Creative
wealth maximization strategies*

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December 2017

Better Benchmarks for Financial Balance

While every personal economy is different, key aspects of successful wealth management can be articulated with simple benchmarks which, if followed, give you a solid chance of surviving or thriving under most circumstances.

Many of the personal finance metrics still in use today trace their origins to the post-World War II middle-class visions of the American Dream, which was built on a foundation of steady employment, generous benefits, and an employer-paid pension. The assumption of these stabilizing factors influenced personal finance benchmarks for saving, borrowing and insuring.

The heyday of lifetime employment and fully-funded retirement is long gone, but many of these personal finance standards persist. It's time for some new benchmarks that reflect current economic realities. In no particular order, here are four standards in personal finance that could use an adjustment.

Monthly housing payment as a percentage of monthly income:

Old Standard: 35-45%
New Standard: 15%

Prior to the housing bubble that preceded the recession, a 2008 *New York Times* finance article said, "If you're determined to be truly conservative, don't spend more than about 35 percent of your pretax income on mortgage, property tax, and home insurance payments." A current bankrate.com article recommends that your monthly housing payment should not exceed 28 percent of your income before taxes.

These recommendations are a pretty close match for the percentages lenders use when evaluating your ability to make monthly mortgage payments. And while they may accurately reflect what you can afford, using these percentages will probably make your mortgage a disproportionately large item in your monthly budget.

For most households, mortgage payments (principal and interest) above 15% will unbalance their larger financial picture; there won't be enough left to save, and it won't be saved fast enough to cover the inevitable surprises that come with homeownership, like a new roof or a flooded basement. And if you experience an income disruption (from a down-sizing, a layoff, a disability) a smaller monthly housing payment increases the chances of keeping the home, instead of selling it at a discount out of financial desperation.

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Saving as a percentage of annual income:

Old Standard: 10%
New Standard: 20%

When a pension and Social Security could be expected to provide a substantial baseline retirement income, long-term personal saving had a supplementary purpose: it made possible the luxuries of retirement, like a vacation home, travel, and golf. But when you remove a pension from the retirement equation and replace it with a 401(k) or another retirement program that relies primarily on individual contributions, the numbers have to change. In addition, the shifting of a greater percentage of health care costs to individuals requires saving not only for the future, but also to build reserves that may be needed well before retirement.

Some financial professionals may attempt to lessen the 20% benchmark by assuming a higher rate of return, but extensive historical analysis by Robert Castiglione founder of LEAP Systems, Inc. makes a strong argument for 20% in order to keep up with Taxes, Inflation, Plan Obsolescence and Technological change. An imbalanced financial plan that results in under-saving, incurs a greater risk today because most households no longer have the safety net of a guaranteed pension.

Liquid funds equivalent to Gross Income

Old Standard: 3-6 months
New Standard: 6-12 months

There was a time when many families could enjoy a middle-class lifestyle on a single income, and most career paths promised long-term employment in positions with generous benefits. A regular paycheck was a given; whether you lost a job or left for greener pastures, it didn't matter, because in a booming economy, people who wanted to work found work.

This middle-class paradigm of stability and abundance profoundly influenced recommendations for liquid funds. Even now, low-end recommendations of three months of living expenses are predicated on the idea that a period of unemployment will be brief.

But consider the new terms in the workplace lexicon, like "under-employment," "gig economy," and "side hustle." Employment today is often tenuous, and more likely to include periods without work. More families rely on two incomes. And the financial safety nets for most workers are smaller, and seem to have larger holes. With fewer financial guarantees in place at the end of one's working life, any income disruptions not only cause short-term distress, but have the potential to disrupt retirement plans. **Maintaining one's financial balance under these conditions requires a larger reserve of liquid cash assets.**

Six to twelve months worth of your Gross Income is the new benchmark doesn't have to be 100% allocated to guaranteed accounts, but it does have to be liquid without penalty – which means you can't include retirement plan assets in this benchmark.

Maintaining one's financial balance under these conditions requires a larger reserve of liquid cash assets.

Life insurance protection:

Old Standard: Needs Analysis New Standard: Economic Life Value

When pensions guaranteed retirement incomes, life insurance for many individuals was focused on addressing the immediate financial needs of survivors due to an untimely death of a breadwinner. The amount of life insurance was calculated using a "needs analysis," which attempted to determine the money that would be necessary to keep a family's finances intact until Social Security and pension benefits became available. More generous plans might include some other financial objectives, such as college funding for children. In this paradigm, life insurance was seen as a temporary necessity, a bridge to the financial guarantees already in place for retirement. But given the financial uncertainties that almost all individuals and households currently face, both today and in the future, the only reasonable approach to life insurance is to obtain as much coverage (maximum) as possible. This reflects the concept of Economic Life Value, a present-value calculation based on an estimation of one's lifetime earning potential.

Economic Life Value does not attempt to assess immediate financial needs, in part because it assumes even an untimely death is likely to occur later than sooner. And the most effective way to provide for unknown future needs is to give survivors the full economic replacement value of the insured individual.

Because one's insurability tends to decline with age, insuring for Economic Life Value as soon as possible is prudent; waiting runs the risk of becoming uninsurable.

Because of these dynamics, affording the Economic Life Value level of protection while maintaining financial balance may initially require term insurance. Term insurance is initially very inexpensive but proves to become one of the most expensive forms of life insurance over one's life. Term coverage should include the option to convert to Whole Life insurance at later dates without having to prove insurability. This approach protects Economic Life Value today, while preserving options to use one's insurability as a financial asset in retirement.

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Hit the Benchmarks, Keep Your Financial Balance

If you get these four benchmarks right, your personal finances are almost certain to stay on track. The unexpected won't cause you to lose your balance, and you'll have the opportunity to accumulate a substantial balance for retirement. Strive to hit these benchmarks, and stay balanced.

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This question was asked by a reader in a September 2017 *Wall Street Journal Investing Report*.

"What's the best type of account to use when saving for college – a "529," a brokerage or savings account, or an UGMA?"

The recommendation, provided by a California financial advisor, was to use a 529 Plan, primarily for its tax advantages compared to the other options. But is it really "the best type of account?"

Whether deliberate or not, the framing of this question reflects a persuasion technique called "thinking past the sale." In order to answer the question, you must assume that the three options listed are your only choices. That's not true. And it neglects what is perhaps the most important factor in saving for college.

The 529 Plan: A Simple Concept, with Lots of Rules

A 529 Plan is a state-sponsored account regulated by the US Tax code that allows deposits to accumulate and be withdrawn tax-free, provided the funds are used for qualified education expenses by a designated beneficiary. 529 accounts are usually established with parents or grandparents as the owners and a child/grandchild as the beneficiary. Most plans offer a menu of passive investment choices, such as mutual funds.

These tax advantages are coupled with restrictions on how the funds may be used, and include penalties for improper distributions. Among them:

- 529 Plan deposits are not deductible from federal income taxes, although some plans may qualify for a state income-tax deduction.
- For purposes of the Free Application for Federal Student Aid (FAFSA), accumulations in a 529 Plan are considered parental assets, and added to the Expected Family Contribution (EFC), which diminishes a student's eligibility for federal grants and scholarships.
- You have limited investment options and usually a "safe" investment fund such as a fixed account or money market fund is NOT an option. Only since 2015 can you now adjust your investments within the 529 plan twice a year. Prior to 2015 it was only once a year.
- There is no annual limit on deposits, but amounts in excess of the gift tax exclusion (currently $14,000 per year per donor) may result in a tax for the depositors.
- Any funds not used by one beneficiary may be transferred to another 529 account, naming an approved relative (such as a sibling) as the new beneficiary.
- Distributions that are not used for qualified education expenses (each state has a list), become taxable income for the account owner, and trigger a 10% penalty as well.
- Student loan payments are not considered qualifying education expenses.

Reading this list might prompt a thought:

"Isn't there another choice for college saving that doesn't have as many restrictions as a 529?"

There is. It's an option with…

- **Tax-free accumulation**
- **Options for tax-free distributions**
- **No restrictions on how distributions are used (and thus no tax penalties for "non-qualified" expenses)**
- **An exemption that keeps accumulations from being included in the EFC calculation on the FAFSA.**
- **Deposits continue if you should become disabled (Waiver of Premium Rider). Self-completing College savings plan.**
- **In the event of a pre-mature death there is a large tax-free death benefit provided to pay for college.**

What is this alternative college savings plan that offers similar tax advantages without the 529 plan's restrictions or tax penalties? ***Whole Life insurance.***

In a side-by-side comparison of features and restrictions, you could make a compelling argument that Whole Life as a college saving vehicle have distinct advantages over a 529 plan. Which is why many parents and grandparents have used Whole Life for higher-education expenses in the past – even before a 529 plan existed.

But using Whole Life for college funding requires some planning and integration with other aspects of your financial affairs.

So…**"What's *really* the best type of account to use when saving for college?"**

Probably the one that nudges you to action. Economist Richard Thaler, a pioneer in behavioral economics, was recently awarded the Nobel Prize for research that showed people are often irrational in their financial decision-making, but can be "nudged" toward better outcomes through well-designed procedures and policies. A 529 plan is a classic example of two economic nudges to encourage saving for college.

The first nudge is specifically stating the account's purpose. For parents and grandparents, an explicitly designated college savings fund is a tangible demonstration of their love for, and

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investment in their children. Every subsequent deposit affirms and reinforces those commitments.

Of course, the same psychological motivation and reinforcement could be achieved with any account – saving, brokerage, cash values, whatever – just by having the designation "College Savings Fund." But a 529 Plan has a second nudge: The tax advantages that make it "official." The government recognizes (and approves of) your intention to save for your children's education by granting a tax advantage.

If you're already motivated to save for your college, why not choose your own nudges? Just because 529 plans have government approval and are presented as the default solution, doesn't mean they are your best choice. Guarantees, investment opportunities, funding limits and withdrawal restrictions should be evaluated in the context of your individual circumstances. ❖

In October, the IRS announced that contribution limits for 401(k)s will increase to $18,500 in 2018, up $500 from 2017. Participants 50 and older can save an additional $6,000 a year through what are characterized as "catch-up" contributions.

If your annual income is $100,000, and you accept the premise of pre-tax retirement plans (that your income tax rates will be lower in retirement), the option to defer almost 20% of income each year to a 401(k) may seem like more than enough to provide a substantial retirement accumulation, as well as delivering an immediate tax deduction.

But what if you're earning $300,000, or $500,000 a year? If you're committed to saving 20% of income, that's $60,000 or $100,000 a year, far more than what can be accommodated by a 401(k). Faced with this lack of deferral capacity, many highly-compensated savers default to making a maximum 401(k) contribution, then placing the rest of their ongoing savings in a personal investment account, paying taxes each year on the interest, dividends and capital gains. If this seems like an inefficient way to accumulate long-term savings, maybe someone – you, your employer, or the financial professionals assisting you with wealth management – should entertain a conversation about non-qualified deferred compensation.

Deferral Options for High-Earners

Under most circumstances, income, whether in the form of wages, commissions or profits, is taxable in the year it is earned. But in some instances, US tax law allows workers to earn income today, yet defer the receipt of it to a later date. For example, contributions to a 401(k) are deferrals of income. Participants voluntarily put some of their income into a qualified plan, to be received (and taxed) at retirement.

401(k)s and similar qualified retirement plans are for the rank-and-file, and in some ways, discriminate against highly-compensated individuals (such as business owners, top-tier executives, and sales reps). But high-earners may be able to enter into individual customized deferral arrangements with their employer. These deferrals fall under the broad heading of Non-Qualified Deferred Compensation (NQDC) plans.

NQDC Basics

Per Investopedia, "A NQDC is a plan created by an employer to enable select employees to defer compensation that they have a legally binding right to receive." There are several formats for NQDC plans (sometimes referred to as "409A plans" for the section of the Internal Revenue Code that governs their use), but all NQDCs have some common features:

- The plan is in writing.
- The employee makes an irrevocable election to defer compensation prior to the year in which it will be earned.
- The plan specifies, at the time of the deferral, the amount(s) to be paid in the future, and the circumstances which will trigger payment. There are six permissible "triggering events" for payment: an end-date, separation from service (e.g., retirement), a change in ownership or control of the company, disability, death or an unforeseen emergency.

In most NQDCs, the deferred payments will include a calculated future value, often in the form of interest or investment returns credited to the deferral. Other benefits may be part of the deferred compensation agreement, such as life insurance or disability benefits for the employee.

As long as they conform to the basic parameters listed above, NQDCs have great latitude in their design. There are no limits on how much can be deferred. Employees in the same company who are eligible for an NQDC can have deferral plans customized to their specific circumstances.

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