed, and what might be expected to occur if dividends are paid.

A standard whole life policy has a premium schedule intended to last for an insured's lifetime (typically, to age 100, or in newer contracts, to 120). Many of these projections will acknowledge the possibility that accumulated dividends could be used to offset premiums at some point in the future. Some projections might indicate that dividends could offset premiums in very short time frames, such as 7, 10 or 15 years, especially if the owner makes "extra" premium payments during this period.

But while these illustrations may reflect historical performance and/or reasonable assumptions about the future, the policy's actual performance will not match the illustration. And as each year passes, the initial illustration will be increasingly less accurate. Going forward, actual performance will probably exceed the guarantees, because the guaranteed values assume the worst-case scenario every year. But whether actual performance is higher or lower than the projections will vary year-by-year.

Even if a policy in the early premium-paying years outperforms projections, there's a potential problem with electing to offset premiums: the length of time dividends must replace premiums. Suppose a 45-year-old makes 10 years of payments, and then at 55 decides to use dividends to offset premiums. A reasonable life expectancy is age 85, which means relying on the 10th-year projection to be accurate for at least 30 years (if not longer). What if, after 20 years of offsetting premiums, dividends decline dramatically? A projection at age 75 could reveal that resuming the payment of premiums is required to keep the policy in force. If premiums aren't paid, the policy may lapse, resulting in the forfeiture of all benefits.

This worst-case scenario has precedent. Because interest rates were exceptionally high in the 1980s, then steadily declined to historic lows over the past three decades, some premium offset scenarios have failed. Relying on overly-optimistic initial projections, some policy owners stopped paying premiums, only to find years later that their policies were under-funded and in danger of collapsing. A significant amount of litigation against agents and insurance companies ensued.

Paid-up Policies

There are whole life policies that can achieve guaranteed paid-up status in a period shorter than age 100. Common policy types include 10-pay and 20-year plans, or paid-up at 65. Unlike the offset scenarios referenced above, policy owners do not have to hope future dividends will cover the cost of maintaining the policy. Once the scheduled premiums have been paid, the benefits are contractually guaranteed³; a policy owner can be assured that no future premiums will be required. But the

annual premiums will also be higher than a standard whole life schedule.

Policy owners may find benefit in buying, or altering, their whole life policies to guaranteed paid-up status. Premiums can be re-allocated to other financial products or added to discretionary income. The higher premiums that accompany a guaranteed paid-up schedule also typically accelerate cash-value accumulations. In a retirement scenario, the combination of a paid-up policy and substantial cash values may permit the policy owner to make systematic withdrawals from the paid-up policy—often on a tax-favored basis.⁴

Knowing What You Can and Can't Do

The illusion in projected offset scenarios is that paid-up status can be achieved with a premium offset; it can only be accomplished with a paid-up whole life policy at a predetermined age or year.

That said, once a whole life policy, which matures at age 100 or right around age 100, is established and has accumulated cash value, policy owners may be able to safely offset premiums on an intermittent basis. If a business owner hits a cash flow crunch, or an individual loses employment, the offset option makes it possible to keep the policy in force with no out-of-pocket expense, and premiums can be resumed at a later date. In these instances, a brief period of dividends substituting for premiums will not jeopardize the policy's in-force status (although it will diminish cash value accumulations).

Psst...If Your Eyes Are Glazing Over, Just Read This

Dividends, and their impact on guaranteed, projected, and actual policy performance, can seem like bits of financial trivia. But dividends offer policy owners **flexibility** in maintaining or enhancing their whole life benefits. Every review of your life insurance program should include a discussion of how dividends are being applied. ❖

¹ Dividends are not guaranteed. They are declared annually by the company's Board of Directors.

² The premium offset year is not guaranteed and relies on dividends and the surrender of paid-up additions to pay the policy's required premium. There is no guarantee that dividends will be paid or that paid-up additions will exist in the policy.

³ 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.

⁴ 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 59½, any taxable withdrawal may also be subject to a 10% federal tax penalty.



Making DC Look Like DB... It's Not So Easy

"Our approach to saving is all wrong: We need to think about monthly income, not net worth."



In May 2015, Congress introduced a bi-partisan piece of legislation titled the *Lifetime Income Disclosure Act*. The bill, which amends 1974 ERISA retirement legislation, requires employer-sponsored retirement plans to provide participants, on an annual basis, with an estimate of how much lifetime income they could expect from their current savings.

The purpose of the bill is fairly straightforward. As the majority of American employers have moved from defined-benefit (DB) retirement plans like pensions to defined-contribution (DC) plans, such as 401(k)s, the accounting has changed in a way that often makes it difficult for employees to assess their retirement readiness.

A July-August 2014 *Harvard Business Review* article by Robert Merton succinctly summarizes the differences, and the repercussions. "Ask someone what her pension is worth and she will reply with an income figure: 'two-thirds of my final salary' for example..." In contrast, "Most DC schemes are designed and operated as investment accounts, and communication with savers is framed entirely in terms of assets and returns." Merton concludes: "**Our approach to saving is all wrong: We need to think about monthly income, not net worth.**"

Congress apparently concurs. But making a defined-contribution plan look like a defined-benefit one isn't as simple as enacting a law. The two retirement plan models are sort of like apples-and-oranges, and some legislators must sense this, because if approved, the law gives the Secretary of Labor one year to

- issue a model lifetime income disclosure, written in a manner which can be understood by the average plan participant; and
- prescribe assumptions that plan administrators may use in converting total accrued benefits into lifetime income stream equivalents.

Just writing a disclosure statement which can be understood by the average plan participant is a challenge. But determining the assumptions for plan administrators to convert today's accumulation into a lifetime stream of income? That's tough.

The lifetime income stream from a typical DB plan/pension is based on a calculation of a percentage of the employee's average annual earnings for a defined period, multiplied by years of service. Using the formula, an employee can, at any point during their working years, calculate the future income stream they have earned and can expect to receive at retirement. This calculation is relatively simple for the employee, but the financial planning on the part of the employer to make those monthly checks a reality is by no means easy.

A company pension provides lifetime streams of income to a group of retirees through a combination of ongoing employer contributions and investment returns. Each year, the employer evaluates its pool of retirees and past investments, makes some assumptions about future performance, and determines the amount of new contributions needed to perpetuate benefits.

Pension plan administrators are required to report their obligations, returns, assumptions and deposits, and to meet government-established benchmarks. **Yet the most recent statistics indicate up to half of all American pensions, including those for government employees, are under-funded** – retirees are living longer, investment returns haven't met expectations, and administrators don't have the cash to make up for the shortfalls. These challenges are a primary reason employers have phased out DB plans.

A participant in a defined-contribution (DC) plan is really the administrator of a one-person pension, with all the attendant challenges. Determining what a current retirement account balance is worth as a future stream of income requires a multitude of assumptions, all of which are certain to change. What will be the assumed rate of return on current savings? For how long? What is the anticipated retirement age? What life

expectancy and guarantee factors should be used?

The answers to these questions are unique for each individual. Can the Secretary of Labor develop a one-size-fits-all formula that makes every DC plan look like a DB? Lawmakers must recognize the limitations of this proposal, because the last paragraph of the bill reads:



“(N)o plan fiduciary, plan sponsor, or other person shall have any liability under ERISA solely by reason of the provision of lifetime income stream equivalents derived in accordance with such assumptions and related rules and including explanations contained in the model lifetime income disclosure.”

In other words, employers must provide an estimate, but won't be held responsible if it isn't accurate.

Congress may have the right idea in highlighting future income, but it's unlikely that individual retirement challenges facing savers in a DC-dominated world can be solved by a mandated retirement calculation. ❖

A better choice: Getting professional assistance to calculate your own “lifetime income stream equivalent.” Use your numbers, your assumptions, and your resources to estimate your future retirement income. It's still a projection based on certain-to-change variables, but it's based on you, not a generic formula. ❖

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