

**American Association of Individual Investors**

# **The Five Pillars of Financial Planning**

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# Agenda

- **Your Financial Plan**
  - Investing / Portfolio Management
  - Retirement Planning
  - Tax Planning
  - Risk Management / Insurance
  - Estate Planning
- **How to find a Financial Planner ...**

**... if you need one**

# The Five-Step Investing Process

## **1. Personal Investor Profile, PIP**

Age, Time horizon, Risk tolerance, Tax status, etc.

## **2. Investment Policy Statement, IPS**

Goals, Asset classes, Asset allocation, Trade rules, etc.

## **3. Design your portfolio as defined by your IPS**

Pick specific funds for each account

## **4. Implement the portfolio**

Go online and make purchases

## **5. Monitor your portfolio**

Rebalance or buy/sell as per your IPS

# The Investor's Universe

## Speculation / Day Trading

## Momentum Strategies

## Growth / Stock Picking / Market Timing

## Contrarian Strategies

## Value / Dividends Investing

## Buy and Rebalance

## Diversified Portfolio

# Years

## Months

## Weeks

## Days

## >>>>>>>>>> Frequency of Trades >>>>>>>>>>

# Passive Investing

- **Build a diversified portfolio**

## International stocks      Emerging Markets

**Real estate    Natural resources    Commodities**

## Domestic small-cap stocks

## Domestic large-cap stocks

## Long-term bonds

## Short-term bonds

## Money market funds

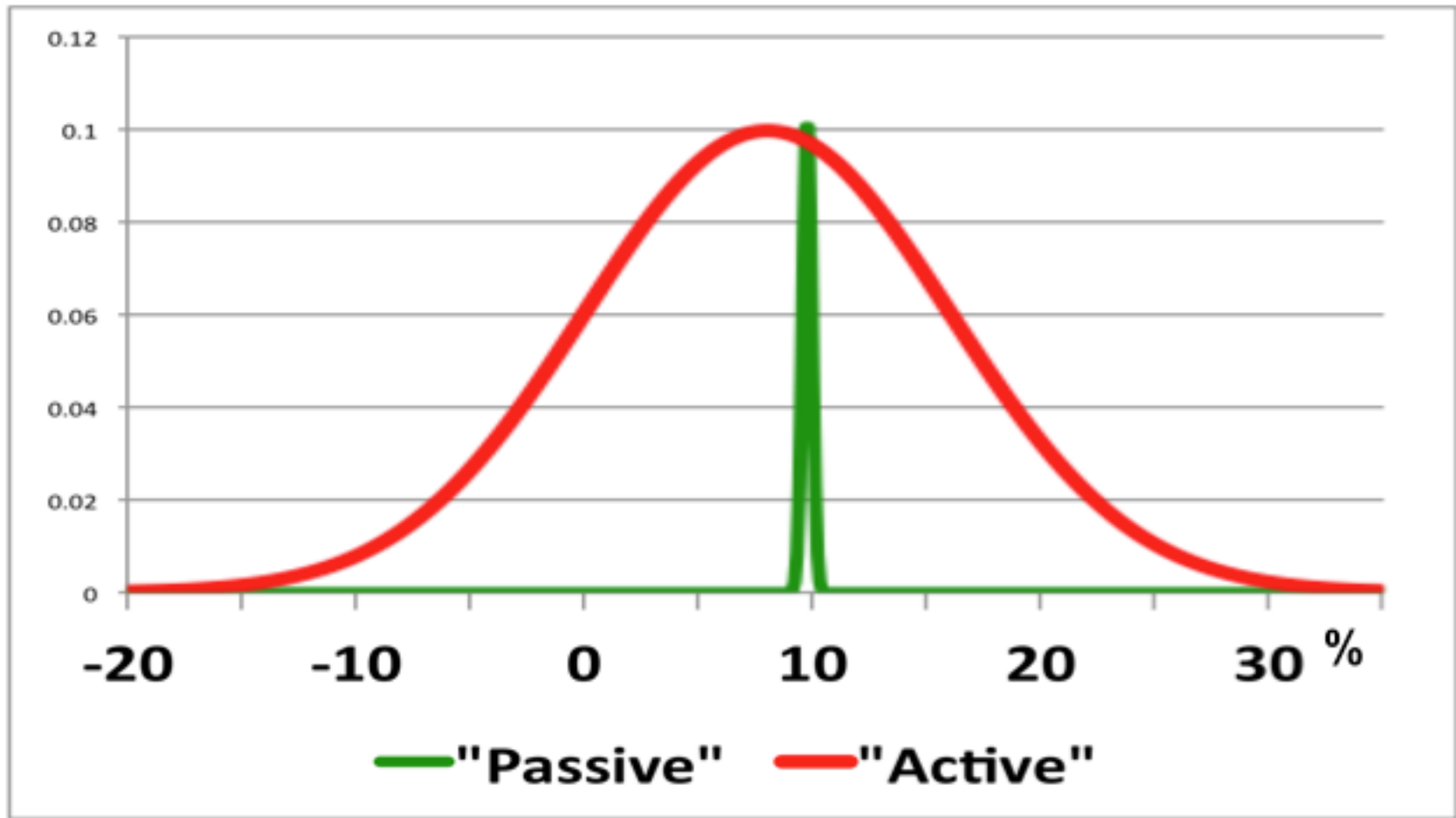
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- **Rebalance annually, or on percent deviation**

# Passive versus Active Investment Strategies

- **Passive investors + Active investors = Total Market**
- **Passive investor**
  - Definition: Diversified portfolio of cheap index funds
  - Market return less small expense by definition
  - Tight distribution (all aiming for the same target)
- **Active investor**
  - Definition: Everyone who is not a passive investor
  - Must get market return less a larger expense on average
  - Wide distribution (aiming for diverse targets)

# Let's Compare Hypothetical Returns for Active and Passive Strategies



# Who is on the Other Side of Your Trade?

- Who is on the other side of your trade?
  - Pension funds, Endowment funds
  - Mutual funds, ETFs
  - Individual investors (smart and not-so-smart)
- Do you have an unfair advantage?
  - Better data, more experience, smarter
- Are there enough not-so-smart individuals to take the other side of your trade?



# Investing Take-away

- **Ten-word summary of my IPS**
  - **Build a diversified portfolio of cheap index funds. Rebalance annually.**
- **Quote of the day ... Charlie Ellis**

“If you must play the market to satisfy an emotional itch, recognize that you are gambling on your ability to beat the pros. So limit the amounts you play with to the same amounts you would gamble with the pros at Las Vegas.”

# Retirement Planning

## Accumulation Phase

- **Start early; Try to save 15% of your earnings**
- **Tax-advantaged savings accounts**
  - **Traditional IRA, 401(k) plans, 403(b) plans**
    - **Contribute before-tax dollars**
    - **Portfolio growth is tax-deferred**
    - **Pay ordinary income tax on all withdrawals**
    - **Must start required minimum distribution at age 70½**
  - **Roth IRA, Roth 401(k)**
    - **Contribute after-tax dollars**
    - **Never pay tax on growth or withdrawals**
    - **No RMD for Roth IRA for original owner**

# Retirement Planning

## Distribution Phase

- Retirement income ... the 3-legged stool
  - Social Security + Pension + Portfolio income
- Retirement expenses
  - Basic expenses + Discretionary spending
- Shortfall must be provided by retirement portfolio
  - What is a safe withdrawal rate from your portfolio?
  - A bucket approach may be helpful
- Most financial houses offer retirement planning software, but .....
  - ... you may need to build a personal spreadsheet to accommodate go-go, slow-go and no-go years

# Required Minimum Distributions

- Applies to all retirement accounts (except Roth IRA)
  - Must start withdrawals after age 70½
- Most people use IRS Table III
  - Table II if spouse is >10 yrs younger and sole beneficiary
  - Table I is for an inherited IRA
- Consider taking RMD early in the year
  - Beware “first dollars out” rule if doing Roth conversion
  - RMD cannot be converted to Roth IRA
  - Therefore RMD must be taken before conversion
- RMD must be taken by the estate in year of death
  - Don’t leave your heirs a challenge at the end of the year

# Safe Withdrawal Rates

- **Bengen's 4% Rule (1994, updated 2004)**
  - Allocate 50% - 75% of portfolio to equities, with the balance in intermediate Treasuries
  - Withdraw 4% in first year; increase by inflation each year
  - Historically (1926-92) worst case portfolio lasts 35 years
  - Can use 4.5% if we add small cap stocks
- **Guyton and Klinger (2006)**
  - Can use 5.2%-6.2% if we include safety rules
- **Pfau and Doken (2015)**
  - 4% rule may be optimistic in today's environment
- **Sun and Webb (2012)**
  - Use IRS Required Minimum Distribution tables

# Retirement Planning Take-away

- **Open a Roth IRA for your grandkids as soon as they have any income from a paper route**
  - **Reimburse them twice their contribution !**
- **Beware withdrawing more than 4% to 5% per annum from your portfolio.**

# **Tax Planning**

## **The Tax Reduction and Jobs Act, TRJA**

- **Maximum corporate rate cut from 35% to 21%**
- **New 20% deduction for certain pass-thru entities**
- **Individual Federal Income Taxes**
  - **Rates reduced slightly**
  - **Standard deduction doubled to \$12,000/\$24,000**
  - **State/Local taxes deduction capped at \$10,000**
  - **Personal exemption eliminated**
- **Roth IRA conversions can no longer be recharacterized**
- **Estate tax**
  - **Exclusion doubled to \$11.2M/\$22.4M (portable)**

# Tax Efficiency

- **Tax-inefficient assets, e.g. CDs, bonds, REITs, etc.**
  - Spin off interest
  - Non-qualified dividends
  - Short-term capital gains
  - Taxed as ordinary income (37% maximum)
  - Most suitable for tax-advantaged accounts
- **Tax-efficient assets, e.g. munis, stocks, etc.**
  - Spin off qualified dividends
  - Long-term capital gains
  - Taxed at preferential rate (20% maximum)
  - Suitable for taxable accounts



# Tax Diversification and Asset Location

	<u>Trad. IRA</u>	<u>Taxable a/c</u>	<u>Roth IRA</u>
Contributions	Deductible	Income	Income
Distributions	Income	Inc./Cap Gns	No tax
Inheritances ...	Worst	Good	Best
... taxed as ...	Income	Step-up	No tax
Tax-inefficient assets	*****	*	*
Tax-efficient assets	****	*****	****
High growth, REITS, etc.	*	*	*****

# Qualified Charitable Distributions

- QCDs are a tax efficient way to take RMDs if you are charitable inclined
  - Avoids tax at ordinary income rate
  - Avoids increased AGI; no impact on Medicare cost
  - Must be over 70½
  - Contribution must go directly to charity (not to DAF)
  - Limit of \$100,000
- Alternative strategy
  - Donate appreciated stock from taxable account
  - Increases AGI; may impact Medicare cost
  - Taxable income not impacted after charitable deduction  
i.e. avoids the capital gains tax
- Both strategies can help rebalancing your portfolio

# Tax Take-away

- The tax world is uncertain
  - Diversify between taxable accounts, tax-deferred accounts and tax-free accounts

# Risk Management

## Insurance is Inherently Costly

- Premium is expensive
  - $\text{Cost} = \text{Actuarial cost} + \text{Overhead} + \text{Profit}$
- Theory of Large Numbers
  - You cannot predict the future, but the actuaries know to the day the lifespan of the average person
- Insurance works best for events with a low probability of occurrence, but a high life-altering cost
- Self insure for small items
- Should buy insurance to manage the risk for life-altering events (potential train wrecks)

# Annuities

- Consider an annuity to cover the shortfall, after Social Security benefits, in essential expenses
- Immediate annuities
  - Pay one time premium now to buy a monthly cash flow for the rest of your life, starting immediately
  - Example: At age 65 a premium of ~\$200,000 will buy an immediate monthly “pension” of \$1,000 (~6% pa)
- Deferred (Longevity) annuities
  - Pay one time premium now to buy a monthly cash flow for the rest of your life, starting at a later date
  - Example: At age 65 a premium of ~\$30,000 will buy a monthly “pension” of \$1,000 starting at age 85 (~40% pa)

# Social Security Benefits

- **Primary Insurance Amount, PIA**
  - Calculated from Average Indexed Monthly Earnings, AIME
- **Benefit at Full Retirement Age, FRA, = PIA**
  - FRA = 65 to 67 depending on year of birth
- **Can claim benefits as early as age 62 ...**
  - ... but lose up to 5/9 of 1% for each month early
- **Can earn 8% pa increase in benefits by delaying claiming benefits to age 70**
- **Spousal benefit at FRA = 50% of worker's benefit**
- **Survivor's benefit = 100% of worker's benefit**

# Medicare

- **Must sign up in 7-month window around 65<sup>th</sup> b'day**
  - Draconian penalty unless covered by a creditable plan
  - 1% per month for each month late
    - Part A: Major medical, hospitalization
    - Part B: Doctor visits, outpatient care
    - Part C: Medicare Advantage plans
    - Part D: Prescription drugs
- **Part B premium=\$134/month + IRMAA**
  - Max Income Related Monthly Adjustment Amount = \$295
- **Medicare has limited coverage**
  - No coverage outside U.S.; Consider Medigap policy
  - Negligible long term care benefit; Consider LTC insurance

# Train Wreck #1: Long-term Care

- **Assistance with the “activities of daily living”**
  - Bathing, dressing, toileting, eating, transferring, (cognitive impairment)
- **70% of people over 65 will need LTC**
  - Average stay of 2 – 3 years
  - Cost >\$100k per annum for assisted living facility
  - I can self-insure for this, right? Wrong !!!
- **Must insure for the worst-case scenario**
  - How would your family handle your finances if you were mentally incapacitated for 20 years?
  - Need a policy from a highly rated provider, with the longest term available, and an inflation rider if possible
  - Consider life insurance or an annuity with LTC benefits



# Train Wreck #2: Liability Litigation

- Need protection against claims for bodily injury, property damage, lawsuits for slander, etc.
  - Your teen-age driver is at fault in a freeway accident
  - Your dog bites a neighbor's child
- Who needs umbrella insurance?
  - Probably anyone with assets greater than the liability limits of their auto and homeowner's policies
- How much coverage?
  - \$1M - \$2M minimum (incentive for insurance company)
  - \$2M - \$5M typical; Suggest your net worth + delta
- Cost: Approx \$150 - \$300 pa per \$1M insured

# Insurance Take-away

- Insurance is not an investment
  - Only buy it when necessary
- Beware the potential train wrecks
  - Long-term care and liability litigation

# Estate Planning

## The Major Documents

- **Will**

- Legal document expressing a person's wishes
- Distribution of property at death; must be probated
- Nominates an executor to oversee the distribution
- Effective on death; cannot provide for incapacity
- California intestate law: Everyone has a will !

- **Revocable Living Trust**

- Agreement to distribute assets; avoids probate
- Must transfer title of assets into trust
- Usually during the trustor's lifetime he/she acts as trustee
- More flexible than a will; can accommodate incapacity
- Includes a "pour-over will"

# Other Estate Planning Documents

- **Power of attorney, POA, for financial/legal matters**
  - Appoints an agent to manage your affairs if you are unable to do so. Choose your agent carefully
  - Immediate or Springing
  - Expires on death
- **Advance directive**
  - Health care POA. Choose your agent carefully
  - Living will; defines the care you want if incapacitated
  - Organ donation
- **Letter of Intent:** Informal disposition of personal items
- **Ethical Letter:** Pass on your values and philosophy of life

# Probate

- Judge determines the validity of the will and appoints an executor to manage the estate
- Advantages of probate
  - Creditors must submit claims within 4 months
  - Court supervises distribution of assets
  - Transfers clear title to property
  - Court can settle disputes between heirs
- Disadvantages of Probate
  - Complexity: Petitions, accountings, hearings, etc.
  - Time consuming; can take 6 months to several years
  - Lack of privacy; anyone can view the documents
  - Cost: approximately \$23,000 for a \$1M estate in CA

# Duties of a Successor Trustee

- **Read and understand trust and will documents**
  - **Consider your willingness to accept the job**  
**Great honor but hard work, time-consuming**
- **Immediate tasks**
  - **Select a funeral director**
  - **Arrange for services and burial/cremation**
  - **Verify details for death certificate; order 20 copies**
  - **Notify Social Security Administration/Medicare**
  - **Notify bank, brokers; accounts frozen by state for 40 days**

# Successor Trustee's Duties, contd.

- **Legal and financial issues**
  - Retain an estate attorney
  - File for new Tax ID for trust
  - Collect, sort and store all documents at a safe location
  - Shred unwanted docs; store others for 3 to 7 years
  - Open new bank/brokerage accounts after 40 day freeze
  - Pay all bills and manage brokerage accounts prudently
- **Sell house; Contract must be approved by beneficiaries**
  - Consider retaining professionals to hold an estate sale
- **Keep meticulous records**
  - File timely tax returns and reports to beneficiaries
  - Distribute (bulk of ?) assets to beneficiaries
  - Consider waiting 3 years before distributing remainder assets and closing out the trust, in case of an IRS audit

# Can your Trustee Access Your Digital World When You Die?

- **Which files/accounts should your trustee access?**  
Letters, emails, spreadsheets, photo files  
Online bill payments, Facebook, Linked-in, Twitter, etc.
- **Can your trustee access these accounts?**
  - Does he/she know your logon ID and password?
  - Against all security rules, consider keeping a clear text written list of all IDs and passwords in a safe place known to your POA agent and successor trustee
- **Make sure trustee is given authority in your trust**
  - Authorizes him/her to access accounts which remain open (e.g. bill paying), and to close the others



# California's Right-To-Die Law

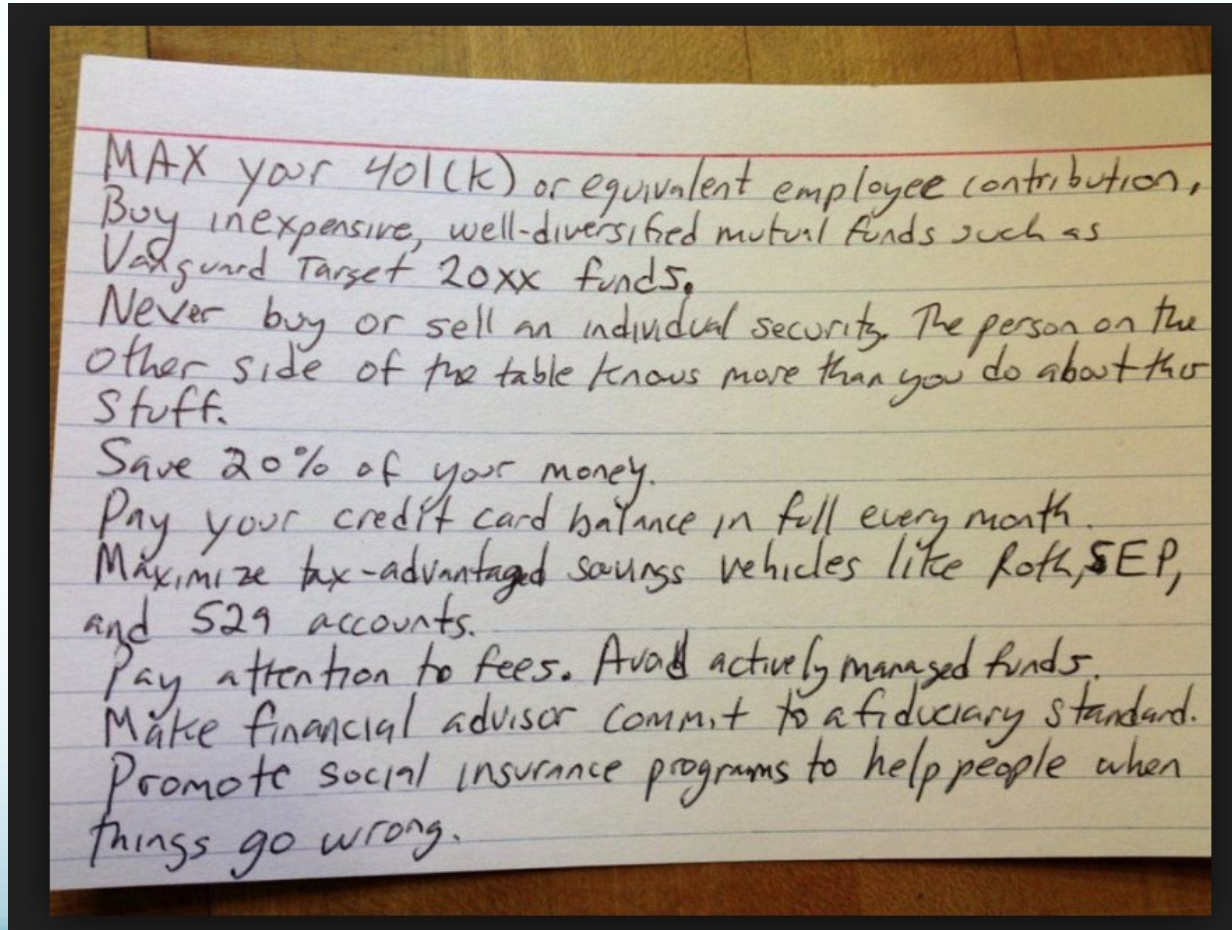
- Signed into law in 2015, effective June 9, 2016
  - Sunsets in 2026 unless amended by further action
- Requirements: Patient must .....
  - Be an adult CA resident, age 18 or older
  - Be diagnosed with a terminal illness by 2 physicians
  - Have mental capacity to make own decisions
  - Make a voluntary request to to the attending physician
    - Two oral requests > 15 days apart, plus written request
    - Cannot be made thru a POA or health care directive
  - Have physical capacity to self-administer the drug
- Not effective for comatose or Alzheimer's patients

# Estate Planning Take-away

- **Just Do It !**
  - Everyone with assets should have an estate plan.
  - Develop clear goals of what you want; then hire a good estate planning attorney.
  - Check your beneficiary designations regularly

# Harold Pollack (2013)

## Your Financial Plan Should Fit on an Index Card



# Live Planning

## Aligning Your \$ With Your Values

- It's difficult to make a plan until the future is defined
  - “We don't know where we're going, but we're making good progress!” ... Yogi Berra
- First define the life you want to live
  - Money is merely the means to that end
- George Kinder's Three Big Questions
  1. How would you live your life if you had plenty of money?
  2. What would you change if you only had 5 years left?
  3. What would you most regret not doing if time's up?
- Ken Rouse's 15 Attributes
  - Rank the attributes, pick top 5, then the most important

# Do you need professional help?

- Are you comfortable with ...
  - ...Time value of money, present value, future value, etc.
  - ... Uneven cash flows, internal rate of return
  - ... Excel spreadsheets
- Do you have time to manage your financial affairs yourself?
- Do you enjoy doing it?
- Be aware of cognitive disabilities as we age
- Note: Estate planning is not a DIY job
  - You should hire a competent attorney who specializes in estate plans.

# A Financial Planner Can Help

- Set realistic personal and financial goals
- Manage your portfolio
- Generate a retirement plan
- Optimize your multi-year tax strategy
- Review your insurance coverage
- Review your estate planning documents

# How much help do you need?

- **Do you want general financial planning help?**
  - Investments, taxes, insurance, estate planning, etc.
  - Hire a Financial Planner
    - Certified Financial Planner (CFP designation)
    - Chartered Financial Consultant (ChFC designation)
- **Or do you want help with just your investments?**
  - Hire a portfolio manager
    - Registered investment adviser (RIA)
    - Chartered financial analyst (CFA)
- **For help with your taxes**
  - Hire a CPA or Enrolled Agent (EA)
- **Or can you do it all yourself?**

# How Do You Know The Planner Has Your Best Interest In Mind?

- **Some “financial planners” are merely salesmen**
  - **Most brokers work on commission**
  - **Only required to sell you a “suitable” security**
- **Fiduciary relationship**
  - **Pledged to act in your “best interest” at all times**
  - **Must disclose all conflicts of interest**



# How Is a Financial Planner Paid?

- **By the hour: Garret Planning Network**
- **Monthly subscription: XY Planning Network**
- **By the project**
- **As a percentage of assets under management**
  - **Typical fees range from 0.5% to 1.5% of AUM**
- **Annual retainer**
- **Check out**
  - **Financial Planning Association**
  - **National Association of Personal Financial Advisors**

# How Do You Hire a Financial Planner?

- **First, be very clear on what you want help with**
- **Interview at least 3 candidates**
  - Most will give you a free hour to determine a good match
- **Questions to ask**
  - How do you get paid?
  - Have you signed a fiduciary pledge?
  - Are you an expert in the field I need?
  - Are most of your clients like me?
  - What designations do you hold?
  - Do you have a back-up plan for vacation? retirement?

# Final Take-away

- **There's so much more to financial planning than spreadsheets covered with \$ signs !**

# To probe further ... Investing

- *The Importance of Diversification in Retirement Portfolios*, Craig Israelsen, AAI Journal, April 2015
- *The Advantages of Simple Allocation Strategies*, Wesley Gray, AAI Journal, November 2015
- *Rebalancing Update: How Frequently Allocations Should Be Adjusted*, Charles Rotblut, AAI Journal, March 2017
- *Trading More Frequently Leads to Worse Returns*, Terrance Odean, AAI Journal, November 2014
- *Determinants of Portfolio Performance*, Gary Brinson et al, Financial Analysts Journal, July/August 1986 and May/June 1991
- *Investing at Level 3*, James B. Cloonan, AAI, 2016
- *A Random Walk Down Wall Street*, Burton Malkiel, W.W. Norton & Co.
- *Winning The Loser's Game*, Charles D. Ellis, McGraw Hill

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- *Converting to a Roth IRA Can Minimize RMDs*, Judith Ward, AAI Journal, March 2015
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- *How to Make Your Money Last*, Jane Bryant Quinn, Simon & Schuster, 2016

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- *How to Harvest Losses While Maintaining the Position*, Ben Branch, AAI Journal, November 2016
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- *Social Security Benefits Lose Buying Power*, Mary Beth Franklin, Investment News, April 2, 2018
- *Social Security Made Simple*, Michael Piper, The Oblivious Investor, 2017
- *How Big is Longevity Risk?*, Bob Collie, AAll Journal, October 2015
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- *5 Things You Should Know About Long-Term Care*, Ellen Stark, AARP Bulletin, March 2018
- *Getting Real About LTC Insurance*, Kimberly Foss, Financial Planning, June 2016
- *How Much Umbrella Insurance Do I Need?* David Marotta blog, August 2015

# To probe further ... Estate Planning

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- *Preparing Clients for Widowhood*, Bill Harris, Journal of Financial Planning, April 2017
- *12 Guidelines for Widows, and Suggestions for Husbands*, Karen Altfest, AAI Journal, October 2016
- *8 Steps That Will Make Live Easier for Your Heirs*, Deborah Levenson, AAI Journal, July 2006
- *When It's Time to Transfer Financial Decision-Making*, David Littrell, AAI Journal, September 2015
- *Inherited IRAs – What You Need to Know*, FINRA Investors Alerts, January 3, 2017
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# To probe further ... Financial Planning

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- *A Fancy Financial Adviser Title Does Not Ensure High Standards*, Tara Siegel Bernard, New York Times, July 6, 2012

# Useful Websites

- [www.aaii.com](http://www.aaii.com) Broad selection of investing material
- [www.siliconvalleyaaii.org](http://www.siliconvalleyaaii.org) Previous presentations/slides on various topics
- [www.santaclaracountylib.org](http://www.santaclaracountylib.org) /Online Library 24 7/ Research/Bus. & Money Free access to Morningstar, Value Line, Wall Street Journal, etc.
- [www.bogelheads.org](http://www.bogelheads.org) Lazy portfolio data
- [www.7TwelvePortfolio.com](http://www.7TwelvePortfolio.com) Craig Israelsen's portfolio
- [www.callan.com](http://www.callan.com) Callan chart
- [www.caniretireyet.com](http://www.caniretireyet.com) Darrow Kirkpatrick's retirement calculators
- [www.obliviousinvestor.com](http://www.obliviousinvestor.com) Michael Piper's blog
- [www.reversefunding.com](http://www.reversefunding.com) Reverse mortgages

# Useful Websites, continued

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- [www.medicare.gov](http://www.medicare.gov) Medicare website
- [www.stantheannuityman.com](http://www.stantheannuityman.com) General annuity information
- [www.immediateannuities.com](http://www.immediateannuities.com) Annuity quotes
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- [www.livingto100.com](http://www.livingto100.com) Life expectancy calculator
- [www.estateplanning.com](http://www.estateplanning.com) Comprehensive source of useful information
- [www.ethicalwill.com](http://www.ethicalwill.com)
- [www.letsmakeaplan.org](http://www.letsmakeaplan.org) Find a CFP professional
- [www.nafpa.org](http://www.nafpa.org) National Association of Personal Financial Advisors

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