# THE ROAD TO *Financial Maturity*

## Part I: The Accumulation Phase

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# Part I: The Accumulation Phase

In my view, the Accumulation Phase consists of:

- Establishing a firm financial footing
- Creating net worth
- Managing financial success

The final two stages, **financial independence and transfer of wealth**, are more in depth. This should not be surprising since one's financial situation typically grows more complex as assets increase and financial concerns become more serious.

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The Road to Financial Maturity: Part I

# Establishing a firm financial footing

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## My earliest memory of money centers on a childhood friend who regularly saved money from his daily paper route.

He would take his weekly collections and put them into 3 piles. The first pile was to pay the newspaper company for his deliveries. Next, he would make a pile for bubble gum and baseball card purchases. This made great sense to me as an avid card collector. Then, he made a third pile which was about as large as the second one.

This one I could not understand. He said it was for his Trans Am when he turned 16. I knew Roberto Clemente, Mike Schmidt and Gaylord Perry, but I did not know what a Trans Am was or why anyone would set aside money for such a thing that you could not have until several years into the future.

He eventually turned 16 and bought his used, blue Trans Am. And boy, was he ever cool!

Not surprisingly, I have learned a few things about money since those days. And I believe this early lesson about money - the deferred gratification that comes from the systematic saving of part of what one earns - is probably the most important lesson that anyone can master.

Establishing a firm financial footing is the first step to financial maturity. In order to do this, you need a reasonably predictable cash flow to start. A job is a good start. You can also be the recipient of a trust fund distribution or a government payment like SSI benefits or even a legal settlement. What matters is that you have a flow of dollars from which you can begin to systematically save.

## Like my childhood friend, you will need 3 “piles” of money.

You need a pile to put the money you will spend on sustaining yourself. Then you will need a pile to take care of contingencies like building an emergency fund and to cover basic needs and insurances. This may include, where possible, your employer’s benefit plans. And you will want a savings pile to start building for the future.

The Road to Financial Maturity: Part I

# How do I get enough money?

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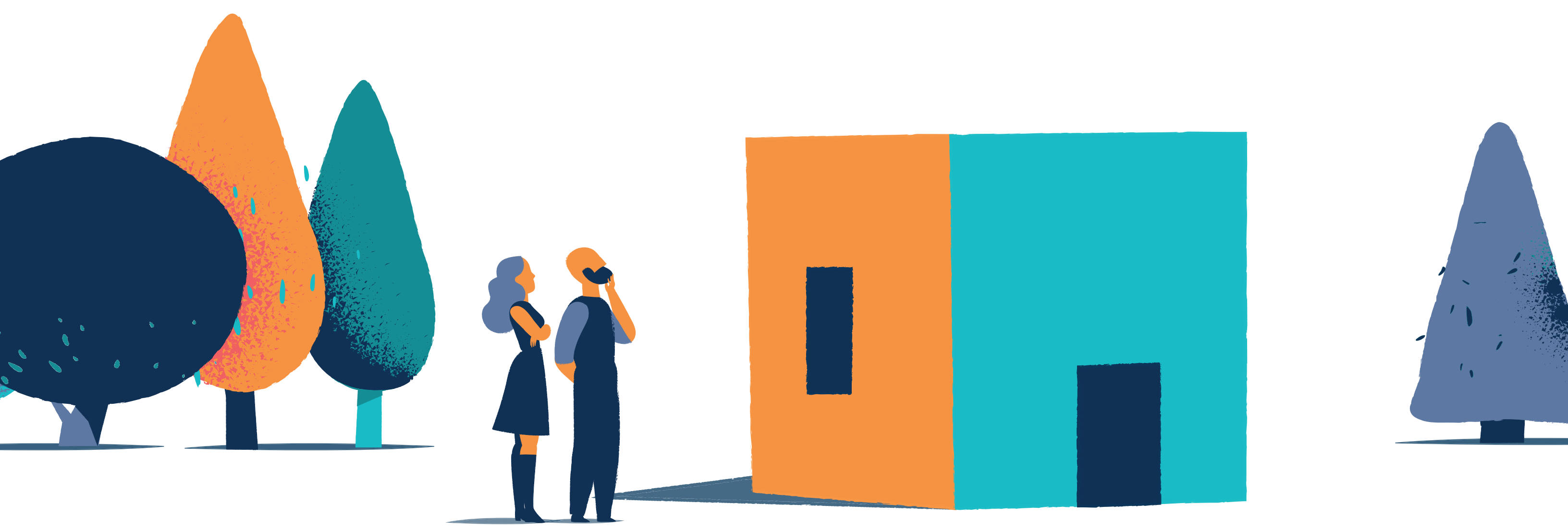
This area of planning centers on the fundamental question: *How do I get enough money?* Enough to buy a house, enough to send my kids to college, enough to retire on, enough to buy a vacation home, enough to take a dream trip, and so on.

**The simple mechanism is to save part of what you earn, invest it, protect it from taxation where possible and then give it time.**

At its bare minimum, an accumulation plan is equal parts savings, time, and faith in the future.

Of course, if it were really this simple, everyone would do it. But, given that the most recent data on retirement reveals that the average family approaching retirement has $56,000 in total assets including the equity in their home, it is obviously not that simple.

The mechanics of successful accumulation planning are somewhat more involved than simply depositing a portion of one's check in a savings account every month.



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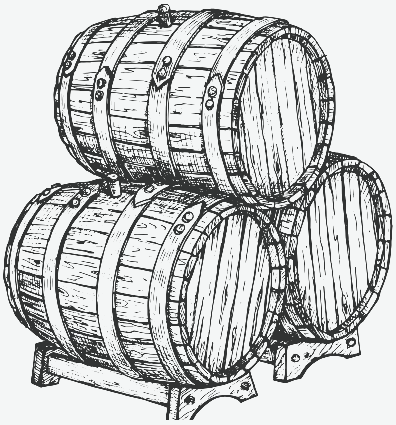
# Creating net worth with simple tried-and-true strategies

Both of my children learned to play violin at a young age by using the Suzuki method. Dr. Suzuki believed that any child could learn to play a musical instrument. His description of his teaching method was it's simple, but not easy.

The same can be said here. To achieve success in the accumulation phase, one can follow a simple, well-worn path of tried-and-true strategies. When taken in tandem and practiced over a long period of time, these strategies provide an excellent framework for responsible financial management. It's just not always easy to put these into action on a consistent basis.

## **The 3 Barrels of Money:** What is the purpose? What exactly are we saving for?



I began with the disposition that saving some of what you earn for later is a good thing. But, if setting aside money on a regular basis is the task, what is the purpose? What exactly are we saving for? Well, each person's situation will be different and thus it is not enough to simply save money in a pickle jar month after month. Savings must be deployed properly in order to reach the goals.

To understand how deployment can be best accomplished, picture a timeline that begins today at your current age and is spaced out in one-year increments. Run the line out to age 70 or more. Now, divide up the timeline into three major sections by drawing two lines perpendicular to the timeline.

If you have drawn this out on paper, you should have three regions: the first is a period that goes from your current age to roughly 3 years from now; the second goes from that point about 3 years from now to age 59 ½, and the third goes from age 59 ½ onward. If you are older than 59 ½, there is a different approach covered in the chapter on retirement income planning.

# The 3 types of money that characterize a prudent savings approach

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## These 3 timeframes define the 3 types, or barrels, of money that characterize a prudent savings (and investment) approach in the accumulation phase. Each of the barrels has unique characteristics and each is important in its own way.

I define the first barrel of money as an emergency/opportunity (EO) fund which is fundamentally meant to be a defensive position. It is one of the protective measures we deploy to keep the "here and now" enjoyable. Along with the other protective strategies of using disability and life insurance to keep you and your family in the "comfortable" position you currently enjoy, the EO fund is a collection of cash that keeps you going if times get tough.

## Typically, financial advisers will suggest 5 to 7 months of take-home pay as a good starting point for this fund.

I go a step further and add to this figure all the money we expect you will spend in the next three years – a car purchase, re-modeling projects, big trips, etc. The key to saving for barrel 1 is to adequately set aside money in sufficient amounts to cover the necessary expenditures over the next one to three years and any potential emergency financial situations that may arise.

Alternatively, we can also view this fund as an opportunity fund. What if your best friend calls to tell you that he's going on a round-the-world cruise and he wants you to go, but you only have until next Monday to get the money together? Or, what if an excellent business opportunity develops and you want to participate? In any case, whether for emergency or for opportunity, such savings are best deployed when they are in safe, predictable assets like checking accounts, CD's and interest-bearing instruments where the principal value is guaranteed - or at least very stable.

Note that the dividing line between barrels 2 and 3 was drawn at age 59 ½. This is not an arbitrary number, at least not arbitrarily chosen by me. It could be argued that it was arbitrarily chosen by Congress when it chose the age to define the tax law surrounding IRA's and 401K's. Regardless, money that is available for use prior to age 59 ½ (barrel 2) is generally taxable as it grows while money in barrel 3 is typically tax-favored until its withdrawal; however, barrel 3 money is generally "hands off" until that peculiar age of 59 1/2. Otherwise, a 10% premature withdrawal penalty is imposed in addition to normal income tax.

If we characterize the first barrel as "defensive" money, then barrels 2 and 3 can be considered "offense." More specifically, these barrels are for the money that will be invested in growth-oriented instruments like stocks and stock-based mutual funds. They are designed to build real wealth above and beyond the annual ravages of inflation. The principle difference between the two will be whether or not the money is tax-favored for retirement. This is where real wealth accumulation happens!

Thus, we have defined three types of money: an emergency/opportunity fund which is primarily defensive in nature, an investment pool that is generally available for use and therefore taxable year-by-year, and an investment pool that is tax-favored in return for an agreement that you will not touch it until many years from now. The key then is to properly allocate your monthly savings in order to properly "fill" each of the barrels.

# The general trajectory of a normal economic life in America

## We might sum up this timeline approach to the barrels of money by looking at the general trajectory of a normal economic life in America.

While you are building your career in your 30's, you may also be building and furnishing a house with spending that typically comes from barrel 1.  In your 40's, you are building up your children and writing their tuition checks (barrel 2 money). In your 50's you begin to get serious about retirement (rebuilding your barrel 2). In your 60's and 70's you will focus your energy on enjoying your own retirement (and thus using barrel 3 money). Beyond that, you begin to look at your legacy - what you will leave to your children, grandchildren and charity. Because you will spend a lot of money over your lifetime, you need to put away a lot of money during your working years and, you will need to put those funds into all 3 barrels.

## **Diversifying tax strategy:** A penny in taxes saved is a penny earned.

The simple fact that Ben Franklin pointed out two centuries ago is still true today: a penny saved is a penny earned. Although, had there been income taxes in his day, it is likely Ben would have added a corollary: a penny in taxes saved is a penny earned. Every time your savings and investments are taxed, you're a step further from your final goal. Thus, investing with an eye toward tax efficiency is paramount.

# Diversifying Tax Strategy Cont.

Obviously, there is significant opportunity to protect investment income from taxation in barrel 3 since it is, by its character, a tax-favored environment. Whether you have a Roth IRA, Traditional IRA, 403B plan, Tax Sheltered Annuity, or any other retirement instrument, it is all barrel 3 money and it is all tax-favored.

All other things being equal then, we would expect an IRA or a Roth IRA invested in a mutual fund and starting off at $100,000 to be worth more than the exact same fund, also starting off at $100,000, but invested in a personal brokerage account. The one and only reason is that the brokerage account will be taxed year by year and the IRA will not.

It is more difficult to get favorable tax treatment on savings and investments in barrels 1 and 2; however, there are well trod paths in this area to get favorable tax treatment including tax-free money markets, variable life insurance and US Savings bonds.

Likewise, there are some tax deferrals on instruments like individual stocks and mutual funds, although they are ultimately taxable upon sale.

While one endeavors to diversify one's investments to take advantage of changing currents across different markets, it also makes sense to consider diversifying your tax strategy. Having money deployed across barrels 1 through 3 not only properly allocates money to the specific tasks to be accomplished in those timeframes, but it also allows you to spread out tax liabilities across time. When you need to "harvest" some of your investments in the future, one aspect of the decision on which investment to sell will be what the tax consequences are.

Since we do not know with any great accuracy what our friends in Congress will be doing with the tax code over the next 5 and 10 years, it is always good to have several different strategies at work. That way, no matter which way the laws change, you will always have an instrument that is treated more favorably than the others you may own.

## A final word on taxes here: do not let the tail wag the dog!

Too many times people make bad financial decisions based solely on the tax consequences of the decision. Taxes are important, but they are not the most important. Reaching your overall goal, following a long-term plan and being faithful to your saving targets are all far more important.

# Managing Debt



One of the most common questions I get is whether to take additional savings and apply them to paying down a debt more quickly or to invest the money in additional investments. The good news is that there is no bad answer: any additional saving you do will increase your net worth. Is one approach more efficient than another? Perhaps.

In the case of high interest debt, particularly consumer debt that does not qualify for income tax deductions, I prefer to pay off the debt rather than to invest, so long as the debt is a temporary aberration and not the result of continued overspending on your part. If you are consistently overspending, then you are mired in step one of financial progression. You must re-visit the discussion on consistent cash flow and systematic savings. But, if the debt is a one-time occurrence, then I like to pay off the debt and move on.

In the case of a mortgage or other "productive" debt, like a business loan, you may find you are better off continuing to accrue assets by saving and investing rather than paying down debt more than is required by the lender.

First, we know that if the debt interest is deductible, Uncle Sam is defraying the overall cost. We also know that there is a substantial advantage to having additional assets on your balance sheet. If you pay off the debt, then the capital is sunken. The only way to get it back out is to borrow again, which puts you right back into the debt you were trying to avoid in the first place. Where possible, I would rather see clients build capital in their barrel 2 investments rather than accelerate debt repayment. They can always cash in assets and pay off the debt if they want. But why give away capital unless you absolutely have to?

The Road to Financial Maturity: Part I

# Managing financial success

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## College Planning or Saving for the Kids

Apart from health care costs, the fastest growing component of family expenses is education. Whether measured by property tax increases, independent school tuitions or the skyrocketing price tag of college costs, education is an ever-increasing portion of family spending. While you may debate the merits and qualities of one college over another, the facts are clear: children with 4-year college degrees earn, on average, 3 ½ times more in lifetime income than those without one.

Therefore, economically painful as it may be, parents continue to bear the cost of higher education in the optimistic view that it is a solid investment in the future. I heartily concur.

There is no getting around the fact that most people need to begin saving for college sooner rather than later. Funding an entire year's tuition from current earnings is unlikely for most people. In some cases, the stay-at-home parent that raised the kids will re-enter the workforce as the children are going off to high school. The new-found income from the second parent at work becomes the "college fund."

Those who can save while the kids are young should consider a straightforward approach to set up a systematic monthly investment program into a series of mutual funds that are growth oriented. This can be done in the parents' names (bucket 2) or within a 529 Plan.

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## Retirement Planning or Saving for you

**The most wide-ranging topic in personal financial planning is retirement planning.** The preparation required for this major life accomplishment is substantial. Yet, a majority of recent retirees report that they spent more time planning a two-week vacation than they did planning their entire retirement. Is this really true? I suspect not. But I do know that the daunting task of envisioning and then planning out one's retirement is a project that is better set aside while you consider what villa to rent in Tuscany. It's just more fun to plan a vacation than it is to plan your retirement.

The overall trends in retirement planning are pretty obvious and well reported in many popular media outlets. The baby boomers are entering their retirement years in large numbers and will continue to do so over the next 15 years. Defined benefit plans, or pensions, are being eliminated or frozen at a rapid rate. This means employers are no longer willing to shoulder the long-term well-being of their former employees. Instead, 401K plans, or defined contribution (as in, employee contribution) plans are exploding.

We read daily of the looming implosion of Social Security. Each year, there are fewer and fewer workers paying into the system while, at the same time, system beneficiaries are growing at a considerable clip each year. Even with "full benefits" being pushed back year by year, the system will fail sometime in the next 20-30 years by most estimates unless benefits are scaled back. This is a real issue for your retirement plan. Can we depend on continued Social Security benefits at the current level? Suffice to say, another pillar of the average American retiree's façade is crumbling; there is a real uncertainty in the level of future retirees' Social Security benefits.

If this weren't enough, add to the mix that the average retiree in this generation is retiring *4 years sooner* than in the previous generation; and, that same retiree will live 9-15 years longer in retirement than his/her parents did in their retirement.

One final zinger: the cost of medical care is skyrocketing relative to all other aspects of our economy. I don't have to tell you who incurs a disproportionate amount of medical costs in our society, but I will. Retirees do.

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# Summary: What determines your financial success

In the end, what will determine your financial success relative to accumulation goals is the persistency of regular savings; protection of those assets from taxation as much as possible; prudent and appropriate use of life and disability insurance to keep you from backsliding; and suitable investments at a reasonable cost. That, in its essence, is financial planning for the accumulation phase.

With diligence and hard work, you will slowly but surely progress from laying the groundwork for success toward financial independence. As savings and investments continue to grow and the safety net of insurances are solidified, you will find yourself transitioning to a more tangible and challenging phase of financial maturity: the active management of your financial assets in support of very significant family goals like college education funding and your own retirement.

As you systematically begin to fill the buckets, you will notice that the numbers start amounting to something. It's slow perhaps at first, but the inexorable forces of continued savings and time will pay off.

The final point here is to follow the process. Set up systematic investment programs that help you fill your barrels on a consistent basis. How much you put in each month is not as important as making sure that you make the investment each month. Protect your investments from taxation where possible and be prudent with your debt. And then sit back and watch your net worth grow.