

# CREATIVE Wealth Maximization Strategies

TRIAD | WEALTH SYSTEMS  
Russ McMillan, President  
600 Emerson Road, Suite 110  
St. Louis, MO 63141  
Phone: 314-997-1388

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## Upon Further Review... Security Is Important!

Stocks, bonds, insurance and other financial instruments have long histories. But while most of the financial vehicles available for use in personal financial programs have been around for several centuries, the personal financial services industry is a relatively young business. In fact, what is generically referred to as “financial planning” is so young that most of its customers are still waiting to see if it will deliver its promised benefits of financial security and prosperity.

From a big-picture perspective, the storyline presented by the financial services industry is one that begins by helping Americans to save during their working years and ends with a fulfilling retirement funded by profitable investments. But because the narrative about the financial services industry is primarily strongly tied to the Baby Boomers – those Americans born between 1946 and 1964 – the end of the story is far from certain. Boomers are just beginning to retire, and what was anticipated may not come to pass. New realities are challenging old assumptions, and as a result, the storyline may need some revisions.

### A little history lesson may be helpful

Historians often refer to the Americans who preceded the Baby Boomers as the “Greatest Generation.” This is the generation that survived the Depression and won World War II. As the Greatest Generation has matured, it also became the first generation for which retirement was a wide-spread

reality. The combination of Social Security, employer pensions and increased longevity made it possible for a large number of senior Americans to stop working long before they stopped living.

Still, most Americans of the Greatest Generation had limited exposure to the financial services industry. Both Social Security and the company pension were accounts managed by someone else, and the monthly checks weren’t much different than paychecks. Remembering the hardships of the Depression, much of

the Greatest Generation also had an aversion to debt and the stock market. The services of stock brokers, insurance agents and accountants were available, but having a team of financial professionals working together and monitoring your financial program was something only “rich people” needed.

It wasn’t until the Baby Boomers entered the workforce and the Greatest Generation began retiring that the financial services industry began to emerge. Several writers on the history of financial planning point to the establishment of the Society of Financial Counseling Ethics in 1969 (which would

evolve into the Certified Financial Planner Board of Standards) as the beginning of an attempt to provide comprehensive financial services to a wide range of Americans.

Directly or indirectly, the population surge created by the Baby Boomers has provided the impetus for the growth of the financial services to the masses. At every stage of life, the demographic wave of Boomers has meant economic growth. When Boomers graduated from high schools, the enrollments in community colleges and universities swelled. When Boomers started families, there was a housing boom (which



*Here's a quick quiz on a basic financial concept. Do you know the answer?*

**A married retiree must decide on an annuity option for his company pension. He is given three choices. Which option will result in the highest monthly payment?**

- A. Life only
- B. Life with joint survivor
- C. Life with 50% joint survivor

helped inflate the value of their parents' homes as well). The spectacular gains in the stock market during the late 1980s and 1990s coincided with the Boomers starting to save for retirement. Better-educated, wealthier and large in number, Boomers provided financial institutions with an enormous opportunity to market financial products and services. In 1950, there were just over 100 open-ended mutual funds in existence. It took another 20 years for the number of funds to pass 250. Today, there are over 10,000 different mutual funds.

### Boomers aren't their parents

As the financial service industry began offering planning services, it presented accumulation and

**There is no formula that will deliver guaranteed income from non-guaranteed assets.**

retirement paradigms based primarily on the experiences of the Greatest Generation.

In the Greatest Generation retirement format...

...you owned your home free and clear before you retired, and were completely debt-free.

...your employer provided generous health care benefits.

...financial professionals talked about the "three-legged stool" approach. Social Security comprised one supporting leg, your employer pension was another, and personal investments made up the third leg.

...the goal was to live on earnings and conserve principal. Since Social Security and the pension were providing a steady stream of income, the major planning concern was allocating personal investments to keep pace with inflation. This included selecting financial products that fluctuated in value but provided the opportunity for higher long-term returns.

Assuming the economy and the markets would continue to perform in the next three decades like they had in the past three, optimistic financial pundits were certain Boomers could anticipate an even better financial life than their parents. Experts believed retirement ages would steadily decline as real estate and stock portfolios generated out-sized returns. ("Why wait until 65 or 62 to retire? With good strategies, you might be able to quit working at 55!")

But the Baby Boomers aren't their parents. And the world they live in isn't the same either.

- Unlike the Greatest Generation, many Boomers nearing retirement still have debt. They have mortgages, credit cards, car loans, and even education debt.
- Boomers may live longer than their parents, but they also face higher health costs. As a result, experts are now recommending that individual

financial programs should include an additional \$200,000 just for medical expenses. Providing for the possibility of long-term care is another looming financial issue. (The next final economic boom caused by the Boomers might be a surge in the long-term care industry, from nursing homes to in-home services.)

- And for Boomers, the three-legged stool paradigm has one shaky support, and another one that's disappearing. Social Security worked for the Greatest Generation because there were so many more Boomers paying into the program. Boomers don't have as many workers stepping in to replace them, and consequently the program is unsustainable. Guaranteed employer pensions based on years of service are disappearing, replaced by 401(k) plans. This transfers the burden of contributions and management to the individual. Personal savings, which used to be the "extra" that provided for the luxuries in retirement, is now required to cover all the bases – provide a steady income, cover medical expenses, and kick out the bonus money to live the good life.
- Just for good measure, add a stock market that appears to have leveled off, fuel prices that have taken off, and home values that have dropped off precipitously.

For Boomers, this is not the retirement scenario they imagined. A May 16, 2008 *USA Today* article, "The Incredible Shrinking Nest Egg", stated: "Americans need to face a sobering fact: They're not likely to have as much money for retirement as they'd projected. Which means many of us will have to save more, expect less and work longer than we'd planned." The Employee Benefits Research Institute's April 2008 poll of retirement confidence showed the biggest one-year drop in the 18-year history of the survey.

### For maximum opportunities, you must establish financial security

As the differences between the two generations become apparent, there is a growing sense that financial success for Boomers may require significant adjustments not only in expectations but also strategies. One topic that's emerging: the importance of financial security. People want to know what they can count on in their financial programs.

When Social Security and a company pension formed the backbone of one's retirement assets, it was easier to consider the risks and rewards of non-guaranteed financial



products. But if you take away an underlying foundation of safe assets delivering a steady income, it tends to create emotional distress. And when people are stressed about their money, they often compound the problem by making poor financial decisions. And here's the kicker: Sometimes those poor financial decisions include not taking *enough risk*.

An article in the May 5, 2008 issue of the *National Underwriter* about a recent retirement conference in Las Vegas highlighted the dilemma.

Joseph Jordan, a senior vice president for MetLife, pointed out that many people don't invest aggressively – even if they could get better returns – because of fear. And even the most rational statistical analysis won't override the emotional response to financial insecurity. “This is a tragedy in the financial service business,” Jordan said. “We've developed a lot of left-brained analytic tools to solve right-brain emotional issues.”

Zvi Bodie, a professor of finance and economics from Boston University, dismissed the idea promoted by some commentators that diversification is a satisfactory method for reducing financial risk. For Bodie, there is no formula that will deliver guaranteed income from non-guaranteed assets. “It's complete baloney to say that stocks become safe due to time and diversification,” he said. “History proves that the ups and downs of the stock market do not cancel out over time.”

His idea of the simplest, most effective way to manage or avoid risk? ***Don't invest.***

According to Bodie: “Put it (money) into a safe asset. If it's in a safe place it's not investing.” This emerging emphasis on financial security doesn't mean you shouldn't invest at all. Rather, it says that if you want to invest well, you'll make sure you address your financial security issues ***first***. For emotional and practical reasons, “safety first” is a key principle for maximizing financial performance.

Based on the paradigms of the previous generation, the financial services industry focused much of its attention on the opportunities for higher returns through investments in the stock market or other non-guaranteed financial products. But the primary purpose of accumulating assets for retirement is to deliver a secure income. As the Boomers move into retirement, it will be interesting to see if the strategies formulated in the past several decades will deliver the financial security necessary to allow for a truly satisfying retirement.

**DOES YOUR FINANCIAL PROGRAM HAVE “SECURITY” FEATURES? IF YOU'RE NOT SURE, CALL US TO FIND OUT.**

## The Cash-Flow Reserve Strategy: A Direct Application Of The Financial Security Principle

Harold Evensky and Deena Katz are financial advisors and co-authors of several books about investing. A June 14/15 *Wall Street Journal* article titled “How To Bulletproof Your Nest Egg”



featured the married couple's “cash-flow reserve strategy” as a way to “create regular paychecks for retirees.” The following is a brief overview.

Evensky and Katz began developing their approach in the 1980s. The basic idea was to move a percentage of assets out of the investment portfolio and into safe, guaranteed financial vehicles for the exclusive purpose of providing income for a specified period (say 5 or 10 years). The remainder was invested in long-term vehicles. At regular intervals, the safe account would be replenished with earnings from the long-term investments. Over the years, the couple has fine-tuned the approach into three pieces. A checking account is for living expenses, a cash-flow reserve portfolio has two years of spending money divided between two low-risk options, and the remainder is allocated to various investments.

According to the *WSJ* article, this “financial security” approach came out of the pair's dissatisfaction with two commonly used retirement strategies:

1. Relying on dividends and/or interest to provide income.
2. Taking steady withdrawals from a mix of investments – regardless of market conditions.

Mr. Evensky says the first approach “makes no sense” because it requires a high percentage of low-risk assets to provide the income. This limits one's ability to invest in higher-return, longer-term alternatives.

As for taking steady withdrawals from fluctuating investments, Evensky says the real risk in retirement is having to sell holdings when markets are falling. This creates the potential for “reverse” dollar-cost averaging, because if steady withdrawals are taken from an investment that is declining in value, it requires the sale of more shares to provide the same amount of income. This leaves fewer shares on which gains can occur in the future, so even if the investment bounces back, you have less value than before.

Knowing that your income is secure, other assets can be invested to maximum advantage. You won't have to liquidate at depressed prices, and as time passes, these additional assets can be re-allocated to replenish the secure income account.

In this strategy, addressing the financial security issue means less money is “invested.” However, the emotional tranquility that results means there is a greater likelihood that investments can be allocated in a way that is most profitable.

## How Bad Is It?



*Maybe It's Pretty Good –  
We Just Don't Know It*

Here's the lead paragraph  
from a June 18, 2008  
*Washington Post* article:

**Ask Americans how the economy is doing, and their answer is stark: It is not just bad, it is run-for-the-hills terrible. Consumer confidence is at its lowest level in almost 30 years. Only 12% of Americans think the economy is in good shape. On the Internet, comparisons to the Great Depression are widespread.**

Contrast that first comment with the introduction from a speech given on January 29, 2008 by Patrick Toomey, President of the **Club for Growth** at Michigan's Hillsdale College:

**The fact of the matter is that we in the United States, and to a lesser degree the entire world, have just lived through – and continue to live in – the greatest period of prosperity in human history. Over the past 25 years, more wealth has been created, more people have been lifted out of poverty, standards of living have been elevated more dramatically, and the quality and length of life have improved, more than ever before in recorded history.**

Forget the is-the-glass-half-full-or-half-empty discussion. These two sound-bytes aren't even talking about the same glass!

How can two opinions on the same issue be so different? **It's all about the frequency of the message and one's frame of reference.**

The average American consumer views today's economy in the context of today's gas prices. Toomey, a former Congressman and Harvard graduate, views today's economy in the context of previous decades. Both views are compelling, but for different reasons.

The *Washington Post* article was titled “Why We're Gloomier Than The Economy.” In it, staff writer Neil Irwin states that “According to most broad measures of how the economy is doing, it's not all that grim...”

Economists are “trying to figure out why Americans' perceptions are so much more negative than the data...”

Irwin thinks one of the main causes of consumer pessimism may be the cumulative impact of minor, but frequent, economic setbacks. Citing a Columbia Business School study, he offers this example: Someone who has to pay an extra \$25 to gas his car gets a dose of bad news every time he fills up. This economic pain is further reinforced each time he sees the \$4 per gallon price in giant numbers on a sign. Technically, he is no worse off than if his rent had increased by \$100 a month. But because the cost increase is presented on a daily basis, it feels a lot worse.

Not only do these “little” economic pains occur more frequently, they affect everyone. Says economist Michael Feroli, “If the unemployment rate goes from 5 to 7 percent, it affects 2% of the population. If gas prices go up, almost 100% of the population feels terrible.” In summary, when a large segment of the populace is receiving small pieces of negative information every day, the collective mood is pessimistic.

But when you consider the American economy over the past 40 years, most of the population should feel quite upbeat. Toomey offers some compelling evidence.

**People have more money.** 1989 median net worth was \$69,000. In 2004 it was \$93,000. In 1983, only 19% of Americans owned stocks. By 2005, more than 50% were investors. The Dow Jones Industrial Average began the 1980s at 825. Even after recent declines, the index is still over 11,000, representing a 1,300% increase in value.

**People are working.** In 2007, U.S. manufacturing output was the highest in history. In 1970, average unemployment was nearly 7%. Since then the trend has been downward, with unemployment remaining at or below 5% since 2003.

**Prosperity has touched everyone.** It's not only the rich who are getting richer. Says Toomey:

“These gains in wealth and income have resulted directly in a better standard of living for virtually every segment of American society – including the poor. Among families living below the official poverty line in the early 1970s, less than 40% had a car, almost none had color televisions, and air conditioning was virtually unheard of; in 2004, 46% owned their own homes, almost 75% owned a car (indeed, 30% owned two or more cars), 97% had color TVs, and 67% had air conditioning. The poor in the U.S. have an average of 721 square feet of living space per person, as compared with 430 in Sweden and 92 in Mexico.”

It's true that high fuel prices, inflation and declining housing values could be the beginnings of a significant downturn for the economy. But considering the

economic progress of the past three decades, it is also possible that the economy will find a way to rebound. For example, higher fuel prices might spur the development of cheaper alternatives.

In addition, those who are financially prepared might find golden opportunities in the current economic slump. As real estate values have declined, some regions are noting a jump in sales, as buyers recognize properties that can be purchased at a discount.

Small doses of bad economic news, when delivered on an every-day basis, can have a cumulative effect on the psychology of the populace. But when individuals see the bigger picture, there are still ways for them to prosper, even in difficult times.

## 401(k) loans and the Cash Crunch

In last month's issue, the article "HELOCs and the Cash Crunch" discussed how some changes in home-equity lines of credit (HELOCs) might impact your ability to tap the equity in your home for financial emergencies. This issue looks at another popular cash-crunch option: borrowing from a 401(k) or other qualified retirement plan.



Loans against retirement account assets are on the increase. According to a Transamerica Center for Retirement survey cited in a May 5, 2008 *Wall Street Journal* article ("Raiding the 401(k) Nest Egg"), 18% of workers had loans outstanding from their plans at the end of 2007. This represents a 50% increase over the previous year. *WSJ* writer Jennifer Levitz says the dramatic increase may be because cash-strapped consumers are "no longer able to tap their houses for cash and are up against their credit-card limits."

Qualified retirement plans (those that qualified for tax-deductions) were not intended to be used as emergency funds (that's why they're called retirement plans). So while there are ways to access the account accumulation before retirement, there can be some adverse consequences. The following is an overview of some of the pros and cons of borrowing from retirement accounts.

### Pros

- According to statistics provided by the [www.psc.org](http://www.psc.org), almost 90% of 401(k) plans offer loan options.
- The basic terms for all plans are very simple: You may access up to 50% of your account's value, up to a maximum of \$50,000.

- There is no additional qualification process; no credit checks, no appraisals. Many plans allow loans to be initiated with a phone call; others require nothing more than a short loan form.
- There are no immediate tax consequences even though you will be liquidating part of the retirement account in order to secure the funds.
- The interest rate terms are usually quite favorable. You pay the rate set by the plan, usually a couple of percentage points above the prime rate. Loan payments can be deducted directly from your paycheck, similar to deposits to the plan. Although there are some exceptions, loans generally must be repaid in regular installments over terms no longer than five years.

### Cons

- Once you take a loan from your account, you may not be able to take another loan until the current balance is repaid, as only 45% of plans surveyed allowed multiple loans.
- Unlike a home equity loan, the interest on a 401(k) loan is not eligible for a tax deduction.
- If for some reason you do not repay the loan before you leave, the unpaid balance will be considered a distribution from the plan. This makes the distribution subject to federal and state income taxes generally an additional 10% penalty if you are under age 59½. This factor can come into play if you terminate your employment, as loans can only be made to active plan participants; at the time of termination, any outstanding loans must be repaid.
- Most financial commentators see 401(k)s as a good place for long-term investments, the type that fluctuate day-to-day but have the opportunity to deliver higher returns over time. Loans disrupt this accumulation strategy. The account must either be allocated to safer alternatives to guarantee availability for loans, or run the risk that liquidation will either blunt high returns or be made when the account is momentarily showing a loss.
- The money used to repay the loan ends up being double-taxed. Whether you repay the 401(k) loan out of your salary or from a bank account, those payments are all made back into the 401(k) with after-tax dollars. So, let's say your monthly interest payment is \$300 and you're in the 28% tax bracket. You'll have to make \$416 in gross earnings to make the \$300 payment. Then, when you retire and take withdrawals, you pay taxes yet again. According to an April, 2008 report issued by Valerie Gieseke, a senior consultant at TRI-AD, "the true cost of the loan can be 20% to 40% higher than is evident due to this double taxation."

## Isn't it time to stop using "Plan Bs?"

An emergency cash reserve – guaranteed, stable, liquid – has always been the best response to unexpected financial circumstances. If you know you have the money, you know you can take care of the problem. (It's that "financial security" thing discussed in the opening article.) The problem many people have with leaving a significant amount in a safe asset is the low rate of earnings that accompanies the security. That's why so many try to find other assets to serve as cash resources.

While loans from retirement plans are an option, using them to cover financial emergencies is probably not their most efficient financial application. Retirement plans were designed to encourage long-term saving. Even though there is no immediate tax consequence to taking a loan, each loan can have adverse tax consequences – even if you repay it. A 401(k) loan to meet a cash crunch shouldn't be your first option; it's a Plan B – or C.

Last issue's examination of home-equity loans mentioned the use of life insurance cash values as an alternative resource for cash emergencies. For slightly different reasons, cash values may also be preferred to taking a 401(k) loan.

A typical whole life policy will allow owners to access between 90% and 95% of their cash values, and the amount withdrawn is not limited to \$50,000.

Depending on the particulars of the loan and the life insurance policy, it is possible that loan repayments to cash values can be made over a time period longer than five years, and in irregular installments.

(An important note: Unpaid loans and withdrawals may incur tax consequences and/or affect the life insurance benefit. Make sure your decision to tap cash values is based on all the pertinent facts.)

When not needed for financial emergencies, the accumulation of cash values provides long-term options for maintaining the life insurance benefit. An insurance policy initially purchased to provide income for beneficiaries in the event of untimely death can also play a crucial role in an estate plan or provide additional resources for end-of-life medical needs.

If you have a whole life insurance policy, and are in the midst of a cash crunch, contact your financial professional to understand how cash values might assist you in weathering the storm or getting back on your feet.

### ANSWER TO THE FINANCIAL LITERACY QUESTION ON PAGE #1

A is the correct answer. An annuity payment calculated on only one life will result in the highest payment. However, the payments last only as long as the individual is alive. The other two options provide for payments to a survivor (usually a spouse) as well. Because the obligation is based on two lives instead of one, the monthly payouts are reduced. In the life with joint survivor option, the payment remains the same after the first person dies. In the life with 50% joint survivor option, the initial monthly payment will be reduced by 50% if the annuitant dies first. (This option results in a higher monthly payment than a simple joint survivor option, but less than the life only choice.)

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600 Emerson Road, Suite 110  
St. Louis, MO 63141-6762  
Phone: 314-997-1388  
Fax: 314-787-5600  
[www.triadwealth.com](http://www.triadwealth.com)