

III. Wealth Foundation and Factors

Chapter 5. Wealth Goals & Objectives

Grow It, Protect It,
Spend It, Share It¹
- Stuart Lucas

Key Points

- Wealth goals signify personal values
- Objectives are based on goal statements
- Grasp link between risks and objectives
- Wealth distribution or growth objective?

Lifetime wealth goals should be defined in unique personal statements after answering key value questions. They are a worthwhile supplement to other household declarations. Wealth goals incorporate values. An understanding of general investment risks and personal behavior risks is useful prior to converting wealth goals into financial objectives. Analysis supports an outline for potential objective returns, wealth accumulation, and distributions relative to types of risk taking. Then the wealth goals can be translated into long term objectives. Flexibility and tuning of wealth objectives will be the concluding discussion.

Wealth Goal Setting

Goals are unique expressions of personal values, especially between spouses. It is worth soul searching to try to find what environments, life scenarios, and approaches will most likely lead to peace and security. Alternatively, the vision is to live values that lead to lasting happiness.

Most people informally define and adjust goals as they mature, learn more about themselves, and better understand how the world works. A few people find their interests and natural skills during the college education period. They may demonstrate a disciplined, determined disposition and creativity to develop their interests and skills into valuable capabilities. Thereafter, a bit of good fortune may lead to achieving informal goals through productive employment and forming associate networks. Those rare individuals may never formally look at individual and relationship values or relate them to goals. This discussion poses some questions and comments for the others, singles and married couples, who are interested in examining values and matching them to compatible personal goals. Goals based on values offer a wealth development framework

through an unpredictable life journey. A few of Stuart Lucas' value searching questions² are presented to identify values that become the foundation for financial goals. Simply stated, financial goals are generally grouped as distribution oriented throughout a household's lifetime or growth oriented beyond a household's lifetime through children and or multi-generation causes (gifting).

- What do you want to accomplish with your life and your wealth?

Some people want to explore the world, experience different cultures, or pursue a destination where life is comfortable and secure. Others cherish family relations and will do anything to make sure that children experience a better life than their own.

If simple lifetime spending without remaining assets at death is desired, then low or moderate risk distribution oriented objectives may be employed. Unique collections or gifts are often included.

Conversely, if greater than a household's lifetime wealth is desired, then growth oriented, nurturing objectives, which involve higher risks (and may fall short of success), should be pursued. A multi-generation stable home base will normally be helpful to establish an environment and provide wisdom to younger family members and long term charities or causes.

Wealth development requires intelligent risk taking. Starting or continuing a business is generally the best way to build wealth in a free society. Investing in a friend's business or funding a new technology is another high risk, potentially high return approach to grow wealth. As discussed in a later chapter, diversification of development projects is recommended to limit total risks.

- What is your tolerance level for anxiety or complexity?

If high stress can not be handled or if multiple relationships can not be separated into manageable parts then sleepless nights are likely. That indicates anxiety. Yet nothing is worth losing sleep over. Low or moderate risk distribution oriented goals are more achievable and best for worriers.

Section Outline

But, if stress can be handled and if complex factors and relationships can be divided into workable components then you may have the disposition to go for the gold (wealth growth oriented goals). Your stress handling capacity shows a higher risk tolerance to both sleep well and potentially develop more wealth. As the saying goes, there are no guarantees of achievement, but you can handle shortfalls in pursuit of a more significant prize.

- How do you value accountability?

For the purpose of goal setting, the idea of accountability needs to be understood. Accountability is a discipline and a burden. Free spenders don't like to be hemmed in or constrained by budgets. Some people don't feel they have the time to keep good financial records. There are people, who simply don't know how to evaluate performance. Finally, other people are easily intimidated by advisors or counter parties in a relationship or transaction and accept non accountability. There is no universal formula or checklist to set up objective standards of accountability. Creativity is often needed to negotiate acceptable checklists or accounting standards.

If you don't value accountability, then whatever goal is followed will not be clearly measured and most likely not achieved. The idea that somehow, you will know success, when you see it, does not work in the pursuit of goals. Luck will not accomplish goals. For those who don't value accountability, low risk distributive goals are suggested. Work just hard enough to make ends meet.

Conversely, if you value accountability then thorough planning is initially needed to determine budgets, make appropriate checklists, and keep score. Higher risk, growth oriented goals can be sought because you have an approach to know when results are not in an acceptable range. Accountability will not result in achieving goals, but it will let you know when you are off track (out of range) and in need of a mid course correction.

- Are you a rational optimist?

If your values are biased toward fickle optimism or general pessimism, then you may have problems with uncertainties and risks. In those cases, distributive goals for a household's lifetime are appropriate.

Alternatively, the rational optimist has a better chance to deal with numerous uncertainties and make adjustments to pursue growth oriented multi-generation goals. During most lifetimes there is a significant probability of a major societal disruption such as a major war or economic depression. Those events require plan adjustments. The rational optimist has a better chance to avoid giving up, remain focused and determined, and adjust plans.

- How does the family communicate about wealth and trust? What virtues do you cherish?

Good, trusting communication is rare and needs to be cultivated through a lifetime process including married spouses and their children. The results will not necessarily be similar views concerning politics or religion. However, ideally they will build a trusting foundation for discussing wealth building and related financial objectives and issues openly, while remaining absolutely confidential within the family. The dinner table may be a good place for informal discussions. A more isolated place, such as a vacation condo or get-away rented house, may make sense as the children grow older and have their own children. Key educational, elder assistance, business, or strategic investment decisions requiring good, thoughtful decisions may be made at annual family vacation meetings.

Some spouses consider specific cherished virtues as values on which trust is built. The virtues may have classic Western Greek origins (temperance, prudence, fortitude, and justice), secular Roman origins (e.g. constantinum (perseverance), gravitas (responsibility), and veritas (honesty)) or religious origins (e.g. Christian faith, hope, charity (agape)). If a spouse feels strongly about focusing on a virtue as a foundation for trust, it may be an appropriate value for inclusion in a family goal statement.

Section Outline

The household with complexities and divisive secrets will have limited communication and trust. The constraints should be recognized, because they will reduce the desires and chances for long term wealth goals. Only simple wealth distribution goals are likely to be achieved in this situation.

The household that is biased toward openness and straightforward trust has an excellent opportunity to develop inter-generational wealth. Values can be passed down through good communication; children may be educated in their best aptitudes and desires; and long term investment decisions can be made in a good trusting setting. Transactions (paying the bills) can be used as learning experiences. For example, a payment of a 17 year old daughter's two week trip with a school group to Italy may require a discussion of expected value prior to the vacation and completing a related language course to show serious interest. Growth oriented goals are creatively pursued in this type of environment.

- Are you interested in developing financial leadership?

Financing and credit are the life blood of economic exchanges. The household that is not interested in finances will likely be uneducated and at a disadvantage. Risk taking should be limited for those, who are not interested in understanding how transactions take place. Wealth distribution goals, where risks can be transferred or isolated, are best for the financially disinterested or deficient.

Developing financial leadership means more than financial interest. In a household the lady may be more competent than the gentleman. Similarly in a multi-generational family, a son or daughter may have the interest and aptitude to pursue the best financial education and varied business (employment) experiences. That individual, the best qualified, should be groomed or prepared to succeed in leading the family investments or business. Good financial leadership gives the household or business a better opportunity to go for growth oriented financial goals.

A few value related questions were presented to help think about goals. Contemplative people will consider many more value issues and questions. The point here is to present a few issues (not a checklist) to facilitate good quality goal statements. (There will be investment checklists in the following chapters.) The quality of a unique personal goal statement is important as a foundation to review when adversity inevitably rises. A paragraph of simple, meaningful value expressions should make up the goals statement.

Simple Example Household Goal Statement

A few household scenarios that are developed throughout the following chapters provide initial goal statement examples.

Martinez Family

Brief member description

Robert Age 57 District Sales Manager – Food Supplier

Anita Age 57 Administrative Assistant – High School

Children Carlos Age 25, Single, Graduate 2 yrs. Junior College degree U.S. Air Force operations liaison

Jenny Age 22, Single, Graduate 2 yr. Junior College degree Lives with parents, Secretary 35 hrs/wk

Robert & Anita's Goal Statement

Our children are important to us and don't need any financial help. We expect to take care of our own retirement spending to an old age (three of four parents are alive, have sufficient resources, and live in assisted living communities). Limited pensions and 401K plan investments make up our financial resources. We sleep well, have no investment education, and don't take small or foreign stock risks. Our home mortgage is our only debt and will be paid in 4 years. We do not plan to leave any assets at death to children or charities. We look forward to being grandparents. Our budget is modest and can adjust if needed.

Merton Family

Brief member description

Terrance Age 35 Prototype modeling and specialty tool business
BS and MS Mechanical Engineering;
worked in father's machine shop

Section Outline

Carolyn Age 32 At home mother; part-time computer applications programmer
BS Computer Science degree
Children Sarah Age 5
Peter Age 3

Terrance & Carolyn's Goal Statement

We are fortunate and cherish our children. Honesty, perseverance, and trust are our core values. Good communications are a family priority. Our parents are self sufficient and live in a nearby community. We support each other. Our home mortgage payments are reasonable. Terrance enjoys his specialty products business challenges. We have a company tax deferred savings plan, but little investing experience. Carolyn does business and home budgets and has a keen involvement in the children's education. We would like Peter to lead the business, if he is interested, after Terrance retires.

Investment Risk Characteristics

It is helpful to broadly review investment risks before discussing generally distribution or growth oriented wealth objectives. Investment risks can be generally characterized as owner or lender risks. A key dimension is controlling or non-controlling ownership. The issues are equity holding positions or asset property rights. Assets usually produce net income or profits, which are either retained to further increase income producing capacity or paid out to the owners as dividends or other cash flows. Ownership interests can also be held in real estate; commodities, such as gold or oil; currencies; or other alternative assets that are expected to appreciate in value during the holding period, but do not pay out cash flows. Controlling interest equity owners have an opportunity to make operating and capital improvement decisions. Owning an income producing property, such as a residential apartment building, or a business, are common examples. Controlling interests generally own more than 50% of the shares outstanding regardless of the legal structure (i.e. proprietor, partnership, or corporation), although in various situations as little as 30% interest can establish a controlling influence.

Asset Owner Higher Risks – Ups and Downs

A property increases in value as an operating asset if earnings and owner cash flows (dividends) increase (higher annual rates of return.) An asset, where comparable assets trade daily, enjoys an established current market price. This is normally a better indicator of an asset's true value due to liquidity in case an owner must sell it for any reason. Alternatively, an owned asset normally decreases in value if its earnings are less than expected or if the market price for various reasons falls. Equity market prices do not precisely reflect current or expected future earnings and often are priced at significant discounts or premiums to long term price/earnings (cash flow) ratios. An equity position has an unlimited upside appreciation potential (opportunity) and possible 100% downside loss (risk). Leverage (debt financing) adds risk.

Asset Lender Risks – Know Your Counterparty Loan Receiver

Lending risks are based on the willingness and capacity of the loan receiver to repay the loan per the agreed upon terms and conditions. The loan receiver is the counterparty in a transaction. This situation differs from an asset transaction, where property title is passed after a defined transfer settlement (escrow) period. The lender and loan receiver are in a relationship, where the lender expects and can get no more than his money (or other liquid asset) back at the end of the transaction period with agreed upon interest payments. Lenders may require collateral, such as a home in the case of a mortgage loan or an automobile in the case of an auto loan. The capacity of the U.S. government to pay the agreed upon interest and return of the principal at maturity on a Treasury note is a superior position to your brother-in-law repaying a junior loan on his new car. This is due to the government's better resources – its citizen taxpayers. Even though the junior loan is backed by the car as collateral, a senior car loan holder must be satisfied first, if any agreement payments are not made. Be aware of all related lien agreements, prior to making loans.

Bond and other loan loss risks should generally be less than equity risks. Thus, lenders usually expect lower returns than equity or ownership rights holders. A U.S. Treasury security or a certificate of deposit guaranteed by the Federal Deposit Insurance Corporation has full government resources support. The investment risk is very low regarding interest payments and

Section Outline

principal return at maturity. Yet, prior to maturity the market value of a Treasury note may differ from face value due to prevailing market interest rates and a CD agreement will likely demand a penalty payment if redeemed prior to maturity. Creditworthiness, liquidity, and solvency factors impact lender risks. A lender position usually includes interest payments stated in the covenants agreement and expected full repayment of principal at maturity. The maximum returns potential (generally repayment of principal at maturity and holding period interest payments) is defined in the agreement. The downside risk is that a defaulted uncollateralized loan becomes worthless. Defaulted collateralized loans (e.g. mortgages) may be worth the net proceeds (e.g. 50% of principal) of a foreclosure collateral property sale. The lender generally is focused on a lower risk (return of capital) than the equity owner, who is focused on the higher risk and higher return (return on capital.)

Non-controlling interests have limited flexibility

Non-controlling interests in equity assets are limited to voting rights at annual and specially called shareholders meetings. Initiatives can be sponsored for vote by a shareholder per adopted ownership structure policies and procedures. Issues generally involve operations, capitalization, and governance. For instance, a partnership that owns a residential apartment building may include 5 partners. One partner must persuade two other partners to assure approval of an initiative. As the number of shareholders increases, most non controlling interests have less influence. They must look at their investment strategy different than those of the controlling interest. As an example, the owner of 1 share of Berkshire Hathaway stock has far less than 0.1% interest in the corporation, while Warren Buffett owns nearly 32% voting interest in the corporation and the effective controlling interest. The small shareholder may submit an initiative for possible voting as an annual meeting agenda item. Yet he relies on the judgment of Mr. Buffett, as Chief Executive Officer, to make capital allocation and corporate management decisions.

The non-controlling public company shareholder usually votes with his (her) feet by deciding to buy, hold, or sell shares based on the future valuation outlook. The thought process is similar for non-controlling shareholders of a mutual fund or other securities. A shareholder

should research and understand the business fundamentals in enough detail to make an informed decision concerning a valuation related to operations and strategy. An evaluation of market price over or under valuation is equally important.

The buy (or no buy) decision is most critical. Generally, relative value and potential investment returns are determined with the buy decision. Buying at a high price based on appropriate measurements is generally a higher risk momentum strategy. The idea is that a new speculator will come along and pay you a higher price, when you want to sell. While an asset is held, the primary analysis is to form an opinion if the asset is within an acceptable range of both operational stability and market under or over valuation. Buy and sell decision factors are discussed in future strategy chapters. The point is that non-controlling investment shareholders do not influence the fundamental performance of assets held. They simply vote with their purchases and sales on whether the asset valuation is expected to appreciate or depreciate or more specifically if they have a more desirable use for the money. Great investors, such Warren Buffett, point out that purchasing a stock is purchasing a part of and owning a business. That logic holds for him because he purchases many businesses, where he has controlling interest and owns an investment portfolio of non controlling interests in companies, where he has unusual knowledge of the management. For most people, without his resources or knowledge, the inference that a normal investor should buy shares and thus passively hold a business indefinitely is often not good advice.

An added thought – behaviors and risk tolerance

Behavior risks, which were discussed in Chapter 4, are as important as investment asset risks. A person with significant negative emotional biases should be very cautious about selecting assets with volatile expected price movements. Those, who can not accept the prospect of an asset loss, should simply save through essentially risk free loans to the U.S. government or FDIC guaranteed banking system using Treasury securities, CD's, and highest quality asset money market funds. No after-tax inflation adjusted return should be expected from a risk free holding. There is nothing wrong with being a low risk tolerant saver, who manages to self reliantly live within his or her means. In fact, it

may be best for a household that is biased toward selling higher risk investment assets after significantly losses, to simply save and supplement retirement income with social security payments or other pension or annuity income streams.

Those, who have a tendency toward large greed/fear risky behaviors, may consider immunizing themselves (transferring or reducing risk) through purchase of high quality annuities, where there is reasonable certainty that the fixed or inflation adjusted periodic payments will continue regardless of personal moods. Overconfidence, herd following, and regrets are other personal negative emotional biases that should be considered in selecting the investment risk level that can be tolerated in the worst case scenario (where safety margins are critical).

Investment Risk Complexities

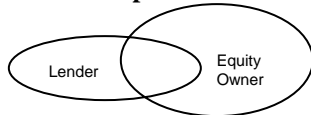


Figure 1. Overlapping Investment Risks

Figure 1 depicts the possible overlapping complex nature of investment risks. Although equity owner risks are conceptually larger than lender risks, the risks may overlap in various ways. Investment equity risks can be relatively smaller if assets are high quality, consistent performers or controlling interests allow operational risks to be reduced. Lender risks may be relatively larger if counterparties have limited capacity or desires to perform as agreed to. The investment risks may overlap based on the nature of either the loan or the performing asset. A convertible bond may simply change (risk levels also change) from a loan to an equity share, if the owner decides to make the conversion. (The risks of other equity shareholders also change, as added equity shares outstanding dilute their interests.) A less than investment quality (junk) bond generally acts like a hybrid equity asset and requires a higher risk premium (interest payment) to compensate for its inferior quality. On the other hand, a high quality preferred stock offered by a solid company with little debt on its capital structure (right side) balance sheet may perform similar to a bond risk level. Negative behavior biases increase total risks, especially during worst case scenarios. This investment risk section simply

presents the concepts of lender and performing equity asset risks and issues, which change their natures and levels. Before setting goals and objectives, it is good to know the difference between lender and equity owner property rights and risks. In any case, risks change and during a lifetime, wealth management wisdom is found in the 1949 quote of aerospace test engineer Edward Murphy “whatever can go wrong, will go wrong.” Just try to prepare for possible risks.

Translating Goals to Financial Objectives

Wealth financial objectives can be categorized as distribution or growth oriented.³ Stuart Lucas’ wealth management ideas are developed in discussing financial objectives. Wealth distribution objectives focus on generating sufficient wealth to provide for household needs through a retirement spending lifetime with a margin of safety. An emphasis can be on maintaining purchasing power or steady nominal income during retirement. There are considerations and risks with either approach.

Wealth growth objectives focus on wealth continuity, including financial resources, at death to support future family members or causes beyond the current household’s lifetime (a legacy, if the term is preferred.) Alternatives may include conserving real wealth as well as retirement spending purchasing power, retaining per capita next generation family member wealth with retirement spending purchasing power, and for the truly productive growing wealth in addition to retirement spending purchasing power for either next generation family members or causes. Issues related to each alternative are discussed in preparation for the Chapter 6 discussion of specific wealth factors.

Retirement – Distribution Oriented - Constant purchasing power objective

The constant lifetime purchasing power objective is relatively straightforward. The household objective is to maintain inflation-adjusted constant purchasing power retirement spending through the death of the last spouse. No estate is planned to be left to heirs or others. In the following chapter, the key factors will be analyzed thoroughly. Generally, the objective implications are a desire to sleep well with little anxiety about risk taking. That is a low risk tolerance. Social security and lifetime inflation adjusted pension cash streams are good choices to implement the constant retirement spending objective. All the risks are effectively

transferred to those providers of the retirement spending cash payout streams. If social security and pensions are not sufficient, an adequate cash amount must be available to purchase the lifetime inflation adjusted annuity. Some households do not want to purchase an irrevocable contract annuity or do not have a pension. In those cases retirement spending above social security payments must be self financed from retirement investments. Assuming a full lifetime (age 65 to age 95) for one of the household members, the time horizon (e.g. 30 years) and the retirement investments spending rate (3.5 to 4.0%) can be defined. Required inflation adjusted investment returns will be discussed in the following chapter. The need to increase the spending rate, most likely due to health issues at advanced ages (over 80 yrs. old) should be considered as part of a margin of safety.

Retirement – Distribution Oriented - Stable income objective

The stable lifetime purchasing power is a simpler, but riskier retirement spending objective. Inflation is not considered in defining the stable annual income objective. Therefore, all other factors must at some point be flexible enough to change (increase) the stable income constraint to adjust for the inflation bite out of purchasing power. Consider the Martinez household, which plans to retire in 8 years (Robert age 65) with a \$72,000 annual spending budget. Assume that long term inflation remains at 3½%. In 15 years the U.S. dollar's purchasing power can generally be expected to decline to 60% of initial retirement day. The Martinez's may have difficulty stretching their nominal \$72,000 budget at that time, unless most of their income is sheltered from inflation. They may adjust a stable income or hybrid income/purchasing power objective to maintain an acceptable standard of living. An alternative may be to work past age 65.

Retirement plus legacy – Growth Oriented - Constant purchasing power and conserving real wealth objective

The constant retirement purchasing power part of this growth oriented objective is the same spending plan as the first distribution oriented alternative. However, with growth oriented alternatives, the pre-retirement financial wealth must generally be large enough and invested at moderate or higher risk levels to achieve both the current generation retirement spending and

future generation estate purchasing power. The retirement spending rates would likely be less than the 3.5% to 4.0% spending rates suggested in the first distribution objective and the required investment returns would be high (6.0% or more per year). For example, if a family's net worth at Age 65 retirement is \$8,000,000 and their annual spending rate is 2.5% (\$200,000), in order to leave an \$8,000,000 purchasing power estate the annual after tax returns must average 2.5% + 3.5% = 6.0% minimum. A good financial education and growth oriented investment strategy, including an efficient tax approach, is needed to achieve the plan in the long run. Financial leadership and competence must be demonstrated to effectively achieve better than normal market returns. It is achievable, but difficult.

Retirement plus legacy – Growth Oriented – Constant purchasing power and per capita real wealth conservation objective

The constant retirement purchasing power part of this growth oriented objective remains the same. However, the wealth growth bar is set higher. The objective is to achieve a remaining estate at death of the last spouse for each second generation family member. Each estate will equal Terrance and Carolyn's net worth at the start of their retirement. For example, they plan to leave Sarah and Peter each an estate of approximately the purchasing power of their net worth. Assume Terrance effectively retires in 30 years at age 65, inflation continues at a 3½% annual rate, and Terrance and Carolyn's net worth is nominally \$20,000,000. Specifically, in 30 years 60% of their wealth equals the approximate market value (\$12,000,000) of the business and the remaining 40% (\$8,000,000) equals their \$1,000,000 home and \$7,000,000 of other investments. The Mertons live well within their means in Arizona. In 30 years, their annual retirement spending will be \$400,000 or 2% of their net worth and remain thereafter at a constant purchasing power. Either Terrance or Carolyn is expected to live for 30 years until their estate is passed on to Sarah and Peter. Over the retirement period the Merton estate must effectively double in purchasing power in order for Sarah and Peter to inherit the same purchasing power estate value. The compounded after tax annual investment returns must average 2.0% (spending) + 3.5% (inflation) + 2.5% (real growth) = 8.0% minimum. That is an after tax rate of return, which requires a controlling business interest, to adjust and grow through the

ups and downs of a free society plus other high return passive investments. In other words, Terrance needs to have the good fortune that Peter is interested and competent to grow the business. Business risk taking skills are needed. Half of Sarah's wealth will be in the business and half of Peter's wealth would be in the business that he runs. Intergenerational accounting will naturally take place. Terrance and Carolyn may make loans to Peter and Sarah for home down payments, top quality educational tuitions and global tours, etc. Excellent communication and trust within the family is also required. Growth oriented inter-generational wealth objectives are achievable, but very difficult for most people.

Retirement plus legacy – Growth Oriented – Constant purchasing power and real wealth growth objective

The constant retirement purchasing power part of the other growth oriented objectives remains the same. However, the wealth growth bar is set even higher as the objective is to achieve further real growth for the legacy family over generations. There are few families that achieve real after tax returns of over 10% for the long run. The head of the clan must be extremely entrepreneurial, have good communication skills, and be lucky. Political societies generally require the family to mix good business skills to provide value to customers and good political skills to finance wars, bail out critical entities, or simply influence government operations to reduce their impact on family business profits. The Rockefellers and the Kennedys are examples of families that mixed patriarch business skills with children, who became senators and other high political officials, that looked out for family interests. This final financial objective example is presented for completeness. It is rare and will not be developed further in this wealth guidance book.

Wealth Financial Objectives – How long is your family life cycle?

Time horizon is a critical wealth planning factor. It will be quantified in the Chapter 6. At this point, consider how the objective time horizon influences the choice of distribution or growth oriented objectives. Distribution objectives are focused on the financial security of the immediate household. When both spouses pass away, the distribution objective ends with remaining assets being dispersed without a specific objective at the estate proceedings.

Growth objectives focus on time horizons longer than the lives of the immediate household. Financial assets are used to develop the family wealth through future generations. Growth objectives are difficult to achieve. Passing down solid virtues and providing the most relevant education to cultivate the aptitudes and interests of the next generation members, develops good stewards of the family's values. However, competence may be lacking and accidents or bad luck (wars, depressions, etc.) may occur, so that the family members, businesses, or causes do not flourish and prematurely die out. Legacies of increasing family wealth in either financial or influence terms after the third generation are rare. It is easier to develop a son (daughter) to take over the business than it is for the grandson (granddaughter) to develop a later family member (including cousins) to succeed in growing the business (and dividend outflows) or supporting causes (e.g. advanced medical devices or drugs). Growing inter-generational wealth is much harder than conserving and distributing it.

Connecting Wealth Objectives to Investment Risk Taking

Wealth objectives depend on the capacity and focus to take investment risks. It is conceivable to earn high income in exchange for skilled work, save 15% regularly (far more than normal), and simply hold the savings in risk free Treasury notes, CDs, and money market accounts. For higher income tax households the after-tax inflation adjusted account values can be expected to simply remain stable (no risk, no return) annually.

To quantify the example, assume an Ohio attorney household earns the equivalent of \$200,000 (constant 2009 U.S. dollars) annually beginning at age 30 and saves 15% (high rate) of non tax deferred income for 35 years. At age 65, the household would own their home debt free, paid all obligations of their children's growth period, spend (after taxes and savings) at about an \$110,000 consumption rate, and have the equivalent of \$1,050,000 liquid retirement assets. The question is: **Can the family continue to live at their standard of living for 30 years of retirement after saving at a very high rate and taking no investment risk?** Assume constant (about \$40,000) dollars annual Social Security payments, 4% withdrawal rate of the risk free retirement account (\$42,000 after tax income), and very low SSA payment related income taxes.

The household can expect to spend at about an \$80,000 annual consumption rate. **They would be spending at an approximately 25% lower standard of living during retirement.** Taking no investment risks and a taxable high savings rate makes a stable no risk distribution goal saving plan achievable with a somewhat lower retirement standard of living. A low risk plan improvement would be to purchase a fixed purchasing power joint life time annuity at age 65 that may increase the effective retirement financial asset spending rate from 4% to 5% and limit the retirement standard of living reduction to a less noticeable 15%. In conclusion, retirement spending wealth distribution objectives can be achieved with high working income, high savings rates, and no investment risk taking.

Family growth oriented wealth requires investment risk taking. For most households, business ownership risk taking is needed for growth oriented objectives, due primarily to the opportunity to control investment operational risks. The objectives can be achieved through investment risk taking in non-controlling passive securities or limited partnerships. However, as demonstrated throughout the following chapters, 6% or more annual real after-tax long term returns are very difficult to achieve.

Next consider a certified public accountant. He developed an interest in financial securities at an early age while going with his stock broker father to the office on Saturday mornings, majored in accounting, received bachelors and masters degrees, and earned his CPA accreditation. His household savings rate is the same (15%), the household income is the same (\$200,000), and the consumption rate (\$110,000 after taxes and savings) is the same as the attorney household. He also lives in Ohio. However, he and his wife have a wealth growth goal that includes either their son or daughter following on in the CPA firm, limited liability corporation (LLC). At the death of the remaining spouse, the wealth growth goal is for the son and daughter to receive an estate including the business value equal to the age 65 family net worth. In future chapters, tables will be used to show the component values and cash flows. For simplicity, business and other details are not included here.

The key assumption is that the knowledgeable CPA consistently earns 5.5% after-tax real

returns on combined business growth and passive investments for 30 years between age 35 and 65. At age 52, either the son or daughter starts working in the LLC. The question is: **Can the family continue to live at their standard of living for 30 years of retirement after saving, taking controlling (business) and passive investment risks, and leave an age 65 equivalent estate to both the son and daughter at the death of the last spouse (age 95)?** The CPA household is consuming the same as the attorney household for 35 years. However, their real returns are 5.5% annually. At age 65, the combined much riskier business and investment somewhat illiquid household net worth is expected to be \$3,000,000. During retirement, the patriarch CPA household plans to withdraw net worth assets at a 3% rate (\$90,000) annually. After receiving SSA payments, they are much more likely to keep their annual retirement consumption rate (\$110,000) unchanged than the attorney household. They also plan to continue investing passively in the business and other investments to earn the 5.5% after-tax real return. **Caveat:** Note a wealth growth oriented goal is riskier than a distribution oriented goal. If an economic downturn (e.g. 1931, 2008) occurs in the 5 years prior to the death of the last spouse, the specific terminal wealth goal will not be met. Being aware of the warning, a remainder (with a 3% retirement investments withdrawal rate) 2.5% annual after tax return for 30 more years will grow the \$3,000,000 to a little over \$6,000,000. In other words, it is conceivable that the CPA household can leave the same purchasing power estate to their daughter and son as they accumulated at retirement day. Life is full of details. In practice, deaths, divorces, and various parent to children transactions will change the numbers. At this time, the examples are simply meant to show how knowledgeable aggressive investment risk taking is necessary to achieve wealth growth objectives, instead of wealth distribution objectives (which generally require savings and moderate risk taking.)

Flexibility and Changing Goals

Life is uncertain regardless of the best made plans and efforts. Wealth objectives may realistically need to change from growth orientation to distribution orientation for many reasons. The message is to first make wealth objectives that are implemented through strategic plans. After monitoring and minor adjustments, if the financial wealth objective can not be reasonably achieved, then it should be reset,

Section Outline

instead of abandoned. Life changes (disabilities, terminal life conditions, births, economic discontinuities, and deaths) distract focus and at a minimum require minor objective adjustments. As further discussed in Chapter 6, the spending (withdrawal) rate during retirement or more years of work prior to retirement may be needed to adjust for inadequate resources at the desired retirement target date. Alternatively, the terminal estate wealth growth objective may need to be reduced.

Flexibility is necessary to adjust in response to new conditions. In nearly all cases, risk tolerances and risk taking should not be increased if milestone financial wealth objectives are not met. Incremental reduced risk taking is often a more appropriate response in highly uncertain times. Psychologically, progress toward reduced objectives is much better than taking larger risks and possibly losing more critical financial assets. As stated in opening this chapter, the family goal statement is a worthwhile supplement to other agreements. The stated values should not change. However, personal capabilities or economic conditions may change. Maintaining the flexibility to adjust financial wealth objectives and persevere with limited economic resources should keep the core values that lead to personal happiness intact.

¹Lucas, Stuart *Wealth* 2006

²Ibid 1 Pg. 39

³Ibid 1 Pg. 67

IV. Wealth Foundation and Factors

Chapter 6. Wealth Flow Factors –
Multi-Dimensional Wealth Planning

Key Point – Significant Seven Wealth Factors

- Household time horizon (longevity)
- Retirement Spending (withdrawal rate)
- Risk Tolerance (financial behavior bias)
- Investment Returns (portfolio volatility)
- Gift commitments (sharing with others)
- Inflation (political disorder)
- Taxes (manage frustration efficiently)

Key factors are defined, analyzed, and joined together into a wealth development plan in this chapter. Then Martinez and Merton family example wealth plans are presented. Each factor includes uncertainties that may be increased, reduced or otherwise addressed in different ways that may impact other factors. Converting wealth financial objectives into specific wealth development plans is primarily a scenario analysis course of actions. The financial wealth development plan should be orchestrated so that it best addresses unique household needs with flexibility to deal with various scenarios. There are no flawless plans. Yet it is best to establish well thought out plans to navigate through a dynamic life.

The significant seven wealth flow factors are: household time horizon (longevity), retirement spending rate (resource withdrawal rate), household risk tolerance (financial behavior bias), expected investment returns (related portfolio volatility), gift commitments (spending on others including estate wealth growth), expected inflation (currency depreciation/purchasing power reduction), and tax payments (paying legal government charges efficiently). Time horizons, risk tolerances, and retirement spending rates are factors that a household should understand best and are potentially most controllable. They influence the selected expected investment returns or other cash flow streams (with related risks) for retirement spending and wealth growth commitments. Inflation and taxes are results of government policies and actions. Individuals have least immediate control over these factors. Inflation can be somewhat hedged through thoughtful investment portfolios (or living in a long term stable currency country such as Switzerland). Taxes for most upper middle and higher income households are the most frustrating wealth flow

factor because at all levels of government they are historically high and carelessly spent. Tax complexity is so excessive that most people do not pay the exactly correct amount after wasting an extraordinary amount of time working through various sets of conditions and scenarios. That said, understanding the tax code is necessary to pay taxes efficiently and maintain after-tax investment returns.

Time Horizon – How long do you expect to live?

Expected life spans are the highest impact financial wealth factor. An expected 70 year life span with 30 years of earned income and 15 years of retirement poses a much different wealth development profile than a 95 year life span with 40 years of earned income and 30 years of retirement. Regular physical exams to measure health and controlling actions to limit life threatening conditions provide information to estimate life spans. Parent and family member life spans indicate life spans assuming similar life styles. Advances in medical knowledge, medicines, and procedures in addition to generally more sanitary environments offer opportunities to live healthier and longer lives than our parents. Naturally, habits (e.g. good and bad -smoking, etc.) diets, exercise (bodies and minds), and relationships specifically affect expected life spans.

A multi-factor bottoms-up survey available from various sources is a reasonable way to estimate life span. An example survey is available at www.RealAge.com. Larger samples with many independent factor data bases provide better estimates. Note high impact factors and estimated differences between biological age and a factor based age. Obesity is a high impact factor. Conversely, if your multi-factor based age (e.g. 55 years old) is 10 years less than your biological age (e.g. 65 years old), then based on the factors (your special conditions, heredity, life style, etc.) used, you should plan for a longer than normal life span.

Notice in the Table 1 Congressional Research Service 2006 Report on Life Expectancy in the United States that dramatic medical advances reduced death rates over the period shown. However, the lack of progress in diabetes death rates, which may be understated due to other direct primary causes of death, is a recent poor diet and lack of exercise life style decision phenomenon.

Table 1. Age-adjusted Death Rates for Various Causes of Death (per 100,000 population)

Cause	All causes	Heart Diseases	Cerebrovascular diseases	Diabetes mellitus
1950	1,446	586.8	180.7	23.1
1980	1,039	412.1	96.2	18.1
2002	833	232.3	53.5	25.3

Actuarial tables provided by the U.S. Social Security Administration and others give top down estimates of generalized life expectancies based on a current age. For most people, they offer very limited information. The 2004 SSA actuarial table estimates that a 65 year old male will live another 16.67 years (Age 81.67 at death) and a 65 year old female will live another 19.50 years (Age 84.50 at death). The age at death assessments (total life spans) become more accurate at older exact ages, because more information is included about actual deaths of people who were born in the same year. The SSA estimate that a 30 year old male will live another 46.58 years (Age 76.58 at death) and a 30 year female will live another 51.05 years (Age 81.05 at death) provides very little value on which to make wealth plans. (However, they provide good information for insurers to price annuity products for a large group.)

Whether a physical examination life condition, multi-factor bottoms-up survey, or top down actuarial estimate is used to calculate approximate life spans, recognize that environmental conditions and health care are continually improving. Expected life spans are increasing as shown in Chapter 1 Tables 3 and 4, which are repeated below as Tables 2 and 4. Table 2 indicates recent progress by showing the change in expected remaining life for a 65 and 75 yr. old male between 1990 and 2000 according to National Vital Statistics reports.

Table 2. Male Expected Remaining Life (years) At Ages 65 and 75 in 1990 and 2000

Age	1990	2000	% Change 1990-2000
65	15.1	16.3	7.9
75	9.4	10.1	7.4

In 10 years statistically the average male post Age 65 life expectancy increased 7.9%. Be aware that the life expectancy for women at Age 65 is about 2.5 to 3.0 years longer than men. A longer term estimate of increases in life expectancies from the Table 1 CRS report is

shown below in Table 3. If the end of employment continues to be planned at Age 65, the average retirement period is expected to increase.

Table 3. Projected Life Expectancies, SSA, in Selected Years (in years)

Year	At Birth		At Age 65	
	Male	Female	Male	Female
2005	74.8	79.6	16.2	19.0
2025	77.0	81.2	17.5	20.0
2050	79.4	83.2	18.9	21.4
2075	81.3	84.9	20.2	22.7

Finally, the Society of Actuaries RP 2000 projected 50% and 25% probability of life expectancy for a healthy Age 65 male, female, and one (second to die) of a male/female couple is shown in Table 4.

Table 4. Age 65 Expected Remaining Life (years) At 50% and 25% Probability

Prob. (%)	Male	Female	Couple
50	18.3	20.7	25.0
25	23.9	26.8	29.6

In 2000, the probability that one member of an Age 65 male/female couple will live 30 years was about 25% and the probabilities continue to increase. (The SSA, National Vital Statistics, and Society of Actuaries data are calculated slightly differently with different year databases, so that their expected life span data differ by a few years.) Time horizon or longevity risk is the most important wealth distribution or growth objective risk (i.e. running out of money).

The specific question for wealth development planning is: **What life span should an individual or couple plan for?** For about half the population, an age at death can be approximated within about 3 to 5 years. Heredity, special conditions, life styles, and improving societal life aiding trends are key inputs for thoughtful people to make reasonable estimates. It is generally suggested to use a 25% probability that one spouse of a couple will live to age 95 and plan for 30 years of wealth distribution after retirement at age 65.

Investment Withdrawal Rates - Retirement Spending – Living within Your Means

The wealth distribution factor relates directly to the expected retirement period and financial resources available to meet spending needs. In some situations spending cash flows may be

Section Outline

provided by government insurances and employer pension plans. For example, if a retired couple receives full inflation adjusted pensions (85%) from a fully funded plan and U.S. social security payments (20%), then their retirement spending budget is more than fully funded (105%) without any purchasing power risk. Assuming that health care potential needs are fully insured, then their financial risks are small and no investment risks must be taken. In a more general case if financial resources are substantial, held in risk free accounts (U.S. treasury bills, money market checking accounts, etc.), and spending (3% withdrawal rate) during a long retirement is fully budgeted, then no financial investment risks may need to be taken.

Most people do not have a financial or investment risk free situation. A sacrifice must be made between saving for long term goals, such as retirement spending and other wealth purposes, and current consumption of a desired good, service, or experience. Historical advice dating back to Babylonian times, suggests a 10% savings rate. Tax deferred savings plans (IRAs, 401Ks, etc.) are good vehicles to allow investment returns to grow prior to withdrawal during retirement. The employer sponsored plans (401K, 403B, etc.) also provide a company match (usually ranging from 3% to 5%) within the tax deferred framework. Discipline to start and auto pilot habits to continue pay period transfers to savings plans are simple concepts, which many people find difficult to follow.

The withdrawal rate depends primarily on the expected retirement period and secondarily on the expected investment returns during retirement (assuming moderate or conservative risk taking). Table 5 provides simple boundary conditions based on conservative investment returns that offset annual inflation after taxes (0% real return) and moderate investments returns that offset annual inflation and provide an after tax return (2% real return = 2% long term risk premium). The retirement periods range from 20 to 30 years. Suggested annual spending is the % withdrawal rate times the investment assets available at retirement.

Table 5. Withdrawal Rate Suggested Ranges

Risk/Retirement Period (Yrs.)	20	30
Conservative (0%)	5.0	3.3
Moderate (2% risk premium)	6.0	4.4

For example, a 20 year retirement, using conservative investment returns and assuming a 5% annual withdrawal rate equal to \$100,000, would be funded by a \$2,000,000 retirement account at Age 65. More realistically, a \$20,000 annual social security payment would provide 20% of the spending and reduce the needed retirement account to \$1,600,000. Another example is a 30 year planned retirement, utilizing moderate risk taking returns and assuming a 4.4% annual withdrawal rate that would equal \$100,000 and be funded by about a \$1,820,000 retirement account at Age 65 with social security payments. The second example is more complex due to the risk premium, which will change during the 30 year period. Generally more risky moderate investments will be used during the first 15 years and less risky moderate investments will be used during the last 15 years of expected retirement. Changing risk premiums will be discussed in a future chapter. At this time, the point is that the **suggested withdrawal rate** from self investment (not pensions or annuities) accounts should be between 3.3% and 6.0% based on risk tolerance and expected retirement spending period for the normal retiree.

How is risk tolerance assessed?

Risk tolerance assessments are complex and should be estimated qualitatively and then quantified with scenario assumptions. The appraisal should consider behavior biases, which change under different conditions, and actual asset operational, financing, and market historical risks in terms of profits or returns volatility. A precisely unbiased behavior individual would be as rational as a correctly programmed computer. Unfortunately, those individuals do not exist. That is why Chapter 4 presented an analysis of behavior biases. A wise person should identify emotional and rational behavior biases based on recognizing and analyzing past investment mistakes. Emotional biases, such as inability to accept a loss (prospect theory), greed (or fear), and overconfidence, are problematic traits that may demonstrate a low risk tolerance. Personal circumstances and the capacity to accept the consequences of risk taking must be understood. Living through breathtaking stock market sell-offs, such as the 1974 down market, the sharp brief Oct. 19, 1987 crash, or the across-all-asset-classes 2008 deleveraging down market, offer valuable experiences to study. Risk tolerance variations during turbulent times indicate a worst case risk tolerance. That is when critical risk tolerance is

Section Outline

shown and the most costly mistakes are made: “throwing in the towel” or selling assets when the pain of loss is intolerable. It is often near the sell off bottom prior to an asset price recovery.

Defining behavioral risk tolerance levels during the most difficult times is strongly suggested. Opportunities may be lost while some investments are held in cash; more importantly, potentially costly fear and thus serious investment losses should be avoided. Similarly, rational biases showing over simplification without due diligence and poor agent selections with serious conflicts of interest also demonstrate low behavior risk tolerances. A high or aggressive risk tolerance requires much effort to find useful information and employ a consistent method to respond to unacceptable scenarios. Asset fundamental factors or market characteristics studies may be part of a process used to reduce rational short cut biases. Agent selection, including insurers, accountants, lawyers, and investment advisors, is especially important. They serve in a position of trust and if they don't make a best effort or actually have a conflict-of-interest at a critical time, risky bad wealth management decisions may be made. A bias toward careless agent selections indicates a lower risk tolerance for possible paths that they can lead you into. For most people, the initial significant risk tolerance assessment should be based on personal behavioral biases.

Wealth resources include both human capital (potential earning and savings), and financial capital. High human capital due to a relatively long future working period and a highly marketable skill can justify a higher financial capital risk tolerance. A 32 year old surgeon can look forward to decades of income and savings. Aggressive risk taking with an investment portfolio of predominantly public and private equities is usually reasonable. In a bad scenario, where the portfolio loses 40% of its value, such as 2008, the doctor's time horizon of 20 to 30 years of income would allow him to hold the positions, which most likely will recover in value. A 65 year old sales manager with little human capital and limited retirement spending resources could only justify a conservative risk tolerance. The sales manager often can not afford to lose even 15% of his retirement resources.

Be sensitive to the changing nature of asset risks. Long term asset historical risks change during intermediate time periods. Past long term risk

profiles do not guarantee future risk 15 yr. profiles. During normal times, equities, bonds, and commodities respond differently to economic conditions and future forecasts. Their price variability (standard deviation) and relationships (correlations) differ, so that a diversified investment portfolio which includes different asset classes is expected to show reduced variability risk. However, abnormal conditions can be severe. When they result in reduced financing due to wars, poor policy decisions, or incomprehensible regulations, then all asset classes may suffer from reduced market demand and forced selling to raise liquidity. In those situations, all asset classes may behave the same way. Their relationships become correlated, normal asset diversification benefits are overwhelmed, and all asset class prices decline together, such as during World War I, the 1930's economic depression, World War II, and 2008. After markets have behaved favorably and predictably for 3 or 4 years, it is wise to rebalance a portfolio to a bit lower risk asset weights (proportions); that is approach capital preservation after a fortunate period of good capital accumulation gains. Assessing personal behavior biases, past experiences, time horizons based on human and financial capital, and market worst case scenarios are useful in determining financial risk tolerance profiles.

Expected Investment Returns vary dramatically; past asset returns are not good future forecasters

Asset markets include long secular periods (about 15 to 20 years) of generally favorable and unfavorable conditions. Available long term market data history of the past 80 to 140 years includes alternating favorable and unfavorable periods. Based on political and economic policy errors, disorders occur that include world wars, global depressions, and deep regional recessions. The disruptions cause bad secular economic and investment return periods. Eventually, good secular economic and investment return periods follow. The challenge is to have a general idea of the current secular conditions and expected investment returns over your investment time horizon. Favorable investment periods begin with cautious attitudes, low equity price/earnings (P/E) ratio valuations, declining bond yields, declining inflation, entrepreneurial limited regulations, and declining tax rates. The outlook for both higher asset operating returns and increased investor valuations is encouraging during favorable periods, and investor returns remain high until eventual policy errors occur

and financing and/or asset bubbles (at high P/E's) explode. Unfavorable investment periods begin with the opposite conditions of over confidence, high equity valuations, low bond yields, low risk premiums, unstable monetary policy, serious asset bubble explosions, poor fiscal policy decisions, increased regulations, and increased taxes. The outlook for asset operating returns and investor psychology remain pessimistic during unfavorable periods until voters elect leaders with good policies that change the secular trend. At this book writing secular conditions are unfavorable for high asset investment returns. Near term returns should be expected to be below long term returns until financial and asset bubbles are corrected and new government leaders swing the political economic setting from stifling over control to simpler limited government.

Table 6 provides a very simple list of diversified mutual fund asset expected (long term) nominal returns and risk parameters before taxes in a 3.5% long term inflation global economy. Real returns after taxes and inflation adjustments are about 4% to 6% lower depending on the asset category. A broader discussion will be presented in future chapters. The current point is that higher expected return assets, such as equities (stocks), experience larger price movements (annual standard deviation (S.D. risk)), more severe declines, and especially correlated movements during market downturns. Expected returns relate to risk taking.

Table 6. Mutual Fund Asset Long Term Returns & Risk Metrics

Fund Category	Annual Return	Annual S.D. Risk	Severe Market down risk	Correlation Move together
Money Market	4	4	0	MM vs. others Low
Govt Bonds	5	6	10	Bonds vs others Moderate
Large Stocks	9	10	30	Large vs. other stock High
Small Stocks	10	12	40	Small vs. other stock High
International Stocks	10	12	40	Intl vs. other stock High

Constructing a portfolio to achieve expected long term returns with overall efficient risk is challenging during secular favorable investment periods. During unfavorable periods asset

returns are relatively low as market changes are choppy back and forth, upside moves are cut short, and overall real returns are about 4% to 6% below normal. In other words, there is much less than normal progress made toward wealth accumulation during unfavorable periods.

Nobody knows exactly how long a generally favorable or unfavorable period will last. Therefore, it is best to expect less than normal long term retirement portfolio investment returns, include alternative scenarios of possibly working longer than desired if economic wealth does not grow as planned, and reduce investment risks during retirement in order to **reduce the likelihood of running out of money**.

Giving is good; When is the best time to do it?

Wealth distribution and growth oriented goals must both address the survival goal - retirement spending. Thereafter, the gifting goal or future generation wealth goal is complicated by the time horizon factor. A gifting goal may be short or long term based on how value is perceived. Giving gifts during the first 10 years of retirement affords the opportunity to experience the satisfaction of the good deed. The good may be a dedicated classroom at your alma mater, a scholarship for a future dentist, or many other causes. Gifts may be the basis for long term relationships. Gifts methodically given over a long retirement period may also reduce an estate prior to death and limit related taxes. Therefore, the value of giving prior to death offers some favorable considerations. Alternatively, gifting at death affords a safety margin of economic resources for unexpected retirement spending. Gifting at death also results in a longer period to grow the wealth. Seek competent estate planning and tax advice. Gifting is a complex factor.

Expected Currency Inflation Rates – Difficult to Insure Against

The United States has the most advanced economic monetary system available. The Federal Reserve Bank, which regulates the banking system, attempts to meet conflicting objectives: price stability and full employment economic (productive) growth. Price stability is measured by different methods. The common method is the core Consumer Price Index (without volatile energy and food components). The FRB fears deflation more than inflation because of the possible rare special case of

severely depressed economic conditions, where people delay purchases in quest of future lower prices. Otherwise, the stated goal is usually core CPI less than 2.0%. In ideal conditions that is as stable as can be expected. However, in the real world, the FRB does not have timely information or fully control the pseudo banking system of domestic private, hedge, and foreign sovereign wealth funds (SWFs). Thus, the tools to attain price stability are limited. The full employment economic growth objective conflicts with price stability. Periodic congressional testimonies and questioning of the FRB Chairman naturally focus on a full employment economy. There is clever populist reasoning in the congressional rhetoric. Unfortunately, the FRB is pushed to support congressional fiscal legislation, which destabilizes the economy through increased deficit spending, added regulations, trade policy, or tax policy. Very few FRB Chairmen are independent and strong enough to respond that fiscal policy is not their responsibility. The FRB must balance its objectives, when poor fiscal policy makes the economy less productive and limits growth. Stagflation is the risk in those circumstances.

There are a few fiscal policy errors to watch for. Price controls and extreme supply regulations eventually cause inflation. President Nixon's price controls during the 1973 oil embargo and President Carter's energy supply regulations during the 1979 oil embargo caused extreme inflation, which the FRB could not control prior to FRB Chairman Volcker's dramatic 1981 actions. A weak currency (U.S. dollar relative devaluation) policy, usually in quest of increased demand for exports, is another issue that the FRB must deal with. The 1979 policy mistakes were compounded by a 30% drop in the trade weighted value of the USD over a 6 month period. Inflation was a direct result. Be aware of price controls, key asset supply regulations, and a weak USD policy.

A carbon credit tax plan to limit politically incorrect energy supplies is a potential inflation related policy error. In normal times, expect long term inflation to continue to average 3½%. If you spot one of the 3 stated policy errors, expect more inflation for at least a few years and reduce long term debt (yields up and prices down to adjust for inflation) holding maturities to reduce exposure. The inflation rate was well over 8% for extended periods in the late 1970's and early 1980's and there is no new law of

human wisdom that will prevent it in the future. Otherwise, consider reducing inflation impacts by purchasing Treasury Inflation Protected Securities (TIPSs) or life time fixed annuities with inflation adjustments. Inflation (depreciation) of the currency is a sad reality of a political economic country or region's (e.g. European Common Market) financing and exchange system. Be vigilant. Strategies to reduce its impact are discussed in future chapters.

Taxes – Ouch!

Taxes - income, capital gains, property, utilities, estate, etc. - are complex frustrating issues. For those who watch the legislative or citizen initiative processes of enacting tax laws, tax increase justifications show limited understanding of economics. If a good or service is taxed more, an incentive is set for less to be produced. There are also unintended consequences because of reactions to disincentives that result in less revenue than expected. Other than raising revenue, moralistic tax justifications often involve envy of the successful income achievers. Tax rates at times are also decreased and predictably revenues increase, as the after-tax returns for work or transactions increase. In fact, on rare occasions specific small taxes are eliminated, when it is realized that the tax collection administrative costs exceed the revenue raised. Because taxes change and complexity generally rises over time in unpredictable ways in response to various social engineering credit schemes, wealth objective tax planning is very difficult.

There are a few key issues to recognize. Tax deferred employer sponsored 401K, 403B, and related plans have four key advantages: automatic payroll deductions, savings tax deferral, company match tax deferral, growth tax deferral until funds are withdrawn during retirement. Individual retirement accounts are also tax deferred and more flexible, although there is no company matching aspect. There are large differences between state taxes that over the long term impact after tax income, savings, investment returns, and tax deferred account withdrawals. It is little wonder why New York City professionals retire to warmer weather and no income taxes in Florida. Knowledgeable, long term tax advice is valuable for tax planning and payment efficiency. Alternative minimum tax traps, tax deferred account required minimum distribution details, tax loss harvesting

efficiencies, and annual gift limitations are a few issues, where a tax professional can provide valuable advice.

U. S. federal and state taxes are now at a historically high level relative to enactment of the U.S. Constitution and the 16th amendment. The 15% of upper middle and higher income tax payers, who pay nearly all the individual income, dividend, and capital gains taxes, are hit very hard. Accumulating wealth is difficult. The discipline to pay taxes efficiently is necessary to accumulate, grow, and distribute wealth.

Uniting the Significant Seven Wealth Development Factors into your unique plan

Wealth planning starts with a time horizon. Regardless of distribution or growth objectives, some wealth must be spent (distributed) to support household life and responsibilities. Retirement investment account withdrawal rates or cash inflows from pensions and annuities define a desired retirement spending level. Normally the desired spending level is equal to or less than pre retirement spending levels. However, the spending level is simply desired.

The following factors help determine if retirement accounts, pensions, or annuities are inadequate and if the desired spending level must be reduced. Risk tolerance and expected returns per investment portfolio risk accepted should be carefully analyzed to determine a sound wealth objective strategy. Taking excessive risks turns potential investing into gambling. It is better to take fewer risks, sleep well, and maintain the wealth development process through thick and thin, than to panic and quit the plan when the pain of losses becomes unbearable. The process boils down to self discipline. Expected investment returns vary with secular trends. Be wary of investment advisers, who promise long term investment portfolio returns without scenario analyses that discuss potential losses. Government leaders make mistakes that result in periods of less than long term returns. Your wealth strategy must deal with those periods.

Gifting may be part of a wealth growth objective. If you are comfortable that your retirement wealth distribution needs are covered with a margin of safety for the unexpected (longer than expected life), then you can develop a more complex wealth growth plan. Generally, family inter-generational growth is planned. However, gifting to non family members or causes can also

be part of the wealth growth objective. Family wealth growth or gifting objectives often have longer time horizons and take higher investment risks than wealth distribution objectives.

Inflation and taxes are uncertainties that must be dealt with to preserve or grow wealth. Tactics are required to defend against surges in inflation, as well as tax uncertainties that jeopardize or reduce investment returns. Uncertainties caused by unexpected inflation or new taxes require time to be understood. Human nature does not like uncertainties. Anticipating inflation changes and responding to taxes efficiently with good processes, key trigger points, and tactics for prompt protective actions is important.

Analyzing Examples

Robert & Anita's Goal Statement

Our children are important to us and don't need any financial help. We expect to take care of our own retirement spending to an old age (three of four parents are alive, have sufficient resources, and live in assisted living communities). Limited pensions and 401K plan investments make up our financial resources. We sleep well, have no investment education, and don't take small or foreign stock risks. Our home mortgage is our only debt and will be paid in 4 years. We do not plan to leave any assets at death to children or charities. We look forward to being grandparents. Our budget is modest and can adjust if needed.

Distribution Oriented - Stable income objective

The stable lifetime purchasing power is a simple, but risky retirement spending objective. Inflation is not considered in defining the stable annual income objective. The Martinez household plans to retire in 8 years (Robert age 65) with a simple \$72,000 annual spending budget. The Martinez's may have difficulty stretching their nominal \$72,000 budget at that time, unless most of their income is sheltered from inflation. They may adjust a stable income or hybrid income/purchasing power objective to maintain an acceptable standard of living. An alternative is to work past age 65.

Combining Robert and Anita's Goal and Objective Statements into their Wealth Plan

The Martinez goal statement is simple and oriented toward a distribution objective. Their children received limited education and are

Section Outline

essentially self-reliant, although Jenny is living with them. Three of Robert and Anita's parents are alive and self-sufficient. No health limiting conditions are mentioned. The longevity factor indicates Robert and Anita should plan for a long retirement time horizon, including a surviving spouse living to age 95. Their lack of investment experience and no desire for small or foreign stock risks indicate a conservative risk tolerance.

The objective statement is incomplete. Annual incomes, investment assets, savings rates, pensions, and potential retirement dates should be stated. The following financial wealth factors were discovered during subsequent reviews. Robert's 401K account is currently valued at \$200,000. It is invested in a short term corporate bond fund (50%) and in a blue chip (S&P 500) stock fund (50%). His annual salary is \$70,000, 401K contribution rate is 10%, and employer match is 3%. Robert plans to work for 8 years and retire at age 65. Assuming an annual 401K balanced portfolio 6% return and 13% total savings rate, the 401K is estimated to grow to about \$400,000 at retirement. Anita earns an annual salary of \$40,000 and participates in the school district pension plan. She plans to retire in 8 years with a pension annual \$15,000 payout that is adjusted for inflation up to 4% annually. The Martinez family lives in the state of Texas.

Robert and Anita's forecasted Social Security annual payments at retirement (age 65) are \$30,000 and \$17,000, respectively and adjust for inflation, which is expected to average 3½% annually. Their nominal spending in 8 years prior to retirement is expected to be \$90,000. Considering no mortgage payments, their purchasing power budget is expected to be constant during that period. Robert and Anita expect \$59,000 annual inflation adjusted SSA and pension payments during retirement and a total income tax average rate of 15%. Nearly \$50,000 of the Martinez after-tax retirement income will be inflation adjusted risk free pension and SSA income. The combination of Anita's inflation adjusted pension and the combined social security payments effectively alter their stable income objective to a hybrid income/purchase power distribution oriented wealth objective.

Robert's 401K account (\$400,000) at retirement ideally will provide steady income for 30 years. Robert may decide to leave his portfolio constructed as a moderate risk balanced

allocation of short term bonds (50%) and blue chip stocks (50%) with a 6% nominal expected return (3½% inflation + 2½% real return) to combine with the other low risk income sources. His next consideration is whether to withdraw steady nominal income at a 5% rate or \$20,000 nominally (\$17,500 after-taxes), where purchasing power is lost at an annual 3½% rate. He may otherwise decide that a 4% inflation adjusted withdrawal rate will provide steady purchasing power for 30 years. The expected \$16,000 real inflation adjusted (\$13,600 after-taxes) cash flows provide the Martinez family with a high confidence level of inflation adjusted total \$63,600 after tax spending resources. Robert may also consider purchasing an inflation adjusted last survivor life annuity with his 401K plan assets that may pay out about \$20,000 real inflation adjusted (\$17,500 after-tax) cash flows.

The Martinez family wealth distribution retirement plan shows a hybrid stable income/purchasing power objective. If they decide on a 4% inflation adjusted 401K retirement withdrawal rate, then their objective is to maintain purchasing power. The estimated \$63,600 annual retirement purchasing power is about 29% less than their pre retirement \$90,000 spending budget. Stretching for another \$3,400 after tax annual income through a 5% 401K withdrawal rate is not be suggested. Reducing discretionary leisure and charitable spending may allow them to live self reliantly with the smaller constant purchasing power budget. After considering all factors, the Martinez overview wealth distribution plan is a good low risk plan. If Robert and Anita decide to work 3 more years until age 68, their social security, pension, and 401K resources will increase and should provide them about a \$12,000 annual inflation adjusted addition to their retirement spending budget.

Terrance & Carolyn's Goal Statement

We are fortunate and cherish our children. Honesty, perseverance, and trust are our core values. Good communications are a family priority. Our parents are self sufficient and live in a nearby community. We support each other. Our home mortgage payments are reasonable. Terrance enjoys his specialty products business challenges. We have limited IRA investing experience. Carolyn does business and home budgets and has a dedicated involvement in the children's education. We would like to pass the business to Peter, if he is interested, after Terrance retires.

Retirement plus legacy – Growth Oriented – Constant purchasing power and per capita real wealth conservation objective

The constant retirement purchasing power part of this growth oriented objective remains the same. The objective is to achieve a remaining estate at death of the last spouse for each second generation family member. Each estate equals Terrance and Carolyn's net worth at the start of their retirement. For example, they plan to leave Sarah and Peter each an estate of approximately the purchasing power of their net worth. Assume Terrance effectively retires in 30 years at age 65, inflation continues at a 3½% annual rate, and Terrance and Sarah's net worth is nominally \$20,000,000. Specifically, in 30 years 60% of their wealth equals the approximate market value (\$12,000,000) of the business and the remaining 40% (\$8,000,000) equal their \$1,000,000 home and \$7,000,000 of other investments. The Mertons live well within their means in Arizona. In 30 years, their annual retirement spending will be \$400,000 or 2% of their net worth and remain thereafter at a constant purchasing power. Either Terrance or Sarah is expected to live for 30 years until their estate is passed on to Sarah and Peter. Over the retirement period the Merton estate must effectively double in purchasing power in order for Sarah and Peter to inherit the same purchasing power estate value. The compounded after tax annual investment returns must average 2.0% (spending) + 3.5% (inflation) + 2.5% (real growth) = 8.0% minimum. That is an after tax rate of return, which requires a controlling business interest, to adjust and grow through the ups and downs of a free society plus other high return passive investments.

In other words, Terrance needs to have the good fortune that Peter is interested and competent to grow the business. Business risk taking skills are needed. Half of Sarah's wealth will be in the business and half of Peter's wealth would be in the business that he runs. Intergenerational accounting will naturally take place. Terrance and Carolyn may make loans to Peter and Sarah for home down payments, top quality educational tuitions and global tours, etc. Excellent communication and trust within the family is also required. Growth oriented intergenerational wealth objectives are achievable, but difficult for most people.

Joining Terrance and Carolyn's Goal and Objective Statements into their Wealth Plan

The Merton goal statement is clear. Their values are centered on stated virtues. Terrance and Carolyn plan to grow wealth through their family. The objective is a growth oriented wealth that is passed to Peter and Sarah, the future family stewards. Specifically, the Mertons plan to grow economic resources to finance the wealth through the business. Technologies and business relationships change in a dynamic society. Peter (or Sarah) will need to show similar interest and competence to take the reins of the business in the future that Terrance started after he worked in his father's machine shop and earned his advanced Mechanical Engineering degrees. At age 35, the Merton household after tax spending budget is \$115,000. Terrance systematically invests in a diversified group of stock mutual funds in his tax deferred plan that is currently valued at \$250,000. He also adds a total of \$40,000 into the tax deferred investment plan account annually. The long term expected annual rate of return is 8%. In 30 years at age 65, the deferred tax individual account is expected to be valued at \$7,000,000. Terrance also makes annual business capital expenditures that support increased sales and long term net profit growth of 8% annually. In 30 years the business market value is expected to be \$20,000,000 and the home value is expected to be \$1,000,000.

The Mertons live unpretentiously. Their wealth growth objectives are in the high risk, high return category for both business and investments. They may fall short for various reasons. Nonetheless, the financial objective of \$20,000,000 in 30 years at Terrance's retirement to finance the family wealth is achievable if they follow their core values. Their post retirement financial objectives are clearly stated and will result in leaving Peter and Sarah similar purchasing power estates, if methodically followed. For various reasons it is very unusual to grow the financial wealth at a similar rate for 3 generations. The probability that one of Peter or Sarah's children will run the business successfully after Peter retires is not large. Generally, businesses bring in other professional presidents at some point and become public entities in order to finance expansion with public debt and new stock public entities. Terrance and Carolyn are planning to grow wealth in the most predictable way through a family business in a free society.

**Table 7: Summary Wealth Plan Factors
Checklist to thoughtfully integrate for a
meaningful life plan**

Time horizons (Longevity) – Highest Impact
Wealth Resource Factor – Live Prudently

Withdrawal Rates (Spending Flexibility/
Robustness) – Balance & adjust to maintain
self-reliance

Disposition (Risk Tolerance) – Be clearly aware
of risk and don't exceed personal tolerances

Investment returns (allocations, returns,
volatility) – Assuming added risk for high
returns is unsafe

Gifts (value commitments) – investments should
relate to the gift beneficiary's time horizon

Inflation (purchasing power) – politically
determined disorder that impacts without notice

Taxes (varying codes/complexities) – certain
frustrating events that should be managed
efficiently