CREATIVE
Wealth Maximization Strategies

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Was Bill Gates well-prepared or just lucky? (Yes.)

When it comes to money, did you ever notice how some people seem to be in the right place at the right time? How does that happen? Is it random chance, or is there a secret to their success?

If you asked a few of these individuals about their good fortune, some might say they're just lucky. Others (particularly those with healthy egos) might say their success is the end result of their careful planning and hard work. And depending on their individual circumstances, each response might seem plausible. But attributing material success to luck or great planning is selecting two ideas at opposite ends of the spectrum; they both can't be right, can they?

Besides, simple observation shows that a lot of lottery players aren't winners, and many diligent individuals who work as hard (or harder) than the wealthy never achieve the same level of success. So perhaps both of these views are too extreme to be entirely accurate.

Instead, it might be more appropriate to conclude that people who seemed to be in the right place at the right time were those positioned to take advantage of "happy accidents" that fell their way. In other words, material and financial success is usually a combination of preparation <u>and</u> luck. Take the example of Bill Gates.

From a very early age, Gates, the founder of Microsoft and today one of the world's richest individuals, showed an aptitude and passion for computers. It was no surprise that he would make a fortune from his personal computer programs, and no one would say success "just fell into his lap" – he earned it. But several commentators have noted that Gates was born both in the right time (the mid-1950s), and grew up in the right place (Seattle, Washington) to capitalize on his interest in computers. As researcher and author Jean Folger puts it:

> (H)ow successful would Bill Gates have been if he had been born ten years earlier or ten years later? There's no way to tell, but we do know that Gates was able to perfectly take advantage of the newly developing world of computer technology because he was born at the right time and he happened to be at the right place - one of only two schools that had mainframe computers.

Even for a techno-geek like Bill Gates, it was impossible for him to foresee all of the scenarios that might come his way. But because of his cumulative preparation (starting with his first computer in eighth grade) Gates was well-equipped to capitalize on new, previously-unimagined opportunities when they appeared.

In This Issue…

Ninety percent of success is showing up.
– Woody Allen

I'm a great believer in luck, and I find the harder I work the more I have of it.
– Thomas Jefferson

Effective financial plans follow this same arc: it is impossible to guarantee a specific financial outcome, even with the most detailed planning and hard work, because there will always be unknowable future events that will radically impact even the best strategies. **However, it is possible to develop a financial preparedness model so that, if and when opportunities appear, you can take advantage of them.** In other words, you can work at getting lucky.

Probability ≠ *(does not equal)* Inevitability: The False Premise of Many "Planning" Paradigms

This idea, that financial success is often achieved by preparing for opportunities that cannot be seen in advance, can create psychological tension. Most of us like certainty and the sense of control that comes with it. The idea of planning for things that may or may not occur can register as counter-intuitive – honestly, how do you plan for something you can't plan for?

Given this tension, it's natural to wonder if there isn't a better way, a process by which to guarantee results and eliminate uncertainty. Quite often, this desire for better "success methods" in the financial realm leads to historical analyses and statistical probability models.

Flexibility may be a key asset to turning unforeseen events into "happy accidents."

- Looking for the best career path? Read a report on which fields anticipate high demand in the coming years.
- Want to live in the best neighborhoods for raising kids? Yep, there are statistical surveys for that.
- Need to know your "number" for retirement? A computer program can calculate it.
- Looking for the best investments? Hoo boy! Do we have numbers! And pie charts! And allocation models!

Embedded in all of these analyses is an underlying idea that if you arrange enough probabilities in your favor, success is inevitable. But there are two problems with probability models: First, **for statistics to be useful, they require interpretation**. Where one expert sees a correlation between two events, another may only see a coincidence; the same set of facts can support vastly different conclusions. It's like saying success is luck or preparation: who has the right model to interpret the facts?

Second, and perhaps most important, all of these probability studies are **based on the past**. While history may occasionally repeat itself, history also shows that new and unforeseen events often play a much larger role in determining your outcomes than what was expected to occur. Looking to the past to predict the future is like trying to drive a car by looking in the rearview mirror. Even if the view is perfect, it's still looking in the wrong direction.

Flexible Plans = Opportunities for "Happy Accidents"

The inherent weakness of plans based on historical probabilities does not mean all planning is futile. Rather, it suggests different perspectives might yield better results. For example, instead of expending time and energy trying to anticipate future events, it might be more productive to **develop action plans that allow you to respond to opportunities as they occur.**

From this perspective, the Woody Allen comment – "Ninety percent of success is showing up," – rings true in the realm of personal finance. A lot of people miss opportunities for financial progress because they simply can't "show up." For example, they don't have the cash flow or cash reserves to take advantage of a great deal. Or they don't have the time to acquire a new skill, or start a business. In fact, opportunities often find them completely unprepared.

"But how could I have known?" they say. "Ten years ago, who could have anticipated the world would be like this?"

And that's precisely the point. Since you can't know what the future will look like, why make financial decisions that eliminate choices or lock you into plans that restrict your ability to make changes in the future?

You may not be able to quantify it with a number, but having the flexibility to respond to a variety of financial opportunities – including those you can't even imagine today – is an extremely valuable asset. In fact, it may be a key asset in turning unforeseen events into "happy accidents."

Believing that meticulous analysis of past performance can ensure the future is an illusion. In contrast, basic principles of financial preparedness – which don't try to predict the future – are better suited to long-term success. Because you never know what might come your way.

Are your financial affairs prepared for "happy accidents"?

A Checklist of Practical Preparations for Accidental Success

The following checklist offers some practical applications of financial principles that will make you well-positioned to respond to unforeseen future events.

☐ **Cash reserves.** Safe, liquid cash doesn't get feature articles in financial publications, and no one eagerly awaits quarterly performance reports on savings accounts or life insurance cash values. But for those who want to be ready for "happy accidents," nothing has all-purpose financial utility like cash reserves.

In the happy accident paradigm, cash reserves serve two purposes: (1) They are a buffer against negative financial events, like a health issue or job loss; (2) Having cash reserves means other assets will not have to be liquidated, and long-term plans already in place can continue. Cash reserves also make it possible to "show up" for those unforeseen opportunities, such as bidding on distressed assets at auction, making a down payment on a property, or paying the tuition for a new license or professional designation.

In hindsight, some might say "Well, I would have been better off putting that money in the stock market instead of earning a paltry interest rate just to have the cash available." True, but that's a backward-looking perspective. A healthy cash reserve prepares you to enjoy happy accidents. And the return from just one great opportunity can make all those hindsight discussions irrelevant.

☐ **Personalized benefits plan.** Ever heard someone say, "I'd like to make a change, but I can't afford to give up the benefits?" This comment might apply to group benefits available through an employer, particularly health insurance. Group benefits are typically affordable, easy to acquire, and easy to pay for. Unfortunately, most of these benefits are not portable. If you terminate employment, the benefits also terminate.

If you are looking to increase your income and advance your career, you don't want your opportunities restricted because of the lack of a personally-owned, portable benefits package. At a minimum, this means individual life insurance and disability income replacement policies, and perhaps professional liability insurance as well. Since individual policies often entail more rigorous underwriting, the prudent move is to obtain coverage while you are insurable, instead of waiting until an opportunity – like self-employment – makes it a necessity.

☐ **Balanced long-term wealth accumulation.** The impact of new tax rules on investor behavior will not be fully evident for awhile, but being prepared for possible happy accidents requires thoughtful consideration of allocations to qualified retirement accounts. Qualified accounts have measurable up-front tax advantages, but also impose restrictions and tax penalties on early distributions. In contrast, non-qualified accounts have greater liquidity, often accompanied by ongoing "carry costs" of dividends and/or capital gains. How do you determine your appropriate allocations to these different accounts?

Your answer should reflect an appreciation for financial flexibility. If a business opportunity requires a sizable down payment, where will you get the funds? Preparing for happy accidents *challenges* the frequently-heard recommendation to "maximize retirement account contributions," because an over-emphasis on retirement accounts may limit other options.

☐ **Manageable debt.** Borrowing is an exchange of the future for the present; in order to have something today, you are committing a portion of future income. Often, these transactions make sense. But even if you can afford the ongoing payments, too much debt can take away from future opportunities. Paying down debt may not always increase wealth accumulation, but it does buy back your ability to take advantage of the future.

For many individuals, their biggest debt issue is their mortgage. As the residential real estate market has tanked, many homeowners are underwater; they owe more than the current market values of their homes. This situation makes it difficult for homeowners to relocate. A job change could force some tough no-win decisions, like carrying the cost of two homes, becoming a landlord, petitioning for a short sale, or, in extreme circumstances, walking away from the property and absorbing the fallout of a ruined credit score.

There are no hard-and-fast numbers to attach to this checklist. Some ratios or percentages may serve as guidelines, but each individual's situation is unique. However, empirical evidence suggests most Americans, even high earners, are under-funded, under-insured and carry too much debt. These weaknesses may not be financially crippling, but they certainly preclude many from exploring career and financial opportunities beyond their current employment and retirement plans.

Want to beef up your ability to encounter happy accidents?

Meet with the financial professionals who can match practical actions to these principles.

Financing a College Education:

If you are going to start, you <u>have to finish</u>.

Touted as the "clearest path to the American middle class," earning a college degree remains a high priority for most Americans. Why? As *Wall Street Journal* reporter Ben Casselman wrote on November 22, 2012, college graduates have "lower rates of unemployment, higher earnings and better career prospects than their less educated peers."

But because the cost of acquiring a degree has risen faster than almost any other item in the American economy, paying for a college education may be a tougher test than passing the academic requirements of a degree. And the financial challenges can be even greater for those who start college ***but don't finish.***

A college education has become <u>way</u> more expensive

Recent data from the Bureau of Labor Statistics paints a shocking picture (see Fig. 1). Compared to other significant items included in the government's Consumer Price Index (CPI), the rise in college tuition and fees since 1978 has far outstripped necessities like food and energy, and is nearly double the increase for medical care.

From 1978 to 2012, the average annual rate of inflation for the United States, as calculated by the CPI, was 3.87%, meaning $1.00 in 1978 had the same buying power as $3.63 in 2012. If you plotted this number on the graph, the aggregate inflation rate would be represented by a line slightly higher than the increase in food costs. This means both food and new cars became proportionally cheaper over the past 34 years. Meanwhile, energy, medical, and tuition costs grew faster than the overall rate of inflation and thus were more expensive. Yet even among these three items, the increase in college expenses is the outlier. The rate of growth in college tuition and fees has risen at an annual rate of 7.2% – nearly double that of inflation.

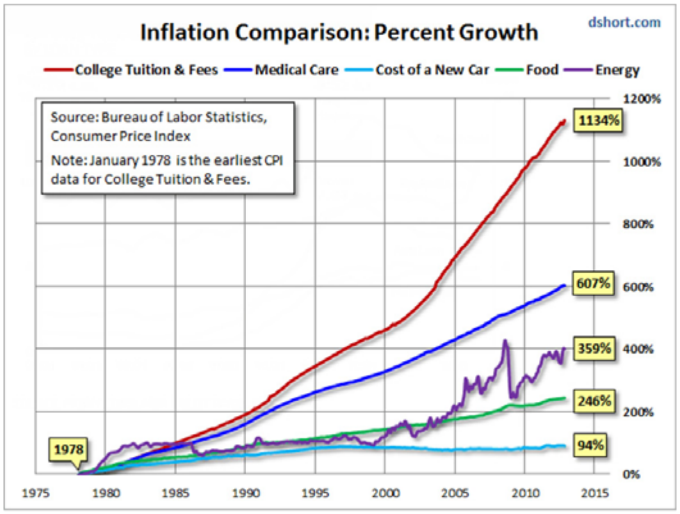

FIG. 1

As a result, more students are borrowing to pay for college

As tuition has become disproportionately more expensive, borrowing to pay for it has also increased. Recently published data from the Federal Reserve shows that since the end of 2007, just before the financial crisis occurred, student debt has grown by **56%** (adjusted for inflation) while other household debt (mortgages, auto loans, credit cards) ***decreased*** 18%. According to a report from the Institute for College Access & Success' Project on Student Debt released in October 2012, "Two-thirds of the class of 2011 held student loans upon graduation, and the average borrower owed $26,600."

Besides economic pressure, educational borrowing has also increased because it is easy to obtain. The same Federal Reserve report found that 93% of all student loans were made directly by the government, "which asks little or nothing about borrowers' ability to repay, or about what sort of education (students) intend to pursue." Loan repayments don't begin until a student has either graduated or is no longer enrolled in school, and in essence, the expectation of repayment is based almost entirely on the assumption of a graduate's increased earnings. This paradigm is being severely tested by the current economy, which finds many graduates either unemployed or underemployed, and often unable to meet their payments. The default rate on student loans now exceeds credit cards, and some policy makers are beginning to wonder if the metrics of educational borrowing need to be recalculated.

The repayment issue is even worse for dropouts

The student loan debt statistics cited by the Federal Reserve referred to 2011 ***graduates***. It did not consider those who borrowed for college, but did not obtain a degree. However, a 2011 study by the Institute for Higher Education Policy found that "58% of the 1.8 million borrowers whose student loans began to be due in 2005 hadn't received a degree. Some 59% of them were delinquent on their loans or had already defaulted, compared with 38% of college graduates."

The problem here is fairly obvious. Absent a degree, the prospects both for employment and enough income to make payments are diminished. A 2010 study by the Education Department found that, among Americans aged 25-34, the unemployment rate was twice as high for college dropouts compared to those who obtained a degree. They also determined that graduates earned 37% more than dropouts.

"Graduating with a lot of debt can be daunting. Having a lot of debt and not graduating is even more daunting," says Lauren Asher, president of the Institute for College Access and Success, in the November 22, 2012, *WSJ* article.

Most families and students already know that college costs a lot of money. In a perfect world, scholarships and family trust funds could make obtaining a higher education a simple proposition: enroll, pay the tuition, earn the grades, get the diploma. The reality, according to Ms. Asher, is

> "…loans have become a necessity for more and more students who a generation ago might have gotten through college without any loans. What we've seen is college costs outpacing both family incomes and available grant aid for a generation."

Strategies for financing – and completing – a college education

With these financial realities in mind, it may be prudent to consider a variety of strategies, in both selecting a degree program and deciding how to pay for it.

Start slow, sort it out, pay as you go. How many 18-year-olds know what they want to be when they grow up? A Kansas State University FAQ web page declares "Approximately 70% of college students will change their major at least once during the course of their academic journey." WikiAnswers puts the number at 80%, and adds… "On average, college students change their major three times over the course of their college career."

Given the high likelihood of a change in career interest, it might be prudent to begin a college education slowly, maybe even part-time. As much as college is promoted as a ticket to a better life, it's not for everyone. Spending (or borrowing) a lot of money to change your mind two or three times, then drop out, is a bad financial decision with a long shelf life – you could be paying for not getting a degree for the rest of your life. Consider taking prerequisite classes at your local community college, exploring different fields, and allowing your interests and habits to mature.

Pay from savings first, borrow last. The default funding model for students (and their parents) is to complete a Free Application for Federal Student Aid (FAFSA) each year, and find out how much student aid is available. Whatever costs aren't covered by grants or scholarships will be paid from individual savings or by borrowing.

As mentioned earlier, student loans are easy to procure, and the terms of repayment are favorable. These factors might induce students to take loans, and hold off on using any personal savings. But if you have money saved for college, it might be wise to pay as much as possible out-of-pocket for the first few years until the student has demonstrated an aptitude and interest for completing a degree program. Once a career path is established, and savings are exhausted, then consider borrowing. Remember: ***borrowing only makes sense if it results in a degree.***

This approach not only minimizes the financial cost of dropping out, but also provides reasonable evidence that the loans will be a good investment in your financial future.

Finish as a full-time student – even if you have to borrow more. Once you have a clear educational objective, the sooner you complete your studies the better. A 2011 report from Complete College America, found that "Less than a quarter of part-time students complete a bachelor's degree within eight years, compared to more than 60% of full-time students." The conclusion: "Time is the enemy of college completion. The longer it takes, the more life gets in the way of success."

Taking more time to complete your studies exacts an opportunity cost. The sooner you graduate, the sooner you enter the job market, the sooner you begin reaping the financial benefits of a college degree – and the sooner you can cut loose the financial anchor of student loan debt. There may be good reasons to make a four-year degree program last eight years, but almost none of those reasons are financially sound.

If any of this information resonates with your personal circumstances, it should be obvious that executing these strategies will require some careful and frequent assessments of your financial affairs. The broad idea behind student loans has been "Don't worry about the cost, just get the degree. Your lifetime of increased earnings will allow you to figure out how to pay for it after you graduate."

That idea is no longer valid. Poorly-structured student loan debt has the potential to impose a lifelong drag on your financial progress. **Before you enroll, have a plan.**

Understanding Life Insurance Policy Loans

Q: Why does the insurance company charge me interest to borrow my own money?

This question is one critics of cash-value life insurance often raise. For them, if the savings accumulated in the insurance policy belong to the owner of the policy, it seems unfair, even unethical, for the insurance company to impose a charge to access the savings. For cynics, these transactions represent a conspiracy to defraud the consumer.

Cash value loans aren't a conspiracy. They just aren't understood very well by most consumers – and even some so-called "financial experts." What follows is an attempt to correct this misunderstanding.

Although the analogy is not exact, a cash value life insurance policy can be understood as being similar to a mortgage agreement. In a mortgage, the borrower assumes control of a piece of real estate immediately, but pays for it over time. At some future point, when the mortgage has been paid, the individual will own the property "free and clear."

Likewise, a policyholder takes control of a specified amount of money (the insurance benefit), and agrees to pay regular premiums over time. Depending on the type of contract, the life insurance policy can eventually reach "paid up" status, i.e., no more premiums are due, and the owner of the contract holds the insurance benefit free and clear.

There are other similarities as well.

Just as you build equity in your property by making monthly payments on the mortgage, equity grows in your insurance policy as cash value. To compensate the lender for the risk of borrowing, mortgage payments are weighted toward interest at the beginning, so equity grows slowly. Likewise, cash values tend to accumulate slowly at the beginning of an insurance contract. And like the mortgage lender, the insurance company has the biggest risk at the beginning of the policy's life. If the company agrees to insure you for a million dollars, and you only make three months of premium payments before dying, your beneficiaries still receive the insurance benefit, and the insurance company takes a big loss (because they were counting on collecting many years of premiums before paying the promised benefit).

Another similarity between a cash value insurance policy and a mortgage is the way that equity can be accessed. With a home, the owner can tap the equity through refinancing the existing mortgage, or taking a separate home equity loan.

If your home is worth $250,000 and you owe the bank $90,000 on your mortgage, you have $160,000 of equity in the property house. In this situation, a bank might typically offer a home equity line of credit equal to 80% of the value of the house ($200,000) minus what you already owe in the mortgage ($90,000), or $110,000. To do this, the bank will charge interest on the amount loaned, and will establish a monthly repayment schedule.

If you have followed the discussion from the beginning, and are tracking the parallels between a mortgage and cash value life insurance contract, a question should be popping up:

> **"If the equity in my home is my asset, why do I have to pay interest to the bank on 'my money,' when I take a home equity loan?"**

Yeah! If the equity is *your asset*, why do you have to pay interest to someone else to use it?

Here's the reasoning for the home equity loan: the interest rate the bank is charging you is an "exchange fee" for converting the value in your house into cash. In theory, you could "spend" your equity by taking pieces of the house and exchanging them for other goods. Two bricks for a loaf of bread. A light fixture for a pizza. But not every grocery store accepts bricks, and not every pizzeria wants light fixtures — like everyone else, they prefer cash.

Not only that, but your house is worth more than the sum of its parts. If you decided to access the wealth in your house by selling it bit by bit, the value would drop significantly on what was left. Taking a home equity loan not only allows you to convert a material asset to cash, it allows you to maintain the ongoing value of the asset, instead of gradually destroying it. You may complain about the rate being charged, but the bank does provide a service in exchange for the interest.

The same financial idea applies to accessing life insurance cash values. The cash value in your policy has a dollar value, but the asset isn't the same as cash — it's an insurance benefit. If you want to convert it to cash, and still keep the insurance intact, the company has an "exchange fee" just like the bank, except:

- The repayment schedule is set by the policyholder, not the bank.
- The insurance company cannot deny access to cash values, although a bank might refuse a second mortgage.

As we said at the beginning, properly understood, a cash value insurance policy is really like a "mortgage" for an insurance benefit. Yet many consumers (and "experts") who never think twice about how a mortgage works for real estate get all worked up about the same features when they are part of an insurance policy. Yet you probably haven't ever heard people make this kind of complaint about a home equity loan — and the banks are much more restrictive than the insurance companies.

Understood in this light, it's possible to see similarities between home equity and cash value loans.

Since there are a wide range of insurance contracts, and your situation is unique, make sure you consult with your insurance professional about suitable ways to use your cash values.

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