

CREATIVE

Wealth Maximization Strategies

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

SEPTEMBER 2006

“Few things are impossible to *Diligence and Skill*”

-Larry Feiler

Ultimate financial objective: Spend and Enjoy!

Question: Why do people save money, and accumulate wealth?

Answer: So they can spend it!

Money is a compelling issue that affects almost every part of our lives, and because it is so pervasive there are all sorts of ways to evaluate it. You can try to quantify the value of money in your life numerically and declare Bill Gates the richest man in the world. You can devise a psychological measure that indicates higher incomes tend to equal greater personal satisfaction. (Best recent money-life correlation: “new research suggests left-handed men with a college education earn 26% more than similarly educated right-handed men” – *World*, Aug. 26, 2006.)

But after sifting through all the jabber about money, empirical evidence suggests there are only three reasons to save and accumulate material wealth:

1. To provide some security against unforeseen events;
2. To spend/enjoy the accumulation at a later date; or
3. To make it easier for future generations to achieve #1 and #2.

These observations don't require lengthy discussion or detailed analysis. Rational people know that life has physical realities and a degree of uncertainty. Rational people also know that the only logical response is to develop plans that will help them achieve these objectives.

In light of these conclusions, one of the essential goals of a good financial program is a plan to spend the money!

So much of the public discussion about money involves acquisition and accumulation, but the ultimate goal of any spending/retirement/accumulation program is to be able to spend well later. “Spending as much as possible” may come across as wasteful and hedonistic to some people. But what is the purpose of saving, if not to eventually spend it? In a financial emergency, the reason you saved was to have some money to spend to alleviate the crisis. In retirement, a large measure of your satisfaction will be the result of being able to



The money you've saved only manifests its worth when you spend it.

spend the money – for necessities and pleasures. Even estate bequests are a sort of spending; you are providing the opportunity for loved ones or favored charities to increase their security or financial enjoyment.

At the most basic level, the money you've saved only manifests its worth when you spend it. Don't gloss over this point. As long as the money sits somewhere (your bank account, a mutual fund, an IRA, wherever), its existence doesn't have a tangible impact on your life. Food isn't more plentiful, the car you drive doesn't get bigger, and your home doesn't get redecorated. **Your accumulation plans have no impact on your material world until you spend the money – or at least know you can spend it if you want to.**

Saving requires delayed gratification, but it shouldn't mean canceled gratification. We have it on good authority that everyone dies. And so far, no one has been able to take the unspent portion with them to the Great Beyond. If those are the facts (and they are), it doesn't make sense to work and save all your life, and then not enjoy the fruits of your diligence and discipline. Yet you might hear or read this advice: **“because of taxes, you might want to delay taking a**

distribution from this account as long as possible.”

This is the reward for 20 or 30 years of delayed gratification, to be advised to wait even longer? That’s only half a financial plan! Saving and the accumulation of material wealth shouldn’t become a form of life-long masochism. Plans to accumulate the maximum should also include plans to spend the maximum!

How then shall we spend?

As mentioned earlier, a central focus of much “mainstream” financial planning information revolves around ways to increase the size of one’s account, because even if spending is the final objective, you can’t spend it if you don’t have it. But how do you spend it, once you’ve accumulated it? In a world where most of the attention is on accumulation strategies, there’s really only *one* widely accepted “spending” strategy.

Living on earnings and conserving principal comes at a steep price.

The Base Plan: Live on earnings, conserve principal (LOECP)

Here’s the simple overview of LOECP: Build a large enough accumulation so that you can live on the earnings. That way, you don’t have to worry about “outliving your money,” because the principal will always be there, generating enough interest, capital gains, dividend income, etc. for spending. When you are gone, the principal can be passed to heirs, favorite charities, etc. Executed properly, the live-on-earnings-conserve-principal strategy accomplishes the three objectives of saving stated above.

LOECP works (and what else is there?)

The logic of LOECP is sound, and easy to understand. You don’t know how long you will live. If you spend/enjoy too much too soon, there’s always the unpleasant thought of running out of money in old age. That’s a real concern, and it’s scary. Living on earnings takes away some of the worry, because the strategy is designed to never exhaust assets. The earnings may fluctuate, but as long as you aren’t touching the principal, your financial spending/enjoying power remains intact.

Of course, many of us not only see our savings or asset accumulations in terms of what enjoyment we can derive from it, but also what it could mean for our children, grandchildren and other special causes we support. So while we want to have enough to enjoy life, we don’t necessarily want to spend it all on ourselves. Living on earnings ensures there will be an inheritance.

The key to success with the LOECP approach is accumulating a pile large enough that ongoing earnings from principal exceed the amount spent/enjoyed. This way, principal grows larger, and generates ever-higher earnings. In other words, LOECP becomes LOEEP – Living-on-Earnings, Enlarging-Principal.

On the other hand...

While LOECP is a workable spending strategy, it may not be the best approach to realize maximum spending. In fact, by its format, using LOECP to provide security and inheritance almost guarantees that you will lessen the spendability and

enjoyment of the money you have accumulated. Consider the following:

The untouched principal is one very expensive insurance policy. It’s true that living on earnings provides security against outliving your assets, but it does so by assuming you will live forever, and that’s not going to happen. The “insurance” you get from conserving principal comes at a steep price.

Essentially, not touching the principal each year is the premium required to provide “old age security.” As insurance, it’s very expensive. With most insurance you pay a small premium to get a large benefit when, or if, something unexpected occurs. But with LOECP, the principal is the premium and the benefit, and there’s no financial leverage from sharing the risk with others.

Consequently, when you decide to live on the interest, the major beneficiary of your “insurance plan” is the financial institution that holds your assets. Let’s use a simple illustration:

If you have accumulated a million dollars, earning 8% annually, living on earnings would produce an \$80,000 annual income stream and never eat away at the principal. Depending on how you evaluate your retirement future, \$80,000 could sound like a nice number. But that’s not the point!

The bank (or pension plan, or insurance company, or investment company) gives you \$80,000 while it uses the million you’ve left in reserve. The institution will put your money to work, primarily to make more money for the institution, not you! Year by year, you get \$80,000 to work with, and they get a million to work with. Who really gets the most benefit from your account? One could argue that it’s probably the financial institution that holds your account.

But if you deliberately plan to conserve principal by living on earnings so you can leave an inheritance, there’s another downside. **The untouched principal may not pass directly to beneficiaries.** Any significant amount of money left to the next generation may be filtered through the government, either by way of estate taxes or income taxes due on the unspent portion. In other words, if you don’t spend it, the government may take a portion before it gets to whomever you wanted to leave it. By using the living-on-earnings approach, you are not receiving full enjoyment from the money, and thanks to the tax law, your heirs may not either. The larger the principal amount, the greater the possibility of diminished inheritance.

Go back to our million dollar example. Assuming one had followed a conventional approach and held the principal in a qualified retirement plan, it’s not unreasonable to conclude the income tax transfer costs at death could reduce the amount passed on to your heirs by 30% or more.

In light of the previous paragraphs, one could argue that LOECP provides greater benefits for the financial institutions and the U.S. Treasury, with you getting the “extra” while living, and your heirs getting the “leftovers” when you die.

Is There Something Better Than LOECP? (How about a PSP?)

The living-on-earnings-consume-principal approach is a one-size-fits-all strategy. The only variables are the size of the principal and the rate of return. But depending on your situation, you may be able to develop a Personalized Spending Plan, referred to hereafter as a PSP. (After all, what's another acronym among friends?) Depending on a variety of factors – such as your age, and the types of assets you hold, and the order in which you liquidate or spend those assets – you may find a PSP results in more money to enjoy.

Here is a sampling of PSP principles that can be used to generate more spending from your principal.

1. Plan to live a long time, but not forever. Considering all the financial objectives you have for the future (security, retirement, inheritance, etc.) devise a plan that allows you to enjoy a good portion of your wealth based on life expectancy, not forever. In other words, plan to “spend down” the principal.

If you use our million dollars at 8% from above, what would happen if you withdrew \$100,000 each year instead of \$80,000? The money would run out in twenty years, but if you are 70 years old when you start this plan, that's twenty years of having 25% more each year. In this instance, that translates to 25% more spending power/enjoyment.

2. Understand that different financial assets have different “spending” characteristics and plan to use them at times when you can maximize their “spendability.” This idea of spending down is not as scary as it might sound, because in making a life expectancy plan, you can include some “backup” items that will actually have more spendable value as you get older.

As an example, a **reverse mortgage** allows homeowners to draw against the equity in their home, with no repayment due until either the homeowner dies or moves out. At that time, the property is either sold or signed over to the lender to satisfy the debt.

While reverse mortgages can be an innovative way to generate a tax-free income stream from the equity of your home, a key variable in the amount of income you will receive is your age. The older you are, the more you'll receive, because the payouts are based on actuarial calculations of life expectancy. Better to spend this asset later, rather than earlier, in retirement.

Through a financial transaction called a **collateral assignment**, life insurance death benefits can also be paid tax-free before death. In exchange for becoming the beneficiary on the policy, a financial institution will make a discounted immediate payout. Again, the amount of the discount is determined by age or medical condition. From a \$500,000 policy, a seventy-year-old in good health might receive \$200,000, while an eighty-five-year old might receive \$350,000. Obviously, the collateral assignment “spends” better the older you are.

(By the way, this is an effective argument for keeping life insurance, even if you don't “need it.” Having it allows you to free up principal from being used as insurance. And if you die without using the assignment option, life insurance is a clean liquid asset to provide tax-free survivorship benefits, or pass on to heirs. As we've said previously, if you decide to

buy life insurance, find a way to keep it. Otherwise, it can be money spent for nothing.)

3. Think flexibly about spending. One of the standard lines of the old-style financial plan is the phrase “you'll be on a fixed income in retirement,” as if your accumulated assets must be arranged to duplicate a pension plan, with a check for the same amount showing up in your



mailbox month after month. When everyone could survive on Social Security and a company pension, that scenario might have worked out. But things change. Don't be rigid in your thinking or your income distribution. Prepare to respond according to your situation.

You may want to plan to spend more now while you can more fully enjoy it, as opposed to deferring the money into the future when you may not be as active. With LOECP, spending more means eating away at your principal; today's enjoyment creates tomorrow's fear. That fear alone can be enough of a deterrent to keep you from spending.

Instead, right from the start, make allowance for your spending to change. For example, make sure some of your assets are in accounts that make irregular distributions possible without extra tax consequences.

With that attitude in mind, you might consider *systematically withdrawing from your qualified plan as soon as possible*. Since any money withdrawn from a pre-tax qualified plan is going to be fully taxed as income on distribution, it may be beneficial to take the money in small, regular amounts, just to dampen the tax impact – even if you don't “need” the money right now. Simply “re-save” the distribution, and put it to work in some other place where future tax consequences are diminished, or your options are more flexible. By preemptively making distributions in this manner, you are less likely to encounter situations that require a large lump sum withdrawal, with the additional income tax bumping you into a higher marginal tax bracket.

4. Finally, don't neglect the wealth-building strategies that make enjoyable spending possible. Spending from principal isn't really much different than spending from your working income. It doesn't require a different type of money.

However, when it comes time to begin spending, some financial advisors may recommend liquidating real assets, like rental property, and converting them to paper assets, (like bonds, stocks or cash). The theory is that this ensures that you won't be faced with a situation where illiquid assets must be sold at a discount to meet an emergency.

However, assuming those non-liquid assets were profitable, it also ensures that you will stop receiving those profits. As we've mentioned in previous issues, a balance of real and paper assets is desirable in most circumstances. Even though liquidity is an important issue, there shouldn't be a flight to paper assets, just because you've moved into spending mode.

Everyone's situation is different, so how you arrange the pieces will vary. **The key is understanding that in order to maximize your enjoyment of the wealth you have worked so hard to accumulate, you should be developing a plan to spend as well as a plan to save.**

HAVE YOU PLANNED TO SPEND (AND ENJOY) WHAT YOU'VE SAVED?

DO YOU HAVE A PSP OR ARE YOU STILL PLANNING FROM THE LOECP MODEL?

(If it's time to contact us, you should do so ASAP, right?)

NEWS DIGEST

(Snippets from stuff we've read, including differing points of view, not all of which we agree with. Want to know more? Give us a call and we can provide you with the complete article.)

DEBT CAN SHACKLE COLLEGE GRADUATES

Debt is a big issue for folks in their 20s. According to the College Board, an association of schools, colleges and universities, 73% of graduates from four-year non-profit private colleges had student loans outstanding with \$19,400 typically owed.

Once kids get into the work force, this debt can cause a heap of financial stress. New York's AllianceBernstein Investments recent surveyed college graduates between ages 21 and 35. Among those who graduated with debt, 42% said they were now living paycheck to paycheck, versus 24% of those who graduated debt-free.

Jonathan Clements, *Wall Street Journal*, August 2, 2006.

CAR THIEVES LIKE ESCALADES, PICK-UP TRUCKS

For the fourth straight year, GM's luxury Cadillac Escalade topped the list of late model vehicles most coveted by thieves, according to analysts of theft claims in 2005 by the insurance industry.

Ford's F-250/350 large pickup truck was in the top five most stolen models along with the Dodge Ram 1500 quad cab pickup and the Sebring four-door sedan, both made by Chrysler. Pickups have become more popular among car thieves as their sales have grown.

The Ford Taurus, and the Pontiac Vibe & Buick LeSabre, both made by GM, were among the least stolen models.

Reuters, June 7, 2006.

AGING POPULATION, LOW BIRTH RATES MAKE RETIREMENT UNCERTAIN IN EUROPE

By 2010 – just four years from now – there will be more 55- to 64-year-olds in the European Union, Austria's social affairs minister warns. The growing number of older Europeans, coupled with low birth rates across the 25-nation bloc, is giving lawmakers a big headache. At issue is how to financially shoulder the burden of an aging society while staying competitive globally and finding workable incentives for people to have more babies.

"It's getting worse and worse. If things continue like this, no one is ever going to get to retire," said Roni Howath, a former Vienna postal worker who retired early and now drives a cab from time to time to supplement his pension. In the past, European taxpayers relied on generous national pension plans fueled in part by those still working. But in recent years, many governments have made severe cutbacks amid fears that with fewer people paying into the system, there will be less money to dole out.

Associated Press, July 17, 2006.

OVER PAST 25 YEARS, CREDIT-CARD DEBT TRIPLES FOR TWO-INCOME FAMILIES

You might have expected that the two-income families of today would have a higher standard of living and greater financial security than the single-earner households of past generations. The fact is most families are buried in debt. In 1981, the average family owed just 4% of personal income in credit card and other unsecured debt. Today, that figure has tripled to 12%.

Elizabeth Warren and Amelia Warren Tyagi, *Bottom Line Personal*, July 15, 2006.

PUBLIC FAVORS HIGHER INSURANCE PREMIUMS FOR UNHEALTHY LIFESTYLES

A new study shows that public sentiment is shifting towards acceptance of higher health insurance rates for people with unhealthy lifestyles, giving human resource executives new ammunition to introduce employee health plan designs with incentives to pursue healthier habits.

Right now, large employers and their health care consulting firms are refining a benefit strategy for 2007 and sourcing vendors to fulfill their requirements. A relatively new angle that is gaining ground is providing financial incentives, such as lower premiums or co-payments, for employees who choose healthy behaviors like smoking cessation, exercise and weight control.

Wall Street Journal/Harris Poll results released yesterday indicate consumer support for such programs is growing. More than half of those surveyed (53%) said they think it's fair to ask people with unhealthy lifestyles to pay higher insurance premiums than those with healthy lifestyles, while 32% said it would be unfair.

PRNewswire, July 24, 2006.

THINGS THAT MAKE YOU GO "HMMM..."

Why some people are willing to pay a higher rate to borrow from "a real person"

If you took on a new mortgage or re-financed your existing mortgage in the past five years, it's quite likely that within the first year of the loan you received a notice from the lender saying "we've sold your mortgage. Beginning next month, all future payments will be made to (blank)." In the language of finance, your individual mortgage became "securitized."

In a normal scenario, a bank lends the homebuyer a large amount, and then recovers the loan (with interest) in small

increments over time. This is a profitable arrangement for the bank, but it has downsides. Money lent to one borrower reduces available capital for other lending, which may be more profitable. With mortgage terms running longer (30 years and beyond), it not only takes longer for the bank to get its money back, but increases the chance the borrower might default.

Securitization is a process that allows an individual lender (like your local bank) to minimize some of these investment risks. In securitization, banks pool their loans and sell them to larger financial institutions. The financial institutions like the regular payments generated by the pool of mortgages, and the bank gets most of its principal back so it can lend again. As an August 2, 2006 *Wall Street Journal* article notes: “securitization has become increasingly popular for banks and investors alike.”

In order to securitize their loans, banks must make sure their portfolios meet high standards that investors would find attractive. The borrowers should have a good payment history, and the amount owed should be low in proportion to the market value of the property. Loans that fit this category are considered to be “conforming,” i.e., they conform to the benchmarks that would make them suitable for securitization, conforming loans often have a lower interest cost than non-conforming loans that the bank keeps in its own portfolio and does not sell. The difference between conforming and non-conforming loan interest rates can be as much as 1.5% higher on a mortgage for the same property.

However, as the market has cooled in parts of the U.S., some real estate investors are finding they may prefer to pay the higher rate – just to keep the loan from being securitized. According to the *WSJ* article, “Real estate borrowers who may have some trepidation about the future see value in maintaining a friendly relationship with a trusted banker rather than be at the mercy of nameless agencies that service the loans on behalf of investors, in case anything goes wrong and they need an understanding ear.”

Hmmm... There’s no limit to the value of good customer service. Like any other retail consumer, borrowers are usually willing to pay a higher price if they believe they will be treated better.

MONEY MAKES A DIFFERENCE (but how much?)

Suze Orman is a syndicated columnist, CNBC business show regular, speaker, and author of several books on personal finance. On her “Money Matters” website, from July 31, 2006, she offered the following thoughts on the connection between money and happiness.

“I would love to live in a world where authentic happiness was achievable solely from the richness of our relationships, but I am a realist. And the reality I see – and that so many of you talk to me about – tells me that money does play into our ability to be truly happy.

I am talking about how your happiness is affected when you are worried about how you will pay bills at the

end of the month, save for the future, and be able to afford to retire – how you will make ends meet.

When that is your reality, I think it is ridiculously hard to be authentically happy.

Look, I want to be quite clear: I am in no way saying that money is all that matters. But I am tired of how scared everyone is to admit that money does in fact make a difference in the quality of our lives.”

What do you think? How much does money contribute to your happiness? Or to put it another way, how much does paying attention to financial matters and the concern over your money situation affect your happiness and security?

Everyone probably has a different answer to those questions. Money may not be the major source of happiness, but it's not something you can ignore or neglect. That's why many individuals find trusted professionals to help them take care with their financial plans. Taking care of your money issues keeps them from diminishing or distracting from the things in life that make you truly happy.

LIFE INSURANCE: ASSET OR LIABILITY?

Robert Kiyosaki, author of *Rich Dad, Poor Dad*, has a simple formula for financial success:

“You must know the difference between an asset and a liability, and buy assets. If you want to be rich, it is all you need to know. It is Rule No. 1. It is the only rule.”

In elaborating on Rule No. 1, Kiyosaki’s definitions are just as simple:

- **An asset is something that puts money in my pocket.**
- **A liability is something that takes money out of my pocket.**

Kiyosaki notes that the biggest problem for most people is they are “financially illiterate,” and can’t distinguish between assets and liabilities. As an example, Kiyosaki points to the conventional classification of a personal residence – asset or liability? For most in the middle class, a home is often mentioned as one’s “greatest asset,” because of the equity that usually accrues over time. But Kiyosaki disagrees, noting that a personal residence takes a lot of money out-of-pocket (mortgage interest, property taxes, maintenance costs, etc.), but puts no money back in – unless the home is sold.

It is interesting to apply Kiyosaki’s asset-or-liability litmus test to other financial instruments. For example:

Is life insurance an asset or a liability?

That’s an interesting question. Here’s an interesting answer.

A life insurance policy can be:

- 1. A current asset or a liability for the policy owner.**
- 2. A future asset for the beneficiaries.**

When a lender asks a borrower to provide financial information, cash value accumulations in a permanent insurance policy are considered assets. And the dividends paid to cash value policyholders could be considered “putting

money in your pocket.” So cash values probably fit the Kiyosaki definition of an asset. *(continued...)*

The death benefit (i.e., the amount that is payable by the insurance company upon the death of the insured) could be considered an asset for the beneficiaries. Of course, when this asset will be received is unknown. Thus, the death benefit should perhaps be classified as a potential asset for beneficiaries.

On the other hand, a lot of insurance policies are surrendered before the death of the insured. When a policy is surrendered, the potential asset for beneficiaries is gone. All previously paid premiums retroactively become liabilities that took money out of your pocket.

Keeping a life insurance policy in force until you die is the only way to guarantee it will become a potential asset. Regardless of the type of life insurance one obtains, the coverage must be kept in force for the rest of the insured’s life for a claim to be paid at death. Different types of policies may offer a return of premiums, or promise cash value growth that exceeds the total premiums paid, but those are “throw-ins” that obscure the fundamental equation of life insurance: A premium is collected to provide a benefit in the event of your death. A death claim is the only way to guarantee a financial benefit from the insurance expense. Only if you keep the life insurance in force, can the death benefit be considered an asset, not a liability.

“But wait, there’s more...”

Death is certain, and having a life insurance benefit in place means a specific financial event will coincide with death. This guaranteed “final transaction” can be used as a powerful, positive influence on other financial transactions. Indirectly, having life insurance may make other assets more valuable.

If a lender offers a bigger loan because the borrower has a life insurance benefit that can serve as collateral (to ensure the lender will be repaid in the event of the borrower’s death), you might say the life insurance put more money in their pocket.

If having life insurance allows a pension recipient to take the “life only” option instead of the “life and joint survivor” at retirement, the extra monthly income (money in the pocket) occurred because of life insurance.

Similarly, if a guaranteed life insurance benefit will serve as an inheritance for heirs, one might be free to “spend down” other assets (see the lead article in this issue) instead of conserving principal. If life insurance results in the increased “spending power” of other assets, it’s more money in the pocket.

BASF, a global chemical manufacturer had a marketing campaign that said “we don’t make a lot of the products you buy, we make a lot of the products you buy better.” Correctly structured, a life insurance plan can be a lot like the BASF slogan: It can make a lot of other assets perform better. Directly or indirectly, life insurance can be a financial asset.

“However...”

If you buy term life insurance, remain alive, and eventually surrender the policy (because the term expires, premiums are too high, no longer want the coverage, etc.), life insurance will become a financial liability. You will take money out of your pocket to pay premiums and receive no asset in return. And the cost of incurring this liability will not be just the premiums, but what those premiums could have been worth if they had been used to buy an asset instead.

That said, there may be times when term life insurance is a necessary and beneficial purchase – even as a “liability.” Obtaining immediate financial protection against an untimely death can provide an intangible asset: emotional security. The long-term financial result may be a total loss, but the near-term risk – “what would happen if I died tomorrow?” – necessitates a response.

“In conclusion...”

Whether or not life insurance is an asset depends on you. With the help of a financial professional, you can choose to structure your life insurance program so that it performs like an asset, or a liability.



CREATIVE
Wealth Maximization Strategies



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