

FINANCIAL
PLANNING SECRETS
FOR SUCCESSFUL
RETIREES

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RETIREES

G. David Biddle

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This book is dedicated to my wife, Valerie, and my sons, David and Sam. Valerie gave me the freedom and support I needed to create my company, and that led to the creation of this book. Above all, Valerie, David and Sam have taught me the value of money is measured by the time it allows you to spend with your loved ones.

CONTENTS

INTRODUCTION	
You, the “Successful Retiree”	9
CHAPTER ONE	
Beware—Hazards Ahead	15
CHAPTER TWO	
Regulatory Issues	30
CHAPTER THREE	
Major Mistakes Retirees Make	41
CHAPTER FOUR	
Long-term Medical Care	53
CHAPTER FIVE	
Insurance Investments	74
CHAPTER SIX	
Investment Theory	88
CHAPTER SEVEN	
Asset Allocation	103
CHAPTER EIGHT	
Insurance Products That Work	118
CHAPTER NINE	
Estate Planning I	135
CHAPTER 10	
Estate Planning II	148
CHAPTER 11	
How to Pick an Advisor	167
CHAPTER 12	
The Biggest Secret of Financial Planning	177
APPENDIX A	189
ENDNOTES	197
APPENDIX B	199

INTRODUCTION

You, the “Successful Retiree”

Before you start this book, I'd like to define who you are, what you are and where you are right now in your life.

Even though the answers may seem obvious to you, I feel it's best to clearly define your situation. That way, you'll better understand the kinds of issues you'll soon be facing—or that you're already facing—and that are dealt with in this book. So, before we proceed, let's first establish your profile and place you in the context of your financial environment.

You are somewhere between the ages of 55 and 65. You might be a little younger; you might be a little older. Exact age isn't important. What matters most is that you've reached a critical juncture that is going to determine how you live the rest of your life.

If you aren't already a new retiree, you've already started thinking seriously about your retirement. Understandably, you're excited about embarking on this new passage. You're also a little bit nervous—as well you should be. The time has come when you have to make some very important decisions.

And these decisions loom very large, because you fall into a financial classification that I've termed the “successful retiree.”

Ambitious and success-oriented, they've have worked hard for the better part of their lives. They were always very conscientious about how they spent money *and* about how they saved it. They've made the sacrifices. They put a child or two (or more) through college, and they gave up that second vacation each year in the interest of secure and comfortable "golden years." Generally speaking, a "successful" retiree is someone who has investment assets of \$700,000 to \$5 million.

So, as you no doubt well know, as a successful retiree, your savings are significant. And now it's time to put that accumulated wealth to work for you.

You're not quite sure how to best accomplish that, and yet so many questions are assailing you. What exactly are you going to do with your retirement plan now? Your social security? Are you going to defer it? Once you get your retirement plan, are you going to keep it with the company, or will you try and manage it yourself? Should you hire somebody to help you manage it? How much income are you going to need, and how much in taxes are you going to have to pay? And just how will you handle that tax situation?

Yes, a lot of forces jump out at the retiree all at once. Very often, mistakes are made.

A New Identity, A New Environment

Essentially, what has happened is that you've assumed a new identity. Generally, when someone assumes a new identity they are, at the same time, entering into a new environment. Metaphorically speaking, that is exactly what you're doing at this point in your life. When entering any new environment, you need help negotiating the terrain. To that end, this book is designed to serve as your field guide.

And don't take that term too lightly; you *are* going to need a field guide to navigate this new terrain. There are a lot of hazards out there awaiting you. Some of these hazards are merely inherent in the situation. Some are self-created. Some involve those who would take advantage of you. Let me present you with a variation of an age-old saying: *Even the strong won't survive very long if they go it alone.* (Thanks to songwriter Elliot Lurie for that one.) That's why you need a book like this.

So, who am I to be telling you what you need to do? It's well that you ask that question. (As you'll soon see, many times throughout this book, I strongly urge you to put some tough questions to those who would seek to manage your money. I even tell you what questions to ask.) Well, as you no doubt learned by looking at the cover, I am David Biddle. Specifically, I am president, founder and senior portfolio manager of Biddle Capital Management, Inc., a company I started in 1995 to specialize in the needs of pre-retirees and seniors. Also, I am one of the few financial experts in the country to have earned the Certified Senior Advisor (CSA) designation through The Society of Certified Senior Advisors, a national educational organization designed to train individuals to better serve the needs of today's seniors. I use the CSA knowledge as the basis of my company, where, along with my highly qualified staff, we address financial issues for retirees. We especially focus on helping seniors increase their retirement incomes and improve their lives while helping them avoid the mistakes that could hurt them financially. (The business itself is doing well: It has experienced 100% growth in each of the years between 1996 and 1999 and 233% in 2000.)

From experienced gained in my practice—as well as feedback obtained through my radio programs, newspaper columns, ongoing research program and financial seminars—I've come to fully understand the financial needs, concerns and special problems

that seniors encounter. I know the traps set by unscrupulous agents, advisors and brokers, and I counsel my clients on the best ways to avoid them. This book summarizes all that I've learned in a career that has taken me from a small retail business enterprise, to large insurance firms and, finally, into my current private practice and public forums. Encouraged by my clients, as well as the participants in my regional financial seminars, I decided to make this information available to everyone in book form. This is my attempt to demystify finances for the average reader.

There's one more thing important for you to know about me: Financial planning, according to my personal and professional philosophy, is not just about money. Rather, it is about the kind of impact money can make on someone's life. The value of money involves more than just its financial worth. Its true value can only be assessed by its impact on the individual and society. That philosophy is what is taking my company in the direction of a concept called "life-planning," something I will explain more in depth later in the book.

At Biddle Capital Management, our work represents more than just a job; it represents a personal mission. Our focus is on making a difference in a client's life. That is what drives me.

I sincerely hope this book, in some way, will make a difference in your life.

CHAPTER ONE

Beware—Hazards Ahead

As I stated in the introduction, you are entering a new environment and with a new identity.

As with any new environment, the first thing you'll need to be made aware of are the biggest hazards. That is what I'll deal with in this first chapter—the three biggest hazards facing new, successful retirees. Keep in mind, this chapter is meant as an alert. Subsequent chapters will deal with ways to handle these hazards.

HAZARD ONE—LACK OF STRATEGY

When you were a youngster, did you ever try out for a sport without first knowing how to play the game? You're placing yourself at a comparable disadvantage if you enter your retirement years without first knowing the “rules.”

Later in life, did you try to start your own company without drafting a business plan? Approaching retirement without a strategy can be just as costly. The worst mistake you can make going into any new situation is to be without a game plan. And going in with only a half-baked strategy can be just as bad—like trying to play baseball on a football field.

There is simply no excuse for not having a strategy for your retirement. The stakes are very high. Yet you would be surprised how many people approach their retirement without a financial strategy. Some of them even try to rationalize their lack of strategy as reasonable caution. “If I don’t do anything,” they figure, “I won’t make a mistake.”

Too late. They already did.

Poor planning makes retirees especially vulnerable to the next two hazards.

HAZARD TWO—SELF-SERVING COUNSEL

Entering a new environment unprepared is like stepping into a jungle—survival of the fittest and all of that. Arming yourself with knowledge is your best protection. You have to know not only what to beware of but *who* to beware of.

Who would you have to beware of most? One of the worst hazards retirees face is the kind of advisor—or agent, or planner, or stockbroker—who places their own interests above their clients.

What do people like that see in someone like you? Some would see you as a juicy retirement plan that will make them a bundle of money in the form of a big commission. The more confused you are about your options, the more vulnerable you’ll be.

At the outset, let me say this: I’m not claiming that all those you’ll encounter in the financial field will be sharks. Many in this field operate ethically. At the same time, however, many operate in a self-serving fashion. Let me give you some examples of what can happen—and what has happened to people I know.

You've Been "Brokered"

Investment advisors like myself have a phrase we use when we come across a client that has been taken advantage of by an unscrupulous stockbroker. We call it being "brokered."

We can easily spot when someone has "been brokered." In one recent two-week period alone, I met with clients whose worth totaled more than \$2.5 million. The majority of them, before they came into my office seeking investment advice, had been dealing with brokerage firms—large brokerage firms, not some fly-by-night outfit. As I looked closely at their portfolios, scrutinizing how the portfolios had been constructed, I could see quite clearly that they were assembled in such a way that benefited the broker more than the client. Let's look at some ways a client becomes a victim.

The Retirement Plan Misconception

Often, big companies with large staff rosters will use brokerage firms to manage their employees' 401K plans. When the employees retire, representatives from the brokerage firms call them up and offer to take care of their financial concerns. The retirees believe that the brokers' offers are merely a continuance of the service they had received from their employers. And the broker representatives know that. They exploit that misconception. Essentially, this can allow a disreputable broker to get in the door.

Variable Annuities

Once a broker is in the door, there is any number of ways he can exploit a retiree's assets for his own profit. And one of these ways is by selling retirees *variable annuities* that are mostly unnecessary and costly. A variable annuity is one of the biggest red flags that may tell you that you have a problem. No doubt, you've heard of variable annuities. These investments have become increasingly popular in recent years. In 1998 alone, \$98 billion

worth of variable annuities were sold. Yet variable annuities—which are an amalgamation of mutual funds and insurance policies—are responsible for some of the most detrimental things that can happen to clients.

Just what is the problem with variable annuities? Well, the IRS says that if you are paying for insurance, any investment earnings within the insurance contract is not taxed until you take it out. And you pay a fee for that every year. You pay a percentage of all your assets under management for that insurance. Now, the client doesn't see that charge, of course, because he never receives a bill for it. The percentage is just taken off the share price of your investments inside that contract. Those contracts pay some of the highest commission of product to brokers. Naturally, they'd like to sell you one. Whenever a client comes to a broker with a large sum of money in his retirement plan—\$700,000, let's say—the cash register rings inside the broker's head.

Very often, a broker will sell variable annuities in an IRA account—something that is totally unnecessary. Since an IRA account is already tax-deferred, there's no reason you would want to pay insurance in there. The fees you'll pay will be excessive. Not only that, but you could subject yourself to lower returns as well as surrender charges. You won't be able to move the contract, and you won't be able to get out of the contract.

If this is such an unsound financial move, why would a broker want to sell you one? That's simple: Commission. Every day I see people come into my office with variable annuities in their IRAs. And until I spell it out for them, they have no idea they have a problem. And it's the almighty commission that has created that scenario. From an investment standpoint, there is no reason whatsoever for a client to do it. In fact, I've debated the issue with a lot of expert financial people about this, and never has anyone been able to give me a concrete reason to put a vari-

able annuity in an IRA account. Still, there are those out there who would encourage you to do it. They'll swear to you that it's a great idea. (*Consult the appendix for a detailed NASD memo about variable annuities.*)

Well, it's not. Here's an example of something I saw happen to one of my clients, a widower. Several years ago, she came into my office with \$480,000 to her name. She came to me because she was unhappy with the way her money was performing. She told me she had been dealing with a broker. "He calls me every once in a while," she said, "but he really doesn't call me very often."

"Do you get your statements," I asked.

"Sure, but I don't really understand them. But he tells me I have all this money."

I asked to see the statements. Except for about \$50,000 of her \$480,000, everything she had was in annuities.

"How did you get all these annuities," I asked, a bit perplexed about what I saw.

She explained that she had some old annuities and the broker had moved them into other annuities for her and recommended that she add money to more annuities. I looked closely at the statements. As an investment advisor, it was obvious to me what was going on. She had an original annuity. The surrender charges were gone, but the broker sold her another annuity. That created two commissions.

I then had to explain to her that she would now face significant surrender charges if she wanted to move the annuities again. The annuities, she was correct, were not producing a competitive rate

of return. And half of them were in IRAs. And her tax rate was low. So, I basically had to deliver some hard news. I told her that the broker had locked her into a bad situation. When the surrender charges on the original annuities elapsed, he had replaced the original annuity with another. And she was stuck like this for the next seven years. Until those surrender charges went away, I told her, there was nothing I could do for her. And I truly felt bad about it. I felt like a doctor who just gave a patient a grim prognosis. This was everything this widower owned, everything that was going to take her through her retirement. And I could offer no cure.

Why did the broker do this to her? Why did he sell her that other annuity? He wanted to make more commission off of her. Every seven years, he was making about a 6% commission on this move. And he had slyly locked her into the situation so that she would have trouble getting out of it. Not only had he locked her in, but also he ensured that every dime she withdrew from profit might be taxable right away upon withdrawal. So this widow suffered a bad rate of return and was subject to a horrible tax practice.

Proprietary Funds

Brokers have a vested interest in trying to sell you something called a *proprietary fund*. A proprietary fund is a mutual fund created by a brokerage firm and, compared to other investments, it is often substandard. Today, more and more of the large brokerage companies manage their own mutual funds. Unfortunately, it's almost human nature for people to feel that, because a large and well-established firm created these funds, the funds must be trustworthy investments.

Unfortunately, that's not true. The majority of these funds are, from a performance standpoint, just horrible. But people buy them because the company representatives they place their faith in push them so heavily. And the reason why these reps push this

substandard product so heavily is because they may get paid more to sell them. Of all the statements that come into my office, about 90 percent of them that I see from a large brokerage fund have at least two proprietary funds.

I once had a client whose entire retirement income came from one proprietary mutual fund. The fund ranked in the bottom quartile of all the funds that had the same objective. This fund had lost 18% over the last six years. I had to tell this client, whose entire retirement income was banked on this particular fund, that he had been sold a poor investment.

What's Your Rate of Return?

You should always know the answer to that question. Here's one of the biggest problems you can have with your portfolio: The broker doesn't tell you how much money you made that year as a percentage. Let's say you have a \$100,000 portfolio and it has made you 6% over that past year. Well, you could have made 6% at the bank in a CD and with none of the risk that comes with having an investment portfolio. What would be the better investment? What would even be the point of having a portfolio? And why doesn't the average investor know how to evaluate the portfolio as a whole? The broker never gives you a rate of return, that's why.

Sure, you can kind of figure it out for yourself: You had \$100,000, and now you have \$110,000. But what did you start out with when you first gave it to the broker? And how many times did the broker change your investments? How much have you really made? How much did you pay the broker? That's the kind of information you need to know.

Until you know how that investment has done—in terms of performance—you don't have anything to go by. You can't look it up in the newspaper. You can't look in the report on the mu-

tual funds, because it doesn't tell you anything. That information is about as valuable to you as a "Peanuts" cartoon.

Surrender Charges

A little earlier, I mentioned something called *surrender charges*. Let's look at some of the ways a client can be "brokered" by these charges.

Certain types of mutual funds are sold like "no load" funds; that is, the client isn't supposed to have to pay any commission on the fund. In fact, the broker tells the client, "You can buy this 'XYZ' fund and I won't be charging you anything to get into this fund." But the broker rarely tells the client that the client will have to pay a significant surrender charge if and when the client wants out of that fund.

This concept can involve an even worse outcome for the client. The mutual fund company could charge the client excessive fees to pay for the commission that *they* paid the broker when the initial deposit was made. How would this happen? The client goes into a broker with \$500,000 and the broker says, "If we invest this money, you won't have to pay any commissions up front."

Of course, the client is delighted. "You mean you're going to help me but it won't cost me anything? That sounds great. Let's do it."

Given the go-ahead, the broker puts the client into what is called "B shares" which enables the broker to get paid 4% of that \$500,000 account—or \$20,000. Not a bad day's work. But who paid for it? The client did. The client is the one writing the check.

Inevitably, down the road, the client goes back to the broker, complaining that the funds are performing horribly: "I don't like these funds. I'm not making as much as my friends are making."

“You mean you want to get rid of them,” the broker will ask.

“You bet I do.”

“Well, I’m sorry,” the broker says, “but if you sell you’re going to lose three percent.”

Naturally, this news will stun the client. “Three percent!? Why am I going to lose three percent?”

“Well, that was the deal,” the broker says. “That’s the kind of shares we bought.”

“I didn’t know that! You didn’t tell me that.”

“But it’s in the prospectus that we sent to your house,” responds the broker

The client is sitting there, no idea of what just happened.

A broker gets paid to move money. Every time you buy and sell—or, more appropriately, every time he buys and sells for you—he is getting paid. And he’s got to keep you happy so that you don’t move your account—or, at least, he’s got to foster the illusion in your mind that you are happy.

And a broker is supposed to have your go-ahead before he can buy or sell anything for you. At least, that’s the way it’s supposed to work. I recently talked to a client of mine who deals with a broker, and I asked her, “Did you ever have a broker buy or sell something without your permission?”

“Sure,” she answered.

“Did you first give that broker written authorization to do that?”

“No, I just thought that was how they worked.”

Now all of this is not to say that every broker in the country is a crook. As I said earlier, there are some ethical ones out there. Some brokers really try and do what they can for a client. They’re conscientious of their clients’ needs and conscious about trying to keep expenses down. But that’s not always the case. So, always be very careful about who you deal with.

HAZARD THREE—LACK OF COUNSEL

Like the first hazard, the third biggest hazard facing the successful retiree can be self-created. It involves the lack of proper counsel. One of the worst mistakes you can commit, as a retiree, is to make a major decision (involving something like your pension payout, for instance) without seeking the advice of the proper counsel—someone like your accountant, attorney or investment advisor. Let’s take a look at issues and areas that can be greatly influenced by the quantity and quality of counsel.

Unnecessary insurance

Very often, as a retiree, you’ll find that agents will try and convince you that you need some kind of new insurance. Sure, certain kinds of insurance are fine. Insurance can be like any other financial tool: If used properly, it can take on great value. However, certain kinds of insurance can also be a great waste of your money. Unfortunately, much of the insurance sold to clients today turns out to be a waste of money.

Pension payouts

This is an area where many new retirees are uninformed or receive misinformation. Determining how you want to receive your pension payout is a crucial decision that involves how much

money you'll receive every month. A bad decision results in a lesser payout. And bad decisions regarding payouts are totally avoidable.

There are many issues to consider. What type of pension payout will be best for you? For instance, do you want some type of benefit for your wife if you should die or do you want to take the higher payout? You may be given that choice. Often, a retiree will have several choices. Unfortunately, many don't seek the counsel of a financial advisor when trying to determine the best choice for their particular situation. It's best to understand all of the financial issues involved before making a decision. Unfortunately, and all too often, clients make those kinds of decisions without a comprehensive understanding. And, also all too often, once a decision about a pension payout is made, that decision is irrevocable. You can't go back to the human resources department and say, "Hey, I changed my mind."

Another common problem about pensions involves a client's 401(k) plan. For instance, have you considered what the benefits would be for you to take your 401(k) plan and move it into an IRA account? Did you know that there are ways to spread that IRA account to multiple generations and significantly spread out the total tax that is due on that account, whereas 401(k) plans don't allow you to do that? No?

Now do you see why a retiree often needs an expert's advice when making payout decisions?

Tax management

Tax management would seem to be a fundamental financial concern, but many retirees let basic tax management turn into an acute problem. Let's say that you're getting your pension and you're going to take some money out of your 401(k) plan. How

do you pay the taxes? How much is that going to cost you? Seek counsel. It's out there.

Estate Planning

Retirement is a good time to review your estate planning with a competent estate planning attorney or investment advisor. In fact, this should be routine. But it's not. Retirees should not forsake this opportunity—and it's a great opportunity—to review all of their documents. You may have to retitle assets or have to figure out ways to manage your federal estate tax.

Improper counsel

Sometimes, improper counsel can be just as bad, or worse, as no counsel at all. Improper counsel constitutes seeking financial advice from the kind of insurance agent or broker who would more likely perform a transaction in *their* best interests. They may even perform a transaction of questionable legality. Here's a story involving one of my clients. One day, an insurance agent who had a license to sell mutual funds calls me at my office. He tells me he's got Mrs. Jones (not her real name) with him in his office and that she wants to sell everything in her account. "She wants you to send her money," the agent informed me.

Mrs. Jones had an investment portfolio with me. Now, I know that this agent who is advising Mrs. Jones is not all that familiar with investments, because he's only an insurance agent. I ask him to let me speak with her.

"Mrs. Jones, is this what you want to do," I asked.

"Yes."

"And do you realize that some of your investments have gone down and that some have gone up and that you're going to have tax liabilities?"

“Yeah, yeah, I realize that.”

The insurance agent gets back on the line. “We want to do this by May 20 because we need to buy the next investment so that she can get the dividend paid from that investment by that date.”

Again, I asked to speak with Mrs. Jones. “Mrs. Jones, is this what you want to do?”

“Yeah, yeah, I want to get that dividend.”

I talk to the agent again. “Okay, I understand. Let me have your number. I need to check on a few things for Mrs. Jones and I’ll call you back.”

I check into what she wants to buy—it’s a mutual fund. I begin to get the picture. Let me explain something about mutual funds. When a mutual fund declares a dividend, the owner of that mutual fund gets paid a dividend and the share price of that dividend then goes down the same day. So, what is going to happen is that the share price will go down, Mrs. Jones receives the dividend in cash and she’ll now have a taxable event. The agent has told Mrs. Jones that she can buy it now and get extra money. What he is not telling her is that the share price will go down. What he’s doing is called “selling dividends,” and it is strictly prohibited in the National Association of Securities Dealers rules of conduct—rules governing this particular agent’s transactions. One of the first things anyone in this industry learns is that you can’t sell dividends.

So, there was a big problem here. I knew this agent’s company, so I called his compliance supervisor. I told him what was going on. This supervisor didn’t even acknowledge you weren’t supposed to do that!

Needless to say, the account didn't go anywhere. Mrs. Jones never even heard from the guy again. I later found out that this agent needed to make that sale in order to continue his employment with that company. He was falling behind on his commissions, and he needed to do something to catch up. (He's since left the company.)

This whole thing really blew me away. Here I am, a compliance supervisor myself—I'm registered as a "principal"—so I have studied the supervisory rules. And here's this agent calling me up and he's essentially telling me flat-out on the phone that he's about to perform a prohibited transaction. And his (and my) client is sitting right there with him! And then, when I inform his compliance supervisor about this transaction, this supervisor doesn't even acknowledge that the transaction is prohibited!

SUMMING UP

Now that you have a sense of the environmental hazards, you'll need to have an understanding of the legal forces working in the industry. If you know what makes the people move, you will be in more control of your own destiny. In the next chapter we will take a look at those forces, but before we move on, let's review the salient points of this chapter:

1. One of the worst mistakes you can make is to approach your retirement years lacking a clearly delineated financial strategy. Congratulations—reading this book is an important first step in that direction. By the end of this book you will understand the workings of the financial industry and the motivations of the industry actors, and you'll know what questions need to be asked.
2. Be especially careful about who you choose to handle your finances. Unfortunately, some unscrupulous agents and bro-

kers do operate in this industry, and they're always on the prowl for retirees—especially successful retirees.

3. Seek reliable counsel whenever making complex financial decisions, especially if your understanding of the issues is not comprehensive. It's best to seek that counsel from an accountant, attorney or investment advisor.

CHAPTER TWO

Regulatory Issues

The previous chapter provided some horror stories involving the kind of chicanery prevalent in the industry. In this chapter, I'll start addressing some practical methods of self-preservation.

No doubt, you want to know how to protect yourself. That begins with choosing a competent and appropriate advisor to handle your financial affairs. But understand this: Making the right choice is not as easy as it used to be. Gone are the days when you could ask a friend or neighbor to recommend someone. The process has become much more complicated. Now you have to be able to perform your own diagnostics, so to speak. To do that, you need to know the right questions to ask.

This chapter will provide you with some of the basic knowledge you'll need. First, I'll focus on some of the legal forces at work within the industry—some regulatory and compliance issues. You'll learn about some of the inner workings of organizations like the Securities and Exchange Commission and the National Association of Securities Dealers and you'll see how their regulations can affect you. You'll also learn about exams and licenses and what the various licenses reveal about the registered representative who acquires them. And I'll reveal the essential questions you'll need to ask when seeking advice from these advisors. Finally, I'll explain why it would

be in your best interests to seek the services of an investment advisor over a registered representative.

REGULATING THE INDUSTRY

Everything in this industry is governed by a rule. This has to be understood by you, as an investor, so that when you consult with a prospective advisor—like an investment advisor or broker—you know the kind of rules that govern their operations. To help you understand the rules, I need to give you an idea of how the industry operates from the standpoint of the National Association of Securities Dealers (NASD).

Because of the NASD, different individuals operating in the industry are regulated by different licenses. You need to know what these different licenses are and what they mean to the licensee. Unfortunately, in today's climate, the average person doesn't comprehend the significance of various licenses. This is what allows brokers, insurance salesmen and others who give financial advice to the public the latitude they need to justify their suspect recommendations.

Some History

First, I'll need to fill you in with some background about the NASD. (Don't worry, this won't be a comprehensive history. That would fill an entire book and only weigh you down with too much detail. I'll only give you the most essential facts. And this information will be elementary but necessary to your understanding of the regulatory issues.)

In the early part of the 20th Century, the stock market operated under very little federal regulation—not even 10 percent of the regulation we have today. However, the big stock market crashes of 1929, etc., resulted in the creation of the Securities and Exchange Act of 1934. And this, in turn, created the Securities and

Exchange Commission (SEC), an agency designed to regulate everything that took place within the different regional stock exchanges that existed (New York Stock Exchange, Pacific Stock Exchange, Chicago Stock Exchange, etc.). Creation of the SEC resulted in four significant changes:

- The Federal Reserve Board now regulated credit.
- Anyone who wanted to become a stockbroker had to register with the SEC.
- Broker-dealers now hired brokers.
- The SEC involved itself with insider trading and it created net capital rules to govern broker deals.

So, in the aftermath of the stock market disasters, a federal body, made up of five government-appointed commissioners, was created to oversee the entire securities market. That was the basic arrangement.

But the broker-dealers—that is, the entities who owned the businesses that hired the broker representatives to sell to the public—balked at the idea of a regulating agency. In other words, they didn't want the federal government sticking its nose in their business.

So, in an effort to placate the government and, at the same time, get it off their backs, the broker-dealers came up with the idea of creating the National Association of Security Dealers, an organization that would perform a self-regulatory function. The broker-dealers took this idea to the SEC and essentially said, "Look, if we create this self-regulatory body within ourselves, we will police ourselves, and you won't have to get involved unless there is a major problem." The SEC agreed to the idea, and that's how the NASD was born.

The NASD soon took on a life of its own. In time, it produced volumes and volumes of very explicit and specific rules that gov-

ern every aspect of the industry. (To give you an idea how mad-deningly thorough the NASD is, let me give you an example of a regulation it created: No letter can ever go out to a client without being reviewed first. You can't even send out a simple letter to a client without going through special procedures, without having it filed in a special place, numbered numerically and signed off and approved by a compliance supervisor. That gives you an idea of how strict regulation is.)

But the most important thing that the NASD did—and the most important thing for you to know—is that it created certain series of exams for aspiring brokers. These exams established a base level of information that all brokers must know and set forth the rules that all brokers must live by. But these exams, broken down into different series, also represented different levels of experience. Registered representatives at different levels receive different licenses that defined their operational latitude (how much a broker is allowed to do for a client).

In order not to clutter your mind with excess baggage, we will only concern ourselves with the specific licenses directly related to the purposes of this book—that is, the ones that will affect you the most as a “successful retiree.” Here’s a rundown of what those licenses are:

Series 6 and 7 Licensing

The basic license that every broker needs is something called a “*series 63*.” In obtaining this license, a broker learns the differences between state registration of securities and federal regulation of securities. That’s all you need to know about that.

More importantly, beyond the basic “*series 63*” are the “*series 6*” and “*series 7*” licensing exams. These exams and their resulting licenses are germane to your situation. Specifically, you need to know how to distinguish the two.

The “*series 7*” represents a general securities license. The exam teaches the basics of investments, and the license allows a broker to buy and sell mutual funds, stocks and bonds. It is a very broad exam and, as such, it is one of the most difficult that the NASD gives. I strongly recommend that if you ever consider dealing with any representative registered with the NASD, you first make sure their credentials include at least a “series 7.” How do you find out? Simple. You ask. That’s all there is to it. No furtive background checks or Internet investigations are necessary. If you ask, the representative has to be truthful. (They *better* be.)

The “*series 6*” is a relatively new exam. It allows a broker to sell mutual funds and variable contracts—that is, the variable insurance contracts like variable life and variable annuity. A “series 6” reveals something very important about the licensee: A “series 6” person is restricted from the buying or selling of individual stocks or bonds. They are restricted to mutual funds or variable contracts. In more general terms, someone registered as a “series 6” comes from an insurance background.

Let me illustrate how these two series work: If someone wants to work at one of the large wire-house brokerages, they have to pass a “series 7” exam. If they’d rather work for an insurance company (a firm like State Farm, Aetna, etc.), generally, they will take a “series 6” exam. Insurance companies are only interested in the “series 6” credential. They have no interest in dealing with individual securities. They only want their agents to sell their insurance policies.

If you encounter someone who has a “series 6,” that should be an immediate tip-off. His primary concern is selling you insurance. On the other hand, someone possessing the “series 7” credential understands investments better than someone who only has a

“series 6.” And like I said, all you have to do is ask, “What series licenses do you have, a 6 or a 7?”

Should you decide you want to go with a broker, it’s especially critical that you’re able to distinguish between the two licenses. If it’s investments that you’re interested in, then you are going to want to look for someone who has a “series 7.” Why? Someone with a “series 6” license, while allowed to sell you a mutual fund, has never been taught even the basic information that the NASD thinks an individual should know about stocks or bonds inside mutual funds. Why would you want to hire someone to sell you stocks and bonds when that person never even passed the basic exam about bonds? To me, that doesn’t make any sense. Unfortunately, a lot of things go on in this industry that don’t make a lot of sense.

Now, I’m not saying that a “series 7” license automatically makes someone better than someone who has a “series 6.” What I am saying is that “series 7” and/or “series 6” will tell you where that person is coming from. Most likely, someone with a “series 6” works for a company that is only interested in having him sell you their insurance. These are the kinds of guys who like to do things like put variable annuities into IRAs (remember that from last chapter?). So you must be cautious. Individuals with a “series 7” license have a broader scope of knowledge.

The U4

Another item created by NASD regulation is the Form U4.

Whenever someone registers with the NASD, they have to complete a Form U4. This is a very thorough process, involving some very probing questions (e.g., “Have you ever been sued by a client?” “Has the NASD ever fined you for anything?” “Have you ever been convicted of any crimes?” etc.)

It's not enough that the NASD asks these questions. You want to pose them yourself. So don't be afraid to ask someone straight out, "Do you have a clean U4?" After all, you might be entrusting your finances to this person. (Much of this kind of information about an individual is also available on the NASD Web site at www.NASDr.com.) And you can generally ascertain the type of person you're dealing with by the kind of reaction your straightforward questions elicit.

But also keep in mind that if that person does have a "yes" on his U4, it doesn't necessarily mean a problem exists. Still, if there is a "yes" on the U4, you certainly need to get some disclosure from them about it before you hire them. (And they should be able to "come clean" with apparent confidence—not hem and haw and wipe their perspiring upper lip like Ralph Kramden caught in a compromising situation: "*Hummina-hummina-hummina!!!*" You get the picture.)

Asking about a person's U4 is one of the most effective ways in determining if you want that person to handle your money. For the most part, however, the public doesn't know about this form, so they don't know to ask.

The Series 24

The "series 24" license represents a higher level of responsibility than the "series 6" or "series 7" licenses. It is not directly relevant to you, but I include it to complete the picture of the NASD governance. This is the license that a general securities principal acquires.

The job of the principal is to oversee the broker representatives registered with the NASD (those with the "series 6" or "series 7" licenses). The principal oversees the representatives' business transactions and generally signs off on the transactions. So, before a general securities principal takes the "series 24" exam to obtain his license, he must take the "series 7" as a prerequisite.

A principal is also known as a branch manager. In any securities office, you will have a branch manager who is a principal and who looks over all of the representative's transactions from a compliance standpoint.

If there is a problem with any transactions—something where the registered rep committed a compliance violation—the NASD will automatically say that the principal didn't do his job and didn't oversee the business properly. The principal, the NASD is saying, should have caught that compliance violation. Thus, the principal, or branch manager, can be held accountable financially if a registered rep didn't do his job right. This is called “failure to oversee.”

Essentially, from a NASD standpoint, that is how everything works. So, if you are looking to hire a registered representative to handle your money, these are the two fundamentally essential questions that you want to ask:

1. Do you have a “series 6” license or a “series 7” license? (Remember, one isn't necessarily better than the other; it just tells you what school they came from, insurance or brokerage.)
2. Do you have any “yes” answers on your Form U4? (If they answer in the affirmative, then you must ask what the “yes” answers are about and can they explain them.)

“Caveat Emptor”

Still, just knowing that information isn't enough. In the current environment, you still have to be careful when choosing an investment advisor. Many things are going on right now that you must be aware of. For instance, Merrill Lynch, the famous brokerage firm, is charging fees for accounts now—something that investment advisors have been doing for 15 years. But Merrill

Lynch has cut a deal with the SEC so that their representatives don't have to be registered as investment advisors but they can still collect fees. That is clearly against what the regulation says. But because Merrill Lynch has a lot of muscle, it can staff its offices with brokers who charge fees yet aren't subjected to the same set of rules as investment advisors. How can this be in the best interest of the public? It can't be. Essentially, what happens here is that you go to Merrill Lynch expecting to hire an investment advisor and you get stuck with a broker.

There is a big imbroglio going on about this, and I don't know how it is all going to play out. But I can tell you this: I have clients come into my office who are in the Merrill Lynch plan, and their portfolios are still suspect. A close look at these portfolios tells me that these clients have "been brokered."

REVIEW

Let's review some of the questions you need to ask when you are shopping around for someone to handle your financial affairs. (And if someone has a problem with that, would you want them handling your money?)

- Are you registered with the NASD?
- What type of license do you have, a series 6 or series 7?
- Are there any "yes" answers on your U4 form?
- If so, what are they and can you explain them?
- Are you registered as an investment advisor? (If they are, then ask to see their ADV Form Part 2.)
- Can I see your investment advisory contracts? (And when you read those contracts, look to see if they are registered with the SEC and if they are registered in your state.)
- How long have you been in business?
- Can you provide me with any evidence of the rate of returns of your other clients?

Now let's review some of the basic information you should remember:

About licenses:

- Someone with a series 6 license has an insurance background and will be interested in selling you insurance policies and variable annuities.
- Someone with a series 7 license has a brokerage background and will be interested in selling you investments like stocks, bonds and mutual funds. His main interest is drawing a commission from your money.
- Someone's U4 is a public document; you're entitled to see it. (Information about someone's U4 is also available on the NASD Web site at www.NASDr.com.)

Investment advisors vs. brokers:

- An investment advisor must be registered with the SEC in order to receive compensation for investment advice. This rule does not apply to brokers.
- An investment advisor is a fiduciary to the client; a broker is not. Therefore, an investment advisor always looks after his client's best interest. He has to. A broker is not required to conduct business in such an altruistic fashion.
- An investment advisor operates on a higher level of responsibility than a broker does. If an investment advisor tries to screw a client, the investment advisor will go to jail.

- Despite the fact that an investment advisor is privy to a lot of inside information, the investment advisor cannot place himself in a better position than a client.
- An investment advisor is required to give a client full disclosure (Form ADV Part 2)
- The investment advisor-client relationship must operate under a contract.

All of the above make the investment advisor the better choice.

In the next section of the book, we will begin looking into specific investments and specific planning techniques.

CHAPTER THREE

Major Mistakes Retirees Make

In this chapter, I'll continue focusing on the basic information you'll need as you assume your new role as a successful retiree.

This chapter harkens back to the “hazard” issues raised in Chapter One—the self-created hazards involving lack of strategy and lack of counsel. In this chapter, we'll get into some of the more specific major mistakes retirees tend to make relating to those issues. These mistakes include not having an investment system, not identifying the financial risks areas pertaining to retirement, not knowing your performance rate of return, and not designing a strategy.

BASIC MISTAKE #1: NO INVESTMENT SYSTEM

Essentially, people who have no investment system operate without a method. This is the wrong approach. When you invest, you should utilize a method that has some degree of historical basis—that is, it has proven in the past to be effective.

The problem begins when people are advised to, or will try to, do their own investing. Whether it is through no-load funds, stocks or bonds, investing over the Internet, or through discount brokers, too many “wannabe” investors make decisions without basing those decisions on a conscious and concrete strategy. People

who take this approach often succumb to the “chasing effect.” They “chase” after the market based on what they hear through the usual pipelines—casual advice or news reports. Chasers fall victim to faulty information or hype. Chasers lured by hype always run behind the eight ball.

Let’s use the case of technology stocks as an example. For a while, that’s all you heard about. We were subjected to an information overload about technology stocks and how wonderful they were supposed to be. You’d open the papers, or you’d turn on CNBC, and reporters, columnists and commentators extolled technology stocks as the new Holy Grail. “Technology stocks are going through the roof,” they all said. “That is what you gotta buy!”

And what did other investors say?: “Technology stocks are great! That’s what I read in *Barrons*. That’s what I read in *The Wall Street Journal*. Hey, that’s what I’m going to buy!”

However, what most people don’t realize is that, by the time such information appears in the papers or on TV, it’s already old news. Investors basing their decision on news reports are only chasing after a market. They are not staying on top of or ahead of the market—which is what savvy investors are supposed to do. Keep this in mind: News reports are in the past tense. In a sense, reporters are covering history. What they’re telling you happened a day ago. And if that is what you base your investment decisions on, you are literally going to be a day late and most likely a dollar short.

Consider what happened with those wonderful technology stocks. Everyone went out and bought them without realizing they were buying at the wrong time. They were, in fact, buying when perhaps they should have been selling. That’s why technology stocks turned out to be a big bust.

It's an old story, really. Too often, investors buy when they should sell and sell when they should buy. Here's another example: Remember what you read about small cap stocks? Back in 1997 and 1998, the rap on small cap stocks was how they "under-perform, under-perform, under-perform!" You couldn't find any good press on small cap stocks. The average investors believed they wanted to steer clear of small cap stocks because the news media was telling everyone not to buy them. Those who owned them wanted to unload them. Unfortunately, almost everyone missed a gigantic move that outpaced the rest of the market late in 1999.

Peter Lynch, the well-known investment expert and author, put it precisely and succinctly when he said that, if left to their own devices, investors will usually buy at the wrong time and sell at the wrong time.

I find that retirees, as a group, tend to be especially influenced by the media. This is a big mistake on their part. It exhibits a lack of fundamental knowledge about what is really going on with their investments. So, as far as your investments are concerned, you have to do more than just trust your gut or read the papers. You need to apply a structured investment system that, essentially, disconnects your brain from your stomach, because your stomach will always cause you to lose money.

Which System?

At this point, you must be asking, "Okay, so what investment systems work?" Well, there are various systems that are effective, and we'll go over these systems in detail later in the book. Right now, let's just stick with some of the basic information that you need to know.

Here is the most basic bit of information that anyone can give you about the market: No one ever knows where the stock or

bond market is going. That's an immutable truth, and it's a fact you have to understand and accept from the outset. Knowing where the market is going is like predicting the future—no one can do it.

The only way to deal with the market's uncertainty is to come up with a methodology that allows you to operate in various market conditions—bull market, bear market, sideways or flat market. This is where Modern Portfolio Theory comes in. Modern Portfolio Theory, developed in the 1980s, addresses why people make money in the market as well as what are the key issues that create performance. This is also called *asset allocation*.

Asset Allocation

Do you want to know the secret to doing well in the market? It's asset allocation. Asset allocation states that one fundamental decision you make will be responsible for about 90 percent of your long-term return. And that decision involves percentage of allocation—what percentage you will put in cash, what percentage you put in bonds and what percentage in stocks as well as what types of stocks and bonds.

Asset allocation is the concept that really determines what an investor will make—not whether you get into the market at the right or wrong time, or whether you buy Microsoft vs. Cysco (or any equivalent comparison).

Allocation also is broken down into different types of stocks and different types of bonds. Now, some people believe that you should put your assets in the portfolio, leave it alone, never touch it, don't pay attention to it. No human being, they say, has the ability to make any improvement to your rate of return. Some claim that asset allocation doesn't even work. They say you can do just as well by picking a bunch of different stocks and waiting to see how they will do. But I definitely think there's a place for

asset allocation in terms of a system. And, as I say, we will go into investment systems in much more detail later in the book.

BASIC MISTAKE # 2: NOT IDENTIFYING RISK AREAS SPECIFIC TO RETIREMENT

There are several significant financial risk areas that retirees don't know about or simply choose to ignore. These risk areas involve issues that could negatively impact your retirement income in a profound way—make no mistake about that. These areas include:

- The IRS, or tax planning
- Health care
- Inflation
- Income
- Estate planning

The IRS, or tax planning

Many successful retirees have very large 401(k) or IRA positions. As soon as they turn 70-and-a-half, the IRS will come knocking on their door wanting some withdraws. How will the retirees handle that? And how can they make sure that money goes to their heirs? They need to know how to deal with all the tax ramifications of that income.

Unfortunately, many people think that tax planning only entails sitting down with an accountant sometime between New Year's Day and April 15. Trust me, there's more to it than that. Tax planning, especially for someone like yourself, the successful retiree, involves creating a long-term, comprehensive tax strategy that minimizes the effect Uncle Sam will have on your income—or your estate, or your kid's situation, for that matter.

I feel that effective tax planning should involve both an accountant *and* an investment advisor. Why do I feel that way? Many ac-

accountants have a difficult time looking beyond the present situation (“How much do you owe the government this year?”). Therefore, they have trouble devising and applying long-term tax strategies. Clearly, an accountant should be involved in that kind of process, but an investment advisor will have a more clear idea how to design a long-term strategy. (At the same time, though, I find that some successful retirees don’t even use accountants. Usually, they have very simple tax returns and try not to use accountants. No need to put out that extra expense if it’s not absolutely necessary.) Generally, people don’t know they have a tax-planning problem until their investments lose money one year and they still have to pay tax. A long-term strategy can help you avoid that problem.

A long-term tax strategy can be cut up into three pieces: non-IRA assets (how you handle those from a tax standpoint), IRA assets, and estate tax.

- For your non-IRA assets, the simple rule of thumb is to figure out if you have a tax problem, and the way to do that is by determining your actual tax rate. To determine your actual tax rate, you take how much money you made and divide it by how much you made in taxes. That will be your rate. Very often, people are surprised at how low that number actually is. But that is today, and you may not be taking large withdrawals out of your IRA. What about down the road? Also, you may not have doubled or tripled your investment portfolio like you should have up until this point in your life.
- For your IRAs, you need to start taking withdrawals at age 70 and a half (that is the IRA rule most retirees are familiar with). But how do you calculate that withdrawal? You may want to ask yourself if you should take the lowest withdrawal. Or you may want to convert some of these assets into differ-

ent types of IRAs, like a Roth IRA. How do you want to deal with that type of issue?

- As far as the estate tax is concerned, congress has helped to raise those brackets—as to who will pay estate tax—and it is clearly an issue for the successful retiree. Those with a \$700,000 estate, with competent investment management, are going to have estate-planning problems in their future.

One example of how this all ties together is with the concept of “gifting.” Is gifting your assets to your children a reasonable strategy? How will that affect you from a tax standpoint—income tax, capital gains tax? There are a lot of different issues that concern you.

It is very easy to pass over the tax issue. But that only creates a scenario where you and your spouse have passed away and a big tax bill remains to be paid. Who do you think will be hit with that bill? Your kids will; be sure of that. I have some clients who tell me that they don't let it worry them too much. “I started with zero,” they say. “At least the kids are getting something.” And then I have other clients who are acutely aware of this issue and they want to do their utmost to minimize any estate tax.

The problem with estate tax rates is that they are very high. So the key is a long-term, comprehensive, overlying tax strategy for multiple years.

Health Care

For many retirees, the health care issue is something they just don't like to think about—for any number of reasons. But they'll have to deal with it, as this is an area of significant risk.

The probability of somebody in the successful retiree age bracket going into a nursing home is extremely high. And the cost can be

absolutely devastating to the estate. Again, I know that people don't like to think about this, but I urge everyone to think very hard about the long-term health issue.

Because of recent medical advancements, yours is the first generation that really needs long-term health care. If you look at the charts (and I'll show you them in next chapter), you'll see that people now live longer than ever before. Medical science is getting better and better at keeping people alive. Some people are even "outliving" their bodies—that is, their bodies collapse around them. It's a scenario that can create significant financial damage to a family. It also extracts a profound emotional toll.

But these issues can be very easily handled through long-term care. If your assets are above a certain level, you want to buy long-term health care insurance. I assure you. (Also, depending on your asset level, you may want to try and qualify for Medicaid.) If handled correctly, long-term care premiums can be relatively inexpensive; you don't need to buy the "Rolls Royce" plan, so to speak. In fact, most people are shocked when they find out how inexpensive it really is, relative to their total assets. Couple this with the peace of mind it provides, and you'll see that long term health care is quite a bargain. Believe me, it will mean a lot to you to know you'll never become a burden to your family. And with the benefits that can come with it—like in-home care—long-term health care insurance is a great product. I recommend it for most of our clients.

Unfortunately, many people don't realize the benefits of long-term care. This shortsightedness can be devastating. I've seen large investment portfolios cut right in half by the cost of nursing home care. If and when you need long-term care, you could be looking at a bill that runs as high as \$70,000 a year. So this issue is critical, as your retirement money has to go a long way. When you assume the risk yourself, you are taking a *major* risk.

With life longevity being what it is today, it's very likely you're going to need long-term health care. I highly recommend it, and I'm not even that big of an insurance fan. I think the premise of insurance goes inherently against the consumer. The idea behind most insurance is that you are never going to use it but you're still going to pay for it all of your life. But the odds are that you are going to use your long-term health coverage. (Again, I'll cover that in the next chapter.) So it is critical to your financial well being—not to mention your physical well being—and it has to be done right. Like any financial tool, it can be abused. But used properly, it can be extremely effective.

Inflation

Investment advisors call this inflation risk, or the ultra-conservative risk. The typical scenario involves an investor heavily into CDs and bank instruments who tends to be frightened by the thought of any loss through investment.

Inflation risk is basically being too conservative with your investments. Conservative investors are so frightened of seeing their principal go down that they sacrifice the ability to keep pace with the cost of items that they must purchase to live—things like food and medicine. We see this in the older population—people in their 80s whose primary investment vehicle is a CD. Here's what happens to them: When investment rates plummet, they find themselves without an income. To put it bluntly, they can't afford to live anymore. Inflation ate up all the purchasing power of their dollar. And the only reason they're in that situation is that they were afraid to take any market risks.

What we're talking about here is the erosion of your living standard, and that is grim scenario. As grim as it is to consider, it's far worse to endure. You want and need to be able to live at the same level in 20 years as you do now.

Income Risk

Does your portfolio have the ability to produce the most efficient income stream without sacrificing the ability to keep pace with inflation? That's another question you need to consider.

Estate Planning

Proper estate planning means having legal control of all your assets in just about any situation. True, this area attaches itself to tax planning. But when we speak specifically of estate planning risks, we speak specifically of the risks involved with not drafting the proper wills or trusts. Generally, wills and trusts only benefit the next generation. However, other important legal documents comprise this area—medical power of attorney, for instance. Medical power of attorney becomes very important in the event of either spouse suffering a disability. Allow me to explain why. Very often I find that either the husband or the wife will handle the finances. You rarely see both equally involved. So, what if something should happen to the partner that handles the finances? What if they become disabled? How does the other spouse then control the assets? That's the kind of scenario that needs to be considered.

BASIC MISTAKE #3: NOT KNOWING PERFORMANCE RATE OF RETURN

Retirees also make a mistake—and run into serious problems—when they don't know the performance rate of return of their investments.

I find that successful retirees rarely know their investment performance rate of return, the actual number. This has always troubled me. If you're paying someone a commission or a fee to manage your assets, then you need to sit down with that person and have them tell you what your assets made—whether the

news be good, bad or ugly. They need to compare your performance rate with how the rest of the market fared.

Generally, brokers won't do this for you. They may pass you off to another investment advisor who will send you a statement or something similar, but the broker—who is supposed to be getting paid for this—won't have that kind of information readily available.

Here's a typical scenario involving performance rate of return: Let's say that in one year your investments returned 6 percent. Well, in that same year, you could have gone to the bank and bought a CD and made 6 percent. In this situation, how did your investment advisor do? Not very well. There's virtually no risk involved with a bank CD, but your investment portfolio could have suffered a drop.

By knowing your performance rate of return, you'll be able to judge the performance of your investment advisor or broker. He should be held up to some standard of responsibility. That's not to say you can't have a bad year; that's all part of the market. If you were down because the market was down, fine. That's a normal occurrence. But if you were down and the market was up, that could be the fault of your investment advisor or broker, and you should be able to discern that very easily. It should be readily apparent. Your investment advisor or broker should be able to provide that information. You should always know your performance rate of return.

And pin it down for this year *and* the long-term as well. Don't be satisfied with being able to say, "I went up this year." If you've been using an investment advisor for five years, you should know what his rate of return is. Remember what you're paying the investment advisor or broker.

BASIC MISTAKE #4: NO STRATEGY

This is the do-nothing approach. People fall into the trap of thinking that if they don't do anything, they won't make a mistake. Wrong. You have to be proactive with your finances. And don't take two or three years to mull over a decision. By the time you decide to act, it may be too late.

REVIEW

Before moving on, here are the important points you should take with you take from this chapter:

1. Approach investing with a methodical approach, or *system*.
2. Be acutely aware of the risk areas specific to retirement finances:
 - The IRS, or tax planning
 - Health care
 - Inflation
 - Income
 - Estate planning
1. Devise tax-planning strategies for the long term.
2. Assume that you *will* need long-term health care.
3. Make sure that your investments will keep pace with inflation.
4. Like tax planning, estate planning should be designed with the long term in mind.
5. Always know your performance rate of return for this year *and* the long term.
6. Above all, do *something*. You must learn to be proactive about your finances.

CHAPTER FOUR

Long-term Medical Care

Health care is one of the most crucial issues you'll face in your retirement years. In fact, it could become the most crucial issue.

So let's state it right up front: At some point in your retirement, it is highly likely that you will have to pay expenses for long-term medical care. You should prepare yourself now for the nearly inevitable, because, as you'll see, illness and debilitation could cause devastating damages to your finances—in almost one fell swoop. Successful retirees make a crucial mistake when they don't deal with the health care risk right at the outset.

We need to confront this risk, specifically the disability issues, armed with knowledge and preparedness. To that end, this chapter looks at the long-term health care policy: who needs it, what types you'll need, how to pay for it, and what features you want to look for.

WHAT IS A LONG-TERM CARE POLICY?

Everyone has bought some kind of insurance sometime in their life—car insurance, at the very least. Almost certainly, you've bought homeowners insurance as well. So you know about insurance; this is not an alien concept. The reasons for these standard forms of insurance are obvious. If something catastrophic

happens to your home, for instance, you just can't replace it by simply writing a check.

You need to apply the same concepts of standard insurance policies to disability. If, for some reason, you become disabled, the prime concern is not how much you are going to lose right now but how much it is going to cost you.

Essentially, a long-term care policy is a disability policy—a disability policy for the later years of life. Throughout this chapter, when I refer to a long-term care policy, I'll be talking about a disability policy.

Another point to understand: By long-term health care, I don't mean the kind of health care insurance you had with your former employer (or the kind of health insurance you needed to buy if you were self-employed). I'm also not talking about the kind of disability coverage your employer provided if, by chance, you were to become disabled on the job. However, the concept of the long-term care is very similar. Long-term care essentially replaces the kind of disability coverage you had when you worked. The reason you got disability coverage at your former place of employment is basic: If you became disabled, you still needed to bring home some kind of salary to pay the bills. Long-term care does the same sort of thing. A long-term care policy is a relatively new product designed by the insurance industry for retirees. And it's a good one.

A long-term care policy works this way: Even though you're now retired, you're still going to have to cover yourself financially if something happens to you. You've amassed a nice amount of assets—a “nest egg,” as they call it—and these assets are what will take care of you from now on. In a sense, these assets become like your previous employer in that they now provide you with your income. A long-term care policy is something this new “em-

ployer” provides for you. Of course, this coverage comes out of your “paycheck,” so to speak.

We’ll see how all this works, and I’ll show you how to buy the best coverage while taking the least amount of loss to your principal.

THE ODDS

First, to understand why long-term health is such an important issue to the successful retiree, we’ll need to look at the current healthcare climate in the United States.

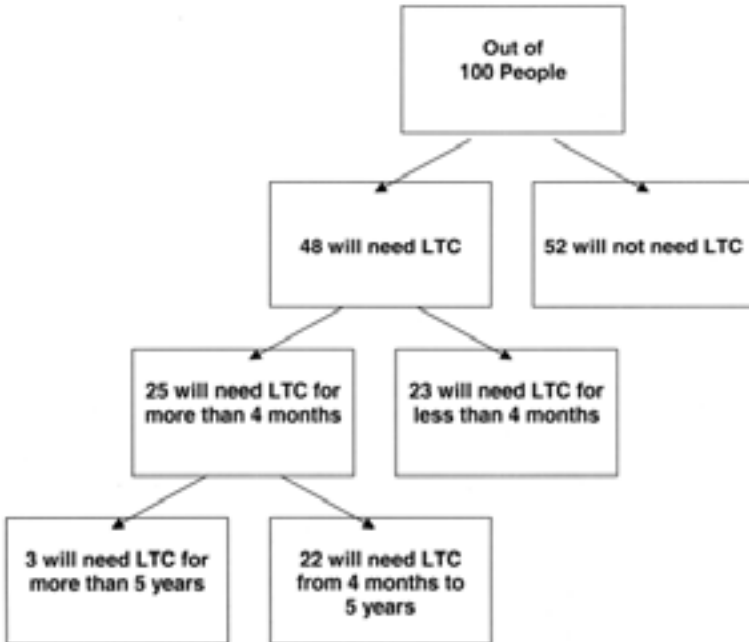
As I’ve stated in previous chapters, medical science keeps getting better at keeping people alive. Life spans are being extended. Life expectancy is increasing. You’d probably be surprised at how long you may be expected to live. Let’s look at some numbers released by the IRS in 1997:

Current Age	Life Expectancy
65-68	85
72	86
73	87
74	88
75	89
76	90
77	91
78	92
79	95
100	103

According to this chart, if you’re 65, you can expect to live another 20 years. That’s a long time. And keep in mind that these expectancies are conservative. Also keep in mind that life spans are only going to continue increasing.

This has some serious implications for you. What we are beginning to see is that medical science will soon outpace the body's ability to handle what medical science can provide. In a sense, many people will start outliving their own bodies. And that is what we're trying to take care of with long-term care.

So, what's the real chance you'll need long-term care? Let's look at some more numbers, from the Modification of National Nursing Home Survey, Society of Actuaries released in 1997, to demonstrate:



The chart starts with 100 random people. According to the survey, 48 of those randomly selected are going to need long-term care policy. They *will* need it. And that is a huge percentage—almost half. Look at the percentages involved in other insurance

policies: The chances of your house burning down are 1 in 75. The chances of totaling your car in an accident are about 1 in 70. So, when you say that almost half the people in our random hundred will need long-term coverage, you're talking about close to 1 in 2. And the number will only become greater in the future, thanks to the advances in medical science. This is coverage that you *are* going to use—much like your current medical insurance, which you use yearly when you go to the doctor. (Most people don't mind paying the premium for that medical insurance. It's expensive, but they see some direct value from it. And most people don't even mind paying the premiums on homeowners insurance, even though most people won't realize any direct value from it.)

The chart goes on to delineate that, of those 48 people who will use the long-term care, 25 of them will need it for more than four months. (In theory, you need long-term care for less than four months.) Three people will need long-term care for more than five years, and 22 will need it for four months to five years.

So, 22 percent of the random hundred are clearly going to use the full benefits of these long-term contracts. And, again, that is a pretty large percentage. That's one in four people who are going to have to pay for medical expenses, or coverage.

So, in summary, life expectancy is increasing. Medical science keeps getting better at keeping people alive. This creates a situation where a high percentage of the older population is going to be faced with expenses for long-term care.

WHO NEEDS LONG-TERM CARE?

Everyone should have disability coverage, but that doesn't mean everyone needs a long-term care policy.

So who would need it?

Well, successful retirees do, and that would be you. Now let me explain why.

Someone whose assets fall below \$400,000 does not need to buy a long-term care policy. That's not to say that they don't need or want disability coverage. They do and they should. But, because of their asset level, they need to find alternatives to long-term care. In fact, the industry has adopted an unofficial rule of thumb: Someone whose assets total less than \$400,000 can restructure their estate so that, should they need long-term health care beyond the scope of Medicare, they can qualify for Medicaid on a disability-needs basis system. But there are significant planning steps they need to take to do this. (Those steps really fall outside of our focus group [the successful retiree] so we really don't need to go over those steps. But anyone whose assets fall below \$400,000 will need to restructure their estates in this fashion, because they will need the coverage. A competent elder care attorney can help with that restructuring.)

Someone who has assets of \$1.5 million or above also does not need long-term care (but, again, they need disability coverage). If someone has assets of \$1.5 million and is reasonably managing those assets (not pulling out something like \$150,000 for income), the long-term care is not really necessary because that person has enough capital to pay the average nursing home cost for a year (somewhere between \$60,000 and \$90,000 annually). Someone at this asset level can handle paying those bills themselves without significantly eroding their estate.

That now leaves us with the people whose assets fall somewhere between \$400,000 and \$1.5 million. These are people who fall within the financial bracket that I call the "successful retiree."

This is the group that needs the long-term care policy. And, of course, this group may include you.

The successful retiree has too much net worth to qualify for and collect from Medicaid, yet they do not have enough assets to handle the expense of self-insurance in the event of long-term care need. Costs of such a need can drain \$5,000 or more per month from an successful retiree's estate, and that's a big hit to take. For married couples, that creates a significant income hardship for the healthy spouse.

I'll state the case more explicitly by assembling an example from the information I gave you earlier. Let's start with the statistic that says 22 percent of the random hundred people selected are going to need long-term care for four months to five years. For the moment, let's place you in that situation and suppose that one person in your household is going to need long-term care for three years. (Based on statistics, this is a reasonable assumption.) For those three years, the total costs could run anywhere from \$180,000 to \$300,000. High or low, that's a significant amount of money. Let's say that you had \$700,000 in your total estate, placing you right in the middle of the "successful retiree" market, and you had to draw \$300,000 from that to pay for the long-term care. That would affect you in two ways. First, and most significantly, it impacts the security of the remaining spouse. Life just became a little bit more risky for your immediate family (your wife or husband) because now you don't have as many assets as you once had—and counted on having—to take care of the future. It will also affect any possible inheritance you planned on leaving your kids. So this is an acute risk, as it is very expensive.

So I highly recommend that people who fall into this middle range (between \$400,000 and \$1.5 million) investigate long-term care insurance. As a matter of fact, if you were one of my

clients, I'd have it in your file that we talked to you about it. That is how strongly I feel about it, and, as I said before, I am not that big of an insurance fan. But we actually offer long-term care in my firm. We have someone who is licensed for insurance who is an employee, and they handle that coverage. We want to make it as easy as possible to get this coverage, because we firmly believe in it.

HOW TO GET LONG-TERM CARE

Hopefully, by now you understand who needs long-term care. Without long-term care, disability can inflict severe damage on your finances. And you should be fully aware of how likely it is that you will use the coverage in some format. None of that should have been difficult to grasp. Those numbers are pretty straightforward.

Okay, now that you know you need it, how do you get it?

Well, as you can imagine, every insurance company has their marketing machines working at full-tilt sending out everything in the world they can about this type of coverage. And it is required by law in most states that everyone receive a brochure, produced by the National Association of Insurance Commissioners, that talks about long-term health care insurance. The brochure is basically a shopping guide for the coverage. It helps you to understand some basic terms and ideas.

Unfortunately, a long-term care policy is a relatively new product. And it is a relatively lucrative product for commissioned salespeople. So you have to be careful whenever a big commission is involved. Abuses do happen.

But I'll go over some of the features of long-term care so you'll know what questions to ask. In other words, I'll have you better

prepared when you intend to buy. What I'll do is take a long-term care policy and try and break it up a little for you, point out the critical elements.

Daily Benefit

The daily benefit is the figure that long-term care will pay on your behalf to a facility if you need inpatient care (a nursing home, for instance).

The first thing that we need to do is determine what you think your daily benefit is, as long-term policies pay a daily benefit. This really gets down to where you fit in that spectrum (\$400,000 to \$1.5 million). It has to do with the fact that a person with \$600,000 in assets will suffer greater damage by a \$300,000 bill than someone with \$1.1 million in assets.

The person with \$1.1 million might be able to do what we call "self insure," which means that they might not have to buy as much coverage. They won't have to transfer a risk, as we call it, to the insurance company. But the person with \$600,000 would probably need to transfer that risk to the insurance company. (Stating it another way, you're letting the insurance company take the risk.) The person with \$1.1 million may only transfer 50 percent of the risk, because he can pay the rest out of pocket and, therefore, doesn't have to pay as much in premium.

So, the daily benefit is a critical element. In long-term care policies, you tend to see daily benefits of \$100 a day, or \$125, or \$130. It can vary depending on different circumstances. Depending on what features are being used, I like to see a daily benefit of about \$120. That's an average figure. What the daily benefit refers to is the daily cost of an inpatient facility. The \$120 figure is what the facility is going to be paid each day on your behalf.

Increases

Next, you have to look at the policies and see if that dollar amount for the daily benefit will stay fixed or will it increase over time. Essentially, this involves inflation protection, and this kind of protection increases your insurance benefit over time to keep pace with the actual cost of long-term care.

We know from recent history that health care costs are only going to go up every year. So, do you increase your coverage each year or not? It would seem a prudent thing to do. And there are two ways you can increase the coverage: the flat increase or the compound increase. To illustrate the difference between these increases, let's use an example with that \$120 figure. If your policy has a \$120-a-day benefit and it has a flat increase of 5% a year, that figure will only go up 5% each year. With a compound increase, you get a lot more coverage in terms of money, but you also pay a lot more. With a compound increase of 5% on \$120-a-day, that figure compounds 5% a year.

If you look at the calculations, that compound "rider" gets you into some very big numbers. So, if you are 60 years old right now and you think you'll need the coverage when you are 85, then you may be buying a lot more coverage than you may really need. So be careful with "riders." This amount of coverage might sound real good right now, and it might sound like something you should get, but it can also be expensive. You don't want to spend more than you really need to spend. "Riders" tend to bring with them a whole lot of premium. So look at the long-term effect. I'm not saying that these are inappropriate, but if your assets are growing, you may not need the compound type of increase. You may just want to stick with the flat 5% increase, or something similar.

Home Care Benefits

Another issue you need to know about is home care benefits. Many policies will provide for a friend, relative or neighbor to

come over to your home and provide some care. For instance, if you can't get around as well as you used to, and if you can't take care of your home as well as you'd like—but you don't really need to go into a facility—a neighbor can come over to help out. The policy will usually pay 50% of that inpatient benefit to the neighbor. So that's about \$50. If you need in-home nursing care, the policy will pay about \$50 (with the \$120 daily benefit). And I find that that figure is usually adequate for anyone's needs. So when you look at a policy, know that you are buying that as well. All together, you have your daily benefit, your inpatient (in a facility) benefit and your in-home benefit. Home care benefits are used to pay for skilled nursing care at home in many cases.

Costs

So how much long-term care do you buy and how many riders do you want to use? Unfortunately, there aren't any rules of thumb to govern your decisions in that area. But a competent investment advisor or insurance advisor can help you determine what you need.

The key to long-term care is that you must coordinate your chosen policy with the growth of your estate relative to investment and the estate planning. It all has to form a cohesive piece. Very often, I see situations where people decided to buy the "Cadillac" plan from an insurance salesman and they wound up buying more coverage than they really needed and paying more than they should.

There has to be coordination between how the investments are growing and your insurance need. Take a guy who has \$700,000 in assets and who takes out \$30,000 a year for income and piles the rest back into the principal. If you look back into the growth of his investment portfolio, you'll see that he'll eventually get to the point, in about 10 years, where he'll be able to self-insure.

This brings up another point about buying long-term care: It helps to have a cohesive team of advisors. I generally don't recommend a situation where you have a completely different investment guy, a completely separate attorney, and a completely separate insurance guy who never communicate with each other. That's when I see policies that are inappropriate for clients. So your long-term care needs to be part of a total plan on how you are going to manage different risks during retirement.

Waiting Periods

When you look into long-term care, you are going to be asked what kind of waiting period you want to use. And here's what you need to know about that: Basically, the waiting period refers to when benefits start to kick in. If and when you need to go into a facility for some inpatient care, your policy won't start paying your expenses at day one. Before it starts paying, the company wants to wait a certain period of time, to see if you'll recover and get out.

Generally, this is how a waiting period works. As an example, let's look at a 60-day elimination, or waiting, period. A 60-day waiting period doesn't mean you are going to start getting a check at day 60. Actually, you won't start getting a check until day 90. However, your benefits do trigger at day 60; that is, they turn on. But you need to accrue those benefits for 30 days until such time that the policy pays. So keep that in mind: You won't start getting a check until 30 days plus the elimination, or waiting, period.

This gets back to the idea of how much of this care can you self-insure? Obviously, if you only have a 30-day waiting period, the policy premium will cost a lot more than if you have a 180-day waiting period. So you might want to self-insure at the beginning of this process (remember, 22 percent of people will need long-term care for four months to five years).

Activities of Daily Living

Another thing you need to know about your policy is how much care you'll need to receive before the benefits are triggered. How disabled do you have to be? This gets to the heart of what long-term care is, and it is determined by a something called an ADL.

You need to be familiar with this term. ADL stands for Activity of Daily Living. According to the National Association of Insurance Commissioners, the ADLs are bathing, eating, dressing, continence, toileting and transferring. These are the traditional ADLs, or the activities or functions that everyone needs to do on a daily basis. You are often considered disabled if you can't perform two or more of these activities without some kind of care. When you look at a long-term care policy, you need to look at how many ADLs it says you need to have before you'll get care. Does it take two? Or, do you need to be unable to perform three of those daily functions before the benefits turn on? Five? Six? A particular policy will determine how impaired you have to be before you are going to get care, and that will determine the quality of the contract. You want to buy the most liberal policy available, which means a policy with the least amount of ADLs. This is critical: *You want to buy a policy with the least amount of ADLs needed to trigger benefits.*

Cognitive Impairments

Most policies also consider cognitive impairments. Cognitive impairments result from a condition like Alzheimer's disease. A cognitive impairment will automatically trigger benefits. In fact, most contracts will say that cognitive impairment or the inability to perform a certain number of ADLs triggers benefits. Let's say you buy a policy that states that your benefits turn on if you suffer cognitive impairment or the inability to perform two ADLs. Whenever one of those two things happens, that's when the waiting period starts and that's when your benefits start to accrue.

Pre-existing Conditions

Another factor that determines the quality of a long-term care contract is pre-existing conditions. When looking into long-term care, you have to consider any pre-existing condition you might have, which could be something as simple as using a cane or something more serious like diabetes. And then you have to see if that pre-existing condition will be covered by the contract and how long you will have to wait before the contract will pay benefits for that condition.

Can You Afford It?

When you put all of those factors together, what do you come up with? What is the bottom line? How much is this going to cost you?

The government has tried to assist people in buying long-term care. They have tried, through tax law, to encourage people to buy it. To this end, the government created what is known as a qualified contract—a contract with special tax qualifications that make the premiums tax-deductible in certain situations. Generally, I encourage people to buy the best policy. It is simply not a smart move to buy a bad policy because you can deduct the premium. Unfortunately, some insurance salesmen will use this as a sales tactic, a bait for you to buy. Don't swallow it. The red flag should rise whenever someone leads his sales pitch with something like that.

The key to affording long-term coverage comes down to three very basic things:

- Are they going to pay?
- When are they going to pay?
- How much are they going to pay?

As I said—very basic.

So, can you afford it? The premium will be an annual or monthly bill, and generally, the clients I deal with have always been surprised at how inexpensive it really is. With my clients I use a general rule of thumb as far as cost: We will not exceed one and one-half percent of invested assets to pay for long-term care. That's it. That's all it takes. It's an amount you can very easily take out of your portfolio without creating a major problem with your future income from the portfolio.

Whenever I first meet clients, I always put the questions to them: "Do you need this care?" "Do you fit within that group?" Then I proceed to demonstrate why they do. Then I reveal how much it will cost them. I lay a budget out on the table (coverage for husband and wife). If a client has \$1.5 million in assets, he's looking at \$10,500. (He'll never spend that much, however.) For a guy who has \$600,000, that percentage (about \$6,500) will be about as much as he can afford. For any policy that goes beyond that one and one-half percent, you need to look into self-insurance or into why that particular policy is so expensive.

DENIAL AND RISK

This next area really has nothing to do with the nuts-and-bolts elements of a long-term care policy, but it is important nevertheless. It involves perspective: How you choose to perceive future risks can very well affect how you live the rest of your life.

True, the topic of illness involves some harsh realities. And for that reason, many people choose to avoid it. But avoidance is a tact that only results in small problems becoming big ones and big problems becoming even bigger.

Unfortunately, I find that too many people are in denial when it comes to health care realities. Often, many of them even scoff at

the notion of needing long-term care, despite so much overwhelming evidence in its favor. Others might just downplay its importance, as in the case of the husband who looks at his wife and says to her, “How about you just take care of me and I’ll take care of you if anything happens to either of us.”

I cringe when I hear something like that. Basically, what they are saying is that they’ll allow themselves to become a burden to their spouse. Why would anyone want to do that to someone else? To someone they love?

But that’s not all I hear. People tell me all kinds of things:

“My aunt Bessie lived to be 103.”

“We don’t need it. We’re from hearty stock.” (Whatever that is supposed to mean.)

“Nahhhh, we don’t die.” (Someone actually told me that.)

“We’re long livers.”

Yeah, I’ve heard them all. I hope they sound as ridiculous to you as they did to me. And I hope they’ll sound even more ridiculous if you ever hear them coming from your own mouth.

If any of those statements reflect your own attitude, I hope you’ll stop and allow yourself a moment to take a reality check. After all, we’re not talking about risking a great deal of money here. What we are talking about is prudent management. I don’t see how anyone can dismiss long-term care if they can stay within a budget. I know people don’t like talking about serious illness, but it’s a harsh fact of life that won’t go away. It’s better to deal with it now than later.

Another thing that people will say is, “We’ve just started retirement. We feel good. We’re only 60 years old. Why do we need it now? We’ll just wait and deal with it another time, maybe in about 10 years.” Well, no one can ever know what is going to happen in 10 years, especially at that age. Consider strokes—the #1 disabling. No one knows when a stroke is coming on. It’s something that just happens. Same with a heart attack. Or cancer. Or the onset of Alzheimer’s. So, statements like that are just another manifestation of the same denial process.

When I look at long-term care with a client, I try to focus on the budget number of one and one-half percent. I tell them that we can pay that percentage of their assets forever, no problem. And I think that that is good, sound advice. Let’s put that one percent up on the table right now, when you can afford it. After all, you might not be able to get it later—after that stroke.

Here’s another thing that might happen: Let’s say you go through the underwriting process to get long-term care. They call your doctor and they come out to see you, and when the process is over they come back to you and say, “It’s not going to cost you five thousand after all. It’s going to cost you seven.” Then what do you do? That’s 1.65% of your portfolio. How will you deal with that?

That leads to an important question.

WHEN SHOULD YOU PURCHASE LONG-TERM CARE INSURANCE?

That’s an easy one: as soon as possible. Why? The longer you wait, the more expensive it gets. Generally, the premium increases 10% each year you wait before securing a policy.

Some people wonder if they’d be better off saving money to prepare for a long-term need instead of investing in insurance. To

be frank, that's foolish. The likelihood of you saving enough to equal what a long-term policy would pay is nearly impossible. For example, let's say that at age 50 you started saving \$680 per year for your future long-term care needs. Invested at 12% annually, you'd accumulate \$164,000 over 30 years. Well, in 30 years the cost of four years in a nursing home could be well over \$600,000. However, the same amount invested in long-term care insurance could provide a policy with benefits of \$631,000 to help handle the costs.

Some people put off purchasing long-term care insurance, thinking they'll shorten the number of years they pay. True, but that approach entails some not-so-obvious costs. Consider:

- Your inflation rider will have less time to work for you.
- Your premiums will be higher.
- You will be without protection.
- You may experience a change in health that could increase your premiums or even prevent you from obtaining insurance at all.

That last point addresses an important reason why you should secure long-term coverage as early as possible: It ensures that you can qualify for coverage. As you grow older—and the risk of adverse medical conditions increase—you run the risk that your premiums could be rated up or, worse, that you might not qualify for long-term care coverage at all. Sometimes people wait so long to apply that they develop medical conditions and notations in their medical records that make them uninsurable.

THE REAL BOTTOM LINE

Do you want to know another good reason to buy long-term care insurance? Well, then, consider this: It can increase your retirement income by as much as 40 percent.

How can paying insurance premiums increase your income? Here's how: It has to do with annual withdrawal from investments. Let me explain. If you decide not to purchase long-term care insurance, then I recommend you withdrawal about 5% from your investments annually. It's the only prudent thing to do. You'll need to preserve capital for possible future long-term care expenses and to avoid running out of money. On the other hand, if you transfer the risk to an insurance company (by paying premiums), you'll be able to withdrawal about 8% annually. For a retiree with \$500,000 in investments, that would mean an increase of \$15,000 in annual income. True, you still need to pay the insurance premium; but that premium should not be more than about 1% of your investments.

By purchasing long-term care insurance, you are able to afford about a 40% increase in your net income. Not only that, you're allowing yourself to maintain your independence for as long as possible.

Hopefully, you'll never need the insurance to pay for a nursing home stay, but the increase in income will have a large impact on your life.

SUMMARY

Let's summarize some of the basic things you need to understand about long-term coverage.

- First you need to determine if you are in the asset range where you need the coverage (If you fall between \$400,000 and \$1.5 million, you need to investigate care. If you fall below the \$400,000 mark, you need to go see a Medicare planning or estate planning attorney. If you are above the \$1.5 million

mark, you need to at least discuss it with your investment advisor so that you can plan for the contingencies.

- If you remember the basic things that I talked about in this chapter, and if you get the insurance industry's shopping guide for long-term care, you are going to be relatively well educated about purchasing the product.

One thing that you need to keep in mind if you are vacillating about buying long-term care: Health care is extremely expensive. Can you handle \$100,000 a year without jeopardizing your family? And unless you can answer yes rapidly and emphatically, then you owe it to your family to get the coverage.

What To Look For In a Good Long-term Care Policy

What follows is, essentially, a template for a good policy. At Biddle Capital Management, these are the features we recommend to clients. Keep in mind, insurance companies differ. Many have excellent policies, but there isn't really one "best company" I can name. Some companies have better rates for people in their 70s than people in their 50s. Other companies offer options that might sound good. As I alluded to you earlier, you need to determine the coverage items that are best for you.

- A Rate Guarantee
- **Nursing Home and Alternate Facility Coverage** – Daily amounts should be sufficient for the geographic area you live in.
- **Home and Community-based Health Care/Adult Day Care** – Again, daily amounts should be sufficient for the geographic area you live in.
- **Waiver of Premium and Dual Waiver of Premium** – The first waives the premium on a policy when benefits are being used; the second waives the premium for the healthy spouse when an ill spouse is on waver of premium.
- Inflation coverage

Additional Features to ask about:

- A broad and flexible alternate plan of care
- No pre-existing condition waiting period
- Restoration of benefits
- Care management (voluntary, free, and a care manager of your own choice)
- Choice of elimination periods
- Will one or more days of home health care reduce the elimination period
- Respite care
- Discounts
- Rate guarantees

CHAPTER FIVE

Insurance Investments

As is the case with other financial tools I've covered, insurance investments can serve a purpose, or they can be counterproductive. It depends on the situation and the client. I have seen them work effectively; I've also seen them abused.

As I'll demonstrate, insurance investments aren't always suitable to the needs of the "successful retiree." This chapter will help you determine when insurance investments are appropriate for you and when they're not.

WHAT ARE INSURANCE INVESTMENTS?

First, we need to define insurance investments. Despite what it sounds like, insurance investments are not "the stocks and bonds of the insurance industry." We're not in that realm of investment at all. Rather, insurance investments are the amalgamation of investment products and insurance products into one unit.

There are three specific insurance investments:

- Variable life insurance
- Variable annuities
- Index annuities

I'll examine each one separately, giving you the essential basics of how they work.

VARIABLE LIFE INSURANCE

This is not an insurance product that should get sold very often to successful retirees. Still, I want to talk about this one first, as it will help you better understand the later section on variable annuities.

I acquired my knowledge of variable life insurance first-hand—in the trenches, so to speak. When I started in this business in the early '90's, I worked for a company that sold variable life insurance. This allowed me to witness up close some of the abuses that occurred. I saw how insurance companies and insurance agents handled this product. I learned what they thought about variable life insurance and I learned something about how they presented the concept to the public.

The most serious abuses I saw involved *disclosure*: Agents weren't providing customers with full disclosure; that is, they weren't being completely forthright and open about the product. Specifically, they overstated the ability of these insurance policies to function as investments, and they were not disclosing the fees involved. They were withholding the kind of information that would help the client make a more educated decision.

Eventually, and justifiably, this approach cost a couple of the major companies—Metlife and Prudential—some serious economic fines and lawsuits. As a result, agents were forced to become more forthcoming with information. But abuses still occur—only now they involve *suitability*. What that means, simply, is that some agents try and convince their clients they need variable life insurance when they really don't.

At this point, let me describe for you basically how the product works.

We start with one big insurance policy, and that policy, upon your death, will pay your designated beneficiary a determined amount. For the sake of example, let's use a \$1 million policy, where the designated beneficiary will receive \$1 million.

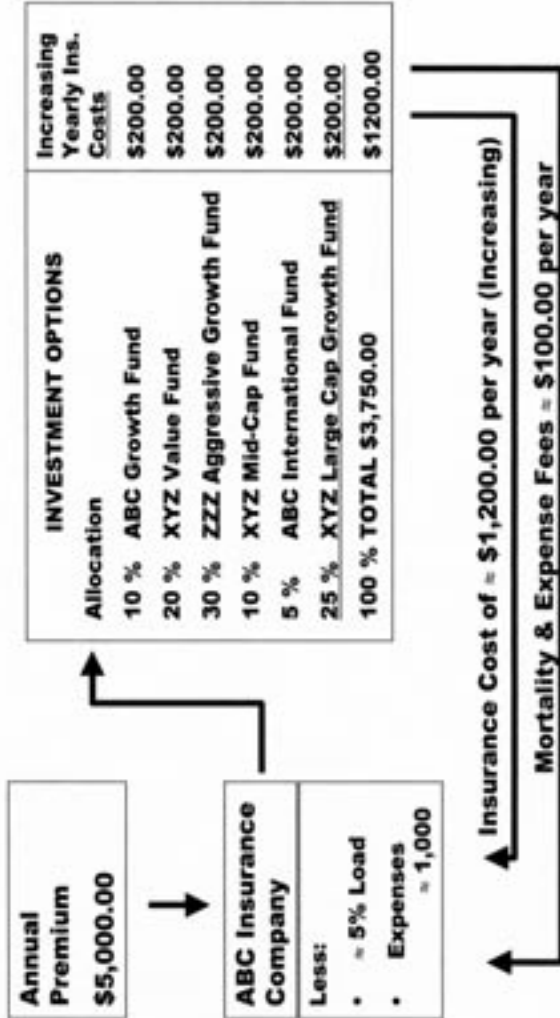
In the traditional insurance format, a client gives money to the insurance company to put into that policy, and the insurance company invests it in buying bonds or real estate or other forms of investments.

Traditionally, that's how it worked. Then equity markets started racking up huge returns. More and more people participated in that market. The insurance companies knew they'd have to adapt to survive. In response, they created variable life insurance and variable annuities.

Sub-accounts

As an adaptive function, insurance companies created something called a *sub-account*. When the insurance companies adjusted the traditional format, the customer's money no longer went directly to the insurance company itself. Instead, it started going into something called a *sub-account*, which is an account that acts very much like a mutual fund. (However, it is *not* a mutual fund. A sub-account is an entirely different legal entity.) With the customer's money now going into the sub-account, the insurance company now hires an investment manager for that account. And the investment manager's job is to buy and sell stocks based on some determined objective, similar to a mutual fund.

Understanding How Variable Life Insurance Works



In this adjusted format, separate accounts are now listed in the insurance policy. As you can see in the above example, I use six separate accounts with various percentages of the customer's money going into each one. It's almost comparable to a 401(k) plan, where you have certain choices of managers and you can allocate how your money goes in and you can allocate what accounts you want to use. Of course, 401(k) plans and variable life insurance are two different concepts, but the comparison at least gives you an idea of how the separate accounts work.

So how does the insurance company get paid in this revised format? Well, essentially, each month the insurance company says to the managers, "Okay, guys, we want our money." And so, each month, the insurance company takes some of your money out of these separate accounts. I use the amount of \$200 for an example. That amount—\$200 a month—comes out of a separate account and goes to the ABC Insurance Company to pay for that \$1 million worth of insurance. The rest of the money is left in the rest of the separate accounts. And that's the basic way that it works. That's the blueprint, so to speak.

Fees

At this point, I need to walk you through something that is crucial to the customer: *fees*. Unfortunately, not all agents talk to the customers about the fees.

This, then, is how fees work with a variable insurance policy: Very often, when you put money into this insurance policy, that policy comes with something called a "load." Let's say we have a 3% load (every policy is different as far as this figure is concerned; you have to look at the policy prospectus or ask the agent for this figure). That 3% load goes into the policy, which means that if you put in \$10,000, then only \$9,700 goes to work inside each of these separate accounts, or sub-accounts. And inside

each sub-account, you must pay the investment manager who is running that account (a big mutual fund company, for instance).

That investment manager is then going to charge you *basis points* (100 basis points equal one percent, 50 basis equals one-half of one percent, or 0.5% of your money). Let's say the investment manager is going to charge you roughly 80 basis points in that sub-account. But there's an insurance company involved here, too, that wants its piece of that pie as well. We're going to say that the insurance company charges 1.5% annually (and again, these numbers are generic, based on policies that I know about; they could be different for any other company). Now your total sub-account charge—based on what the insurance company wants *and* what the investment manager wants—could now be somewhere around 2.3%. And that will be an ongoing fee. It will be charged every year to all assets inside that sub-account (as opposed to the sales load, which is only paid once when you put money into the insurance contract).

All of this raises a question: Why would someone want to put money into a variable insurance contract? Why not just buy term? That seems the easier thing to do.

Well, sure.

And that brings us to the tax issue, specifically, the idea of tax-deferral.

Tax Deferral

The tax deferral concept sounds good to a lot of customers. The IRS currently says that if your sub-account grows and increases in value inside your insurance policy, those accumulations are not taxable until you decide to withdraw them from your policy. That's tax deferral. Essentially, a variable life insurance policy creates a tax-deferred instrument. That's what makes the policy es-

pecially appealing. But examine it closely. In the picture I've drawn for you, to get that tax-deferred instrument, you had to pay 3% up front and then you had to pay 2.3% per year. (And just to let you know, I am being generous with that 1.5% figure going to the insurance company. I've seen it at 2 percent.)

Now, why would anybody want to do this? Well, as I said, it sure sounds good: You buy this insurance policy, and you make all this money inside the policy. That's why variable life insurance policies are so easy for agents to sell. To the potential client, the possibilities sound marvelous. "Put all of your money into it!" the agent encourages. "Put everything you need for retirement into it! It'll take care of everything you'll need to send your kids to college!"

But here is where you have to stand back and take a hard look. Do you really want to pay the insurance company 2%, let's say, plus the insurance premiums that come out each month to obtain this kind of tax-deferred growth? Is it really worth it?

The answer depends upon tax rate, or how much you pay in taxes a year. I'm not talking about your tax bracket. Forget that. Tax bracket doesn't supply you with a very representative number. Rather, your actual tax rate should be the key to your decision. If your tax rate is high, then it makes sense to do it if you need or want life insurance.

How do you determine your actual tax rate? Easy. Look at last year's return. Find out what your total income was. Divide that figure by the total amount of tax paid. That's your real tax percentage. And unless that number is above 30%, you shouldn't even think about variable life insurance. If you do the calculation and your tax rate drops around 20%, then you're considering buying the wrong product. If you really want to buy life insurance, you should buy term and invest the difference.

To tell the truth, variable life insurance policies are really only viable for very specialized uses, like estate planning or other very technical planning. But for the average “successful retiree”—like yourself—variable life doesn’t make sense. The charges inside it are just too great. And, generally, is it not absolutely guaranteed. That, in itself, is a big concern.

“What if I Already Have a Variable Life Insurance Policy?”

Chances are that someone out there might have already bought a variable life insurance policy before they started reading this book. What if that person is you? What do you do now? I recommend that you determine if you really need this kind of policy. After all, you’re retired; do you really need life insurance anymore? And I strongly advise you to get some competent counsel to help you make this decision. If you think you need it for estate planning, then I advise you to consult with an attorney. Remember: the life insurance policy you own is included in your estate, for estate tax purposes. If it’s a million-dollar policy, it can have a dramatic affect on the taxes that will eventually be paid on your estate. It could unintentionally augment the taxes.

So, the rule of thumb for variable life is that it is only applicable in limited circumstances. And if you’ve been considering buying such a policy, first and foremost, figure out if you even need it.

VARIABLE ANNUITIES

Here’s another insurance product that is grossly abused. Variable annuity insurance is an insurance contract very similar to variable life. You pay for tax deferral.

You need to be aware of some of the things that go on with this kind of policy—the death benefit, for one. In variable annuity insurance, the death benefit amount is generally equal to the sub-

account amount: If you put \$100,000 in and its worth increases to \$120,000, your beneficiary will receive, upon your death, \$120,000. It's as simple as that. The possibility of you getting more than you put into a policy is about slim to none.

Let's look at it another way. The death benefit portion of an annuity basically works like this: Let's say that you put in \$100,000. And then let's say that when you die, it's worth less than \$100,000 (because of a drop in the market). The insurance company guarantees that your beneficiary gets \$100,000. Now that sounds very nice of them. But stop and take a close look at the market. If you invest over a 10-year period, you have a 97 percent chance of making money. So, I ask you, what is the likelihood that you are going to die the same day when the annuity drops in value below what you originally put in? Again, slim to none.

I asked an insurance sales representative about such a situation: "What are the odds that an insurance company really has to pay out more than what is there?"

"Virtually zero," he answered.

So, that means that the insurance companies are making lots of money off a theoretical insurance charge. Most likely, it will never benefit the consumer. True, you get tax-deferred growth, but is it really worth it?

Confronted with this knowledge, the average person might say, "Wait a minute, I'm buying insurance and you're telling me that I am not getting any more than what I put in there?" It's a good question to ask. Why would anyone want to do it? Well, again, it's about tax deferral. The IRS says accumulations within an insurance policy are not taxable until you take them out. (*Again,*

I suggest you check the appendix for a detailed NASD memo about variable annuities.)

Charges and Commissions

Variable annuity insurance is similar to the variable annuities we talked about earlier in the book. Variable annuities, you'll remember, are very popular with brokers and people like that because they pay a very high commission. When a broker sells you a mutual fund, the larger amount that you invest, the less you pay in commission percentage. With a variable annuity, the percentage stays the same no matter what amount of investment. The result is that a broker may get paid double the commission if they are able to sell you a variable annuity.

Variable Annuity Fees

Generally, a variable annuity charges one-and-a-half percent for that insurance component. You'd also be paying your sub-account manager, let's say, 80 basis points (again, generic numbers based on policies I've known). So what happens is that you're now paying 1.5% for insurance that you're not really using. In other words, it costs you 1.5% to buy tax-deferred growth. And let's say that the investment manager, net of his fee, makes 10 percent. Then you would make 8.5 percent. The 1.5 percentage difference went to XYZ Insurance Company.

Background on Annuity

It may be helpful here to give you a little background about annuities. The whole idea of the annuity concept is to produce an income stream. That's why annuities were created. The client deposits money into an insurance company, and that company then pays the client an income stream for the rest of his life. If the client lives a long time, he makes out better on the deal. But if the client dies young, the insurance company gets to keep his money.

That is the concept of annuitization: Money goes in so that money can be paid out. Such a contract has two phases: the *accumulation phase* and the *annuitization phase*. During the accumulation phase, assets go in. During the annuitization phase, money comes out—in other words, when you decide to turn the assets into an income stream. But some people don't turn the assets into an income stream. In fact, some statistics show that less than 10 percent of annuity owners annuitize the contracts. They let the money accumulate. And that's a bad idea, because, upon your death, your beneficiary will have to pay income tax on all the assets that have been accumulating in that account. Can you imagine your kids' faces when they inherit an annuity of \$100,000 or even \$1 million and then find out they have to pay a 50% tax on it? And what if you have a large estate (like most "successful retirees" do)? Your kids may have to pay estate taxes upon that as well. So, can you see what happens here? There's a double tax. An annuity is one of the few investments double-taxed upon death. Larger estates may incur estate tax as well as income tax. Amazing enough, the public never gets told about that.

So, you really have to think long and hard about tax deferral. Is it really so advantageous to you after all? Maybe it makes sense to use a tax efficient mutual fund instead.

This should help you understand why I think it is so despicable that some so-called financial advisors will put annuities into IRA accounts. (Remember the horror stories from the first chapter?) An IRA account is tax-deferred already; the IRS says you don't have to pay taxes on an IRA until you take it out. So why would you buy an annuity in that format and pay the one-and-one-half percent to the insurance company for tax-deferred growth that you are already getting?

So why does it happen so often then? The answer is simple: Commission. If a broker can convince you to do this, then he is going

to make a lot of commission on your IRA. And brokers especially love the successful retiree, because most successful retirees have large IRAs. Successful retirees have million-dollar IRAs, or \$700,000 IRAs. Whatever the exact figure, that's going to amount to a big commission for some broker. Imagine a \$700,000 IRA going into an annuity. The commission would be \$42,000. That's a gigantic commission. More than gigantic, it's obscene.

Fortunately, more and more people are becoming aware of what's going on, and annuity companies have started to realize that the public is getting wise to them. Annuities suddenly aren't the greatest thing in the world anymore. So, the companies came up with a lot of fancy things like riders—bells and whistles, I call them—and they keep charging you more for them.

Even so, annuities are still being sold more often than they should. A case in point: Recently, I spoke with a woman who made \$32,000 a year and had assets over \$600,000, and she had put \$500,000 of those assets into annuities. But, come to find out, she wasn't in a high tax bracket, so her kids are going to pay for this tax deferral that is of little benefit to her (not to mention the structural restrictions placed on her by the insurance company). The trouble is, people are just not being counseled well or properly educated about variable annuities. So, here are three things that should tell you if you have a problem:

- You have a variable annuity in an IRA.
- You have more than 20% of your total assets in annuities.
- Your broker keeps telling you to buy new annuities.

INDEX ANNUITY

The flaw with the variable annuity is that it is tied to the entire market—the stock market—and stock markets go up and they go down. Here's another problem with them: Many sub-account

managers don't beat the Standard and Poor's 500, which is representative of the market. This has been especially true in the last couple of years.

But, in recent years, insurance companies (who want to get a hold of assets in any way they can) have come up with a new product that's actually a good product. It's actually an insurance product that I like. It's called an *index annuity*, and there are two reasons why I like it. First of all, the index annuity produces basically the same return as the variable annuity, if they are both invested. With an index annuity, someone deposits money into an annuity—the accumulation phase—and, basically, the insurance company buys what is known as options on the S&P 500 return minus 2% or so. Let's compare that to a variable annuity. The charges with a variable annuity are, generally, 2 to 2.5% percent per year. So, if you invested in the S&P 500 in a variable annuity, you would pay the S&P 500 return less the 2 or 2.5% percent. That's the upside, and there's no big difference there between the index and variable annuity. But look at the downside and you'll see the second reason why I like index annuities. In an index annuity, the insurance company guarantees that you will not have a losing year. For example, with the contracts we use in my office, we guarantee the client will make at least 0% per year. Now, on the surface, that is not a lot. But it turns out to be a lot when the S&P is down 10 percent. A variable annuity will drop 10% in value, but the index annuity protects capital and locks in return. That turns out to be a pretty good return. All of the other basic features are the same.

Here's something to think about: For a moment, let's place this concept in the context of the mutual fund world. Let's say you could buy an S&P index fund that was guaranteed never to lose money. What do you think would happen? You'd have people lined up out the door to buy that mutual fund. That's basically what you get on a tax-deferred basis with the index annuity. It

gives you some guarantee for what you pay in insurance. That makes sense. If I see that a client already has assets in annuities, I advise them to convert the variable annuities into index annuities. Generally, though, I don't like to put new money into annuities.

Variable annuity vs. index annuity? What would you choose? It's a no-brainer, isn't it? So why don't more index annuities get sold? They're a fixed product, that's why. They're sold directly through insurance agents and not through the brokerage companies like Merrill Lynch or Dean Whitter. The brokerage manager can't get paid on index annuities, so they're not promoted heavily.

So, if you have variable annuities past their surrender period, I think it wise to investigate the index annuity concept. And if you seek counsel from someone who doesn't know what index annuities are, then I suggest you move on to someone who does.

Here's something else that you may want to do: Convert any existing life insurance contracts that you feel you don't need anymore into annuities.

CONCLUSION

To review, the three main pieces of the insurance-investment combination are variable life insurance, variable annuities and index annuities. Variable life should only be used in very limited situations. Right now, their sale is far too prevalent. The same applies to variable annuities. They should only be used in limited situations (e.g., for people in high tax brackets who can't save in 401(k)s, IRAs and those types of plans). And like variable life, variable annuities are oversold. But index annuities, which are undersold, can be excellent investments. You are guaranteed not to lose money in any one year.

CHAPTER SIX

Investment Theory

With investment theory, we will cover one of the core concepts of your financial strategy: risk management. Managing risk is central to the Modern Portfolio Theory, which should serve as the rationale behind all the critical investment decisions you'll make.

This chapter will serve as your introduction to Modern Portfolio Theory. I'll introduce you to the basics of the theory, providing you with the building blocks necessary to constructing what is known as a "globally diverse" portfolio. You'll learn the four premises behind Modern Portfolio Theory and come to know and understand terminology like diversifiable and non-diversifiable risk, expected returns, standard deviations, and diversification.

Later, we'll advance to specific investments and the nuts and bolts of building a portfolio. But, for right now, we're going to cover the basics of what every one needs to know.

METHODOLOGY

No doubt, you've investigated the market already, and, most likely, in conversation, you've encountered someone who claims to have it all figured out. Don't believe it for a second. Here is

the first thing you need to understand: Nobody—and I mean nobody—has the market all figured out. I certainly don't. It's simply impossible.

Why? Well, sometimes fact and truth are best explained by using a paradox, so here's one: There is only one absolute certainty about the market, and that is that nothing about the market is ever absolutely certain.

When explaining this to my clients, I like to draw an analogy between the kind of work I do and the kind of work a doctor does, because financial management and medicine are comparable in a very significant way. Doctors and financial advisors are, essentially, providing prescriptions. Financial advisors prescribe financial advice. Physicians prescribe medicine. And in prescribing medicine, physicians know that the drugs they have at their disposal will have a certain affect on a certain population about 80 percent of the time—but never all of the time. There may be some side affects here and some unforeseen problems there. So, basically, 80 percent is about the best they can do. Physicians cannot deal in absolutes. They can only deal in theory. They can only get as close to an improvement as possible.

It's the same way with investment advisors—and let no one kid you that it isn't. We try and give a client an answer that is as close to correct as possible, based on theory. That's the best we can do. Like a physician, we can never be totally correct. But we both have good track records. So we get pretty close.

When a physician talks to a patient about medicine, he's talking about how the medicine *should* theoretically work. Likewise, when we talk about investment theory, we're talking about a true theory and how it should work—not necessarily how it *will* work.

Here's another analogy, especially useful when considering the actual investment portfolio: An architect who wants to build a house must first design a blueprint of the theoretical house. But, as any architect will tell you, this blueprint is really just a proximate rendering of what the house will eventually look like. The finished product won't look exactly like the blueprint. Some of the walls may not end up in the exact spot designated. Or a fixture may have to be moved.

Again, it's the same way with investments. First you develop a vision, creating a picture of what you want to achieve. This guides you in building a portfolio. Next, you try and get as close to that initial vision as possible. That is what investment methodology is all about. No one in this field can ever be absolutely correct. As I say, the best you can do is get as close to correct as possible.

I have found that the best way to do this—and this is what I do in my practice—is to base investments on a combination of theories that are integrated into what is known as Modern Portfolio Theory.

Modern Portfolio Theory, as a portfolio management technique, was developed in the late 1980s by three noted financial economists. And their accomplishment was significant enough to win them a 1990 Nobel Prize. The portfolio management technique they developed is what I use in my practice.

Let's look at it in some detail.

MODERN PORTFOLIO THEORY

Modern Portfolio Theory is comprised of four premises. On paper, these premises may seem basic, but it's essential that you understand them.

Premise #1

The first premise states that *investors are inherently risk adverse*. That is, investors are not willing to accept risk when the level of return generated will not compensate them for that risk. Generally, investors are more concerned about risk than reward.

Let me give you an example of risk measured against the return: Let's say, one year, you make 6%—a six-percent return—on your investment portfolio. And let's say that, in that same year, you could have bought a CD that would have earned you the same 6 percent. Well, you didn't make out so well. You see, you could have earned the same 6% without any of the risk involved in the markets.

But let's say you're looking to earn more than 6 percent. You want 10 percent. In that case, you have to put up with more risk. But the risk premium has to be there. In other words, if you are going to take a risk with your assets in terms of volatility, or the possibility of a loss, then you want a better return.

Premise #2

The second basic premise states that *the securities markets are efficient*. What that means is that instant information is here. No longer can someone say to you, "I know something about a stock that no one else does." Securities and markets are too efficient for that to happen. Sure, it used to happen a lot, a long time ago, when a security would trade on the New York Exchange at one price and on the Pacific Exchange at another price. But that's not the way it is anymore. Also, today, no one can get ahead by knowing something special about a company that no one else does. Those who do use insider information are headed for prison. Information is already priced into the stock.

On top of all that, with advancing information technology

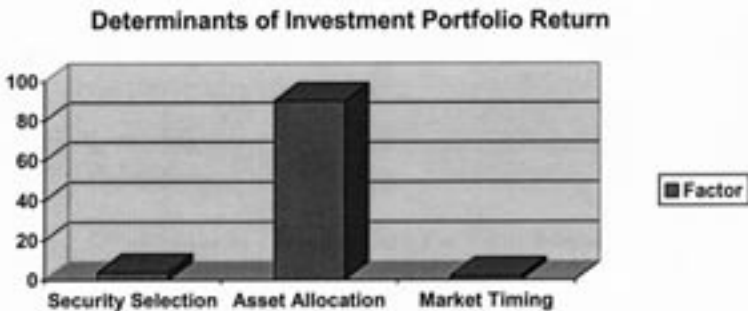
(Internet, etc.) and more sophisticated investors, markets are becoming even more efficient.

Most studies support this idea of an efficient market.

Premise #3

The third premises states that *attention should be shifted from individual securities analysis to consideration of a portfolio as a whole*. In other words, let's not look at just one tree and see how it fares under different environmental conditions; let's look at the total forest and see how it reacts to stimuli like rain, sun, drought, etc.

The efficient allocation of capital in your portfolio to specific asset classes—generally asset classes are cash, stocks, bonds, the generic asset classes—can be much more important than selecting the individual investments. In a significant study, three leading financial analysts evaluated the importance of asset class selection compared to the timing and selection of the portfolio's holdings. They found that *about 90% to 94% of the return is determined by what percentage you put in different asset classes*. And they attributed the balance of profitability to the policies of individual security selections (4%) and market timing's buy and sell decisions (2%).



Since then, people have debated that number down around 80 to 70 percent. But it's not the exact number that's important; it's the concept. Most of what creates your return depends on how much you put in cash and how much you put in stocks and how much you put in bonds.

The study also made it clear that it is especially important to invest for the long term, regardless of management style. An investment policy needs to be tested over a long period of time, such as 10 years. Only in that way can it experience the various economic and market cycles needed to determine its success.

S&P 500 Index, 5 years ending 6/30/01 (1,262 trading days)

<i>Period of Investment</i>	<i>% of (1,262) Trading Days</i>	<i>Average Annualized Total Return</i>	<i>Annual Cumulative Total Return</i>
<i>Fully Invested</i>		14.48%	96.61%
<i>Miss the 10 Best Days</i>	0.8%	5.08	28.14
<i>Miss the 20 Best Days</i>	1.6	-1.35	-6.57
<i>Miss the 30 Best Days</i>	2.4	-6.45	-28.34
<i>Miss the 40 Best Days</i>	3.2	-10.83	-43.63
<i>Miss the 60 Best Days</i>	4.8	-18.10	-63.15

Sources: Standard & Poors, Bloomberg. Index performance figures are historical and reflect reinvested dividends.

Past performance cannot guarantee comparable future results.

Premise #4

The fourth premise states that *for every risk level, there is an optimum return*—or, to put it more precisely, for every risk level, there is an optimal combination of asset classes that will maximize return and minimize risk.

About this premise, the Modern Portfolio Theory basically says this: Quantitative methods can be used to measure risk and to diversify effectively among asset classes. Portfolio diversification is not so much a function of how many individual stocks or bonds are involved, as it is of the relationship of each asset to

each other asset. The percentage and the proportionality of these assets in the portfolio are quite important.

Sound complicated? Don't worry. Many people have a hard time grasping this premise. So I'll put this into language everyone can understand: What this premise says is that if you can stand to lose 10% a year—in any one year—then there has to be an optimal return that you can get for that. And, somehow, you have to be able to figure out what that optimal return would be.

RISK

To better understand this, we have to define what risk is and how investment advisors think about risk. In the Modern Portfolio Theory, risk is divided into two generic categories: *diversifiable* and *non-diversifiable*.

Non-diversifiable risk results from factors affecting financial markets as a whole. It is what we call political risk. For instance, when the Russian ruble gets devalued, it hurts our market, and it is something that we can't control. So, non-diversifiable risk is the inherent risk you take when you invest in stocks or bonds. You can reduce this risk by investing in less volatile securities, like U.S. Treasury Bonds. However, the more non-diversifiable risk an investor is willing to take, the higher the expected returns become.

Diversifiable risk stems from factors affecting the specific investment: the firm, industry, country, or type of asset. Diversifiable risk can be avoided by investing in a number of different assets. We can exercise some control over *diversifiable risk*. Because of that, diversifiable risk is really the major concern and responsibility of the manager. The manager would be looking to lower the risk while keeping the return the same. For instance, he may do this by changing security allocations

in some way, or changing the type or securities. But he should be lowering the risk for his client.

How can an investment advisor affect risk? I try to determine how risky asset classes are. And I can do this by using the quantitative methods I mentioned a bit earlier. Specifically, I try to quantify risk by using standard deviations—that is, *standard deviation* relative to *expected return*.

Expected Return

Expected return, essentially, is a return (based on historical data) that is statistically achievable over a period of time (based on historical return). Expected returns are theoretical returns, not estimated returns. They in no way indicate actual or future performance.

Standard Deviation

Standard deviation is a measure of volatility. In general, the higher the standard deviation, the greater the volatility, or risk. An asset class' annual total return can be expected to fall within one standard deviation of its expected rate of return roughly two-thirds of the time and within two standard deviations about 95% of the time. In other words, an asset class with a one-year standard deviation of 5% and an expected return of 8% would be expected to vary between +13% and +3% about 68 percent of the time and between +18% and -2% about 95 percent of the time.

Let me give another example: Say, for instance, an asset class has a 10% expected return (over a five-year period) and a 10% standard deviation. Then, about two-thirds of the time—plotting 66 times out of a 100—the range of that asset will fall somewhere between +20 and 0.

So, we can define risk as an asset's expected return plus or minus the standard deviation.

<i>Asset Class</i>	<i>5Yr Expected Rate Of Return</i>	<i>1Yr Standard Deviation</i>
<i>Money Market</i>	4.9%	3.3%
<i>Short Term Fixed Income</i>	6.9%	4.5%
<i>US Large Company Stock</i>	13.6%	20.3%
<i>US Small Company Stock</i>	19.4%	38.5%
<i>Int'l Large Company Stock</i>	13.6%	20.3%
<i>Int'l Small Company Stock</i>	19.4%	38.5%
<i>Emerging Markets</i>	16.0%	29.0%

DIVERSIFICATION

Now that you know about standard deviation and expected return, we need to talk about diversification, because most people don't understand the fundamental concept of diversification.

Diversification involves how different asset classes react at different times to different stimuli, whether it is economic or political, or interest-rate risk, etc. In general, diversification involves two scenarios, and these scenarios involve *correlation coefficients*.

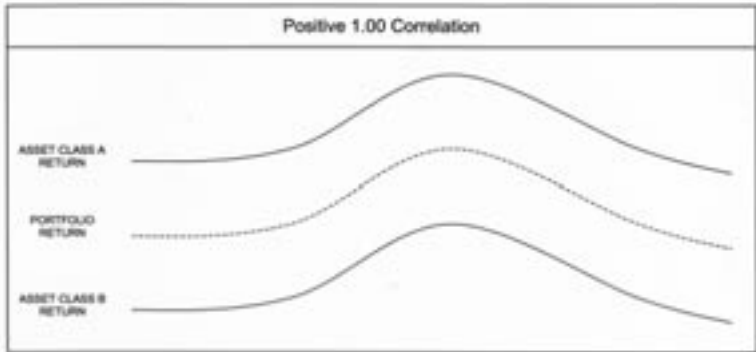
Correlation Coefficients

For those of you who ever had to take a statistics class, you are now finally going to use what you learned. For those of you who haven't, I'm going to give you the easy version.

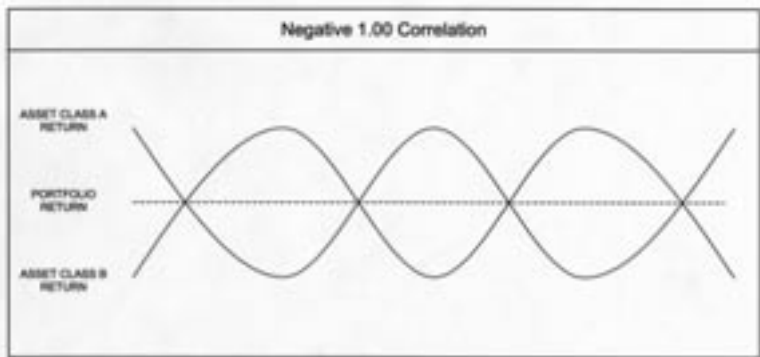
Correlation coefficients reveal the predictability of one asset class, given the knowledge of the other. Correlation coefficients are measured on a scale from "+1.000" to "-1.000," where "-1.000" indicates that both asset classes always move in opposite directions. A measure of zero indicates no measurable relationship between the two asset classes.

So, as I said, we have two scenarios. To start with, you have asset classes A and B. In the first scenario, when asset class A goes up, asset class B goes up. That is a positive 1, or +1, correlation.

There is no diversification there. So the return on the investment portfolio of A and B is going to be the average of the two classes— or right between the two (as indicated on the graph).



In the second scenario, the opposite is true: Asset class A goes up and Asset class B goes down at the same time. That is a negative 1, or -1 , correlation.



What you want to have are asset classes with very low correlation (close to "0.00") coefficients. Why? You don't want any one event, be it economic or political, to affect your total portfolio. In a normal portfolio, some assets will be going up while others will be going down. This means that a portfolio is fully diversified.

So you should never become alarmed if you see something going down in your portfolio. (Whenever I design a portfolio for a client, I tell them flat out that if every single security is going up at any one time, then that is an anomaly. It's highly unlikely to ever happen.)

To achieve diversification, you need to combine different asset classes together. For instance, if you have large U.S. company stocks, you'll get a good diversification affect if you also have international small company stocks. These two kinds of stock don't correlate. Neither has a real positive or negative correlation. And this creates the diversification effect.

Correlation Coefficient Factors

<i>Asset Class</i>	<i>Money Market</i>	<i>Fixed Income</i>	<i>US Large</i>	<i>US Small</i>	<i>Int'l Large</i>	<i>Int'l Small</i>
<i>Money Market</i>	1.000					
<i>Short Term Fixed Income</i>	.555	1.000				
<i>US Large Company Stock</i>	-.100	.156	1.000			
<i>US Small Company Stock</i>	-.103	.022	.790	1.000		
<i>Int'l Large Co. Stock</i>	-.142	.085	.624	.588	1.000	
<i>Int'l Small Co. Stock</i>	-.141	-.051	.506	.529	.886	1.000

This, in essence, is what happens with the diversification effect: If asset classes A and B are jumping all over the place—that is, going up and down—then every piece of the portfolio is bouncing, meaning that there is a lot of volatility and fluctuation. But this is good. The total return of a portfolio is then smoothed out by all of these jumps and drops in any different asset class.

That is what is meant by having a “globally diverse” portfolio. It is a major guiding principle affecting the performance of your investment. It minimizes or eliminates diversifiable risk. That is what diversification is all about. It's simple, actually. Just because an asset class is going down in your portfolio, that doesn't mean you have a problem. In fact, to me, it represents an opportunity, based on the way we manage assets. What do I mean by “an

opportunity”? Well, we know that if one asset class goes up and another is flat and still another is going down at any one time, we then follow the objective of the market. And what is the objective of the market? The objective is to buy low and sell high. That’s what everyone is supposed to do.

When you have an investment portfolio that is designed and managed properly—based on an allocation plan—you are going to have assets that will go up and assets that will go down. And if you set out with a basic picture of what a portfolio should look like—like that architect’s blueprint that I discussed earlier—with so much in this particular asset and so much in that particular asset, we know what to do in that scenario.

For example, let’s say that international stocks are up and domestic stocks are down. What would be the prudent thing to do? Let’s say that you started out with 50% in international stocks and 50% in domestic stocks (not a good idea, but I’m just using these numbers for the sake of example). And let’s say the percentage shifts to 60-40, meaning that international stock has gone up 60% and domestic stock has gone down 40 percent. How do you handle that situation? Do you just let it sit?

No. What we do is we buy whatever is down and we sell whatever is up. We’ve bought low and sold high. And that is exactly what you want to do. This is a systematic rebalancing approach, and it should be part of the investment theory you use. It allows you to lock in gains and buy shares at a discount. Rebalancing is very important.

In a perfect world you would just use cash to buy in the lows in whatever asset class. But this isn’t a perfect world and you would eventually exhaust all of the cash. That is why you have to sell some asset classes that are high. Obviously, this is where the in-

vestment advisor needs to have a good proactive tax planning system to manage the rebalancing.

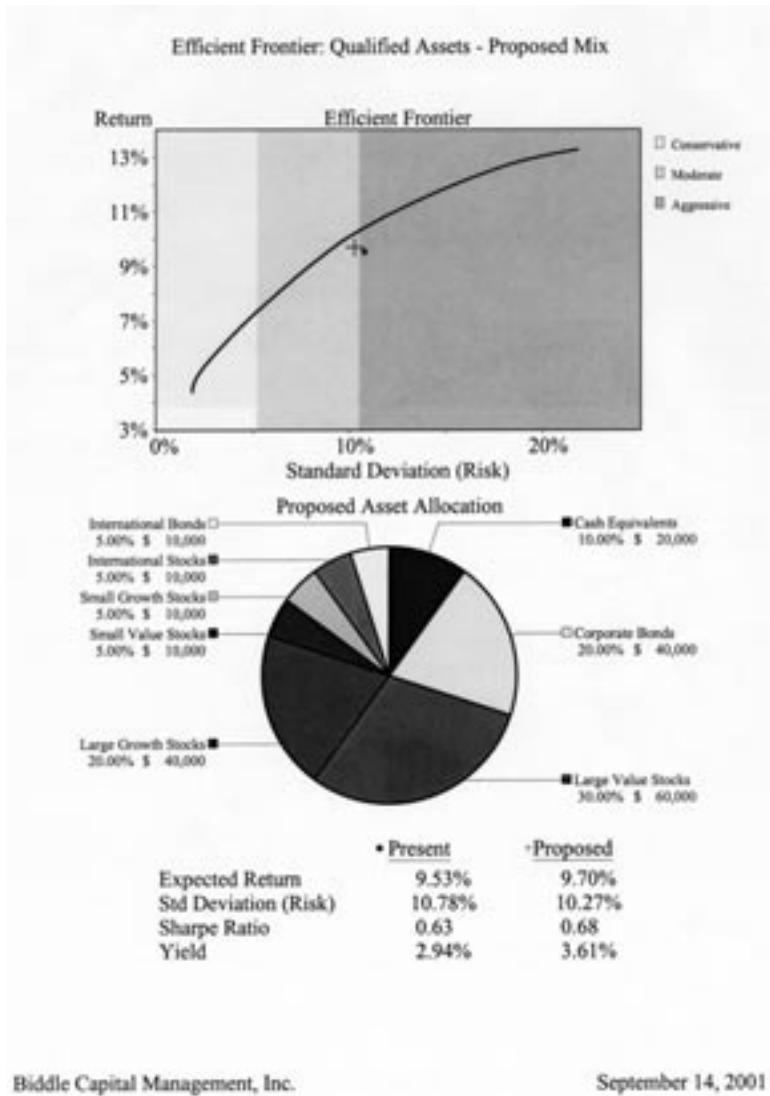
OPTIMIZING WITH SOFTWARE

Those are the basic theories that you have to understand to determine how to create a portfolio. Once you have these basic theories, you then have to come up with some real numbers. In order to do this, you have to go to the computer. There isn't a rule of thumb.

What you need to do is determine how much risk you can take. How much of a drop in any one year could you tolerate? 5%? 10%? 20%? That is the area you have to focus on, because every risk level has an optimal return. That's one of the basic tenets of modern portfolio theory. So you need to find your risk level first. How much can you afford to lose? If you have a million-dollar portfolio and you lost \$100,000 in one year, could you handle that? Well, if you could, we know that, statistically, there is an optimum allocation for that. So risk should determine the return.

I call this the concept of building a portfolio backwards. You first start with risk, then you find out what is the optimal return you can handle for that risk. Working this way helps me, as an investment advisor, to eliminate diversifiable risk—which is supposed to be my job. This requires optimization software, and any competent investment advisor will have that kind of software. Thanks to rapidly developing computer technology, an investment advisor can determine your optimal combination of investments. I use the technique developed by one of the Nobel Prize winners, Harry Markowitz. It's called the Mean Co-variance Frontier. This technique increases a client's opportunities for success. Pictured below is an example of a proposed mix of

qualified assets in an efficient frontier, followed by a proposed asset allocation:



The top is that efficient frontier. So, the most efficient theoretical portfolio that will give you a standard deviation or risk level of 13.88 will generally produce 10.19 percent. Now all this information is based on indexes, and investors can't buy an index, so it is all theoretical stuff. You, as an investor, are trying to get a ballpark benchmark, a target to shoot for, rather than just standing blindly in a field saying, "I hope I make enough money to retire and live on the rest of my life." You can then say, based on all this, "I think we are going to make about 10.10% a year." Therefore you can base all of your financial planning recommendations on that. You can more easily answer for yourself questions like, "How quickly is my estate going to grow?" or "Am I going to need long-term care insurance?"

Once you get your basic allocation, using the optimization software, then you've really built the blueprint for your portfolio. The problem now is to execute it. You have the blueprint, so to speak; now you must build the house.

When you set out to build your portfolio, you understand what is reasonable in the market, you understand how asset classes correlate or don't correlate, and you know that, through the optimization process, you will probably come up with an expected rate of return for your level of risk. You've identified your level of risk. You've also identified which asset classes are most appropriate for you.

With asset classes, the general rule of thumb is that the more asset classes you can use, the more diversified your portfolio will be. However, not every investor is willing to invest in every asset class. And it is really up to the investment advisor and the investor to determine what asset classes are really appropriate in the process of developing that optimization.

So that is the basics of what a person needs to know. And that is what I go over with all my clients.

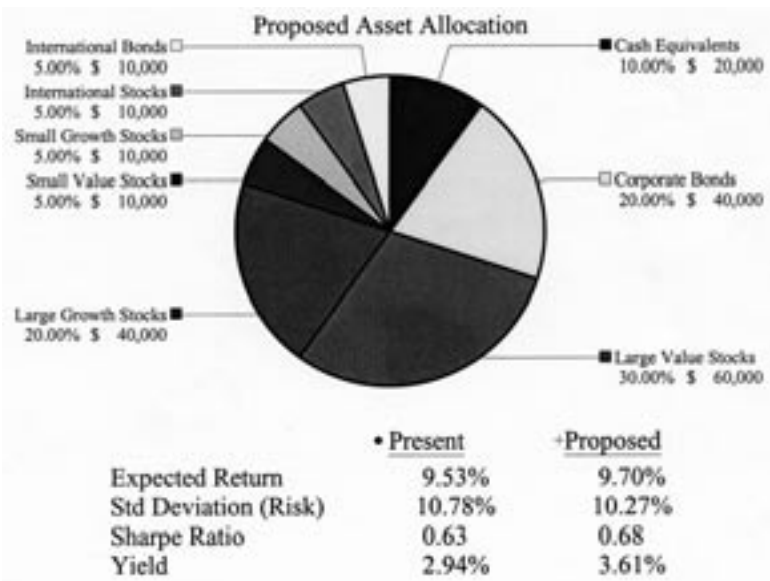
CHAPTER SEVEN

Asset Allocation

In the last chapter, I went over the basics of portfolio theory. In this chapter, you'll learn how to implement an asset allocation plan.

At this point, you understand the basic concept behind designing your own portfolio. You've learned how to draw up a blueprint. Now you're ready to build the house.

What that entails is filling the slots created in the portfolio—in other words, allocating your assets. Remember, an asset allocation plan says you must put $X\%$ into one asset class, $Y\%$ into another, etc. To drive that point home, let's take a look at the pie graph one more time:



Basically, when you look to build a portfolio, you have a couple of choices. For the purposes of this book, we want to discuss stocks, bonds and cash. You must now decide on various types of individual stocks or mutual funds, individual bonds, and bond mutual funds. For you, the successful retiree, those are the things you want to concern yourself with.

Let's take a closer look at the list.

STOCKS

I want to start with stocks first, but before I do, let me say this: It is highly debatable whether anybody is truly proficient at picking stocks. And since all the nuances of picking stocks would fill a book four times the size of this one, I am just going to go over some of the very basic things. Stocks are much more complicated than the other investments we are going to talk about, but, for your purposes, these will be all the things you need to know.

There are two ways to fund the different types of stocks: either use individual stocks or use mutual funds. It's my belief that there is no right or wrong answer in advising an individual on what to do. You just have to determine what feels right for you.

Individual Stocks

The first and most important thing you need to understand about stocks is the "Rule of Sixteen." This rule says that, statistically speaking, if you are going to buy stocks, then you will need to buy at least 16 stocks. Why 16? That amount puts you at a level where you have removed a lot of the diversifiable risk from that portfolio of stocks. If you own a small number of stocks—three, or five, or even 10—you're going to sustain some significant hurt if one of your stocks suffers a steep drop. When you own at least 16—preferably more—the damage won't be as bad.

To demonstrate, let's look at a theoretical million-dollar account, where 20% of that account is in large company growth stocks (I'll define what those are a little later). Doing the math—20% into a million—that means there is \$200,000 in at least 16 of those stocks. So, divide that number by 16 and you come up with \$12,500 in each stock, which is a relatively small amount. So, if you have a portfolio where you can afford to buy 16 stocks then stocks may be appropriate for you as an investment. (Actually, I feel that 20 is the optimal number. In my firm, that's the amount we like to buy.)

Individual Stocks: Pros and Cons

Now let me give you an idea of the disadvantages and advantages of owning individual stocks.

Of course, the big disadvantage is that if one stock takes a nose-dive, it could affect your performance. Another disadvantage is that buying and selling stocks all the time can be a rather expensive endeavor.

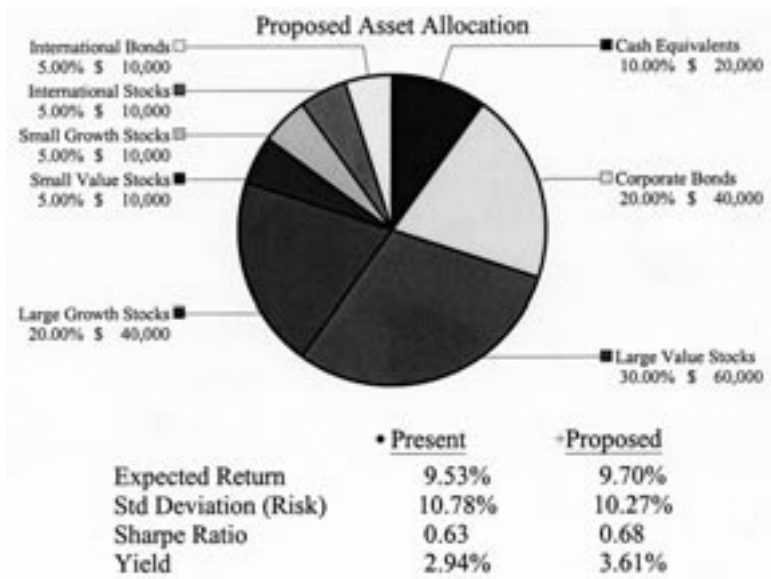
On the other hand, the advantage to owning these individual stocks is that you'll have a very easy time managing the taxes that come out of the portfolio, because you really don't have any tax on a stock besides its dividends, unless you sell. So, you have complete control over when you buy and when you sell.

But beyond that, it is up to you and your investment advisor to determine if all of that is appropriate for you.

Stock Mutual Funds

With stock mutual funds, you can keep from getting hurt too bad if you follow the rules. And there are some pretty good rules that will point you in the right direction.

To explain, I'll need to show you the basic allocation plan once again:



Let's say that this is the allocation plan for "Mr. Jones," a successful retiree who has \$1.5 million to invest. We can use the chart as our template: $X\%$ goes into large cap stocks $Y\%$ goes into small cap stocks. And at this point, let's say that Mr. Jones decides that buying stocks is not an option—whether because of scale, or cost, or maybe he just doesn't feel comfortable doing that. Instead, mutual funds appear to be the way to go.

Now that he has all the pieces of the pie, he must then figure out what mutual fund goes into each piece. How does he do that? In his place, how would you do it? After all, there are more than 5,000 mutual funds out there—more mutual funds than there are stocks, in fact. What do you do? Go to the *Wall Street Journal*? Buy *Kiplinger Magazine*? Or *Money Magazine*? Where does

the average successful retiree go to find the right kind of information to make that kind of decision?

I find that *Morningstar* provides the best information for the public. I am not that big a fan of *Morningstar*. As an investment advisor, I get resources that are more clearly designed for me. But for the public, *Morningstar* suffices.

How do you determine what mutual funds to use? Again, there is no rule of thumb, but let's go over some basic items that will help you decide. First let me define some terms:

- By *large cap*, I am talking about the capitalization of the company. Large cap would be a big company, like Coca-Cola or John Deere or DuPont.
- *Value* means what you think the stock may be currently worth, using a mathematical formula and applying certain assumptions. For example, let's say that Microsoft is worth \$50 a share and it is trading for \$65 a share. It is overvalued. You pay more for it than it is worth. So, you probably don't want to buy it. On the other hand, if the stock is worth \$50 and it's trading for \$40, you can get some value there. That is what is meant by a value stock.
- A *growth stock* is more product-oriented. That's when a company—a medical company, let's say—claims that it has a new drug that they think will attract huge sales and it urges you to invest because it feels its stock will soon go up.

Let's say you want to find a large cap value mutual fund to put into this allocation. Seemingly simple, right? Well, it isn't. And here's why: It all has to do with what a mutual fund really is, so let me explain that for you. A mutual fund is a company that people hire to invest based on certain objectives stated by that

fund. That's a pretty loose definition, and I mean for it to be loose, because a mutual fund is run by a manager who can buy just about what he wants. He might say the mutual fund is a large cap growth fund, but he can still buy what he wants. And a lot of these mutual fund managers are all over the place when it comes to buying. Some managers of very popular mutual fund companies buy things that are way outside their stated objectives. That is what is known in the industry as "style drift." Essentially, it means a manager, by reputation or record, is supposed to be buying one thing but he buys another. It all comes down to the manager wanting to make himself look better. Style drift typically occurs when a manager notices a section of the market that looks real attractive—where everyone is making a lot of money—and he wants a piece of the action. So he'll put his toe in the water and play in that area in order to boost his return and make himself look better. Style drift is not a trait that you want to find in a manager. Style drift is a major problem when buying mutual funds. Style drift misrepresents who the mutual fund manager really is to the client.

Here's another area of misrepresentation: Don't believe it when a representative from a mutual fund company tells you that a team manages their fund. Truth is, only one guy is going to manage that fund. That is the way that it always has been, and that is the way it always will be.

"Team" is a very vogue term these days. It's a marketing buzzword, nothing more. Mutual fund companies try to sell this "team" concept to customers. If a representative comes into my office with that line about a "team" managing the mutual fund, I'm going to take him down—because I understand the inner workings of mutual funds. I talk to portfolio managers and I know what they're doing. This team concept is just a marketing ploy.

Picking a Mutual Fund Manager: The Process

So forget about teams. Let's get to the *real* issue: the manager. When looking at a mutual fund, the first thing I do is determine how long the manager has been there, because that amount of time can make a significant difference. If the manager has been with the mutual fund for three years and the mutual fund has been in existence for 20 years, then the only period of time that I need be concerned with is the past three years—the period that the current manager has been there. And that's the only period that should concern you, too.

But let's say you found a mutual fund that looks good to you. You do a little research and you find that the mutual fund manager has only been there a year. That's not a whole lot of time. It's not going to tell you a lot about his record. What do you do in that case? You'll need to find out where that manager came from. Managers are notorious job-jumpers; they move around all the time. In your subsequent research, maybe you find out he went from Fidelity to Vanguard. What you can then do is research his history in the Fidelity fund, to see how he did there, find out something about his record. Did he move from managing bonds to managing stocks? Or has he always been a bond guy or a stock guy?

The reason this is so important is because, essentially, you are investing in *him*. This is the kind of research I do for my own clients. So, if you are going to attempt this yourself, you have to determine:

- How long the manager has been with the mutual fund.
- Where he came from.
- What period of history you can look at.

Of course, a decision may come easier if you're looking at a mutual fund manager who has been at that mutual fund for 10 years. That's a substantial amount of time. It will give you a good conception of his history and how he operates.

After you look into those three things, the next thing you will want to look at is what this manager likes to invest in. (*Morningstar* utilizes a “Morningstar” box that supplies this information.) Is it large cap value, large cap growth, small cap growth? Something else? Sticking with our theoretical scenario, we are looking for someone who likes large cap value. We want a manager who has demonstrated that his total objective is large cap value and nothing else. We don’t want someone who has demonstrated “style drift.” When deciding for a client, I look at the manager’s record, and, in our scenario, I should be able to see that, for the 10 years he’s been at the mutual fund, the manager only has large value stocks in his portfolio. And a real rating service worth its weight will be able to show you that kind of information about a manager. (Just a note here: Choosing a large cap value stock is especially illustrative for our example, as large cap value is an asset class that has been doing badly in recent times. And the temptation for a manager may be to drift from this objective, because a manager gets paid based on his performance. So, if we’re going for large cap value, we want that manager who stuck to his guns as far as large cap value is concerned. He didn’t drift in his style. After all, the mutual fund company should not be making asset allocation decisions. Those decisions should be made by you, the investor. If you pick a mutual fund that drifts all over the place, then you have lost control of the portfolio. And your chosen asset allocation is the most important thing to you. You don’t want a manager who will be moving things around on you.)

Okay, if your research indicates that the manager has been with the mutual fund for 10 years, and he hasn’t drifted, you then need to determine just how well he has done. And what I look at first is the quartile rankings. Is he in the top quartile, or the top 25, in terms of performance during the periods—during the one-year period, the three-year period, and the five-year period? Where

does he fall—first quartile, second quartile, third quartile? Think of it like the rankings of a sports team, perhaps. Or an actor's most recent film. Did it break into the "Top 20"? Was the film a top-ten grosser during its first weekend of release? It's a way of comparing this mutual fund manager to his peers. How does he stack up against them?

And it's a fair comparison. After all, you're comparing value manager to value manager. You're not comparing a hot sector of the market to a cold sector. And I tell you this: Generally, do not deal with companies who are not in the first quartile in the three- and five-year periods. Those who don't make that cut are immediately removed from my consideration.

Next, look at their actual ranking. Were they first in their asset peer group, or were they 23rd? Were they out there leading the pack, or did they barely make the first quartile? Their positioning is important.

After that, you have to look at some technical issues, like the beta co-efficient and the standard deviation. And that is really all about the volatility of the fund, meaning how much risk did the manager have to take to achieve his ranking. How much volatility was involved? To make it simple, *the best measure is the beta measure*. A beta measure of 1 means that the fund is as equally volatile as your representative index (an index is a random group of securities that represent how a group reacts). So, a beta of 1.2 would mean that the fund is 20% more volatile than the market, which wouldn't be too good. A beta of .9 is less volatile.

If you do all of this on your own, you are going to find that you come up with a surprisingly small number of funds. You may come up with 20 out of 5,000 that really match up with everything you want. Generally, most of those 20 funds will be pretty decent.

With my clients, after that point, I go through some very detailed analysis that is much more technical than what you need to know. But, generally, that's where the artistic portion of investment management comes in. Which fund do you really feel more comfortable with? I may even consider talking with each manager about what is going on. But most of the public can't do that; they don't have the access I would have.

If you are doing it on your own and you get to this point, you are left to your own devices. I can't really give you a good system. A foolproof system doesn't exist. But generally, if you get yourself this far, you can be assured that you are dealing with the top guys, from a performance standpoint. The key is balancing performance against risk, or volatility—the beta measure. That is the artistic aspect of it—the instinctive or intuitive. As such, it is very subjective. You just have to figure out what you feel is right for you. There's no rule of thumb in this area.

I know this may leave you hanging somewhat. But I show and tell you all of this to give you an idea of how hard it is to do it on your own. This is where most people let a professional step in.

To finish with the scenario: So now you have found yourself a suitable fund. Maybe you have found several. Let's say that you found three that you are comfortable with. With \$200,000 that needs to go into large cap value, you then split it between three of these mutual fund managers. And you would probably do reasonably well. But, keep in mind, in this process you'll find that it is very difficult to come up with investment managers that do not drift in their style.

Plusses and Minuses

Let's look at the positives and negatives of equity mutual funds.

On the plus side, you can diversify over a lot of securities. You can even diversify over a lot of managers, even a lot of managers and companies. However, these conveniences come with a price. Mutual funds can cost upwards of 3% annually when you look at management fees, marketing fees and fees associated with trading. If you choose to use mutual funds, make sure you can justify the fees.

On the minus side, you really don't have control over the tax issues. A mutual fund can distribute tax to you even if you don't sell it in that year. The tax issue becomes a little more complicated.

Here's another disadvantage: What do you do if the manager leaves the fund? The new guy who comes in is not the guy who was pulling the trigger on that fund. You must then ask yourself if you want to stick with that fund or move on. And that can be difficult to determine.

But if you follow the basic tools, you should get close to correct—or you should get close to good advice.

BONDS

As far as bonds are concerned, Peter Lynch—best-selling author and one of the top money managers in the field—once wrote that he can't imagine why anyone would pay a mutual fund manager to manage bonds. And, in general, I have to agree with him. I say “in general” because I think there are some specific exceptions to his idea.

But, generally, I feel that bond funds—for many, many reasons—are not advisable. For one thing, you pay a management fee on bonds, which lowers your return. For another, there's an inherent psychological risk: The average investor

has a demonstrated tendency to buy and sell bond mutual funds at absolutely the wrong time—usually when the interest rates are moving in the opposite direction of what they should be doing.

For the most part, the only reason an investment advisor or broker will tell you to buy bonds is because they don't have to deal with them. They buy the bond fund and that's it as far as they are concerned. They don't have to do any more work. They get their commission and walk away from it. (To clarify, I am talking about corporate bonds, treasury bonds and municipal bonds. With other specialized applications—like high yield bonds or junk bonds or international bonds—I think the mutual fund format is useful, because a tremendous amount of analytical work goes into buying those bonds.)

For the successful retiree, I recommend buying individual bonds, not bond funds. How you actually select individual bonds is, again, somewhat complicated, and I'd leave it to a professional advisor. But, in general, I recommend staying away from corporate bonds, municipal bonds and treasury bond funds. If you already have them in your portfolio, you need to stop and ask yourself why. But, I expect you've already asked yourself that question, as the performance on those bonds is so bad.

Who Would You Want to Sell You Bonds?

Here's an important point from earlier in the book that bears repeating, especially when it comes to individual bonds: Ask about licensing. Remember back in the early chapters when I discussed licensing, specifically the Series 6 and Series 7 licenses? You'll recall that someone who only possesses the Series 6 license is not allowed to buy individual stock bonds. His business is with mutual funds only. Because he didn't acquire the Series 7 license, he cannot buy and sell bonds. That is why it is so important to ask about these license se-

ries. Someone you could be dealing with may not be legally allowed to sell you individual bonds. He may be clueless when it comes to individual bonds.

Cash Type Investments

As an investment advisor, what I mean when I refer to cash type investments are treasury bonds and money market bonds. Cash, to me, is the fuel of the portfolio. Cash in the portfolio is your best friend. Cash allows you flexibility. It allows you to buy when markets are down.

In all of the portfolios that I manage, I generally have a target allocation of at least 10% cash all of the time. That gives me the ability to move back and forth and jump in at different times to do what I have to do as a money manager.

To demonstrate what I mean, let's say you have a \$2 million account. That's \$200,000 sitting in cash—in your money market account. And as this money market account is making its 4% or 6%—not doing a whole lot, really—you, the investor, may say, "I want a little more interest in that \$200,000." What are your options? You can buy treasury securities, perhaps, which gives you a little better return. And that is perfectly reasonable.

But a Series 6 licensee will only be able to buy you a treasury mutual fund, whereas a Series 7 licensee can buy the actual treasuries. And, in my opinion, the actual treasuries are much better.

But it all gets back to the level of licensing sophistication your representative has.

Individual Bonds

Let me jump back to individual bonds and give you a couple rules:

As a rule, bond prices—meaning the value of a bond—move with interest rates. Think of it as a seesaw. When interest rates go up, bond prices go down. So, generally, when interest rates are in a low interest-rate environment, you want to buy short-term bonds. They are less volatile.

When interest rates are very high—like back when they were as high as 18%—you want to buy very long-term bonds (e.g., a 30-year bond). In the present environment, I recommend people buy five-year or seven-year bonds. Why? If and when interest rates go down, bond prices go up. So, if you are sitting on a bond right now that is paying you an interest rate of 18% for the next 30 years, that's worth a lot of money, especially if interest rates drop down to something like 10 percent.

What I see happen very often is that a customer will be contacted by a broker who'll say, "We've got this 30-year bond that is at 9%, and the going rate for bonds right now is 8 percent." The customer will say, "Great! I'll lock in my money for 30 years to get that extra 1 percent." Obviously, the customer can sell that bond before that time, but the customer won't know what the value is going to be. It can go up or down. So, generally, I advise you *to stick with short-term bonds in low interest-rate environments and long-term bonds in high interest-rate environments*. What I mean by short- and long-term is maturity—when the bond matures. A seven-year bond matures in seven years; a 30-year bond matures in 30 years. If you stick with that rule, you'll be okay.

Of course, there are other factors to consider—like bond duration or bond quality, for instance. But those are really management issues that an investment advisor needs to handle. And, clearly, you need to be able to discuss management issues with whoever is advising you, unless you feel confident in doing it yourself. But those are the basic rules.

CONCLUSION

What I've given you in this chapter is the basics of how to build a portfolio.

Everything discussed can be easily talked out with a good investment advisor—one who will answer the kinds of questions you, as a successful retiree investor, need to have answered. That's the important point you must take with you from this chapter. You need to have the kind of investment advisor who will willingly and immediately answer those questions, not someone who hems and haws and gives you meaningless “spin” and jargon.

The same holds true if you try and invest on your own and you call a mutual fund company, or you call a broker. Whoever you decide to call should be a competent person willing to answer your questions. Beyond that, the actual building of a portfolio gets very complicated. And you should be aware of that.

If you do decide to do it on your own, here is the strongest indication that your portfolio is healthy and is reacting as it should: In a healthy portfolio, some things will be going up while some things will be going down. That indicates to me that the portfolio demonstrates real diversification and that it is working. That's something I'm happy to see when I manage a portfolio.

And if you're working with an investment advisor, he should be able to give you a good idea of your expected return as well as a good idea of the degree of risk you're taking.

Keep this in mind: A portfolio is organic. It has a life of its own. Some things should be going up, some things down and some should be staying flat. That's normal. That's diversification at work.

CHAPTER EIGHT

Insurance Products That Work

In this chapter I want to cover two important insurance-based ideas that I like. I know this is going to surprise you, considering the stance I've taken in previous chapters about insurance. While it's true that I am selective in endorsing insurance-based ideas, I now want to introduce you to a couple of products I feel are good for you to know about. Indeed, these products are perfect for the successful retiree. As you'll see, they are extremely creative—and they work.

Not only are they effective, they're unique. Ninety percent of investment advisors never even discuss these products with their clients. So, I'm going to make you privy to information dispensed by only the top 10 percent of independent investment advisors in the country.

INDEX ANNUITIES

The first of these products is something called the *index annuity*. This product is ideally suited for people like yourself, who are retired and, by necessity, very concerned about conservation of principle.

To give you a complete understanding of how an index annuity works, I'll need to create for you a hypothetical example. This

example will take into account a lot of what you've learned so far in this book: regulatory issues, how brokerage houses operate, licensing issues. Armed with that foundation of knowledge, you'll be able to grasp the implications and impact this product can have for you.

For the sake of our example, let's pretend we can create our own mutual fund. And let's pick one of the most popular mutual funds available: the Vanguard Standard & Poor's 500 Index Fund. People have flocked to this fund because of the 1997-1999 bull market. However, you should remember that most mutual fund managers fail to beat the market.

Like any mutual fund, the Vanguard S & P 500 Index Fund goes up and down with the market. But let's add an interesting element to this hypothetical situation we've placed ourselves in (where we invent our own mutual fund). Let's say we create a mutual fund that allows us to realize most of the upside potential of an S&P Index Fund but, at the same time, will never go down. In other words, in any one year, we would never lose any money on this fund. For instance, let's say that, in one year, the S&P drops 10% as in the year 2000, or 26.49% (as it did in 1974)—or it drops 4.9% (as it did in 1981) or 3.11% (as it did in 1990). Our investment wouldn't go down.

Of course, as you know, any time you have an investment, you have accompanying fees. So let's figure a fee into our hypothetical fund. And let's say that, since we are the investment managers of this fund, our actual rate of return is going to be the S&P index less a 2.5% fee.

But, as the investment managers, we could turn to our shareholders and say that we are going to guarantee that in any one year we will return at least zero percent. So, even if the S&P goes down 14.8%—or whatever the number is—we will guarantee

that the shareholders make at least 0% yearly. That beats the market in 2000 by over 10 percent.

Sounds great, doesn't it? What do you think would happen if such a fund actually existed? Well, for one thing, all of the major roadways leading to our office would be clogged. If we could guarantee against market loss, people would be breaking down our doors to get to it. And the second thing that would happen—and this would be inevitable—is that the Security Exchange Commission would probably shut us down. Why? Because no fund is allowed to make such a guarantee. The SEC would have a real problem with our mutual fund. And that's why something like this hypothetical fund doesn't exist in the real world of mutual funds. From a regulatory standpoint, no one is allowed to guarantee against loss. But it sure is a great idea. In fact, let me show you just how great it is. Let's take the idea a step further and attach some real numbers to it. Let's come up with some specific examples.

Let's say we started this mutual fund in 1970 and we invested \$100,000 in the S&P 500. Where would we end up in 1999? (See chart)

Comparison of the Return on the S&P 500, Dow Jones Industrial Average, Index Annuity, Variable Annuity,
and an S&P 500 Index Fund over the past 30 years (Initial Investment of \$100,000)

Annuities tied to the S&P 500

Year	S&P 500	Percent Change	DJIA	Percent Change	Variable Annuity	Percent Change	Index Annuity	Percent Change
1970	\$103,984	3.98	\$104,810	4.81	\$100,980	0.98	\$100,980	0.98
1971	\$118,875	14.32	\$111,219	6.12	\$112,411	11.32	\$112,411	11.32
1972	\$141,390	18.94	\$127,436	14.58	\$130,329	15.94	\$130,329	15.94
1973	\$120,468	-14.8	\$106,309	-16.58	\$107,131	-17.8	\$130,329	0.00
1974	\$88,561	-26.49	\$76,987	-27.58	\$75,538	-29.49	\$130,329	0.00
1975	\$121,570	37.27	\$106,497	38.33	\$101,425	34.27	\$151,182	16.00
1976	\$150,271	23.61	\$125,525	17.87	\$122,328	20.61	\$175,371	16.00
1977	\$139,156	-7.40	\$103,848	-17.27	\$109,606	-10.4	\$175,371	0.00
1978	\$148,235	6.52	\$100,575	-3.15	\$113,464	3.52	\$181,544	3.52
1979	\$175,628	18.48	\$104,785	4.19	\$131,028	15.48	\$209,647	15.48
1980	\$232,656	32.47	\$120,440	14.94	\$169,643	29.47	\$243,191	16.00
1981	\$221,138	-4.95	\$109,320	-9.23	\$156,156	-7.95	\$243,191	0.00
1982	\$268,782	21.55	\$130,747	19.60	\$185,123	18.55	\$282,101	16.00
1983	\$329,408	22.56	\$157,246	20.27	\$221,333	19.56	\$327,237	16.00
1984	\$350,075	6.27	\$151,374	-3.73	\$228,571	3.27	\$337,938	3.27
1985	\$461,144	31.73	\$193,241	27.66	\$294,239	28.73	\$392,008	16.00
1986	\$547,226	18.67	\$236,882	22.58	\$340,346	15.67	\$453,436	15.67
1987	\$575,957	5.25	\$242,229	2.26	\$348,004	2.25	\$463,638	2.25
1988	\$671,617	16.61	\$270,940	11.85	\$395,367	13.61	\$526,739	13.61
1989	\$884,423	31.69	\$343,978	26.96	\$508,798	28.69	\$611,017	16.00
1990	\$856,959	-3.11	\$329,048	-4.34	\$477,711	-6.11	\$611,017	0.00
1991	\$1,118,062	30.47	\$395,902	20.32	\$608,938	27.47	\$708,780	16.00
1992	\$1,203,230	7.62	\$412,431	4.18	\$637,071	4.62	\$741,526	4.62
1993	\$1,324,508	10.08	\$469,028	13.72	\$682,175	7.08	\$794,026	7.08

Year	S&P 500	Percent Change	DJIA	Percent Change	Variable Annuity	Percent Change	Index Annuity	Percent Change
1994	\$1,342,005	1.32	\$479,060	2.14	\$670,714.64	-1.68	\$794,026	0.00
1995	\$1,846,375	37.58	\$639,318	33.45	\$902,647.76	34.58	\$921,070	16.00
1996	\$2,270,213	22.96	\$805,635	26.01	\$1,082,816.25	19.96	\$1,068,441	16.00
1997	\$3,027,630	33.36	\$988,043	22.64	\$1,411,559.27	30.36	\$1,239,392	16.00
1998	\$3,892,744	28.57	\$1,147,101	16.1	\$1,772,494.97	25.57	\$1,437,695	16.00
1999	\$4,712,313	21.05	\$1,436,422	25.22	\$2,092,430.31	18.05	\$1,667,726	16.00
2000	\$4,283,240	-9.11	\$1,347,677	-6.18	\$1,839,037.00	-12.11	\$1,667,726	0.00
Rate of Return	12.89%		8.75%		9.85%		9.50%	

*S&P 500 and Dow Jones Industrial Average Data provided by CDA Wiesenberger.

S&P 500 Index Fund calculated as 0.8% less than the S&P 500.

Variable Annuity calculated as 3% less than the S&P 500.

Index Annuity calculated as 3% less than the S&P 500. Return on Index Annuity cannot be greater than 16.00%, nor can the return be less than 0.00%.

I know what you're thinking as you're looking at this chart: "Wait a minute. What this says is that our mutual fund made over 9 % with no down years. So how on earth did that happen?"

Here's how: When you look at the chart, you can see that there were several years (1973, 1974, 1981, 1990, 1994) when money was lost in the S&P 500. But in the example we created, we guaranteed against loss. Basically, what we did was produce an investment vehicle that has less risk than the market and still offers a better return.

It reminds me of the old investment adage: "If you want to make better returns in the market, you have to buy small cap stocks because they are extremely aggressive." Well, with our example—the mutual fund that we have created—we just tossed that adage out the window. Our theoretical investment turned the whole investment world upside down. All of the rules and the sales tactics just became obsolete.

At this point, I want to show how a *variable annuity* would do in this situation. (You remember the variable annuity—how they were sold and oversold, and how people found themselves with a large percentage of their assets in variable annuities that were stuck inside IRAs.) Well, the average fees on a variable annuity are about 3 percent. Therefore, to calculate how a variable annuity would fare against the investment we created, you would take the S&P 500 minus the 3 percent. What's left would be the net return every year.

And what would the net return be? Let's consult the chart to get some figures. If you had put \$100,000 in variable annuities in 1970, then you would have had \$1.8 million in 1999. Again, looking at the chart, you can see that that is *significantly* less than the S&P 500—but, there is even a greater disparity between our theoretical investment and a variable annuity. True, a variable annuity is tax-deferred. And with that advantage, maybe that makes it all right. Still, you're comparing a variable annuity at \$1.8 million to our investment at \$4.0 million. The net return on our investment is 11.1 percent

There's a reason why I wanted you to understand the workings of our theoretical investment. True, because of regulatory issues, it is not—and never will be—available to you in mutual fund form. But guess what? *It is available in an annuity form.* That's right. And it's called an index annuity, and it is tax-deferred. It is the first of these two insurance-based products that I recommend.

Variable Annuities vs. Index Annuity

Here's the part where our hypothetical investment enters the realm of the practical, so pay close attention.

If you've read this far, you know that variable annuities are not good. Some of you might even be stuck with them. But—and here's some good news—there are ways you can fix them.

If you want to fix a variable annuity, you first should determine if it's in an IRA. If so, then you've got a problem with your broker. (He “brokered” you—remember that term?) Your broker sold you something that guaranteed him a large commission. He's benefiting himself, not you. And I'm willing to bet that he never told you about something called an index annuity. No doubt, he praised variable annuities as the greatest thing since sliced bread (and from his end, it is). At the same time, he was silent on the subject of index annuities. Here's why: Most brokers won't discuss index annuities because they are restricted from soliciting them because the brokerage firm can't get a cut. On the other hand, if they sell you a variable annuity, they (the firm and the broker) get a fat commission.

Let me guess what most likely happened when you were sitting in your broker's office. You went to him and essentially said, “I don't want to pay taxes on my money. I want to put it into something that is tax-deferred.” And your broker essentially said, “Aha! Variable annuity! That's what you need and that's what you want and that's what I've got!”

If it didn't happen that way, then it happened this way: You said to your broker, "I have this old fixed annuity that has been sitting around forever paying only 3 percent. What should I do with it?" And he said, "Aha! Variable annuity. That what's you need and that's what you want and that's what I've got!" It's the brokers' equivalent of the knee-jerk response.

But what you may have really wanted was an index annuity. After all, since 1970, an index annuity has produced a 3.6% greater return each year, resulting in \$3 million worth of more money over 30 years. But you didn't know about this because your broker didn't tell you.

Brokers don't tell clients about index annuities because they'd rather their clients didn't know about them. Index annuities are not a registered security. You only need an insurance license to sell them. That's a very important point. *If an index annuity can be sold directly by an insurance agent, that means that the brokerage house has no control over that asset.* No regulatory requirement exists that says a broker has anything to do with that transaction. It's a transaction that exists outside of the brokerage community. Therefore, what do they do? Well, in many situations, brokerage houses will inhibit the sale of that product because it takes money out of the brokerage community and out of the broker's pocket. The money from that transaction instead goes directly to the insurance company. The bottom line is, big brokerage houses have a lot of operation expenses to pay—costs of all those big buildings they're housed in, their secretarial staff, phone lines, computer terminals, etc.—so they're not going to be interested in anything that isn't going to put money in their pockets.

So you get sold a variable annuity when what you may really want is an index annuity. At my firm, we have a specific analysis

we perform for clients. It demonstrates how a variable annuity fares compared to an index annuity. And it's a very revealing analysis. An index annuity beats a variable annuity hands down. An index annuity can actually be guaranteed—much like that hypothetical investment vehicle we created.

True, a younger person who doesn't yet have to care about guarantees is not going to be all that interested in this type of product. But an index annuity is ideally suited for you, the successful retiree, as you are at that point in your life when you must be concerned with conserving your principle. And with this product, you conserve your principle because you are guaranteed to make zero percent. Now I know that that doesn't sound like a lot. But think of it this way: If the S&P loses 20% and you've made 0%, you beat the market by 20 percent. That's a dramatic advantage. Your 0% is going to look pretty good when your neighbor is down 20%—when his \$1 million just turned into \$800,000 and your million is safe. You just had your cake and ate it, too: You not only conserved your principle, you made more money than the S&P index fund.

So, the best way for you to invest in the S&P 500 may be an index annuity. How do you go about fixing that variable annuity? Well, since it's an insurance contract, you better be careful. The only thing required to sell this is an insurance contract, so you have to find someone who specializes in this area. The agent who sold you your homeowner's policy is licensed to sell this product, but he or she might be totally clueless about it. An index annuity is just like any insurance policy: You have to tread very lightly and you have to be very careful about who and what you are dealing with, because there are a lot of junk contracts out there. And, unfortunately, the junk contracts pay the highest commissions. You just can't call up the local insurance guy and say, "Hey, I want an index annuity." Chances are, that local insurance

guy won't be an expert about the product. Very likely, he'll sell you a junk annuity because he smells a commission.

So here are some things to look for in the annuity contract:

1. **Participation rate** – This refers to how much of the market appreciation you participate in. This can be described as a percentage (90%, for example) or it can be described as a flat number (the market less 2.9%). Usually, participation rates change and aren't guaranteed. I've seen contracts that say the participation rate can be moved to 50 percent of the market. That's not a good deal. It's not the type of contract you want to buy. You want something higher.
2. **Earning cap** – Some companies will put a cap on how much you can earn, and that cap will determine the quality of the contract. For example, in 1995, the S&P 500 made 37.58 percent. That's a lot. But what if your index annuity contract says the company caps you at 15 percent? That's not so good. Who made that other 22 percent? The company did.

So, when you are looking to purchase an index annuity, you want a good participation rate and you want high caps. Those are some of the keys to a good contract.

Also, I've seen annuities that don't even guarantee a rate of return. They guarantee that you won't lose, so your guaranteed rate of return is zero. But I don't like that idea. I would want a guaranteed profit every year—and so should you. There aren't that many contracts that fit those criteria.

Here's another thing to remember: Index annuities are a very specialized area. A low percentage of annuities are sold as index annuities. Why? Like brokerage houses, the big insurance companies love those fee-dripping variable annuities. A big company

wants its agent representatives to get licensed with a *Series 6*. And you remember the *Series 6* license from an earlier chapter: It's a limited license that limits the choice of investments a broker is able to utilize. The companies want their agents licensed this way so that they can sell you—guess what?—variable annuities, variable life insurance and mutual funds (ironically, the most profitable for the companies). The large companies are more concerned with variable annuities because they can, of course, make more money off of them.

So this is a neat little product available to you and directly suitable to your situation as a successful retiree. It has a lot of advantages. You just need to find someone who is truly competent in this area.

Index annuities—check them out. Just like long-term care, it's a good use of insurance.

Now let's move on to another good product.

PENSION ASSET TRANSFER

Here's a really clever product, one that will lessen your tax burden.

In my business, I often see retirees who have very large retirement plans or IRA assets. That, of course, is good. You're talking about accumulated, tax-deferred money. The only problem is, when you take the money out, you have to pay income taxes. And, depending on circumstances, there might even be estate taxes attached. So you're talking about a significant percentage. Combining the income tax and the estate tax, you come up with a tax rate of about 60 percent (under current law). That means if you've got a million-dollar asset, Uncle Sam gets \$600,000. And

that means that your heirs—your children—are left with the smaller purse.

Makes you crazy, doesn't it? Well, what can you do about it? That's not a rhetorical question. There's a solution to the problem and it is something called the *Pension Asset Transfer* program. Ever heard of it? As with index annuities, most people haven't.

Pension Asset Transfer is a concept developed by a GSL Advisory Services, Inc., of Walnut Creek, California. It's great for retirees, and its impact is profound. How profound? As profound as the elimination of the estate tax. The program enables you to take money out of your qualified plan—your IRA, retirement plan—tax-free.

I know what you're thinking: "How in the world is it possible to take money out those accounts tax-free? The IRS won't allow it."

Well, guess what. The two gentlemen who developed this program—Ed Lichtig, MBA, and Larry Weiss, CPA—received a positive determination letter from the IRS. In essence, the IRS told them, "yes, you can do this." You'd be surprised the effect a determination letter from the IRS can have. I have not met an attorney or an accountant who did not enthusiastically endorse this concept once they heard about that letter of determination.

What Lichtig and Weiss have developed in this program is a very specialized prototype document that provides "enhanced flexibility" within a retirement plan. And it's a very ingenious document that enabled Lichtig and Weiss to exempt themselves from certain rules (again, with the IRS' blessing). Taking advantage of the latitude allowed, they came up with a way to use equity-

indexed life insurance as a means to get money out of a qualified plan tax-free.

Again, I know what you're thinking. You're probably as skeptical as I was when I first heard about the concept. In fact, my first thought was, "Here they come again. Some insurance guys have come up with another way to sell a junk policy that will earn them a big commission." When the company first contacted my office, I didn't want to talk to them. However, I was curious enough to visit their Web site. Eventually, I did meet with Lichtig and Weiss, who turned out to be well-credentialed professionals. When I got all the information, figured out how their program worked, I paid a visit to some tax attorneys and accountants and tried the concept out on them. At first, they looked at me like I had just tossed chicken bones and tarot cards on their desks. But when I showed them that determination letter from the IRS, they became believers. "You're not going to run into any problems with that letter," they said.

Okay, let me walk you through some specifics, to give you an idea of how Pension Asset Transfer works.

Here's the basic idea: If you have a qualified plan—like an IRA—you can move it into their plan and, from inside that plan, you can purchase life insurance. You can purchase the insurance on you, your wife, your kids—it doesn't matter. (And if you're in poor health, don't worry about it. That's not really a concern.) Now, anybody who is quite familiar with life insurance will probably tell you that, when you put money into a policy, it tends to evaporate very quickly. And this is what I mean by that: Let's say you put a \$50,000 premium payment into the policy. That doesn't mean that you have \$50,000 cash value in that policy. The insurance company takes out their expenses, and they'll probably have surrender charges and a bunch of other such items in there. But, over the long term, that money will start accumulating again.

Before I go any further, I've got to stop and point out two significant things about Pension Asset Transfer:

- First, the life insurance product that Lichtig and Weiss use in this program is variable life insurance. (*Ominous thunder on the soundtrack.*) I know, I know—all throughout this book I've been telling you that variable life is never the right thing for the successful retiree. But this is the one exception to that rule. (In the financial industry, there is always a rule and at least one exception to the rule.) I don't have a problem with variable life in this situation—*only* in this situation—even though it drips with fees and is inefficient in every way. The dramatic tax benefit that you'll realize will outweigh all the negatives of the variable life product.
- Second, Pension Asset Transfer really should only be used by those who have IRAs in excess of \$750,000, or by those who have IRAs that they currently don't need for income, but they've accumulated the money nevertheless.

Okay, to continue.

So let's say you want to put \$50,000 into this product. Here's what is going to happen: You buy the policy and, let's say, you put \$50,000 a year into it for three years. That means you've put \$150,000 into it, but because of surrender charges and other costs, the policy is probably only worth about a third of that—that is, if you wanted to cash it in. The policy is growing interest on \$150,000, but, if you cashed it in, it would only be worth about \$50,000.

Well, the idea with Pension Asset Transfer is to take that policy and withdraw it from your IRA—at the same time dramatically lowering the amount of insurance you purchased. True, most insurance

contracts won't allow you to do all of that. But Lichtig and Weiss have found a very specific policy that, indeed, allows you to do exactly that. MetLife can't do it. Prudential can't do it. But you can do it through this specialized product. Now, just because someone like Prudential can't do it doesn't mean we're dealing with some little fly-by-night company. We are dealing with a very specialized product that only works in this application.

Moving forward: You then take this insurance policy out of your IRA. Granted, if you take it out, you're going to have to pay *some* taxes. You'll have to pay tax on that \$50,000 value that you have. But it is worth \$150,000, so it is gaining interest on \$150,000. So you just took out \$150,000 from one-third of the tax liability.

But it is still in your estate—you still own the policy—although any withdrawals that come out of that policy are going to be taxable. So let's assume here that they have not yet repealed the estate tax. There are several things you can do with the policy. You can leave it in your estate, and it may be taxed. But some people will gift it to their children, so that their children will now own it. Okay, so let's advance that situation—the children owning the policy—to a next logical step. Perhaps mom and dad might be in need of some money. Maybe they weren't smart enough to buy long-term care insurance and they had to go into a nursing home for awhile, and now they need some money. Well, the kids can take the money out of the policy and gift it back to the parents. So mom and dad get their money. And they get it tax-free, because they are going to take a loan against the policy. They just took the money out tax-free.

Let's look at the opposite type of situation, where the parents are never in need of the money. Ten years after gifting the policy to their children, mom and dad die. What happens to the insurance policy that the kids now own? Going back to the figures used in the example, we see that, 10 years ago, the parents put \$150,000 into the

policy. It has been accruing interest on that amount for 10 years. Let's assume that it made 10% a year and, 10 years later, it is worth \$250,000. What is the tax treatment of that amount upon the death of the parents? Do you think it's taxable? No, it is not taxable. All the money just went to the kids tax-free.

So, basically, Pension Asset Transfer is a conduit that truly allows you to control the taxes on IRAs. It allows you to get access to them and it allows you to get a majority of those assets to your kids tax-free. And if you are still alive and need the money, you can get it tax-free as well—in the process of a loan against the money that you already have.

And what is the best part of all this? The IRS, in its letter of determination, says you can do it.

As I've said, this is a very unique product. It's very rare that the average broker has even heard about it—even a successful broker. But that doesn't mean it's a gimmick that an insurance company has dreamt up to get its agents to sell more insurance. At first, that's how I felt. I thought it was just another crazy scheme coming out of California. But it has been written about in the top pension guides. Many industry experts have analyzed it very carefully, and with positive response. And make no mistake—the advantages of Pension Asset Transfer are unbelievable. This can catapult you into a totally different tax realm.

The average brokers don't have access to this product, mainly because their compliance departments won't allow them to have anything to do with something that's not going to make a big brokerage house any money. That's why you need to deal with an independent investment advisor. And that's why you need to be able to ask the questions I talked about earlier in the book, about issues like licensing. It is critical that you can put those kinds of questions to someone who might handle your money.

CONCLUSION

The two products discussed in this chapter serve as two perfect examples why many people miss the boat on excellent investment products or techniques. They operate under the misconception that if you go to a big brokerage house—like Merrill Lynch or Dean Whitter—the agents there will take care of you, just because they belong to a big brokerage house. Well, it's not true. In my experience, I've seen the grossest mistakes and misinformation come out of those types of companies.

REVIEW

Let's recap the important points you need to take from this chapter:

- I've shown you that there is an instrument that enables you to fix your variable annuity problem. And hardly anyone knows about it. This instrument is an index annuity, and it is a very neat product available to you and directly suitable to your situation as a successful retiree.
- I've shown you a technique that allows you to take large chunks of money out of your IRA tax-free and get it to your kids and get it to yourself tax-free. This technique is known as Pension Asset Transfer, and it can even make it possible to lower your estate taxes.
- Ninety percent of the people I meet with don't even know about index annuities or Pension Asset Transfer.

But now *you* do.

CHAPTER NINE

Estate Planning I

As estate planning can become quite involved, I'll break the subject into two chapters. The first (this one) will deal with the basics. In the next chapter, I'll cover some of the more advanced estate planning techniques.

Essentially, at its most basic level, estate planning involves maintaining control of your assets. To really drive that point home, let me illustrate by showing how some famous people fared in controlling—or *not* controlling—their own assets.

Estates of Famous People

<i>Name</i>	<i>Gross Estate</i>	<i>Settlement Costs</i>	<i>Net Estate</i>	<i>Percentage Shrinkage</i>
<i>William E. Boeing</i>	\$22,386,158	\$10,589,748	\$11,796,410	47%
<i>Gary Cooper</i>	4,984,985	1,530,454	3,454,531	31%
<i>Walt Disney</i>	23,004,851	6,811,943	16,192,908	30%
<i>J.P. Morgan</i>	17,121,482	11,893,691	5,227,791	69%
<i>Elvis Presley</i>	10,165,434	7,374,635	2,790,799	73%
<i>John D. Rockefeller, Sr.</i>	26,905,182	17,124,988	9,780,194	64%
<i>Frederick Vanderbilt</i>	76,838,530	42,846,112	33,992,418	56%
<i>Dean Witter</i>	7,451,055	1,830,717	5,620,339	25%

Some of the information is rather startling, isn't it?

One thing you may have noticed about the people on the list: All of them are dead. This helps illustrate another essential underlying concept of estate planning. This might sound some-

what bizarre, but estate planning is a way to extend your influence beyond the grave. As you'll see in this chapter, what you do when you are alive will determine the shape of your estate after you're gone. I'll demonstrate why that is such an important consideration.

THE THREE STAGES OF ESTATE PLANNING

Estate planning involves controlling your assets at three different stages:

- Stage 1: When you are alive and capable of making planning decisions.
- Stage 2: If and when you become disabled and cannot handle your financial transactions.
- Stage 3: After you're dead (Oh, yes – you still can control where your assets go)

So, let's get down to basics.

STAGE 1

In the first stage of estate planning, you are alive and healthy. You're still an actively involved member of society. You've worked most of your life and now you're enjoying your retirement. You're taking trips, working on your golf game, writing your memoirs, whatever. Things couldn't be better. So, what is it you should be doing to control your assets during this period? Well, first you need to know that you have several rights that you can exercise. You can:

- *change the title of your assets*, meaning that you can change a title from your name to your spouse's name, to your children's names or to a trust—whomever you wish, really.

- *gift your assets*, meaning that you can make a gift of any or all of your assets to any other person (or entity like a favorite charity) that you choose.
- Buy and sell assets

The meaning of that last one is fairly obvious, I'm sure.

As you can see, you enjoy the most flexibility during this stage. You are not severely disabled, physically or mentally. So what exactly do you do?

The answer is rather simple. I have found that, for most of my clients, the best course is the least complex. Take the path of least resistance. Do whatever is easiest.

Think about it. Who really wants to sit at home balancing 15 different investment accounts? This is the time of your life when you should be enjoying a game of golf, taking up archery, going on a cruise, planning a cross-country RV trip. Therefore, here's what you need to do to make your life easier:

1. Consolidate your assets into as few accounts as possible.
2. Title and organize your assets in such a way that, if you become disabled or die, your assets are structured so that someone else can handle them in an efficient manner.

In other words, consolidate your accounts and put them in a title format so that your disability trustee, or your executor, can handle the assets without getting stressed out. Whoever you name should be able to easily determine where your assets are and what you can do (or—what they can do for you, according to your wishes). And here's something crucially important to ponder: As your trustee or executor is most likely going to be a spouse, a close

relative or a good friend—someone that you care about—it's the only reasonable thing to do.

The time to make those kinds of decisions is *Now!* Listen, I know how easy it is to put those kinds of decisions on the back burner. Many people do. It's only natural. But consider this: You can't perform that kind of planning when you become disabled or die. Therefore, the key to this stage is quite simple: Construct the plan when you don't really need it yet. Be proactive. In other words, just *do* it!

Here's another reason why you have to be proactive: One of the general rules in life is that, when you die, three entities can get your money: your children, a charity, or the government. Where it goes depends on what you do now. In Stage 1, you still have a choice. And if you choose to do nothing, the money will go to Uncle Sam first. If you choose to be proactive, the money will go to your loved ones or it can go to your favorite charity.

Overall, it is really a pretty painless process. So there's no reason why you shouldn't act now. In fact, it is something that really *needs* to be done.

STAGE 2

Retirement can be—indeed it should be—a pretty carefree, enjoyable period of your life. However, reality often intrudes. Something might happen that disables you in some significant way, either physically or mentally. How can you control your assets then?

A disability can come via a serious heart attack or a disabling stroke. Disability also can involve a cognitive impairment, like Alzheimer's disease. However the disability occurs, you could end up losing control of your financial situation. And that's very

serious. It usually means that someone has to step in and make decisions for you. And here is where all those proactive steps that you took in Stage 1—all of that planning, the quality of documentation—will come into play.

Documentation

The quality of your documentation can be especially significant in this stage. If you aren't concerned about documentation, you'll more than likely get stuck with some generic form that will have very little bite. I see it happen a lot.

That is why it's so important to choose a good attorney. Unfortunately, most people base that decision on issues totally unrelated to estate planning. Some choose an attorney who doesn't even specialize in estate planning. Instead, they might choose someone who specializes in real estate—and only because that attorney's name is familiar. They might remember that the attorney performed a great settlement for their neighbor or their kids. That's flimsy criteria for choosing someone to help you with your estate planning.

And if you choose an attorney in that fashion, you may get sub-quality documentation. You'll find yourself stuck with a generic, toothless document that we in the business call a "macro." A macro is generic legal document that attorneys keep on their computers. And pretty much all they have to do is type in a client's name and address. So, if you choose an attorney who doesn't specialize in estate planning, that attorney is going to use a macro on you. He'll double-click on the little macro icon, type in your name and address, and then wait by the printer as the computer spits out a generic document, and you'll have to pay \$300 bucks, and it all seems so simple. You might think this attorney did a good job because it was so quick and painless—not to mention cheap.

But you may have just cut yourself short.

Unless that document gives another person power of attorney if and when you become disabled, your rights and abilities—as well as your trustee’s power to act on your behalf—have become compromised. You still want to be able to exercise the rights you enjoy in Stage 1 when you are disabled. And some generic document may not give you the power to retitle assets, buy and sell assets, or gift assets to other people or charities. So you have to watch out. You need to spell out in your documentation that you have given another specified person the power to act on your behalf. And, depending upon the severity of your disability, it may be right and necessary to gift part of your assets or perform other functions. But, without effective documentation, your trustees’ hands might be tied and your rights may be compromised.

A good estate-planning document upholds your rights. And you are only going to get a good document from an attorney who specializes in estate planning. I can’t stress enough how important this is. We are talking about financial control, a significant issue. You can’t afford to be lackadaisical about this. Take care of it before something happens to you. The quality of an estate-planning document is critical.

Of course, when you hand over the control of your assets, that doesn’t mean you are giving the executor or trustee carte blanche to do whatever they please. If you put your oldest son in charge of your money, it doesn’t mean that he can take his family to Disney World on your ticket. You need to place certain mechanisms in your documentation—mechanisms that clearly state that whatever is done with your money, it is done in your best interests. And, again, that comes back to using a competent, qualified attorney to set up your estate-planning document.

Another important document related to disability is the *medical directive*, a separate document that deals specifically with medi-

cal treatment. And, again, the quality of that document is imperative, though not as imperative as the quality of the document that will control your assets. Make sure you talk to your attorney about it—your *estate-planning* attorney.

One more document I need to mention is the *revocable living trust*. I will go into more detail about this in the next chapter—as it is a very important issue—but I want to at least make mention of it at this point. A portion of the revocable living trust is usually the disability portion—or the “disability provision.” If you do a revocable living trust, you need to pay careful attention to this portion. There are pitfalls to be aware of. (We’ll go into that in more detail when we discuss living trusts.)

STAGE 3

To best illustrate what happens in Stage 3, let me create for you a scenario.

Okay, you suffered a heart attack, and you were disabled (Stage 2). If you took care of everything in proactive fashion (Stage 1) then you have good quality documentation. Someone you trust is now in charge of your financial situation. Your bills are being paid, your investment decisions are being made, your estate is being structured—all according to your wishes. (Of course, your trustee even may be applying for Medicaid or dealing with long-term care insurance on your behalf.)

Unfortunately, when people are disabled, sometimes they don’t get better. If you pass away, what is going to happen to your assets? Well, what happens will be dictated by how the assets are titled—whether they are in trust or titled in your name only or in a joint name with your spouse.

After you die, those who are left behind now must work out who gets what and how they get it. For the sake of this scenario, let's simplify the situation and say that your spouse has predeceased you. (Most likely he or she would have left everything to you; the surviving spouse would be the first to inherit.) So how do you control your assets after you're gone? It's not as outrageous a question as it appears.

As you were your children's last surviving parent, it was up to you to have spelled out where your assets go. Also, you accommodated for special requests (e.g., your favorite watch going to your oldest son). But how do those wishes get carried out? You—and everyone who will now be involved—would like it that everything would be handled efficiently, in a manner that is not cumbersome to anyone. Hopefully, you made the proper decisions back in Stage 1. And let's certainly hope that you didn't say, "It's not worth paying the attorney another thousand bucks just to make it easier on the kids when I am not here."

What if you didn't know much about estate planning and weren't very proactive in Stage 1? You didn't really organize anything, and you named someone an executor of a will that you made 25 years ago and hadn't looked at since. Now, whoever is that executor, it will be his or her job to tally everything up, find everything that should have been left in an organized format, figure out where your accounts are, get those accounts valued and then, basically, go through a process that is called *probate*. It's not a pleasant experience.

Probate

Probate is commonly defined as a court process for changing titles of assets upon death. But let me tell you what it really is: Probate is a way for attorneys and the government to get your money. And that's the plain truth, one of those dirty facts of life. Attorneys make a lot of money probating estates. And some states

make a lot of money off of probate in the form of taxes. But probate is completely avoidable—or it's at least almost completely avoidable.

So, we're at the point in the scenario where the probate process has reared its ugly head. The local government and an attorney are looking to get a large chunk of money from your estate. But, when you were alive and well, you weren't thinking about probate. You might have even said, "I don't care what happens after I'm dead. Why should I?" Well, here's one big reason why you should have: Everyone now involved in your estate will be forced to endure this big process that will take nine months. And major problems will happen—believe me, they will. Count on it. Someone is going to get hurt. One family member is going to get angry with another. And someone else is going to feel shortchanged. And someone else will feel that the undeserving were somehow accommodated at their expense. Don't think it won't happen in your family. I've seen it happen all the time. I even was involved in a situation where one of my clients sued his 87-year-old mother because he felt he wasn't getting enough in the will.

Trust me, big problems happen. And they happen because most people don't want to take the time, or spend a relatively little amount of money, to really spell things out with an attorney. And if you don't want to take the responsibility to control the assets after you're gone, then it is going to be your fault that your family is fighting. And who controls your assets in that situation? The kids and their egos and their spouses egos.

Those are the ugly effects of a poorly planned estate. And I think you'll agree that it's ugly. You don't want it to be part of your legacy. It's not the kind of influence you want to extend beyond the grave.

Revocable Living Trust

So how do you get around probate? The best way is by utilizing something I mentioned earlier called a *revocable living trust*. Let me explain more fully what it is.

First of all, *a revocable living trust does not, in and of itself, reduce your estate state tax*. It has nothing to do with federal estate tax. It has to do with local government and probate.

By utilizing a living trust, you are creating a trust that you are the trustee of—you have complete control of whatever assets are in that trust. The trust document controls who gets what. It travels to them the way a joint account would, and it travels to them almost immediately. The trustee merely changes the title on the account and the kids get the account. You don't have to go to the attorney and you don't have to go through the court system (the probate system). It all just happens. I have seen estates that have been settled with living trusts and, conversely, I've seen estates that didn't have living trusts. I've seen it both ways, so I can tell you from experience, it is so much more efficient when you have a living trust. This is how simple it works: You merely send a couple of pieces of paper to the company and they change the title, because the trust document already said that they have to do it.

But here is an extremely important point to remember: *The trust document only controls assets that are in the trust*. Let's look back at Stage 1 for a moment, when you created a living trust with your attorney. What that created for you was this bucket, so to speak, this trust. But what does it control? If you don't put any assets into that trust, you are not going to control anything.

And here's what could happen if you don't use the trust properly: Let's say you have all of your stocks and bonds in Merrill Lynch

in your name only, and you create a living trust named for you. Well, if all of those stocks and bonds are not retitled in the name of your trust, then you've wasted every penny that you gave to the attorney who created the document.

So, essentially, what you are doing is gathering all of your assets that are spread far and wide and placing them into a single bucket. That is what lawyers call "funding"—funding your living trust, or putting your assets into that trust. And that is the key. I can't tell you how many times I've sat in front of people who have paid \$3,000 to \$5,000 to an attorney to create some beautiful documents, but they didn't place any assets in those documents. And that's a shame, because those documents would have worked perfectly—if only the clients had placed their assets inside the documents. Instead, they never bothered to fund it, or they forgot about a certain account, or they never really figured out how to use it. And it came down to them to figure it out, because attorneys think it's a nightmare. Attorneys don't want to have to fund a trust. It's a very difficult thing to do to gather all of a client's assets and place them in a trust. So don't assume an attorney's doing it for you.

And if you decide to do it yourself, be careful, because it can really be a tedious and confusing task. It's better to have your financial advisor do it for you. Tell him what you need done and what you want to have done. Remember, the diligence that you exert about control during Stage 1, when you are healthy, will become crucial when you are disabled or you die. That is, your proactivity will become magnified in stages 2 and 3. Conversely, the lack of control that you display in Stage 1 is again magnified in the latter stages. In other words, it comes back to haunt you—or, more appropriately put, it comes back to haunt your heirs. *You* haunt your heirs. It's that influence from beyond the grave that I keep referring to.

So—plainly put—for your heirs, it will either be easy or hard. It can be a piece of cake or it can be a pain in the butt. There is no in-between. And it is all up to you.

Of course, we're only talking about probate fees and fees of administration for right now. These are just the basics—things that you *should* know. We haven't mentioned anything yet about Uncle Sam's hand being out. So let that be our segue into the next section.

ESTATE TAX

What is estate tax? It is really an excise tax on large transfers of wealth. And what does excise mean? “To cut out.” And that's what Uncle Sam does; he takes his cut. That's the gist of it.

Recently, the House of Representatives decided they wanted to try and repeal the estate tax. In 2001, the estate tax elimination was part of President George W. Bush's tax relief bill that passed into law. The law included an important “sunset” provision that we will explore in the next chapter.

I feel there are legitimate reasons why this tax should be eliminated. Help should be offered to those who get crushed by this tax. I'm talking about families running a business, and farmers, people like that. They need tax relief.

CONCLUSION

So estate planning is all about control. If you want to have good control of your assets, you need to go through the estate planning process. And you need to do it with a competent attorney and a competent investment advisor—and not some guy who really specializes in real estate and can pull a will out of his computer. How do you find these folks? You simply ask them flat

out: Do you specialize in tax and estate work? If they say “Yes!,” go with them. If they say “not really, but I can do it,” move on. You want a firm “yes.”

REVIEW

To summarize, the control documents that you want are:

- Living wills
- Durable power of attorneys
- Revocable living trusts or wills (depending on whether you care about probate or not)

And important issues to be addressed include:

- Simplification – meaning trying to simplify your estate as much as you can
- Documentation – where are the assets and how are they titled.

Any attorney worth his grain of salt is going to go over those issues with you.

So, in the next chapter we will go over the estate tax changes made in 2000 and look at what happens if you have a taxable estate.

CHAPTER 10

Estate Planning II

In the previous chapter, I outlined some of the basics of estate planning—the minimum that you should at least know. In this chapter, I'll go into some of the more detailed issues about the topic, moving from a very basic estate to a larger one involving more complex decisions. In this way, I hope to demonstrate the practical applications of certain financial techniques.

In the course of the chapter, I will define incidence of ownership and how that concept might relate to your estate. I will also reveal why buying insurance, in some cases, can actually work to your advantage in planning your estate. Essentially, what I am going to do is reveal to you the physiology of estate planning. You will also see why a living trust has no affect on your estate tax. You will understand the gifting laws and you will understand what a bypass trust is and how it can work for you.

NEW LEGISLATION

Before we proceed, I need to review recent legislation concerning estate taxes and how it may affect you.

Congress recently passed, and President George W. Bush recently signed as part of the tax cut bill, legislation (called the Economic Growth and Tax Relief Reconciliation Act of 2001 [EGTRRA])

to repeal the estate and generation-skipping taxes. This legislation, will do two things: Over the next eight years, it will gradually reduce the taxes paid by descendants dying during that time, and the estate and generation-skipping taxes will be repealed in 2010.

However, the legislation includes a sunset provision. Under this legislation, the estate and generation-skipping taxes are repealed for one year only: 2010. Changes in the tax law created by EGTRRA will not apply to estates created after December 31, 2010. Come January 1, 2011, these taxes will be reinstated at current rates—unless Congress passes additional legislation that re-repeals these taxes. (Because repeal is largely contingent on the budget surplus meeting current projections, this sunset provision allows a later Congress to evaluate the state of the budget surplus and decide whether repeal of the estate tax is prudent.)

At this point, we can't be sure whether estate tax repeal will ever become permanent, but it's almost a certainty that significant changes will take place in the near future.

In light of this new legislation, it is important that you review your current estate plan. Make sure you're comfortable with the potential increase in the size of your family trust and the decrease in the size of your marital trust.

It's easy to assume you'll live until the estate tax is actually repealed. However, experts urge you not to operate on that assumption. Your estate may be subject to estate tax up to 2009. After 2009, because of the sunset provision, there's still the very real possibility that the estate tax may not be repealed.

Appendix B details the changes brought about by the new legislation. However, this information doesn't address how those changes will specifically affect your personal estate plan. To do

that, you will need to seek competent counsel and review your estate plan. Still, I urge you to carefully read Appendix B.

Now, let's get into some estate planning.

THE BASIC ELEMENTS

Before we get started, let's do a bit of a review on *wills* and *living trusts*. It's essential that you have a firm grasp of these issues.

With respect to estate settlement, you need to be concerned with several expenses: state and local taxes, attorneys' fees, and federal taxes (the federal tax is what most people refer to as the estate tax).

A Will or Living Trust: Which Way do you Go?

Let me reiterate a point I made in the last chapter: Wills and living trusts have nothing whatever to do with reducing your federal estate tax. Many people I encounter in my daily business seem to have a hard time understanding that, so let me say it again: Wills and living trusts will *not* reduce your estate tax. The only reductions you'll see in a will-versus-living trust scenario are state fees, such as probate and attorneys' fees. And that's it.

A competent estate-planning attorney will be able to tell you right from the start whether he/she thinks you should use a living trust or a will. But, for your own information, let me give you the three rules that should determine your choosing a living trust:

Rule # 1 – If you live in a state that has high probate fees, you will be better off using a living trust. It's less expensive than a will. A competent estate-planning attorney will know if your state's probate fees are high. (Florida, for instance, has high pro-

bate fees. Pennsylvania's fees are pretty low. Then there are states like Delaware that fall right about in the middle.) Any attorney who recommends a living trust has to justify for the client the additional costs. If you live in a state with very low probate fees, you most likely don't want a living trust. Of course, there are exceptions. (In the financial world, you always have a rule and several exceptions to the rule.) But generally, it works this way: high probate fees, go with the living trust; low probate fees, opt for the will.

Rule # 2 – You're better off with a living trust if you own real estate in more than one state. Someone living in Pennsylvania and owning a beach house at the New Jersey shore, for instance, would do well to consider a living trust. This circumvents the situation of having probate in two states on that beach property. In a situation like this, you would only have probate in the state in which you live, because the beach property would actually be owned in a trust that is cited in your state.

Rule # 3 – Organization. This one isn't really a rule. It's more of an opinion—a strong opinion. I simply feel that it is better to have everything under one title—in one spot, so to speak—so that one document controls everything. It's less complicated. It makes life a whole lot easier.

And those, really, are the three main reasons why you would opt for a living trust: probate fees, real estate in another state, and organization.

However, do understand that a will and a living trust both essentially do the same thing. Their fundamental reason for existence is to spell out who gets what when you die and to direct what happens if you become disabled. (You'll recall we talked about some of those issues in the previous chapter.)

BIGGER ESTATES, MORE COMPLEX ISSUES

Choosing a will or a living trust is a fairly easy decision if your estate is valued under approximately \$800,000. Owners of bigger estates will face more complex decisions. Let's say your estate is above \$1.3 million. What kind of estate planning issues do you need to understand? What financial tools do you need to utilize? The first things you need to understand are the concepts of *gifting* and the *credit shelter trust*.

Gifting

It's essential that you know the gifting laws, as they can significantly reduce your estate tax.

Without that knowledge you can't move forward, because within the gifting laws exist the most basic building blocks of estate planning. Everything else in estate planning builds upon three simple rules and tools:

Rule/tool # 1 – Gifting laws state that every person can give to another person as much as \$10,000 a year without having to file a tax on that gift. No gift tax is involved.

Rule/tool # 2 – Everybody, in his or her lifetime, possesses something called *unified credit*. Unified credit enables you to “gift” approximately \$675,000 without tax being involved. (*Consult Appendix B.*) Therefore, if you wanted to give away all of your money today, you could give away \$685,000 of it tax-free. (That's \$675,000 that your unified credit allows you plus the \$10,000 allowable gift from Rule #1.) Every one has the ability to give away \$685,000 tax-free.

Rule/tool # 3 – Tax law allows married people to pass on as much money as they want to their spouse tax-free. It doesn't matter if

you are Bill Gates with \$78 billion; your spouse would still get the money without taxes attached.

Okay, those are the three basic rules. Now let's see how they can be applied by creating a theoretical couple with a theoretical estate.

Scenario #1: Sid and Nancy, the married couple who live down the street, have an estate worth \$1.3 million. And, so far, they've done no estate planning. They don't feel their estate is big enough to require any planning.

Therefore, when Sid dies, Nancy inherits the \$1.3 million. And when she dies, her children inherit the estate. And they will have to pay tax on all of the money except for the unified credit. With the unified credit being \$675,000, the remainder is taxable. That creates a tax bill of about \$250,000 for Sid and Nancy's children.

That's a pretty stiff bill. And you know what? It could have been avoided. But Sid and Nancy made a mistake in thinking their estate wasn't big enough to require any planning. If they had been a little more proactive, they could have eliminated that tax bill for their kids.

Let's turn back the hands of time, back to when Sid was still alive, and see what should have been done:

Scenario #2: Sid and Nancy, the married couple who live down the street, have an estate valued at \$1.3 million. Taking stock of all of their assets one day, they decide to go see an estate-planning attorney. Before doing so, they did their homework and they've chosen well. The attorney they picked is a competent estate planner who suggests that they use the credit shelter trust to their benefit. (The attorney reminds the couple that a credit shelter

trust helps married people to pass their unified credit asset amount to their children estate tax-free.)

On top of this trust, the attorney advises Sid and Nancy to split the ownership of their assets. Thus, Sid now owns half of the assets while Nancy owns the other half. They each then own about \$700,000 (whether it may be the IRAs, the house, the property, whatever). The reason for this will become clear in a minute.

When Sid dies, the assets don't go directly to Nancy. They don't travel directly to her ownership. Instead the assets go into a trust. In essence, Nancy didn't inherit the money; the trust did. And the trust inherited the money in the amount of the unified credit. That is, the unified credit amount goes into the trust. (Let me stop here and make sure you aren't getting confused. The unified credit is just the amount of money that you can pass to an entity. With a credit shelter trust, you try to preserve the unified credit.)

To make this move possible, the estate needed to be properly titled. So, tossing the idea of joint ownership out the window, when Sid died, his will or living trust (whichever he opted to use) then directed his assets to go into the credit shelter trust—instead of to his wife.

Okay, I know what you must be thinking at this point. You are picturing a pitiable Nancy standing there with her arms out, crying, “Where's all my money? I needed that money to live on.”

Not to worry! No way would Sid—or the attorney, for the matter—leave Nancy feeling so forsaken and forlorn. Rather, the credit shelter trust and split ownership are being used in a way designed to be more advantageous for all concerned. Sid, in his living trust or will, has put in a provision that says Nancy can invade the principle under certain circumstances

(e.g., a dire medical or financial emergency). But she won't have to invade to principle in order to survive. Another provision states that all of the income from this trust—all of the profits, the dividends, all of the capital gains, all of that stuff—now must be paid to her as income. This is what we call in the industry a “synthetic” ownership of the money. She can get to the principle if she really needs to. But she is getting the income off of the assets. And that income is what she really cares about, or should care about.

So basically, the late husband, in his living trust or will, says that upon his death:

- His assets will go into the credit shelter trust.
- The income from the trust will go to his wife.
- His wife can access the principle if an emergency arises.
- Upon his wife's death, the trust goes to the children.

In effect, the husband's money bypasses the wife. (That is why these trusts are sometimes called “bypass trusts.”) On first glance, it may seem like Nancy has been cruelly shortchanged, but that's simply not the case. After all, she's going to get a nice income from the credit shelter trust. And she can invade the principle if she needs to. And don't forget: With split ownership, she still has her share of the estate, which is valued at about \$700,000. So Sid has played the role of the dutiful husband right to the very end; Nancy will be well provided for.

And now here is where it really gets good.

When Nancy eventually passes away, the children inherit her assets *and* the credit shelter trust, both of which are valued at about \$700,000. Therefore, with unified credit at work here, the children inherit a roughly \$1.3 million estate virtually tax-free.

Do you see how that happened? The estate has been split. The credit shelter trusts are two separate things. And both are qualified for the unified credit. And both the trust and the Mrs. Smith's assets go to the children.

Thus, the family has come extremely close to achieving the first and most fundamental estate-planning step: zero tax on the estate.

AN EVEN BIGGER ESTATE

Now let's look at what can happen with a couple who were even more successful and just as proactive.

Henry and June have an estate valued at \$2.3 million. What can they do to eliminate taxes?

Well, like their friends Sid and Nancy, Henry and June made the appropriate first step and found themselves a competent estate-planning attorney. The attorney—being competent—advises the couple about choosing a living trust or a will and then recommends that they split their assets and create a credit shelter trust.

But here is where the two situations start to differ: There is an apparent problem with splitting the assets. If we split a \$2.3 million estate down the middle, each spouse then is left with an amount that is above the unified credit.* Henry and June are each left with slightly over a million dollars. But that problem is easily surmountable.

*Now, again, the good news is that the government is actually indexing this, and in the year 2006, each person will be able to pass a million dollars. So there is some legislative relief from this down the road – but not a whole lot, in my opinion. There needs to be a whole lot more.

Here's how.

For the sake of this example, let's say that the husband dies first—as in the first scenario. In his living trust, Henry stated that the amount equal to the unified credit will be paid to a credit shelter trust. He stated also that June will receive the income from the trust and would only be able to invade the principle upon emergencies. So far everything is the same as it was with Sid and Nancy. But I'm sure you notice that there is a remaining \$325,000 above the unified credit. What is to be done with that? His trust or will states that the excess of his estate, above the unified credit, goes to the spouse. So the \$325,000 goes to June. And she inherits it with no taxes because—if you'll recall—from spouse-to-spouse, one person can give as much as they want to the other tax-free. So, from the \$2.3 million estate, \$675,000 went in the unified credit. The other \$1.325 million is now owned by June.

Upon June's death, \$675,000 will go to the children tax-free. That's the one-time exemption. The rest is subject to federal estate tax. So, the \$750,000 that the children inherit is subject to tax—at about 50 percent. That means they have a \$325,000 tax bill. Can we do anything about that?

Well, yes. But it all depends on how proactive Henry and June were. Did they engage in sound Stage 1 decision-making (remember the three stages from the previous chapter)? While they were still alive and capable of making decisions, did they stop and think about what would happen further down the road?

And let's say they were very proactive. What did they do in Stage 1 that you can do? First let's look at what they *didn't* do. They didn't buy an insurance policy to help pay the estate tax, which is what insurance people advised them to do (and most likely will advise you to do). The insurance people told the couple that when they die, and given all the estate plan-

ning tactics out there, they will owe approximately \$300,000 in taxes on their estate. So the insurance people—being insurance people—recommended that the couple purchase a \$300,000 policy that will cost \$10,000 a year and that will then enable them to pay the children \$300,000 to pay the government. It’s pennies on the dollar, they pointed out. (This is one of the big reasons why the estate tax may never go away: Insurance companies make billions of dollars selling these kinds of policies. Do you think the large insurance industry lobby wants the “death tax” to go away?)

Buying that kind of policy is a very hard concept for most people to grasp—and understandably so. Why spend money to pay a tax bill that will come due after you die?

Well, there is a better way to go, and I’ll clue you in on what it is.

But first, let me make one thing perfectly clear to you: Life insurance is included in your estate. In other words, that \$300,000 insurance policy that you just bought—if you decide to go that way—will be taxable. For Henry and June, that means their estate would then be valued at \$2.6 million. And estate tax will be paid on that heightened amount. At this point you’re probably thinking, “Doesn’t buying a policy for that purpose just make matters worse?”

Indeed it does. So here is what you really want to do: Go ahead and get the insurance, but then create a life insurance trust for it. That is, create a trust that will own that insurance policy.

Before I demonstrate exactly how that works, let me explain another key concept that you need to understand.

Ownership and Trusts

Understanding the concept of ownership—or “incidence of own-

ership”—is essential to smart estate planning. Ownership determines if you pay estate tax on an asset. And it means that you control that asset. You can do what you want with it. You can give it away if you like.

Ownership brings into play the two types of trust: the *revocable trust* and the *irrevocable trust*. A revocable trust, as the name implies, is a trust that you can change. Conversely, an irrevocable trust is a trust that you cannot change.

The reason why a living trust has nothing to do with estate tax is that a living trust is a revocable trust. You can tear it up the very next day after you've created it. Or you can simply change it. You have total ownership control of what happens in a living trust. Therefore, it is part of your estate. Assets in a living trust are in your estate.

If you put assets in an irrevocable trust, those assets are considered outside of your estate. The credit shelter trust is an irrevocable trust. The female spouses in our two scenarios—Nancy and June—do not own the assets in their respective credit shelter trusts. True, they have a beneficial interest in those assets, because they get income from those assets, but neither can go into the trusts and take money out at her discretion.

That is why you would want to create an irrevocable life insurance trust: You can put the life insurance policy in that trust and the policy will not be included in your estate.

Low load Insurance

I realize that it sounds like I am justifying the idea of buying insurance again. Well, in this case, yes—I am. Why? Read closely, because I am going to let you in on a little-known secret of the world of insurance. There is a product that fits perfectly into an irrevocable life insurance trust. It is called “low load life insurance.” And I'd probably lose a bet if more than one percent of

you reading this book ever heard of “low load insurance.” Whenever I bring it up to my clients, the first question out of their mouths is, “What is *that*?”

Let me then describe for you what low load insurance is. It is life insurance that you pay a fee advisor for that has no commission built into it. And if it has no commission built into it, the premiums are 30-40% less. And the cash value is significant. For our purposes, I don’t want to totally define low load insurance for you—to explain everything there is to know about it—but let me tell you straight up: I firmly believe that you should find yourself an advisor who knows about this product. And this brings up another one of those red-flag situations that you must be aware of: If, when dealing with an insurance agent, if that agent tells you that it makes no difference if the insurance is load or low load, then that agent doesn’t know what he/she is talking about. So get out of the office.

It sure as heck makes a difference if the insurance is load or low load. Absolutely it does. That agent has just revealed to you that he/she doesn’t know anything about the product. And it’s very likely that most agents won’t know about it. Why? The large insurance companies make so much money selling estate planning insurance policies that they discourage their agents from learning anything about low load insurance. (I work in Delaware, where the market is pretty sophisticated, and even here, the biggest estate planning attorneys don’t even know about it or understand it.)

On top of that, the average insurance salesman working for an estate planning insurance company really has no incentive to want to sell you low load insurance. He’d rather sell you the kind of insurance policy that will earn him 50-100% of your first-year premiums in commission. That means that if you put \$10,000 a year into the policy, he’d be making \$5,000 to \$10,000 up front. That’s a pretty decent day.

The average insurance salesman not only does not want to sell you a low load policy; he simple does not like the fact that these things even exist. A low load life insurance company—or a company like my own—may only charge \$1500, no matter how big the policy is. At my company, we charge that amount because we are charging for our time. Therefore, we lower the premium while doing the client a tremendous benefit, taking only a tenth of what the agents from the big insurance companies make. That's why insurance people perceive low load as a threat to their livelihood.

So remember—despite what the insurance people are inclined to say, low load policies exist. And I strongly recommend that you investigate these policies. By no means are they the only tool available, but in certain circumstances, they can make a tremendous difference. True, sometimes a traditional policy turns out to be better. But I advise you to seek the counsel of somebody who knows the difference between these policies. You owe it to yourself to make the option available to you.

Okay, I know you must be asking at this point how all of this relates the Henry and June's situation. So let me get back on track. So far this is what happened. The couple has a \$2.3 million estate. Henry dies. His assets go to the credit shelter trust. The remainder goes to June. June dies. The children then inherit about \$750,000. But they'll turn to ABC insurance company and say, "We want \$300,000." And they'll get the money, and they'll have to pay no income taxes on the insurance proceeds used to pay the estate tax.

YOU HAVE OPTIONS OTHER THAN INSURANCE

Charitable giving is the great equalizer of estate taxes. Through giving to charities, you can actually eliminate the estate tax. If you're more comfortable with a charity getting that tax bill rather

than Uncle Sam, this may be the way to go. I have outlined a few ideas below, but this is where competent counsel is critical.

Charitable Remainder Trust

Let's look at another good estate planning tool called the charitable remainder trust. You'll recall that, in the previous chapter, I told you how your assets could go to three places when you die: your heirs, your favorite charity, or the government. If you are proactive, you can make sure the money goes to the kids or to charity. If you aren't proactive, the government will butt first in line and take a healthy portion.

One way to be proactive—and thus eliminate the government—is with a charitable remainder trust, which works well for people owning stock. Ever since the bull market in the late 1990s, a lot of people now have got company stock, or have inherited stock when they were very young, and the stock has a very low-cost basis. When it gets sold, the seller gets hit with a big capital gains tax. So what is the natural tendency? People owning such stock will sit on it.

But a tricky thing happens relative to capital gains: When you die, and your assets pass on to someone else, the capital gains tax until the year 2010 is eliminated. What happens then is what is known as a “reset of basis.” If you own very low-basis stock, and it passes on to your children, the capital gains tax disappears. But if you own company stock—which is paying you, let's say, a 2-3% dividend—you might have a couple hundred thousand dollars of that stock. And that is not a real efficient use of your money. As you could be getting income from that asset, you could be making an 8% dividend.

What can you do? You can create what is known as a charitable remainder trust. This trust is created so you can put those assets in that trust. The trust beneficiary will be a charity. Upon your death, that charity will get the money.

But a very interesting thing happens when you put the money into a charitable remainder trust—specifically when you put your stocks into that trust. First of all, you’ll get a big tax deduction. And guess what? You can sell that stock now and not have to worry about being taxed. Why? Simple: A charity doesn’t have to pay taxes. Right? You all know that. So, go ahead, sell that stock. Invest it differently. Receive the income off of those assets.

Let’s stop a moment and take a look at what we’ve just done: You’ve increased your income, you’ve removed the capital gains tax, and you got yourself a nice tax deduction. Pretty nice, isn’t it?

But, whoa, you say. Put on the breaks a moment. Haven’t I just disinherited my children? My kids won’t get those assets, right? Isn’t that how it works? Those assets have to go to charity? Even the kids will be looking at you and saying, “Hey, dad! What are you doing? Isn’t that our money? I thought we were supposed to get that.”

Don’t worry. You can replace that wealth. And here’s where the insurance man comes around again. He’ll want to sell you something called a “wealth replacement trust.” A wealth replacement trust, really, is nothing more than an irrevocable life insurance trust with a big policy sitting inside it.

So, again, if you use the right kind of policy—it might be a low load policy or it might be a traditional policy, depending on your situation—you can replace the wealth by using a portion of the income that you got and paying it into an irrevocable life insurance trust.

ASSETS NOT CASH

Now I want to take you into an area that is pretty advanced and somewhat complicated. And it has to do with assets that are not cash or investments. These kinds of assets can be a family busi-

ness, or a farm, an apartment building, some kind of commercial property.

For an example, let's use a family that owns a million-dollar commercial property. They have a \$3 million estate and a million of it is this property. How do you get that kind of asset to the kids? That family could use an instrument called a limited partnership. Here's how it works: When you create a limited partnership, you have two types of shareholders, limited partners and general partners. Limited partners have no control. Limited partners have no vote. They can't make decisions. They only own a piece of the asset. On the other hand, the general partners have all of the control. They do all of the work and make all of the decisions. A general partner is a control partner. That means you could have a situation where 1% of the stock is in general partner units and 99% is in limited partner units. And the only person who has control is that one general partner.

What the family then can do is put their commercial property into a limited partnership. The IRS will allow the limited partners to take a discount on its value for estate tax purposes. It allows this because limited partners have no control and couldn't decide to sell the property if they ever wanted to. The property could be said to be valued at a million dollars. But if it is put into a limited partnership, it is actually worth less. And discounts over the years have actually gone up. It used to be that a 30% discount was very aggressive. Today a discount of 60% on a commercial property is not a bad figure.

This is an area that has to be handled by a very competent estate-planning attorney. It is higher-end stuff that you have to be very careful with. But it shows you that you can effectively take that million-dollar asset and make it worth less on the estate tax returns. It can go as low as \$600,000.

So you have eliminated at least \$150,000 in tax right away. And then you can gift the asset to your children. You can get it to the children while you are still alive and let that asset appreciate. In essence, what you are doing is taking a discount, you are able to gift it out of your estate and get it to the kids, and you don't lose control—because you could own \$10,00 worth of that property and still control that entire property as the general partner. So it is a planning tool that is available to you if you have an estate worth over \$3 million and you have those types of assets (building, real estate, business, something like that). Seek council with a very good estate-planning attorney to determine if that structure is helpful to you.

SUMMARY

There are people in the industry who only study and practice estate planning their entire careers. Estate planning is an area that is a bottomless well in terms of resources and ideas. However, I've given you the basic information to help you navigate your way through this area. In this chapter, you've seen the physiology of estate planning. Call it Estate Planning 101.

I've taken you from the basic estate to a more complicated estate. I've defined for you “incidence of ownership” and the gifting laws, as well as why gifting laws really design the estate, and I described insurance tools and various trusts. And I think you now understand why the giant insurance lobby is going to make sure the estate tax never goes away totally. Insurance companies want to sell you these big policies.

The insurance people do have a case where they can claim that insurance is the cheapest way to pay the taxes. I agree with that. The only problem is, as in any other insurance scenario, the companies get greedy and they have ill-trained people that will go out there and try to sell customers something, anything. So you might

want to consider areas like low load insurance or charitable giving.

And do not forget about the PAT program. That can have a dramatic affect on your estate taxes and your estate planning. Don't discount the PAT program; it can be phenomenal in terms of estate taxation.

CHAPTER 11

How to Pick an Advisor

This chapter serves several purposes. First and foremost, it is designed to help you choose an investment advisor. To that end it summarizes much of what I've covered throughout the rest of the book. But I've now organized the information in such a way that it provides you with a convenient checklist to consult when picking an investment advisor.

INTERVIEWING THE ADVISOR

Seeking an appropriate financial advisor is very much like an employer interviewing a job candidate. After all, the advisor will be working for you. You will be paying that person a fee. Naturally, you want to separate the good candidates from the bad. To do that, you need to know the right questions to ask.

The Basic Questions

First and foremost, you want to know where your prospective advisor is coming from. Therefore, you first want to ask a very simple question that involves a very basic concern: **“What is your area of specialization?”**

The reason you ask this is to determine if you and the advisor are on the same page about how you want your money handled.

And here's another question that involves another basic concern: **“How long have you been in business?”**

The reason for that question is, I think, self-evident.

You may even want to ask these questions before you enter into a formal question-answer session.

Punitive Actions, Complaints

You will be asking the prospective advisor questions involving any punitive action that may have been taken by a regulatory body or any complaints filed against them by a client. Have they ever been fined or subject to any regulatory actions—either by the insurance commissioner of the state they work in, the Security and Exchange Commission, or the NASD or the states security department? These are the same kinds of questions someone is subjected to when they complete a U4 form. But remember: As I said earlier in the book, it is not enough that the NASD asks these questions. You certainly want to ask these questions as well, and you have every right—so ask away. No self-respecting advisor will refuse to answer these questions, and no one you want to get involved with will demonstrate any resistance.

However, let me say again that if a person does have a “yes” on their U4 form, it doesn't necessarily mean they have a problem. A fine or complaint doesn't always signify something bad, but, generally, you should see it as a red flag. As such, it presents a situation that requires full disclosure. They'll need to explain to you that “yes” to your complete satisfaction before you hire them. Also, you should not only be satisfied with their explanations; you should also feel comfortable about how they reacted to the question in the first place.

So be prepared to ask the question early on: **“Have you ever been fined by a regulatory body (e.g., the NASD or SEC)?”**

If the answer is “yes,” you need to know the story behind the action or complaint. Ask them if they had indeed been fined or did they plead no-contest.

Licensing

You can tell how an advisor works by the licenses they’ve obtained. So you need to ask:

Do you have a “series 6” license or a “series 7”? (This is an important question. Remember, this will reveal what school they came from, so to speak—insurance or brokerage.

The “series 6” and “series 7” exams and their resulting licenses are germane to your situation. Specifically, you need to know how to distinguish the two.

The “series 7” represents a general securities license. The license exam teaches the basics of investments, and the license allows a broker to buy and sell mutual funds, stocks and bonds. I strongly recommend that if you ever consider dealing with any representative registered with the NASD, you first make sure their credentials include at least a “series 7.”

The “series 6,” a relatively new exam, allows brokers to sell mutual funds and variable contracts—that is, the variable insurance contracts like variable life and variable annuity. *A “series 6” reveals something very important about the licensee:* A “series 6” person is restricted from the buying or selling of individual stocks or bonds. They are restricted to mutual funds or variable contracts.

So, generally speaking, someone registered as a “series 6” comes from an insurance background. If someone wants to work at one of the large-wire brokerages, they have to have a “series 7” license. Someone with only a “series 6” is only interested in selling you

insurance. Someone with a “series 7” understands investments better. Making this distinction is especially important if you decide to go with a broker. If you are interested in investments, then you want someone with a “series 7.”

Designations

I would also ask them about their designations: **“What are your designations and what did you have to do to get them?”**

Many designations exist. Some are meaningful, some are not. It can be very difficult to weed that out. So let me offer this bit of advice: You want to look for someone who is a registered investment advisor: a CFP, a CPA, or a ChFC. Those designations make for a good candidate. As I said earlier in the book, I feel that successful retirees are much better off seeking out a registered investment advisor. The registered investment advisor has a higher degree of fiduciary responsibility, therefore I think it’s more likely they will give a client better advice. So you might simply want to ask, **“Are you a registered investment advisor?”**

Let’s give a quick review why I feel this way:

If a client is paying an investment advisor for advice about their money, the investment advisor is required by law to tell the client what is in their best interests. A registered investment advisor can go to jail if he tries to get one over on a client. Also, an investment advisor is required to give a client a disclosure document that reveals everything about his firm. This disclosure comes in the form of the official Form ADV Part 2. When you go to a registered investment advisor, they will either give you this form or you should ask for it. Another advantage: When you deal with an investment advisor, everything has to be done under a contract. And this contract outlines all responsibilities.

And let me say again, these are written rules an investment advisor must observe.

Fee Percentages

This leads into the question of fee percentages. The breakdown of percentages will give you an idea of where they specialize. So ask, **“What percentage of your income comes from fees, from insurance commissions and from securities commissions?”**

What is the answer you are looking for here? Generally, you should look for someone who specializes in the fee side—that is, the majority of their income comes from the fee side. Fee income indicates they are a registered investment advisor. And a registered investment advisor has a greater fiduciary responsibility than someone specializing in commissions. You’d like for someone to answer “fees.”

What if the majority of their income comes from insurance commissions? Then ask this follow-up question: **“How do you break down the insurance product you sell?”**

In other words, if someone says that 50 percent of their income comes from insurance commissions, then ask them to break it down further. If they say that the majority is life insurance, then, obviously, that is not someone you want to deal with. Their concerns are not your concerns. But if they say that is long-term care commission, that means that they do specialize in that area. Then you have to look a little further than just the generic answer. Or if they say group health insurance, they clearly aren’t specializing in folks who are retired. You have to look at what those products are.

Product Requirement

You want to know if your prospective advisor has a product requirement—that is, does their job or contract depend on how much they produce in commissions or fees? That makes a big

difference. When someone has to meet an enforced quota, it can make them do some questionable things. Often, that does not work out to a client's best interest. In a worst-case scenario, a client can get screwed. So put that question on your list: **"Do you have a product requirement?"**

The best answer is "no."

What if they do have a requirement? If you are still interested in doing business with them, then you need to ask, "Have you ever been in jeopardy of missing that in any one year?"

If they answer "yes," then it means that you're most likely looking at someone who is a relatively low producer. At the end of the year, his manager will be on his back to have him make that quota. And that means they'll have to sell a bunch of product to hold on to their job. And, as you might guess, that kind of pressure can compel someone to do something that is not in a client's best interest.

References

In a job-interview situation, a prospective candidate is always asked for references. You, as the "prospective employer" in this situation need to do the same. But it will be a little different in this situation. Here's the specific question you need to ask: **"Are there any professionals I can contact as a reference?"**

The key word here is "professional." Let me be clear about this. When it comes to references, the conventional wisdom says you should speak to the clientel—the satisfied customers. Well, client referrals make for very good reading, but that is about it. I happen to think that client referrals may not be representative of real life. When it comes to financial affairs, the fact of the matter is, if you were a financial advisor's client, you would never want your advisor giving out your name to just anyone who could call you up out of the blue and ask you about your business. Not

only is this extremely awkward, it's very unprofessional. And I feel that it's simply not right.

The better, more informative approach is seeking professional referrals. That is, ask your prospective advisor if you can contact an independent CPA or attorney that the advisor has worked with in the past. You will get a much more definitive answer, because that CPA or attorney will not want to put their professional reputation on the line by giving out misinformation. In reality, professionals often are much better at examining the qualifications of an investment advisor.

If you do get such referrals, what do you then ask them? They only have to be general questions, but you don't want to blow this opportunity by pitching softballs. You should ask:

- Do you think this advisor is ethical?
- Does he have his clients' best interests at heart?
- Do you think he is technically knowledgeable?
- If you were to create a list of possible advisors for yourself, would this person be on the list?

In answer to that last question, an attorney or CPA could say something like, "There are some good people out there, and here are those who make my top-five list." If you can elicit that kind of information, you can feel pretty comfortable. That is a good recommendation from a CPA or attorney. Generally, you'd like to have at least two of the references place the prospective advisor high on their lists. If you can get that kind of recommendation, then you've found yourself a good candidate.

Administrative Matters

An advisor's staff or support resources can give you a general indication of that advisor's success in the marketplace. So here are some questions you should ask:

- Do you have a support person or an assistant?
- How long has that assistant been with you?
- What are that person's qualifications?
- What is their job description?

And while you're at it, you should get a copy of that person's qualifications—their resume or any information about them.

Here's a word of caution when you enter into this area of questioning: If you go to a big brokerage house in search of an advisor, expect the company to be a bit cagey on such matters. They will deflect questions about a prospective representative in and of himself. They'll spew a bunch of company lines. "Well, you know we are one of the biggest security firms in the . . . blah, blah, blah . . . and we are currently worth . . . blah, blah, blah . . . you must have seen our ad during the Super Bowl and . . ." And so forth. Well, who cares? What they are doing is diverting your attention from any individual who would give you the financial advice. They like to focus on their big company instead. And there are several reasons for that: For one thing, the big brokerage houses experience great personnel turnover. And when a representative leaves, they try and stick a client with someone else. They don't want to lose the money.

Insurance

You need to ask about insurance provided.

For instance, the SIPC insurance, the Securities Investor's Protection Corporation: That is an insurance that, should the brokerage company that holds your assets goes bankrupt, it will protect you. It is kind of like the FDIC for investments—a very similar concept.

So simply ask, "What insurances are provided?"

THE CHECKLIST

So let's assemble a checklist that you can take with you into the interview situation. Use this as your script, and even use it as the basis of the document that you will have your chosen financial advisor sign.

THE BASICS

- What is your area of specialization? (Are you and the advisor on the same page as far as money management is concerned?)
- How long have you been in business? (Does this candidate have a track record?)
- Have you ever been fined by a regulatory body (e.g., the NASD or SEC)? (If they answer "yes," what is the story behind the action or complaint?)

LICENSING

- Do you have a "series 6" license or a "series 7"? (Is the advisor from the brokerage or insurance school?)

DESIGNATIONS

- What are your designations and what did you have to do to get them? (Look for someone who is a registered investment advisor: a CFP, a CPA, or a ChFC.)
- Are you a registered investment advisor? (This is a more direct approach to the above question.)

FEE PERCENTAGES

- What percentage of your income comes from fees, from insurance commissions and from securities commissions and insurance commissions? (Look for someone who specializes

in the fee side—that is, the majority of their income comes from the fee side.)

- How do you break down the insurance product you sell? (Ask this question of the majority of their income comes from insurance commissions.)

PRODUCT REQUIREMENT

- Do you have a product requirement? (The best answer is “no.”)

REFERENCES

- Are there any professionals I can contact as a reference? (Remember, the key word is “professional.” Don’t accept client references.)

Questions to ask the references:

- Do you think this advisor is ethical?
- Does he have his clients’ best interests at heart?
- Do you think he is technically knowledgeable?
- If you were to create a list of possible advisors for yourself, would this person be on the list?

ADMINISTRATIVE MATTERS

- Do you have a support person or an assistant?
- How long has that assistant been with you?
- What are that person’s qualifications?
- What is their job description?

INSURANCE

- What SIPC insurances are provided?

CHAPTER 12

The Biggest Secret of Financial Planning

If, before reading this entire book, you glance first at the table of contents and, intrigued by the title, decide to skip ahead and read this chapter first—*don't*.

I'd prefer you read the book in chronological fashion. This enables you to experience its natural progression, and this chapter will have greater impact if you allow it to build upon what has come before.

Okay, having said that, let's review for a moment what we talked about in the previous chapter.

In the last chapter, I gave you a list of questions designed to help you pick the best financial advisor. However, I purposely excluded the final and the most important question—which involves the biggest and best secret of retirement planning—as I wanted to devote a whole chapter to it.

So here it is. This, I believe, is the most important question you can ask a prospective advisor:

“What added value can you provide to your clients—or what service can you provide—that significantly sets you apart from the field?”

There are almost a half-million people registered to sell securities. What makes one person different from the other? That is what should concern you now. There really isn't a right or wrong answer here. But you, as an educated successful retiree, should be able to get some degree of feeling from the answer—something that feels subjectively right. Call it a gut feeling, if you will, or intuition. Does their answer inspire confidence? If it does, then that is a good answer. On the other hand, if they can't offer any concrete specifics as to why they are different, how they can add value that someone else can't, then it most likely isn't going to be a good fit for you.

What do I say when someone asks me that question? I point out that my company specializes in helping people who are retired. We understand the needs and the wants specific to their situation, and in fulfilling those, we actually help improve retirement lifestyles. That's a quick answer. For someone actually sitting in my office, I run down a list of increasingly specific items. That is what someone should be able to do for you.

Remember: Financial advising is all about hedging against the future. It involves making decisions now that, hopefully, will make you better off in the future. And no one can predict the future. So you need to know what this person you are talking to—this representative, this prospective advisor—can offer that is unique to your situation.

QUALITY OF LIFE

All of this points to what I feel is the most important element of retirement planning: improving the overall quality of a client's life. Up to this point, I've talked about issues like investments, asset allocations, insurance, etc. I showed you a lot of quantitative figures, trying to impart as much financial information as

necessary. Now I am going to tell you the biggest, best-kept secret to a happy and secure retirement. It doesn't have to do with quantitative measurements; it has more to do with qualitative. It doesn't have to do with quantity, but quality. Specifically, it involves *quality of life*.

The quality of life you make for yourself will determine how much you enjoy your retirement. Quality of life doesn't just involve finances. True, that is a big part of it. But quality of life involves utilizing a holistic approach. I've found that most financial advisors are not trained to think of retirement planning in a holistic fashion. In fact, very few do. Therefore, most are ill equipped to help a client handle the changes that retirement entails.

More than just financial planning, a holistic approach involves "life planning." The mission of my company is to be a life-planning organization. We find out so much about our clients that they become like family. True, all of that is tied into the financial planning. However, life planning takes the client to the next level. Not only do we help people coordinate their finances, we help them coordinate their dreams. We try and help them regain the vision they had 30 years ago, the vision they once had of the ideal retirement.

So, we endeavor to provide a sense of financial security coupled with a sense of personal fulfillment. Some financial planners either "get this" concept or they don't. Most of them tend to be linear thinkers. We, on the other hand, strive to be holistic thinkers. Holistic life planning not only involves the comprehensive financial planning necessary to a comfortable retirement (all of the things we discussed in this book: estate planning, long-term care, investments, etc.); it also involves spousal relationships, family (relatives) relationships, emotional needs, goals, values and spiritual and physical health.

Obviously, this involves the kind of personal considerations not available from most financial planning services. Most financial planners can provide you with solid financial advice, but I strongly feel that the best ones do even more. Traditional financial planning has become somewhat homogenous—just like about everything nowadays. The life planning approach, on the other hand, is individualized to the client. A life planner does not treat each client the same. Each client is different, because each client has different goals, dreams, wishes and concerns.

As such, recommended strategies can vary greatly from client to client. Often we even bring in other advisors and consultants to deal with issues unique to an particular client. As part of this mission, my company—Biddle Capital Management—has formed alliances with appropriate companies and organizations. Through these partnerships, we help retirees deal with the problems and questions that arise—how to buy cars, take care of medical expenses, how to deal with trying relatives (e.g., retirees whose parents are still alive and who are having trouble dealing with their lives).

You won't find this kind of financial advice at a big brokerage firm. It requires a more individualized approach. An advisor has to be passionate about serving people as individuals. This involves building a rapport with an understanding of the client—their needs, their goals, their values. The financial strategy developed must be focused on meeting those needs and goals and values.

THE PATH TO LIFE PLANNING

To help you better understand where I am coming from, let me talk about how I got there.

About a year ago, I found myself at a professional and personal crossroads, and I felt compelled to evaluate my ambitions and direction. Essentially, I began questioning my purpose. This led me to ask myself what was it I really wanted to achieve. What was it I wanted to be remembered for? How would my children describe me to others?

I had founded my company in 1996 to specialize in the needs of pre-retirees and seniors. Fortunately, my company proved to be good at what it set out to do. It demonstrated remarkable growth in only a short period, experiencing 100% growth in each of the years between 1996 and 1999 and 233% in 2000. But, as I was developing the business, I found that I was acquiring a comprehensive understanding of the needs and concerns of seniors, both financial and emotional. I reached a point where I knew I needed to achieve even more—not only for myself, but for my clients as well.

Yes, I had received professional accolades, certifications, and licensing; but, ultimately, I felt that all of that wasn't really helping me to improve someone's life. True, we are good investment advisors. We are good at financial planning. But I needed to know how I could *really* help my clients. Basically, I wanted my company to be a resource to them when they are confronted with situations and realities where money doesn't really matter.

That realization made me assess my professional worth. Did I want to be known as a guy who made people a lot of money? Or, more importantly, would I become known as someone who really helped improve someone's life?

To make an even greater impact on my clients' lives, I knew I'd have to become more than just a financial advisor. I would have to understand the social, emotional and even the health needs of my clients. Most financial advisors will tell you that they feel they make a great impact on people's lives. But most of them are

only taking care of their client's money and selling products. That's fine, but that is not all that I wanted to do. I really want people to be able to say that, because they met me, they enjoyed a better life. If I can do it through financial planning, then that is the way I would do it.

Acting upon this realization, I began developing the concept that would allow me to achieve my professional ambitions. As I began designing our life planning concept, I realized my own past experiences were coming into play. I realized that the reason I specialize in seniors, or retirees, is because I was raised by my grandmother. I was brought up around people in her age group, and that allowed me to gain a unique perspective. I was able to emphasize with how older people thought and felt. I know what their concerns are. I tend to identify with that age group very easily.

Also, as a surrogate parent, my grandmother exerted a tremendously positive influence on the shaping of my personal identity as well as my business philosophies. For one thing, she enrolled me in a school that based its teachings on the Quaker philosophies. This educational experience imbued me with the Quaker elements of servicing the community. As I grew older, I found that I kept coming back to those basic Quaker values of giving to the community and of identifying and nurturing the value in every single person. These philosophical concepts were underlined by my grandmother's own active example. She was a very caring and dynamic person who served on volunteer committees and, in many other ways, was involved in the community. I would have to say that she was the most influential person in my life.

All of this led me to the realization that financial planning should be about more than just money. Rather, it is about the kind of impact money can make on someone's life. The value of money involves more than just its financial worth. Its true value can

only be assessed by its impact on the individual and society. These beliefs underscore my firm's life planning concept.

True, everyone needs financial products, and we make them available. But we take financial planning a step further. I want to know why a client wants to buy a specific product. I need to know why they feel it is so important to them. To that end, we ask our clients a lot of questions, trying to uncover the emotional element beneath what they want to do. That is life planning. That is what has become exciting to me.

I've talked with many financial advisors, lawyers and accountants and they ask me why I would want to become involved in all of this. They tell me that it is not my job, it's not what I am supposed to do. Well, this is more than just a job. It's all about making a difference. And I will keep pushing to make a difference.

THE BASIC PROBLEM

Quality of life involves overcoming the major problem that almost every retiree faces. That problem is a natural product of what people in the "successful retiree" demographic have lived through. Most current retirees have or had parents who endured the Great Depression. From their parents, they heard many compelling stories about that experience. You can't listen to those kinds of stories without being affected in some profound way. Therefore, people whose parents lived through the depression tended to become hard workers and practical savers. They developed a strong work ethic and a sense of frugality.

On top of that, they've lived through a subsequent period of history that has seen a great deal of transition. Technology has demonstrated exponential growth. Culture has undergone sweeping changes. The United States has gone from isolationism to

globalization. The successful retiree not only was a witness to this change, but they have played a large part in the shaping of the world as it is now. By working hard, they have helped create a great economy and they saved a great deal of money (because that is what their parents taught them to do).

Their work ethic and frugality have been a positive force in their lives. However, at the same time, it has worked to handcuff them. Essentially, even though retirees have saved a lot of money—we're talking million-dollar assets in many cases—they have trouble spending it. They either don't want to spend it, are afraid to spend it, or they don't even know how to spend it.

So what happens? They needlessly fret about finances and spend their days and nights passively watching television.

And that is not right.

You've earned that money. You've saved it. This is what you've worked toward almost all of your life. You deserve to spend it.

That's not to say that anything goes and you go out on an extended spending spree. Rather, you need to find out what you really want to do now. You need to go back and remind yourself about all of the things that you have always wanted to do. When you were younger, what did you envision yourself doing? Traveling? Learning how to paint? Writing a book?

Somewhere between the time retirees entered the work force to the time they actually retired, they stifled these urges and ambitions.

Well, up to this point, you have been very practical in planning for your retirement. Good for you. This has brought you to the point where you can truly enjoy the last third—and the most

precious—part of your life. But, where you have been practical, you now need to become creative. Retirement is the time when you are supposed to be having fun. It's the first day of summer vacation. You now have all the time in the world to do the things you really wanted to do, that you have always wanted to do. In fact, thanks to your practicality, the world is now yours.

The only trouble is, most retirees have trouble realizing this. They can't let go. They have trouble making the transition.

But what good is all of that money you've saved if you are not going to use it? You've worked 40 hours a week for 30 years. That comes to about 60,000 hours of hard work, frustration and elevated blood pressure. And the only respite you had was a two-week vacation.

That's a lot of time you put in. A big debt is owed you. The only person who will repay you that debt is yourself. You owe it to yourself to do the things you've always wanted to do. Retirement is here, now: It is time to start living your dreams. And the vacation isn't going to be what is used to be. Now, maybe, you'll fly first-class to Paris—wherever you want to go, experiencing whatever it was that you always wanted to experience. And this vacation can last the rest of your life.

It's time to make that transition.

THE UNHEALTHY ALTERNATIVE

The reason I stress this so much is that I've seen the alternative.

Up to this point in their lives, most retirees have let their jobs define themselves. The job is how they see themselves defined by others. That's understandable. The job is what they have been doing for the past 30 years.

Then, all of a sudden, retirement hits, and this brings a drastic change. New retirees find themselves in the middle of an emotional hurricane. They react to the situation in several ways. Some start to obsess about their finances. Others find themselves at a total loss at what to do with themselves. They are frozen. Still others fret about every aspect of retirement. They wonder if their money is going to run out? They become afraid that their health will give out. Daily life becomes stressful. The first thing that happens is that they start to drive their spouse crazy. I hear this all the time. When I talk to many of my clients, that is the first thing they tell me. “My [husband or wife] is driving me crazy!”

For 30 years, these people couldn’t wait for retirement. But now that it is finally here, they don’t know what to do.

The problem is that your socialization just went away. So, it’s time to re-socialize yourself, and in a different direction. You need to. After all, the final third of your life can involve a substantial amount of time—anywhere from 20 to 40 years. You are going to live longer than your parents did. In general, people are living longer than they used to. More and more people are blowing out the candles at their 100th birthday celebration. The number of centenarians is growing. Remember, if you live another 30 years, how are you going to fill the 60,000 hours of work that defined the second third of your life? That’s a lot of leisure time, and it represents a wonderful opportunity to remake yourself and your life.

MOVING FORWARD

In the last chapter, we developed a kind of worksheet that helps you pick the best financial advisor. Well, now you should make up another worksheet, and this one should be focused on you.

I tell my clients to think of it as an exercise. And I advise that it should be performed by both spouses, but independent of each other. This shouldn't be a combined effort—not at this point, at least.

First of all, you need to sit down with pen and paper and list all of the things you always wanted to do. This will be an exercise that involves a great deal of self-searching—indeed, soul searching. Go back and reacquaint yourself with your younger self. Recall all of your desires and ambitions. Write about what you always wanted to do. Determine what will be the things that will make you the happiest. This may be a complex exercise—you have to go back and essentially become your younger self envisioning your older self. What do you see? What do you recall? What were those things that you once thought would make you the happiest? Did you want to take up gardening full time and develop an expertise in horticulture you never had a chance to develop? Did you want to learn how to write? Paint? Surf? Improve your golf game? Does this involve classes, special tutoring and great deal of informal, self-learning? Well, you have the time now.

So, sit down and figure out what it is that you always wanted to do. Then, make sure that your retirement resources are going to point you in that direction. Finally, make sure you find yourself a financial advisor who understands your needs. Seek out someone who can think holistically in terms of retirement. As I said, there aren't many out there who can. But they are out there, and their numbers are growing. The best financial advisors are beginning to realize that they need to approach retirement planning as a multi-dimensional endeavor. They understand that sound financial planning alone will not ensure a fulfilling retirement.

This is the kind of person you want to work with. You have to make that last third of your life better than the two-thirds it

took to get there, and you need to do it responsibly, economically and methodically. You need to think of the quality of your retirement experience as proactively as you did your finances. That is the key to retirement. That is where the financial advisor can help you out. The advisor should be able to help you plan for your dreams. When you stop and think about it, that is the whole point of this book. All that I've taught is meant to make that happen.

So, determine your passions and make sure you're going to pursue those passions. If there is anything in this book I want you to remember, it is that. That is the ultimate mission of retirement. After all, if you have \$5 million in the bank and if you don't do anything fun with it, then what was the use of working all of those years to make all of that money? In the process of working those 60,000 hours, too many people forgot their purpose. It got lost somewhere along the way.

EMBRACE THE NEW PARADIGM

Remember, money is the vehicle that got you to where you are now, but some people focus too much on the vehicle. Retirement involves much more—it is not only about finances; it involves the mind, the body and spirituality as well. A balance of those four elements is what makes a healthy and happy individual who can lead a fulfilling life.

I want the idea that you must learn how to enjoy life to be the most important take-home lesson you get from this book. Compared to that, all that you have learned so far is actually amounts to very little.

APPENDIX A

NASD Notice to Members 99-35

The NASD Reminds Members of their Responsibilities Regarding the Sales of Variable Annuities

Executive Summary

National Association of Securities Dealers, Inc. (NASD ®) Rule 3010 requires each member to establish and maintain a system to supervise the activities of each registered representative and associated person in order to achieve compliance with the securities laws, regulations, and NASD rules. Variable life insurance and variable annuities are securities, and their distribution is subject to NASD rules. This Notice focuses on deferred variable annuity sales and provides a set of guidelines that are intended to assist members in developing appropriate procedures relating to variable annuity sales to customers.

The guidelines identify areas of concern that NASD Regulation, Inc. (NASD Regulations ®) would expect to be addressed in the procedures of members that offer and sell variable annuities. Although the specific procedures described are not mandatory, members should consider supplementing their procedures to ensure that they will be adequately designed to achieve compliance with legal and regulatory requirements.

Questions concerning this Notice may be directed to Thomas M. Selman, Vice President, Investment Companies/Corporate Financing, NASD Regulation, at (202) 728-8068; Lawrence Kosciulek, Assistant Director, Advertising/Investment Companies, NASD Regulation, at (202) 728-8329; or Elliot R. Curzon, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8451.

Background

A variable annuity is an insurance contract that is subject to regulation under state insurance and securities laws. Although variable annuities offer investment features similar in many respects to mutual funds, a typical variable annuity offers three basic features not commonly found in mutual funds: (1) tax-deferred treatment of earnings; (2) a death benefit; and (3) annuity payout options that can provide guaranteed income for life.

A customer's premium payments to purchase a variable annuity are allocated to underlying investment portfolios, often termed subaccounts. The variable annuity contract may also include a guaranteed fixed interest subaccount that is part of the general account of the insurer. The general account is composed of the assets of the insurance company issuing the contract. The value of the underlying subaccounts that are not guaranteed will fluctuate in response to market changes and other factors. Because the contract owners assume these investment risks, variable annuities are securities and generally must be registered under the Securities Act of 1933.

The underlying subaccounts that are not guaranteed are funded by a separate account of a life insurance company that, absent an exemption, is required to be registered as an investment company under the Investment Company Act of 1940. Variable annuities assess various fees including fees related to insurance fea-

tures, e.g., lifetime annuitization and the death benefit. The fees are typically deducted from customer assets in the separate account.

A distributor of variable annuity contracts to individuals is required to register a broker/dealer under the Securities Exchange Act of 1934 and become a member of the NASD. The distribution of variable annuity contracts is subject to NASD rules.

Typically, variable annuities are designed to be long-term investments for retirement. Withdrawals before a customer reaches the age of 59 ½ are generally subject to a 10% penalty under the Internal Revenue Code. In addition, many variable annuities assess surrender charges for withdrawals within a specified time period after purchase.

Generally, variable annuities have two phases: the “accumulation” phase when customer contributions are allocated among the underlying investment options and earnings accumulate; and the “distribution” phase when the customer withdraws money, typically as a lump-sum or through various annuity payment options.

The myriad features of variable insurance products make the suitability analysis required under NASD rules particularly complex. NASD Regulation has addressed suitability issues in variable insurance product sales in Notice to Members 96-86. In that Notice, NASD Regulation stated that when recommending variable annuities or variable life insurance, the member and its registered representatives are required to make reasonable efforts to obtain information concerning the customer’s financial and tax status, investment objectives, and such information used or considered reasonable in making recommendations to the customer. (1. In addition, a recent NASD disciplinary action discussed members’ responsibilities under Rule 2310 [Suitability Rule] as

they apply to the sale of variable life insurance. 2. See *In the Matter of DBCC No. 8 v. Miguel Angel Cruz.*)

Discussion

NASD Regulation has developed the following guidelines that represent a compilation of industry practices in the supervision of the sale of variable annuities. The guidelines do not mandate any specific procedure. Rather, they are designed to assist members in developing appropriate procedures relating to variable annuity sales practices. The guidelines are not comprehensive and are not intended as a substitute for the member's responsibilities under NASD Rule 3010. Moreover, the Suitability Rule requires an associated person of a member to make an independent determination whether an investment is suitable for a particular customer, taking into account the customer's investment objectives and financial needs.

Customer Information

The Suitability Rule requires members and their registered representatives to make reasonable efforts to obtain information concerning a customer's financial and tax status, investment objectives, and such other information used or considered in making recommendations to the customer.

1. When recommending a variable annuity, members and their registered representatives should make reasonable efforts to obtain comprehensive customer information, including the customer's occupation, marital status, age, number of dependents, investment objectives, risk tolerance, tax status, previous investment experience, liquid net worth, other investments and savings, and annual income. Retention of this customer information can be made in conjunction with the

maintenance of basic customer account information that is required in NASD Rule 3110.

2. A registered representative should discuss all relevant facts with the customer, including liquidity issues such as potential surrender charges and the Internal Revenue Service (IRS) penalty; fees, including mortality and expense charges, administrative charges, and investment advisory fees; any applicable state and local government premium taxes; and market risk.
3. The registered representative should seek to ensure that the variable annuity application and any other information provided by the customer to the member is complete and accurate, and promptly forwarded to a registered principal for review.
4. When a variable annuity transaction is recommended to a customer, the registered representative and a registered principal should review the customer's investment objectives, risk tolerance, and other information to determine that the variable annuity contract as a whole and the underlying subaccounts recommended to the customer are suitable. The registered principal should compare the information in the account application with other relevant information sources, e.g., an account information form, to check for apparent accuracy and consistency prior to approving the transaction.

Product Information

5. The registered representative should have a thorough knowledge of the specifications of each variable annuity that is recommended, including the death benefit, fees and expenses, subaccount choices, special features, withdrawal privileges, and tax treatment.

6. To the extent practical, a current prospectus should be given to the customer when a variable annuity is recommended. Prospectus information about important factors, such as fees and expenses and the illiquidity of the product, should be discussed with the customer.
7. Under NASD Rule 2210, the registered representative may only use sales material that is approved by a registered principal of the member.

Liquidity and Earnings Accrual

Lack of liquidity, which may be caused by surrender charges or penalties for early withdrawal under the Internal Revenue Code, may make a variable annuity an unsuitable investment for customers who have short-term investment objectives. Moreover, although a benefit of a variable annuity investment is that earnings accrue on a tax-deferred basis, a minimum holding period is often necessary before the tax benefits are likely to outweigh the often higher fees imposed on variable annuities relative to alternative investments, such as mutual funds.

8. The registered representative should inquire about whether the customer has a long-term investment objective and typically should recommend a variable annuity only if the answer to that question, with consideration of other product attributes, is affirmative. In general, the registered representative should make sure that the customer understands the effect of surrender charges on redemptions and that a withdrawal prior to the age of 59 ½ could result in a withdrawal tax penalty. In addition, the registered representative should make sure that customers who are 59 ½ or older are informed when surrender charges apply to withdrawals.

9. The member should develop special procedures to screen for any customer whose age may make a long-term investment inappropriate, such as any customer over a specific age. Based on certain contract features, some customers of advanced age may be unsuitable for a variable annuity investment.

Income, Net Worth, and Contract Size Thresholds

10. Members should establish procedures to require a principal's careful review of variable annuity investments that exceed a stated percentage of the customer's net worth, and any contract in which a customer is investing more than a stated dollar amount.

Investment in Tax Qualified Accounts

Some tax-qualified retirement plans (e.g., 401[k] plans) provide customers with an option to make investment choices only among several variable annuities. While these variable annuities provide most of the same benefits to investors as variable annuities offered outside of a tax-qualified retirement plan, they do not provide any additional tax deferred treatment of earnings beyond the treatment provided by the tax-qualified retirement plan itself.

11. When a registered representative recommends the purchase of a variable annuity for any tax-qualified retirement account (e.g., 401[k] plan, IRA), the registered representative should disclose to the customer that the tax deferred accrual feature of the variable annuity is unnecessary. The registered representative should recommend a variable annuity only when its other benefits, such as lifetime income payments, family protection through the death benefit, and guaranteed fees, support the recommendation.

12. A member should conduct an especially comprehensive suitability analysis prior to approving the sale of a variable annuity with surrender charges to a customer in a tax-qualified account subject to plan minimum distribution requirements.

Variable Annuity Replacements

13. The member firm may decide to develop an exchange or replacement analysis document or utilize an existing form authorized by a state insurance commission or other regulatory agency. If such a document is used, then (consistent with the requirements of various states) it should be completed for all variable annuity replacements and should include an explanation of the benefits of replacing one contract for another variable contract. The document also should be signed by the customer, the registered representative, and the registered principal.
14. The registered representative and the registered principal should determine, based on the information provided by the customer and their own knowledge of the product features, that replacing the existing contract with a new contract is suitable for the customer. Consideration should be given to such matters as product enhancements and improvements, lower cost structures, and surrender charges.
15. The member firm should consider developing compliance systems, such as computer programs, when available, that can monitor and identify those registered representative whose clients have a particularly high rate of variable annuity replacements or rollovers. These compliance systems should provide the firm with “red flags” that the firm can investigate to determine whether some of these replacements are unsuitable.

16. A retail member should adopt other measures reasonably designed to ensure that replacement sales activity by its registered representatives complies with NASD rules. Members that “wholesale” variable annuities are reminded that they are also subject to NASD rules, and that they should avoid marketing strategies that are designed primarily to encourage inappropriate replacement sales. Upon reasonable request and to the extent practical, wholesale members should assist retail broker/dealers in monitoring the replacement activity of their customers.

ENDNOTES

1. Notice to Members 96-86 also listed also listed specific factors that could be considered when recommending variable annuities and variable life insurance contracts. These factors are:
 - a representation by a customer that his or her life insurance needs were already met;
 - the customer’s expressed preference for an investment other than an insurance product, the customer’s inability to appreciate fully how much of the purchase payment or premium is allocated to cover insurance or their costs, and a customer’s ability to understand the complexity of variable products generally;
 - the customer’s willingness to invest a set amount on a yearly basis;
 - the customer’s need for liquidity and short-term investment;
 - the customer’s immediate need for retirement income; and
 - the customer’s investment sophistication and whether he or she is able to monitor the investment experience of the separate account.

2. Complaint No. C8A930048 (NBCC Oct. 31, 1997)

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APPENDIX B

CHANGES TO CURRENT TAX LAW

Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)

The tax legislation Congress that has been working on to repeal the estate tax by the year 2010 is now law.

Sunset Provision

However, this legislation—the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)—includes a sunset provision. This provision provides that the changes in the tax law created by EGTRRA will not apply to estates created after December 31, 2010. Essentially, under the current law, the estate and generation-skipping transfer taxes will only be repealed for a 12-month period beginning January 1, 2010 and ending December 31, 2010. Because repeal is largely contingent on the budget surplus meeting current projections, this sunset provision allows a later Congress to evaluate the state of the budget surplus and decide whether repeal of the estate tax is prudent.

If the estate tax and generation-skipping transfer taxes were to be permanently repealed, sometime before 2011, Congress would have to affirmatively re-repeal the taxes. If Congress does not take any action, then on December 31, 2010, the estate tax repeal provisions “sunset,” and on January 1, 2011, the estate and

generation-skipping transfer taxes are reinstated, with the terms and provisions of today's tax law.

If EGTRRA remains the law, it increases the applicable exclusion amount (the amount of property a person can own without being subject to estate tax), and decreases the highest estate tax rate, as well as the highest gift tax rate and the rate of tax on generation-skipping transfers.

EGTRRA increases the generation-skipping transfer tax exemption amount, and reduces the state death tax credit. Upon complete repeal of the estate tax, EGTRRA reduces the maximum gift tax rate to 35% and introduces a modified carryover basis for assets received from someone dying after December 31, 2009.

Under EGTRRA, the applicable exclusion amount is steadily increased until the estate tax is completely repealed after December 31, 2009 (but is then reinstated on January 1, 2011). The applicable exclusion amount is currently \$675,000. In 2002 and 2003, this number is increased to \$1 million. In 2004 and 2005, the applicable exclusion is increased to \$1.5 million. The applicable exclusion is increased to \$2.0 million in 2006, 2007, and 2008. In 2009, the year immediately prior to complete repeal, the applicable exclusion amount is increased to \$3.5 million.

Currently, the highest estate tax bracket is 55 percent. In 2002, this bracket is immediately reduced to 50 percent. It is then continually reduced by 1% each year until 2007, when the highest estate tax bracket will be 45 percent. The highest estate tax bracket will remain at 45% until 2010, when the estate tax is repealed. The highest gift tax rate, as well as the tax rate on generation-skipping transfers, is also reduced, mirroring the deduction in the highest estate tax rate.

Beginning in 2002, the generation-skipping transfer tax exemption mirrors the applicable exclusion amounts discussed above. For instance, in 2005 the applicable exclusion amount, as well as the generation-skipping transfer tax exemption, will be \$1.5 million.

While EGTRRA provides for the complete repeal of the estate and generation-skipping transfer taxes after December 31, 2009, it does not repeal gift taxes. Currently, the highest gift tax rate is 55 percent. This tax rate decreases at the same rate of the highest estate tax bracket until December 31, 2009, when it is ultimately reduced to 35 percent.

Finally, upon the repeal of the estate tax, EGTRRA introduces a modified carryover basis for assets received from an estate. Under current law, and until December 31, 2009, a decedent's assets receive a step-up in basis to the asset's fair market value as of the decedent's date of death. The step-up in basis is favorable for highly appreciated assets with a low basis. If a beneficiary receives one of these assets, and sells it shortly after acquiring it from the estate, gain that he or she recognizes on the sale is minimized.

On January 1, 2010, such assets will no longer receive a step-up in basis, and rather will receive a modified carryover basis. A modified carryover basis means that the beneficiary will receive the decedent's basis in any property received from the decedent's estate. There are a few exceptions—hence the term *modified* carryover basis. The first \$1.3 million dollars in a decedent's estate will still receive a step-up in basis to the fair market value as of the decedent's date of death. Additionally, another \$3 million in assets can receive a step-up basis if they pass to the decedent's spouse. Any assets over \$4.3 million receive a carryover basis.

How EGTRRA Applies to Your Estate Plan

If you are married and your trust is drafted to provide for a mari-

tal trust and family trust after your death, the increase in the applicable exclusion amount will increase the size of your family trust. Any assets you have over the applicable exclusion will be held in the marital trust.

For instance, if a married person currently has \$4 million in assets, and a trust that creates a marital trust and a family trust after his or her death, based on the year in which he or she passes away, the values of the family and marital trusts differ:

Year of Death	Family Trust	Marital Trust
2001	\$675,000	\$3,325,000
2002-2003	\$1,000,000	\$3,000,000
2004-2005	\$1,500,000	\$2,500,000
2006-2008	\$2,000,000	\$2,000,000
2009	\$3,500,000	\$500,000
2010	\$0	\$4,000,000