Creative
wealth maximization strategies*

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Retirement Income: Guarantees vs. Realities

The 1995 movie "Tommy Boy," starring Chris Farley and David Spade, is one of those low-brow comedies that becomes a "classic" because it gets regular rotation on cable TV stations. Farley is Tommy Boy, an immature and dimwitted heir to an auto parts factory, who attempts to keep the business alive when his father, the owner, dies suddenly. Going on the road to meet the company's customers, Tommy encounters skeptical buyers looking for written guarantees, now that his father is no longer in charge. At one sales call, the following conversation takes place:

Tommy: Let's think about this for a sec, Ted. Why would somebody put a guarantee on a box? Hmmm, very interesting.
Ted Nelson, Customer: Go on, I'm listening.
Tommy: Here's the way I see it, Ted. Guy puts a fancy guarantee on a box 'cause he wants you to feel all warm and toasty inside.
Ted Nelson, Customer: Yeah, makes a man feel good.
Tommy: 'Course it does. Why shouldn't it? Ya figure you put that little box under your pillow at night, the Guarantee Fairy might come by and leave a quarter, am I right, Ted?

As the dialog continues, Tommy makes a convoluted analogy that closes the sale (if you want details, Google "guarantee tommy boy"). The essence of his pitch: **it's not the guarantee on the outside on the box, but the quality of the product inside that matters.**

The dictionary defines a guarantee "as a formal promise or assurance (typically in writing) that certain conditions will be fulfilled." Just like Tommy says, a guarantee is intended to make you feel "all warm and toasty inside." It's an additional inducement to buy a product or service, and trust someone.

But even the best guarantees cannot provide absolute assurance. Formal promises, even in writing, cannot make the impossible possible. For guarantees to be credible, they must be based on realistic assumptions. When people rely on implausible (or impossible) guarantees, disappointment will likely follow. This can especially be true with financial guarantees.

Detroit and Illinois: Guarantees erased by realities

On December 4, 2013, two stories ran side-by-side in the *Wall Street Journal*. The first reported the decision by US Bankruptcy Judge Steven Rhodes to allow the city of Detroit to reorganize under bankruptcy law. If it occurs, Detroit would be the largest-ever municipal bankruptcy in US history. The determination that Detroit is broke and can no longer expect to meet its obligations has significant financial ramifications for over 30,000 past and present city employees. As Matthew Dolan reports:

> "In the most watched part of the case…the judge said Detroit's public pension holders aren't entitled to special protection from potential cuts – despite a Michigan state constitutional provision aimed at shielding pensions."

Unions and pension funds contend the retirement plans are guaranteed under state law, but the judge disagreed. John Pottow, a law professor at the University of Michigan, said the judge's decision means "Unions and pension funds no longer have the magic bullet of the state constitution to protect them." In other words, the guarantee is void, even if it is written into the state constitution.

The second *WSJ* report was a similar unwinding of retirement income guarantees, this time in Illinois. On December 3, 2013, state legislators passed an overhaul of the state public-employee retirement system, "cutting benefits for workers and retirees…including reducing the annual cost-of-living increases for retirees and raising the retirement age for younger workers."

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This action was precipitated by faltering state finances; Illinois has the lowest credit rating among the 50 states, and the funding gap in its pension plan is estimated at $100 billion. Unions representing the state employees have asserted that government workers shouldn't be punished for mismanagement by state officials. But in the event of a legal challenge, the state will likely "argue that certain benefits aren't protected, particularly in light of the state's fiscal problems." As House Speaker Michael Madigan puts it, "We're here today because the cost of our present state systems are simply too rich for the resources available." Realities trump guarantees.

The Final Fade-out for Pensions

The circumstances in Detroit and Illinois are perhaps the final act of a generation-long trend away from retirement pensions. The primary problem? Pension funds couldn't keep their promises. For a combination of reasons, their guarantees weren't sustainable. The business was no longer profitable, the number of retirees was too high, the investment returns were too low, and/or the funding was insufficient.

In the place of pensions, most employers have instituted defined-contribution retirement plans, such as 401(k)s, which allow an employee to accumulate a retirement fund, but do not guarantee a monthly income. Instead, the individual has the responsibility of deriving a stream of retirement payments from interest, dividends, or systematic liquidations.

Because interest, dividend rates and asset valuations fluctuate, the income may also vary. In extreme cases, there is the possibility that assets may be exhausted and income stops. This uncertainty may compel some retirees to consider financial products, such as annuities, that promise a guaranteed lifetime income, regardless of the performance of the underlying financial assets. Given the recent events involving the inability of pensions to uphold promises, can consumers rely on guarantees from an insurance company? To revisit "Tommy Boy," the quality of the guarantee is very much connected to what's "in the box."

Individual Annuities and Pensions are not the same

Even though both an annuity and pension fund can promise a lifetime stream of income, the processes by which income is calculated and funded are different. And these differences impact the integrity of the guarantees.

The income guarantees for an annuity typically apply to one person (or two, if the annuitant selects a survivor option). In contrast, a pension plan attempts to provide income guarantees for a large and changing group of people, all retiring at different times.

The funding for an annuity is provided by the purchaser from existing funds; the agreement is fully funded at onset. A pension plan is never fully funded; it constantly reassesses current performance, estimates future obligations, and evaluates whether additional funding is necessary.

The determination of additional funding required for a pension is partially dependent on the estimated investment return a pension's managers believe can be achieved by the plan's portfolio. Because higher projected rates of return mean lower funding requirements, there is often a financial incentive to be optimistic when projecting future returns. In fact, several studies

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have characterized pension assumptions as "overly optimistic," and the subsequent under-performance only makes a funding gap worse. By comparison, insurance company assumptions may border on the pessimistic, both in regard to guaranteed payments, and how well the insurance company's investments will perform. With no recourse to additional funds at a later date, each annuity contract must stand on its own. This reality, along with stringent regulation, compels actuaries to be cautious in their guarantee calculations.

And as recent events demonstrate, pension complexity has made it challenging for plans to meet their guarantees. A dollar-for-dollar analysis might determine that pensions project higher returns in retirement income than individual annuities. But one could also assert that annuities offer more realistic guarantees; historically, insurance companies have a strong track record of keeping their retirement income promises to individual annuity holders.

A Silver Lining for Retirees?

In the "old days" of lifetime employment followed by a lifetime pension, retirees didn't need to do much more than sign a form and collect a check. They didn't contribute to the plan, and didn't really "own" their benefits – even if they were vested, they couldn't demand a lump-sum payment in lieu of a monthly payment. For those who now find themselves wondering if the check will be there because the plan's guarantees cannot be met, there aren't many alternatives; they are stuck with whatever a judge decides and the pension can afford.

Going forward, individuals have much more responsibility to accumulate their own retirement, but they also have more guaranteed options for receiving retirement income. Other vehicles may offer the prospect of higher returns, but **when it comes to meeting their guaranteed commitments, insurance companies have the underlying financial integrity to back their promises.**

As the first generation of defined-contribution retirement plan participants transitions to retirement, many may be looking for "warm and toasty" income guarantees they can rely on. In the long run, the variety of individual income contracts backed by insurance companies may provide more options and guarantees than employee-sponsored pensions. ❖

IS THE NEED FOR A GUARANTEED RETIREMENT INCOME IN YOUR FUTURE?

LOOK BEYOND THE GUARANTEE TO SEE WHAT'S "IN THE BOX."

Life Insurance for Business Partnerships[1]

When people productively combine resources and skills, the end result is often far greater than what each party could accomplish on its own. Business partnerships, when they work, can combine strengths, cover weaknesses, and exponentially increase wealth.

While partnerships may offer the prospect of multiplied benefits and prosperity, they also result in increased exposure; the problems of one party have the potential to become the problems of every other partner. Personal issues become business issues, and individual missteps – even in areas outside the partnership – can have a ruinous impact on everyone. At some point, for a multitude of reasons, some partnerships dissolve.

In recognition of these perils, prospective partners often prepare documents to clearly define the terms of the relationship. In some cases, these documents even prepare for the possible dissolution of the partnership. For businesses, these are often called **buy-sell agreements;** if a co-owner dies, is forced or chooses to leave the business, the buy-sell agreement contains legally binding conditions under which the partnership terminates.

Unless the dissolution of a business partnership is because of complete financial failure in which all partnership assets have been exhausted, a buyout will often include a financial settlement, in which the remaining partner(s) compensate the departing partner for surrendering his/her share in the business.

When partners weigh their buy-sell alternatives, life insurance provides pennies-on-the-dollar solutions, ones that should not be overlooked.

The Unexpected Buy-Sell

When partnerships sour in the course of doing business, the disenchanted parties usually see the problem unfolding. Often, this gives the partners time to contemplate and negotiate acceptable terms to fulfill the buy-sell provisions, such as a stream of payments, or financing arrangements. But what happens if a partner's departure occurs suddenly, without advance notice?

In a 2011 blog commentary, Ryan Hanley, a New York insurance consultant, tells the story of a prosperous 20-year-old business with 40 employees, owned and operated by two partners. When one of the partners died in a tragic automobile accident, the fallout included an agonizing realization that the partner's death may result in financial catastrophe for everyone else. Speaking of the surviving partner, Hanley elaborates:

"A few months later you get a call from your late business partner's spouse asking to set up a meeting to discuss the future of the business. After a lengthy, emotional meeting, you find out your business partner had racked up mountains of personal debt financing some commercial property deals on the side that didn't pan out. Your business partner's spouse, now saddled with that debt, is freaking out and demanding you sell the business to pay the obligations. Now a 50 percent shareholder in the business, the spouse has the legal right to make such demands. Now you either have to spend a boatload of money to buy out the spouse or sell the business you've worked 20 years building."

Remember, the business was prospering, the partners were happy together. But one partner died, and his outside activities – unrelated to the business – now threaten to undo the surviving partner's ongoing prosperity, and end the employment of 40 workers.

The unexpected death of a partner, and its potentially devastating repercussions, can usually be solved in a cost-effective manner with life insurance. As part of a buy-sell agreement, life insurance policies on the partners will, in the event of a death, be used by the surviving members of the business to liquidate the deceased partner's interest, with the proceeds being paid to heirs. This transaction not only delivers fair value to the deceased partner's estate, but also protects the surviving owners from "inheriting" an unwanted partner, such as the partner's spouse or child. It also completes the transaction in a very timely manner, removing anxiety for all parties.

A Great Concept that Requires Expert Guidance

There are several life insurance templates for buy-sell agreements, depending on the nature of the business and the number of partners/shareholders involved. The business may hold the policies, or each owner may hold a policy on other partners. Likewise, the titling of beneficiaries and the payment of premiums will also vary according to the particulars of the business. In situations where the ownership percentage varies between the partners (for example, one owns 70%, the other 30%), the amount of insurance must reflect this difference. If disparities in health and age affect a partner's insurability or the cost of maintaining coverage, the business must decide how to equitably address these issues as well.

In some instances, the owners may receive additional benefits by selecting permanent life insurance policies which accumulate cash value.[2] Besides providing death benefit protection, cash value policies may use the cash values at a later date for distribution to the partners if the business relationship ends, or a partner retires.

A buy-sell agreement without resources isn't much more than wishful thinking. And while a life insurance policy may not address every contingency in a buy-sell agreement, it is an elegant, cost-effective solution to funding provisions triggered by a partner's untimely death.

It is also a detail-dependent process, one that requires a coordination of precise legal documentation with proper policy design. The breadth of these issues, and the importance of getting them right means finding expert legal and insurance support. ❖

[1] The term "partnership" is used throughout this article as a generic term referring to business owners conducting business together - whether in a partnership, corporation, or limited liability company (LLC).

[2] Cash value accumulation in a permanent life insurance policy is not guaranteed. A participating whole life policy from a mutual insurer does have guaranteed cash values.

NOTE: The representative(s) does not provide legal or tax advice. Consult your legal or tax professional about your situation.

The Very Public Discussion of James Gandolfini's Estate

Actor James Gandolfini, best known for portraying mob boss Tony Soprano in HBO's hit series *The Soprano's*, died of a heart attack on June 19, 2013, at the age of 51, while vacationing in Italy. The passing of a celebrity is newsworthy, but two weeks after his death, the media refocused its attention on Gandolfini for a very unusual reason: his will.

Remarried and expecting another child, Gandolfini had rewritten his will in December 2012. On July 2, 2013, representatives for his estate filed the 17-page document with the New York Surrogate's Court. Because probate court records are public documents, anyone can go to the courthouse and ask to see a will. Or, with today's technology, anyone can read a copy online – for free. The *New York Times* even posted the .pdf of Gandolfini's will on its website.

Some commentators estimated Gandolfini's net worth at $70 million, and the combination of a lot of money, celebrity status, and public disclosure has been an irresistible topic for the tabloids, bloggers and even "high-brow" financial publications like *Forbes* and the *Wall Street Journal*. A few details:

> **"The very best defense is proactive estate and financial planning prior to death or disability."**
>
> -Attorney Daniel Purtell

- The property governed by the will's instructions was valued between "$1 million and $10 million," which leads legal experts to conclude that Gandolfini may have done other estate planning that did not require public disclosure.
- An affidavit filed with Gandolfini's will revealed the actor had an Irrevocable Life Insurance Trust (ILIT) for the benefit of Gandolfini's 13-year-old son from a previous marriage. The ILIT owns a $7 million life insurance policy on Gandolfini's life.
- Twenty percent (20%) of James Gandolfini's estate was left to his 8-month old daughter, Liliana. Under the terms of the will, she will receive this inheritance at the age of 21.
- Gandolfini owned a home and land in Italy; the will places these properties in a trust for the benefit of both children.

While the media's interest is primarily about who gets what, quite a few experts from the legal and financial arena have taken to critiquing Gandolfini's estate plans. They question the advisability of making an inheritance available to a 21-year-old. They wonder whether a document filed in New York will run afoul of legal statutes in Italy. They try to determine if the two children were treated equally, or fairly. And they speculate on the potential problems that may arise down the road.

But mostly they wonder: why did Gandolfini decide to make his financial affairs a matter of public record, when it could have been avoided? Estate planning attorney Julie Garber posted a commentary on about.com:

> "(I)n Episode 44 of *The Sopranos*, the fictional Tony Soprano is advised by his fictional CPA to create a Revocable Living Trust to keep his estate plan away from "prying eyes." Apparently in James Gandolfini's case, art didn't imitate life…
>
> Now everyone knows who is getting what from James Gandolfini's estate. On the other hand, a Revocable Living Trust would have allowed this information to remain a private matter that would only need to be revealed to the beneficiaries and Trustees who are named in the trust agreement. Aside from this, a properly funded Revocable Living Trust will avoid the very public probate process altogether."

Most of us, regardless of our net worth, don't want our finances made public, even after we've passed away. On the other hand, since most of us aren't celebrities with $70 million in assets, how much attention would the general population give to our finances, even if they were given a public airing? More than you might think, and not for the relatively benign purpose of critiquing our decisions.

Consider these comments from Attorney Daniel Purtell, from his May 2009 article "Grave Robbery: Identity Theft of the Dead and How to Prevent it:"

> Even the dead are not safe from the nation's fastest-growing crime, identity theft. Scam artists and thieves like to target the deceased because it can take longer for fraudulent activity to be detected than if the victim were alive… Scammers troll through obituaries and probate files for names and addresses. Then they buy Social Security numbers and other personal data—such as credit histories—of the recently departed for as little as $15 on the Internet.

Purtell explains that if the identity of the deceased is stolen, existing accounts may be accessed and new accounts opened for fraudulent activities. The identity thief might sell the information to individuals with bad credit, allowing them to buy property, open credit accounts, even file false tax returns for refunds under the deceased's name. If the deadbeats default, the outstanding debt appears on the deceased's credit history. Although surviving family members are not usually held liable for these debts, undoing the damage can be time-consuming and aggravating. A person like Gandolfini, due to his fame, is probably a less-likely target for identity theft. But those less well-known make inviting targets.

In addition, a listing of assets in a probate record makes a nice shopping catalog for unscrupulous con artists looking to prey on vulnerable heirs and beneficiaries. And now they can shop online!

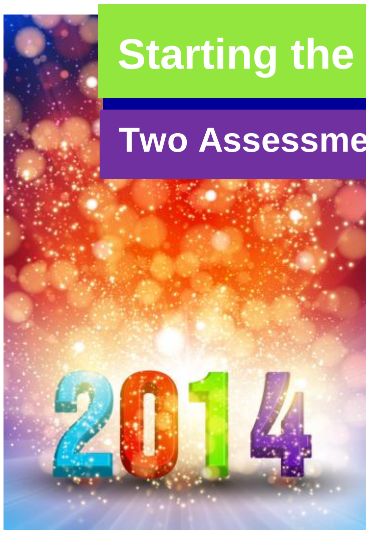
As Ms. Garber mentioned in the excerpt above, the public exposure of one's finances can be greatly diminished through the implementation of a Revocable Living Trust. As recent news events have shown, privacy in the digital age is an evolving technology tussle; we have greater access to information, and this requires greater sophistication to keep our privacy.

The privacy provisions contained in specific legal agreements, such as trusts, merit thoughtful consideration. If you want to protect your assets and your heirs, Mr. Purtell declares:

"The very best defense is proactive estate and financial planning prior to death or disability." ❖

Starting the New Year Right:

Two Assessments, One Question



It's fair to say that the entire history of human life has been characterized by the "tyranny of the urgent." There's always something that needs to be done ***now***, ***today***, in order to head off a crisis. Thousands of years ago, getting the day's food might have been the urgent item on the agenda. Today, it might be re-establishing the satellite link. The tasks are different but the theme remains the same. Most days, we have our noses to our respective grindstones; it's head down, and keep on working.

But every so often, we need to reflect on what has transpired. We need some perspective on the past to help chart the future. And since almost everything in the universe of personal finance is wired to end on December 31, then start anew on January 1, it makes sense to select a time in January to assess your financial position. After all, by January 31, 2014, most of us should have year-end statements for saving, retirement and investment accounts, as well as the income reported on W-2s, 1099s, K-1s, etc. This mountain of financial information is current, and just begging to be evaluated.

Along with the convenience of having a stack of year-end statements, your January assessment can be made even easier by getting **a financial professional to help you.** Many financial service businesses offer comprehensive software and online aggregation programs to quickly compile and sort financial information into net worth and cash flow statements. Involving these professionals helps you get the job done, and also provides better information for them to assist in improving your financial future.

Two Assessments

Software and online tools can provide a financial assessment as detailed and complex as the reports produced by accountants at a Fortune 500 company. That may not be necessary. Most of us can derive great benefit from just two assessments: **a Net Worth statement, and a Cash Flow statement.**

The Net Worth statement

An annual Net Worth statement simply matches your assets against your liabilities and figures whether the balance is positive (assets are greater than liabilities) or negative (the reverse).

Not only is a net worth statement relatively easy to complete, it's also a recognized standard in the financial community, one lenders use to evaluate whether they want to loan money. (And for a lot of Americans, the only time they complete a net worth statement is when they need to borrow.)

As simple as it is, a net worth statement can be quite revealing. First, comparing net worth statements year-by-year is an easy way to mark your financial progress. It can also help you identify which assets and activities are most productive.

For example, suppose you took advantage of a 0% financing offer and bought a new $35,000 vehicle in October, no money down, with payments for 48 months.

On your financial statement, the new vehicle is listed as an asset. But how much is it worth? $35,000? Any dealer will tell you that as soon as you drove it off the showroom floor, the re-sale value dropped immediately. So maybe it's worth $30,000. But what is the outstanding balance on the loan? Even at 0% interest, the amount might be greater than the vehicle's current value. If everything else stayed the same, the car purchase resulted in a decline in net worth – in the short term, purchasing a new vehicle might not be a "wealth move."

Not to say that the new vehicle was necessarily a bad purchase. Most of us need reliable transportation, and buying a new vehicle could be a legitimate solution – the monthly payments might be less than the repair bills that would be incurred if you kept driving a clunker. However, having a few of these non-asset building transactions each year adds up – or doesn't add up – in terms of building your wealth. In an annual net worth comparison, some people might find that while their standard of living is rising each year (bigger home, better car, nicer vacation), their net worth is stagnant, or growing quite slowly.

A net worth statement should also tell you which activities are the most productive. Guess what? The greatest increases in net worth will probably be the result of two fundamental financial actions: ***accumulation and appreciation***. Accumulation is setting money aside – in the bank, an insurance policy, a retirement plan, an investment account. Appreciation is the increase in value of your financial assets, through interest, dividends, or increases in market value.

The Cash Flow Statement

Once you compile a current net worth statement, most households also want some perspective on the trajectory of their wealth building. Are we trending up or down, and how quickly? This is where a Cash Flow statement can offer valuable insight.

A Cash Flow statement is a comparison of the inflow of revenue against the outflow of expenses during a specific time period. In a business, a cash flow statement is typically very detailed, accounting for every financial transaction, ideally zeroing out revenues against expenses.

But even if you keep to a fairly strict budget, household finances are often opaque – it's often hard to determine what you really spent on food, entertainment, gifts and all the miscellaneous transactions of life. Fortunately, a personal cash flow statement doesn't usually require CPA-verified detail. It is possible to identify the fixed items in your financial life; the monthly mortgage, car payments, utility bills, insurance premiums, savings allocations, etc. It is also possible to list major one-time expenses that occurred during the year (new furniture, large medical expenses). Add up the fixed regular expenses and one-time costs, put an educated guess on the fuzzy items, and see whether income exceeded expenses for the year.

Hopefully, the cash flow number is positive, because positive cash flow makes it easy to increase accumulation, one of the building blocks to increase net worth. If your cash flow is negative, there may be ways to re-structure your finances to correct this condition; maybe spending needs to be curbed, or debt can be re-financed.

The One Question

Preparing Net Worth and Cash Flow statements should lead to some self-assessment. But what kind? Unless the numbers are really disturbing, the most productive assessment should not be a discussion of your career, earnings potential, or need for more money. And there's no reason to immediately start an agonizing hunt for ways to reduce your standard of living. A better question to ask is:

"Given my current resources, how can I become more efficient?"

This question addresses issues that can be acted on – right now. In a typical financial household, this could include re-allocation of savings, re-structuring debts, paying off balances to improve monthly cash flow, using earnings from one account to fund another, changing insurance deductibles – the list isn't endless, but it's probably lengthy. And the improvements might be significant. ❖

Suppose you regularly compiled a year-end Net Worth and Cash Flow statement every January.

- **Don't you think you would have a better handle on your financial progress? *Sure you would.***
- **And you just might find that the habit of regular assessment eventually means fewer tyranny-of-the-urgent moments and more what-would-we-like-to-do experiences.**