Creative

wealth maximization strategies*

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When the 401(k) was introduced a little over three decades ago, it was intended to *supplement* monthly checks from Social Security and employer-sponsored pension plans. Today, many pensions are gone, Social Security has a funding problem, and the primary responsibility for providing a steady retirement income falls to individuals and their 401(k) accounts. For the thousands of Americans retiring each day, there's a growing sense that the task of turning their savings into monthly checks is one they either don't want, or for which they are not well-suited. As Jennie Phipps puts it in a December 2016 bankrate.com article:

> It is becoming increasingly clear that getting through retirement by living off investments is too difficult and unpredictable for most of us. This uncomfortable conclusion has been driving the government, employers and particularly insurers to seek out an alternative — something that functions a lot like an old-fashioned defined benefit pension plan.

This nostalgia for an "old-fashioned defined benefit pension" plan is because it promised a lifetime income for the retiree (and in most instances, a surviving spouse) from a formula based on a worker's earnings and years of service. In contrast, 401(k)s and other defined contribution plans deliver a lump-sum at retirement (with the amount dependent on contributions and investment performance), then leave distribution to the discretion of the retiree. Many retirees adopt one of two prevalent income-producing strategies for lump-sumaccumulations:

1. Taking earnings (interest, dividends, capital gains) as income while preserving principal.
2. Systematically drawing-down earnings and principal, based on an annually adjusted percentage of assets.

Both approaches require ongoing management by the retiree, and neither has the guarantee of a lifetime income. These shortcomings become greater concerns as one ages; retirees feel less competent about managing their affairs and more troubled by the prospect of running out of money. No surprise that a recent LIMRA survey (Life Insurance and Market Research Association) found eight in 10 U.S. workers favor employers providing direction on how to convert savings into a retirement income – like the pensions they remember their parents receiving.

But as attractive as a pension might seem, there are good reasons for their demise.

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Pensions: Too Many Ingredients

Pension plans are like sausage; we may like the taste, but most of us don't know (or want to know) the ingredients. A pension is a constantly changing mix of past, current and future participants that requires regular reassessments of life expectancies, obligations, projected returns, and on-going capital contributions. These complexities, with their uncertain costs and the attendant liabilities, explain why many employers have jettisoned pensions. And of the pensions still in existence, many are in poor financial condition (including Social Security, the nation's biggest pension). A Wilshire Consulting report found that "87 percent of the 92 state retirement systems that reported data for the 2014 fiscal year were underfunded." Historically, the destiny of most pension plans is either suspension or implosion, with the risk that some retirees will not receive what they were promised.

Annuities: Fewer Ingredients, Better Results

A better option for a guaranteed retirement income could be an individual life annuity. In this arrangement, an insurance company promises a lifetime stream of payments in exchange for a lump-sum premium. Annuity contracts offer a range of payment options, but to replicate a pension, an individual would typically select a life and joint survivor format, which guarantees monthly payments for an individual and a surviving beneficiary for as long as one of them is alive.

Similar to a pension plan, a life annuity insures against three significant retirement risks:

- *Longevity risk* — the risk of outliving one's assets.
- *Market risk* — the risk that fluctuating asset values might decrease income.
- *Management risk* — the risk that mismanagement, whether due to ignorance or diminishing mental capacity, could result in loss of principal and income.

A life annuity is similar to a pension plan in that the insurance company provides lifetime incomes for all participants by averaging out the costs of those who live past life expectancy against those who die early. By pooling resources, everyone's risk is diminished, and every annuitant can expect a guaranteed income.

You might say the annuity's ingredients for providing a lifetime income are of better quality. Unlike a pension, the insurance company doesn't have to plan for an unknown number of future participants; it only provides income for those who buy an annuity. And the plans are fully-funded up front; no future payments are required to maintain benefits. Because the mechanics are simpler (and the financial regulation is stricter), insurance companies have a stellar track record for keeping their lifetime income promises. What's more, in many scenarios, an annuity may provide a higher monthly income than either principal-conserving or draw-down strategies – while guaranteeing it for life.

Pension Ignorance Impacts Annuity Utilization

In consideration of these advantages in both income and guarantees, economists have long recommended annuities as being the optimum instrument for turning accumulated assets into streams of guaranteed income. But retirees have been slow to embrace individual annuities, in large part because of their "mis-remembered" perspective on pension plans.

A decision to buy a life annuity is usually irrevocable. Although today, there are many different annuity contracts available that are not irrevocable. If the annuitant dies before life expectancy, there is no "refund" of the unused premium; the excess is used to ensure those who live beyond life expectancy will get their checks as promised.

This arrangement is not different than a pension. The difference is a pension is funded by an employer. In theory, the cost of providing a pension comes from a reduction in an employee's compensation, but this cost is hidden. It's not a deduction on a pay stub, and it doesn't show up on a W-2.

With a pension, employees didn't see how the sausage was made, and psychologically, they didn't pay for it. With an annuity, retirees see the costs, and perceive a possible "loss" if they die early. Yet this is the same loss they experienced with a pension in exchange for guaranteed lifetime benefits.

Other Ingredients – And Help to Put Them Together

If you are retiring with a lump-sum, your income-generating options are not restricted to choosing between a draw-down schedule or a life annuity. There are almost infinite ways to combine guaranteed insurance products with other financial assets to deliver a mix of reliable income, sufficient liquidity, and minimized management responsibility. Every situation is different, but it is worth exploring these options with a financial professional. ❖

You may be pleasantly surprised as how easy it is to turn a lump-sum into a monthly pay-check when you add some insurance and don't have to do all the work.

Do the Right Thing: Insure Your Economic Value

A fundamental purpose of life insurance is to replace an individual's economic value should they die earlier than anticipated. Considering that the ability to earn an income is one's greatest financial asset, it is logical to select an amount of life insurance that reflects this lifetime earning potential. Yet this logic is sometimes skewed by a misguided emphasis on reducing costs. Instead of fully insuring one's economic value, some consumers and financial professionals focus on determining the *minimum* amount of life insurance needed for the economic survival of beneficiaries resulting in financial disaster for the surviving family.

A simple illustration highlights both the ethical and practical shortcomings of obtaining the least amount of life insurance.

The Example

A 35-year-old husband is killed by an intoxicated motorist. The event is devastating to his family, both emotionally and financially. Beyond any criminal prosecution, the family of the deceased will almost certainly pursue a civil action to secure a financial judgment against the drunk driver.

In court, representatives for the family will establish the lifetime economic value of the deceased. This will be an assumption of future lifetime earnings, reflecting the victim's vocation, anticipated raises, professional advancement, remaining working years, the impact of inflation, etc. Projected future earnings will then be reconfigured as a present-value amount, i.e., a lump sum needed today to replicate this projected stream of income. This present-value number would be the baseline for determining financial compensation due to surviving family members.

The logic and justice of seeking financial compensation equal to the lifetime economic value of the victim should be easy to comprehend. Two follow-up questions, and the answers, should make it apparent that this rationale applies to other circumstances.

Question 1: Is there any reason the family should consider asking for an amount ***less*** than the husband's full lifetime economic value? For example, if the family already had enough assets to survive, and didn't "need" a judgment for the full economic value of the deceased, would it be advisable to seek a lower amount, or perhaps nothing at all?

Question 2: If the husband died from a heart attack while sitting in his living room watching TV, would the lifetime economic loss be any less to the family compared to him dying from the auto accident?

The correct answers, and their implications, should be obvious. Regardless of the level of financial well-being of the survivors, they deserve to be fully compensated. There is no moral justification for seeking a lower settlement amount by arguing the survivors "don't need it." And the magnitude of the economic damage does not change if there is no one to blame for the husband's death; a drunk driver, a one-car accident or a sudden illness all cause the same financial loss.

> Insuring for full economic value is the only way to effectively address all financial needs that might result from an untimely death.

Lifetime Economic Value: The Only Logical Approach

If it is reasonable to pursue legal action to have someone else pay your full economic value in the event of a wrongful death, how can you justify using a different standard for insuring an untimely death that can't be blamed on anyone? "Well dear, if a drunk driver kills me, you'll receive two million dollars, but if I slip and fall, it will be $500,000 – because that's all you really need to survive without me."

Making a life insurance decision based only on what is thought to be needed by survivors may appeal to cost-focused consumers, but the premise is wrong. It is impossible to accurately calculate the costs that might result from an untimely death today, and those costs would surely be different if a death occurs two years, five years or twenty years later. Since tomorrow's financial "needs" will be different than today's (and might be far greater), **any needs-based calculation is flawed the day it is made.**

When using low-cost term life insurance it is often within one's budget to fully insure your economic value. Usually the cost of the term life insurance is less expensive than your auto and home insurance. $2.5 Million of ten year term for a male age 35 at Preferred Plus is less than $60/mo. You can't think your car or home is more valuable to your family then your economic value. Insuring for full economic value is the only way to effectively address any financial needs that might result from an untimely death.

Who Determines Lifetime Economic Value?

In a legal action, arriving at your lifetime economic value is a detailed process. You could probably replicate the calculations, but there's an easier way: Simply ask a life insurance company.

All insurers have underwriting parameters for how much life insurance they will consider offering an individual, and these guidelines roughly reflect lifetime economic value. Here's the verbiage and amounts from a highly-rated American life insurance company:

The following information reflects general life insurance guidelines equal to the present value of potential future earnings which would be lost at the death of the insured.

Age	Maximum Life Insurance
31-40	25 times income
41-50	20 times income
51-60	15 times income
61-65	10 times income
66-70	1 times net worth
71-80	1/2 times net worth
81+	case by case

As applicants get older, the declining income multiples reflect shorter time periods; a 51-year-old has 20 less earning years than a 31-year-old counterpart. And as people move into retirement, the criteria switches from their future economic value as earners to the future economic value of the assets they have accumulated.

Don't Under-Estimate Your Value (or What You Can Afford)

Many consumers are surprised when they see an insurance company's assessment of their lifetime economic value, especially in light of the amount of insurance they actually have. *("You mean to tell me I'm worth $3 million? I only have $250,000!")*. And shortly thereafter comes the thought: *"That's a big number. How could I afford to insure my lifetime economic value?"*

In reality, securing life insurance equal to lifetime economic value today may be quite doable, especially for younger applicants. Term insurance, graduated premiums, even financing options, can all be used to maximize current life insurance protection. A life insurance professional can not only provide the policies, but also offer guidance on how to pay the premiums.

Instead of thinking you can't afford to insure your lifetime economic value, you should ***find out how much you can insure.***

Buying as much life insurance as the insurance company will offer is a sound risk management strategy because obtaining

individual life insurance is dependent on one's health. Insuring for full economic value today reduces the chance of having to re-apply later, and avoids the risk of being declined because of health conditions that were not a factor earlier. ❖

Have you tried to insure your lifetime economic value? It's the logical basis for deciding how much life insurance you should own. ❖

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