Financial Literacy – Level 100

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Current Environment

- Current environment is uncertain.
- We look to the basics at times like these.

Questionnaires – Documents to be included

- Income tax returns for past years.
- Wills
- Trusts
- Life Insurance Policies
- Pension plan summaries
- Business agreements for privately held companies
- Prenuptial Agreements

Questionnaires

- Name
- Address
- Email
- Phone
- SS#
- Date and place of birth
- Dependents and dates of birth

Questionnaires

- Names of Advisers
- Life Goals and Timeframes
- Assets
- Liabilities
- Contingent Liabilities
- Potential Inheritances

Questionnaires

- Current Employment
- Pensions/Deferred Compensation/Stock Options
- Budgets

Questionnaires

- Risk Tolerance
- Risk Tolerance vs. Risk Capacity

Analysis

Everyone starts out with a basic balance sheet (spoken like a true accountant).

Assets:

Human Capital – Present value of future revenue streams - work and or social systems (i.e. SSD)

Inheritances – Present value of future gifts if applicable

Liabilities:

Retirement – Present value of life requirements not funded by company pensions and SS

- The path to creating financial independence where all liabilities are funded by assets and or cash flows requires most to convert human capital to financial capital. Most because many receive gifts or marry others that have assets that can be shared.

Early Life

- Early Life– Low financial capital when compared with human capital.

Early Life

- 1. Generally a period where investment growth is emphasized. However, not all human capital is identical. Some people are equities (i.e. involved in careers with exponential growth opportunities). Some are bonds (i.e. involved in Government service with COLA wage adjustments). Those that are equities may not have risk capacity (they might not become MD at GS and might not have a backup plan) so they may need to tone down the equity allocations.

Early Life

Retirement investment options

- **Defined benefit plans**
- **401k/Profit Sharing Plans**
- **403(b) plans**
- **IRA/Roth IRA**
- **SEP and SIMPLE Plans**
- **Annuities**

Early Life

- Passive Management:

  Expectation is that Markets are efficient.

  Market returns cannot be surpassed regularly over time.

  Low-cost investments held for the long-term will provide the best returns.

Early Life

- Don’t try to time market.
- CNBC interview.
- http://video.cnbc.com/gallery/?video=3000079634
- https://www.youtube.com/watch?v=nh2uRB8gPkI

Early Life

- Active Management:

  Expectation is that that a specific style of management or analysis can produce returns that beat the market.
  It looks to take advantage of mispricing in the markets.
  Analysis is costly but results in excess profits net of costs.
  Market timing is one of the approaches.

- Momentum Strategies:

  Look to stay with hot hand. Rebalancing half way is one of the strategies.

Early Life

- 2. Education funding for themselves as well as others – Investing in human capital via enhanced education. Should loans be paid off early? What is the ROI on private vs. public college education. Use of 529 Plans.

Early Life

529 Plans

- Earnings are not subject to federal tax and generally not subject to state tax when used for the qualified education expenses of the designated beneficiary, such as tuition, fees, books, as well as room and board. Contributions to a 529 plan, are not deductible for federal tax purposes but are for certain states tax purposes.
- Many different investment options.
- Up to 5 years gifting allowed ($75k) with single investment (once every five years).

Early Life

College funding

- U.S. Government Grants
- State Grants
- College Grants
- Loan Programs

Early Life

- 3. Housing – Rent vs. buy decisions. Tax efficient ownership (potential use of multifamily units). Proper use of leveraging. Borrowing at 4% (in most years much higher rates) to buy housing that appreciates at inflation rates?

Early Life

Rent or buy:

- Compare the total amount of money you would be spending over time if you purchase, minus the potential value you might receive if you someday sell the property. Compare this to cost of renting less the return on the money that would have been used for the down payment.

Early Life

4. Roth options

- Maximum contributions to your traditional and Roth IRAs can't be more than $6,000 ($7,000 if 50 or older), or your taxable compensation for the year, if your compensation was less than this dollar limit.

- Modified AGI Limitations:

  $199,000 (phase out starts at $189,000) for married filing jointly or qualifying widow(er),

  $135,000 (phase out starts at $120,000) for single, head of household, or married filing separately and you did not live with your spouse at any time during the year.

Early Life

5. Prenuptial Agreements – Potential provisions

How will you handle premarital assets and debts in the event of a divorce? Will they return to the person who brought them into the marriage?

What if one person's premarital property is used to pay off the other person's premarital debts (e.g., school loans)? Will payments be reimbursed?

How will you handle the income and assets you accumulate together? Will they be owned anything other than 50/50?

Who will make the financial decisions and handle the checkbook?

Early Life

5. Prenuptial Agreements – Potential provisions

Have you discussed your long-term financial goals (i.e. retirement) and how each of you will contribute?

If one of you owes spousal support or child support from a previous marriage, how will those payments be made?

Will you file joint tax returns?

Should the agreement to be renegotiated at a specific times?

Penalties for fault on divorce?

Early Life

6. Risk Management – Focus is on human capital

- Life Insurance
- Disability Insurance
- Health Insurance

Property coverage increases in importance as assets accumulate.

- Property & Casualty
- Umbrella

Early Life

- Life insurance if others are dependent on cash flow. Emphasis on low cost (i.e. term or fixed pay) high face amount. Conversion to permanent options can be helpful.

Early Life

- Disability insurance should be purchased as early as possible.
- Should be paid directly for tax free benefits.
- Tailor the policy to specific needs (income shortfall requirements – usually up to 50-60% of pre-disability income).

Early Life

- Extend elimination period if available to reduce costs.
- Check out disability definition. Professionals should look at specific occupation options.

Mid Life

Financial Capital meeting and/or exceeding Human Capital

Mid Life

1.Investment strategies

- Maximize tax savings with various types of retirement programs.
- Asset location (tax alpha) is also key.

Mid Life

Create tax alpha

- Tax efficient investments in taxable accounts.

- Tax inefficient investments in tax deferred accounts.

- Taxable accounts would include:
  Broad stock index funds
  Low turnover stock funds
  Tax managed funds
  Individual stocks

- Tax deferred accounts would include:
  Taxable bonds
  REITs
  CDs
  High turnover stock funds

Mid Life

2. Risk management

- Insurance
- Asset allocation
- Incorporation
- Family transfers
- Trusts

Mid Life

Property Coverage - More assets to protect.

Business ownership will require new types of coverage:

- Liability Coverage
- Business Interruption

Mid Life

Life Insurance for Business Owners To Protect Business Interests

- Key man insurance
- Funding buy sell agreement
- Business continuation.

Mid Life

Asset Allocation for Investment Risks

- Specific company
- Market Risk
- Inflation Risk
- Interest Rate Risk

Mid Life

Transfers to Corporations, Partnerships and LLCs

- Set up family businesses that have restrictive covenants for distributions.
- Effective income and estate planning tool.
- Provides for continuation of asset management on disability.
- Must be run as a separate entity.
- All assets transferred into the business are controlled by business manager.

Mid Life

Transfers to Corporations, Partnerships and LLCs

- Closely held corporations have to be careful not to comingle personal and business assets.
- Assets should be properly titled and accounted for.
- Shareholders can be sued as individuals. This could put the company stock at risk.

Mid Life

Transfers to Corporations, Partnerships and LLCs

- Partnerships and LLCs are used to limit exposures to profit distributions.
- Distributions can be withheld if subject to a charging order.
- Separate entities for separate properties (each building should have a separate LLC).
- Separate business and property into separate entities.
- General partners have unlimited liabilities. Use a corporation to be the GP.

Mid Life

Transfer to Spouse

- Client can still enjoy the assets while not having legal title.
- Not very costly to implement.
- Divorce can cause complications. Must have a high level of trust before assets are transferred.
- Family dynamics can be an issue.
- Transfers can be made to other family members which can be trickier.

Mid Life

Tenancies by the Entirety

- May only exist between spouses.
- It therefore can not be severed by creditors.
- States rule what types of assets can be titled this way.
- Terminates upon divorce or when either spouse dies.

Mid Life

3. Convert experience into equity.

- Stock option strategies (qualified/nonqualified).
- Creating wealth with entrepreneurial endeavors (proper business structures and planning).
- Merger strategies – use of Self Cancelling Notes and Private Annuities to purchase other companies.

Mid Life

Executive Compensation

- Qualified pension and 401k/profit sharing plans
- ESOPs
- Incentive stock options
- Nonqualified stock options
- Phantom stock
- Deferred compensation

Later Life

Greater focus on risk management and capital preservation but with unknown life expectancies growth can’t be forgotten.

Later Life

1. **Distribution strategies:**

- Does the 4% rule still apply?
- With extended life expectancies, focus should be on investing for end of life and not for beginning of retirement. Otherwise retirees may run out of money in retirement. Deferred income annuities may be part of the solution. QLAC strategy. Use of immediate annuities.

Later Life

How much do we need?

https://www.youtube.com/watch?v=jaqR6fYQ8Oo

Later Life

2. Legacy – Is this a focus?

- When should distributions take place via Family Limited Partnerships and/or trust strategies.

Later Life

3. Estate planning

- Wills
- Trusts
- Durable Power of Attorney – Designates person to make legal and financial decisions if incapacitated.
- Health Care Proxy – Designates person to make decisions regarding health care issues
- Living Will – Life sustaining options

Later Life

Suggested documents for executor

- letter of last instructions
- medical records
- income and gift tax returns
- insurance policies
- titles and deeds
- will and trust documents
- bank/brokerage statements

Later Life

Charitable Trusts

- **Charitable Remainder Trust**

  Grantor or the grantor's beneficiaries receive periodic income. Designated charity receives the assets that remain at the end of the trust period.
- **Charitable Lead Trust**

  Charity receives income. At the end of the trust period, the remaining assets are paid to the grantor or the grantor's beneficiaries.

Later Life

CRT and Wealth Replacement Trust

- Establish a Charitable Remainder Trust by transferring appreciated property to irrevocable trust. Charity is the beneficiary of the trust. Lifetime interest in the income is retained. Tax deduction for the contribution.

- Collect cash flow and use portion to purchase life insurance policy (usually second to die insurance) with heirs as beneficiaries.

- Can be a way to preserve family wealth and meet charitable goals.

Later Life

Family Limited Partnerships

- Effective way of splitting income among family members
- Family interests can be owned directly or thorough a trust.
- Limited problems if capital or services or contributed. If capital not a material factor then may be a problem regarding income assignment.

Later Life

3. Risk management

- Long Term Care insurance options.
- Life insurance options to fund distribution patterns (person may have specific assets for specific heirs – i.e. family business – and may need to provide liquidity for others)

Later Life

Long Term Care

- There are various options to cover Long Term Care.
- Self-Insurance - Many are able to self fund.
- Medicaid – Very stringent income and resource limits.
- Long-Term-Care Insurance – Can be purchased to cover the exposure. Elimination periods and daily benefits can be adjusted to meet insurance premium budget.
- Long Term Care Riders on Life Insurance – Usually a percentage of the face amount.

Later Life

Acceleration of Life Insurance Benefits

- Some policies offer living benefits. They are usually associated with terminal illnesses. They are usually available by via rider.
- Viatical Settlements – allows a terminally ill person to sell a life insurance policy to an investor.

Later Life

5. Rightsizing strategies to make resources last.

- Morningstar interview
- http://www.morningstar.com/Cover/videoCenter.aspx?id=450477

Later Life

Reverse Mortgage – An alternative to rightsizing?

- Annuitizes the equity in the home.
- Must be at least 62 years old for most companies.
- Generally must occupy the home as their principal residence.
- Payments are computed using standard annuity methods.

Later Life

Reverse Mortgage

- Lender bears property value decline risk.
- Owner is responsible for ongoing maintenance and costs (i.e. insurance, property taxes). There are significant costs associated with the mortgage that need to be considered.

Later Life

Roth Conversions

- Federal income taxes on the conversion amount. Future income tax free if withdrawals are taken after the five-year aging period has been met and you are age 59½ or over, disabled, or deceased.

Later Life

Roth Conversions

- Particularly beneficial if legacy asset.
- No minimum required distributions.
- Recharacterization allowed if investments decrease in value. May want to split conversion into separate asset class accounts.

Cases

- Single person.
- 30 years old.
- Rents apartment.
- Student loans outstanding.
- 401k available at work with match.

Cases

- Married couple.
- Both 40 years old.
- Young children.
- Homeowners.
- Limited life insurance.

Cases

- Married couple.
- Both 60 years old.
- Homeowners with modest equity.
- Husband has ownership in business and 401k plan investments.
- Significant inheritance by wife.

Cases

- Married couple with children from prior marriages.
- Husband 70. Wife 55.
- Homeowners. Other significant assets.

Other Issues

- Financial Infidelity (NJ CPA Magazine, November 2015)
- Rightsizing (Morningstar Interview) http://www.morningstar.com/Cover/videoCenter.aspx?id=450477

Financial Infidelity

- Financial infidelity is the violation of an assumed or stated contract between couples about spending, saving and investing.

- Some of the more obvious examples of financial infidelity are accumulating credit card debt and hiding it from a spouse, withdrawing assets from a joint account or excessive gambling—all while keeping them a secret from a partner.

Financial Infidelity

- Less-obvious examples include making risky investment decisions without consulting a partner, or even hiding expensive purchases from a spouse because he or she may disapprove.

- Sometimes the intention is not so much to deceive, but perhaps keep the peace at home. In any event, to avoid financial infidelity there must be sufficient transparency via open and honest communication about financial decisions that impact a relationship.

Root Causes

- There are many reasons why financial transparency can be hard to achieve. For example, couples may not agree on how to spend money. One spouse may have more expensive taste, while the other prefers to save money. This can also be true if one spouse makes more than the other and feels a sense of entitlement toward their assets. Spouses may also feel a lack of independence if they are required to coordinate every purchase. Inheritances, second marriages and other unique family situations can further complicate matters.

Financial Management

- It is important for couples to determine what they want their shared financial life to look like. The earlier this is agreed upon, the easier it will be to achieve. Some couples may decide to keep separate bank accounts, have an additional joint account for shared expenses or decide to keep one joint account for everything. Either way, it is important that both parties know and agree on what is going in and out of these accounts.

Financial Management

- Many couples choose to employ a segregation of duties when it comes to managing household finances. One spouse may take complete responsibility for paying the bills and balancing the checkbook, in which case the other spouse may lose touch with the couple's financial picture over time. This can lead to financial infidelity if the spouse who is making the spending decisions does not consider what is best for both.

Financial Management

- One way to alleviate this risk is to make sure that both parties are aware of what is going on. Having regular, open conversations about how much the couple is spending is both necessary and important. Not all household decisions can be democratic votes, but it is important that the intention that fuels these decisions is always in the best interest of both parties. If both parties are involved in paying the bills now, there is less of a chance for a dispute later.

Investing

- The line between right and wrong for investing is not as clearly defined. With many variables, each person may have different goals and ideas about how to reach goals. One spouse may not share identical risk preferences. When it comes to identifying appropriate asset allocation or changing a portfolio, it is important that both parties are consulted.

Debt

- Couples often enter into relationships with acquired assets or debt. Couples need to be open and honest about their complete financial pictures. They should discuss whether assets will be held jointly or kept separately, as well as agree on a plan to pay off any debt. It is also a very good idea for individuals to share their credit reports with their spouses.

Post-nuptial Agreements

- Designed to protect assets acquired during the marriage.
- They can be used to alter the terms or update a Prenuptial Agreement. This may be required if the economics change over the life of the marriage(i.e. change in jobs)
- Couples that want to make plans for the division of their assets in the event of divorce.
- Child custody cannot be written into the agreement in certain states.

Post-nuptial Agreement Requirements

- Full disclosure by both parties
- Both parties should have independent representation
- The parties may not be under duress
- The terms have to be fair and equitable
- They are the same standards that are required for prenuptial agreements except that the parties have a fiduciary relationship so extra care is required.
- Requirements are state specific.