THE LIFE CYCLE OF WEALTH

EXPANDED EDITION

DECISION-MAKING THROUGH FOUR PHASES OF LIFE

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Overview

In the digital era, wealth-building strategies, money management techniques, and "how-to" financial planning tips all compete for our attention. Instead of trying to navigate the nuances of personal finance based upon the loudest message or a catchy slogan, take a step back. Recognize that success in life requires excellent decision-making, which includes two ingredients: knowledge and wisdom. Having knowledge means having information needed to make decisions. Having wisdom means having a mature perspective from which to make those decisions. With respect to personal finance, *The Life Cycle of Wealth*™ does provide some important technical insights, though it primarily provides the uncommon wisdom needed for excellent decision-making.

Decision-making for who exactly? Throughout this text, the words "you" and "your" are used to simplify content, but with the intent to communicate "your family" on two levels –1) the core family (i.e., household) and 2) the entire family tree. Further, the concepts offered are designed to facilitate conversation on both familial levels, which is critical when strategic decisions happen (Chapter II – About the Cycle). Also, "wealth" and "money" are considered synonymous, so wealth is considered in financial terms with two primary components: 1) a balance sheet and 2) cash flow. A balance sheet refers to assets owned personally – business interests, real estate, personal property, invested assets, etc. – and debts owed personally – mortgages, liens, student loans, credit lines, etc. Cash flow refers to personal income recognized, and expenses incurred for a given period. Importantly, the interaction of these two financial statements is critical: if the balance sheet is the foundation for your family's financial life, cash flow is either a builder or a destroyer of that foundation (Chapter IX – The Power of Cash Flow).

If your balance sheet and cash flow comprise your wealth in financial terms, then being "wealthy" must mean reaching financial independence – the point at which you have the freedom to make life choices without financial constraints. Such independence happens when a family's balance sheet is stable enough to provide for at least the current generation. Further, this independence means that cash flow is positive or neutral – even if a major source of that income is the balance sheet. For those who have attained financial independence, this text offers you important insights into the challenge of providing for future generations. For those still in pursuit of independence, *The Life Cycle of Wealth*™ provides a clear view of the road ahead, a concrete approach to managing risk, and an overview of the financial professional(s) available to guide you. For all concerned, *The Life Cycle of Wealth*™ delivers a holistic view of personal finance, and a method for developing a long-term strategy to fund your purpose for life.

About the Author

Aaron Kolkman is a retired securities principal and developer of *The Life Cycle of Wealth*™ model. He previously worked for three major U.S. financial institutions before founding a portfolio risk management firm during the 2008 financial crisis. Kolkman is a recognized leader in aggregate portfolio Mean Variance Optimization (MVO) techniques to support financial planning. His Minneapolis strategic planning team incorporates all phases of The Life Cycle™, with an emphasis on written estate strategies. Kolkman holds a B.A. in Psychology, a M.S. in Finance, and a Graduate Certificate in Financial Analysis. He is also a CERTIFIED FINANCIAL PLANNER™ and an ACCREDITED ASSET MANAGEMENT SPECIALIST™. Kolkman is the principal of Fidere Media, LLC, and co-author of THE RISK MANAGER™ - a conservative economics, planning and portfolio management blog for families. He is a member of the Committee for the Fiduciary Standard, the International Association of Advisors for Philanthropy, and the Financial Planning Association. A native of South Dakota and Nebraska, he now lives in Plymouth, Minnesota. In his free time, Aaron loves spending time outdoors and traveling with his children. He also enjoys running and biking, listening to music, and watching science fiction movies.

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"Command those who are rich in this present world not to be arrogant nor to put their hope in wealth, which is so uncertain, but to put their hope in God, who richly provides us with everything for our enjoyment. Command them to do good, to be rich in good deeds, and to be generous and willing to share. In this way they will lay up treasure for themselves as a firm foundation for the coming age, so that they may take hold of the life that is truly life.."

- 1 Timothy 6:17-19 (NIV)

Finding your Fiduciary

As you have read so far, considering wealth as a conduit for pursuing life goals and solving problems, means developing a strategic plan to pursue those objectives and funding them in an optimal manner. Unfortunately, developing a strategic plan can feel like drafting the blueprints to your house without experience. To be clear, you might know something about leveling, framing, wiring, roofing, drywalling, or finishing. This does not mean that you are qualified to draft the blueprints that integrate each of those areas. In short, you probably need some help.

I remember a successful real estate developer asking me why he should pay a financial services firm for its expertise. I told him that "from a planning standpoint, your family will likely pay less in taxes, insurance premiums, and probate costs. From an investment management standpoint, your family will likely take less risk, get a better return, or both... The tough part is understanding the long-term value of what's being offered." Seeing long-term value has everything to do with understanding which professional(s) to engage, and which financial professional(s) to engage is perhaps the most important decision your family will make.

The importance of this decision is probably the most evident with investment outcomes. DALBAR, Inc. conducts an annual family behavior study, entitled *Quantitative Analysis of Family Behavior* (2013, www.dalbar.com). This advanced research has consistently demonstrated that over the past 20 years, individual families who did *not* work with a financial professional have underperformed major market indexes between 3.96% and 5.36%, versus their peers who *did* work with a professional.

Unfortunately, the decision about which professional(s) to engage (and for which purpose) can also be the most confusing. There are only subtle differences in the titles and descriptions used by financial professionals to describe themselves and their offerings, yet there are major differences in the types of professionals and the types of products and services they provide. What follows is a brief explanation of the five different types of financial professionals you may choose to engage. While this is by no means an exhaustive list of financial professionals and their differences, it is adequate for understanding the general categories of professionals that are available for you to engage, and what to expect when you do.

The Insurance Professional

Who they are: This type of financial professional is obviously an excellent resource for protecting that which is most important to you – your family, your income, your homes, cars, etc. I have met countless caring, hard-working, and well-informed insurance professionals in the past 15 years. They are among the most well-meaning type of financial professional you can engage, and a good resource for making insurance produce decisions – property/casualty, life, health, etc.

What they do: This professional is often the most product-driven financial professional you could engage. To the extent you need to buy a product (policy, annuity, etc.), this group is typically going to move heaven and earth to get it for you and probably do so competitively. Recognize, though, that their knowledge may be limited to the products they sell. Getting objective advice or financial planning accomplished with your insurance professional can be quite difficult, if not impossible.

How they think: It has been said that to be successful in the insurance industry, the professional must "have the heart of a social worker and the mind of a capitalist." This is perhaps the most accurate description of the best insurance professionals I have met. They have a great deal of care and concern for their customers, and a great deal of motivation to drive their own income.

How they sound: The insurance community is trained to offer "programs" and "solutions" that provide "protection" or a "guarantee." It tends to refer to "customers" rather than clients, although both might be used. They tend to talk about products that they are excited about for one reason or another. Finally, insurance professionals use a great deal of material to market their products. This material may include references to "financial services" and "your financial future." The insurance professional may carry any number of professional designations, which may include, but are certainly not limited to, any of the following: CLU®, ChFC®, AAI, ACSR, AIP, ARM, CEBS, CIC, CISR, CPCU, CPSR, LUTCF, REBC, RHU, AAI.

How they are paid: Insurance professionals are compensated primarily by commissions paid on the insurance plans they sell. As a result, they maintain relationships entirely with those customers and/or referral sources who provide them with a continuous source of new business. If they are relatively new to the financial services industry, they may be quite aggressive to maintain a steady cash flow in the short-term.

The Brokerage Professional

Who they are: This is the type of financial professional that is in the business of transacting securities products – stocks, bonds, mutual funds, variable annuities, etc. They, like the insurance

professionals, are not likely to give advice or practice financial planning. The brokerage professional is typically newer to the investment side of the financial services industry than their advisory and wealth management peers, although often very capable. This is a great professional to engage for a specific investment product need.

What they do: The brokerage professional often has great ideas and solutions (i.e., products) for a specific need. They are used to opening and funding accounts, and handling orders. They aren't necessarily active traders, but they carry a transactional mindset. For those that offer client reviews, they typically do so with the idea of measuring the success of previous transactions and with the hope of developing more transactional business.

How they think: Regardless of age or experience, brokers are the purist of capitalists and therefore quite opportunistic – for their clients and for themselves. In many cases, they have made a great deal of their own money, and become encouraged by their own success, believing they can bestow that success to their clients.

How it sounds: The brokerage community talks about investment products. A broker is most likely to call you with a "tip," an "opportunity," or an "idea." If they are experienced at their work, they almost always discuss their "years of experience." And while the brokerage professional may carry any number of professional designations, he/she is much more likely to talk about their specific expertise versus their academic pursuits. Finally, they are referred to as "representatives," "registered representatives," or "financial representatives." This is appropriate given they are representing a specific firm and its products. Also, most broker/dealers (i.e., brokerage) firms and

their representatives are members of the Financial Industry Regulatory Authority (FINRA) and the Securities Family Protection Corporation (SIPC). So, when you see "FINRA" or "SIPC" you are probably dealing with a brokerage professional.

The various types of brokerage licenses and compensation arrangements that brokerage professionals work from are beyond the scope of this text. However, it is important to know that there is a progression of knowledge among brokerage professionals based on which licenses they hold. Most brokers carry a FINRA Series 7 (General Securities Representative) license, although some carry a FINRA Series 6. Additional state-level licensing requirements include either a FINRA Series 63, 65 or 66. The following link provides a breakdown of common securities licenses held by practicing brokerage professionals: http://www.investopedia.com/articles/financialcareers/07/securities_licenses.asp#axzz276h4JNMm

It is also important to note that brokerage professionals are obligated to meet the requirements of their firm and the Securities Exchange Act of 1934 ("The 1934 Act") as well as the regulatory organizations that enforce the 1934 Act. The overall regulator of the securities industry is the Securities and Exchange Commission (SEC) which was created by the 1934 Act; however, the Financial Institution Regulatory Authority (FINRA) is the primary enforcer of brokerage regulations for the SEC. FINRA is an independent, privately-held corporation contracted by the SEC to carry out enforcement duties under the 1934 Act. Therefore, FINRA is employed by the SEC. For more information about FINRA, please visit www.finra.org. For more information about the SEC, visit www.sec.gov.

It is also important to know whether the professional works with a traditional brokerage firm, an independent brokerage firm, or an institutionally-owned brokerage (i.e., owned by a bank or insurance company. An independent firm will typically have the most objective view in servicing its clients. Although its professionals are captively representing the brokerage, the firm typically offers a wide array of products to serve clients. Traditional brokerage firms are normally involved with both the primary and secondary markets, meaning they are in the business of underwriting and distributing initial securities offerings (primary markets) as well as acting as broker/dealer after the securities are offered (secondary markets). The traditional brokerage firm is highly profit-driven. By comparison, most independent firms are primarily engaged in the secondary markets, where most public delivery of products occurs. Profits are certainly critical, but client delivery is often more pronounced. Finally, an institutionally-owned brokerage firm tends to view their brokerage business as a revenue enhancement or an unfortunate necessity (sometimes both). Most do not consider their brokerage business as a primary driver of revenues, and therefore offer a more limited menu of options to clientele. Also, the institutional culture tends to mimic a traditional brokerage firm being driven by institutional financial results.

How they are paid: Traditional brokerage professionals are paid a commission for transacting securities business. Changes in technology have provided a more fluid option for brokers and their clients, known as a "wrap fee," or a fee in lieu of a commission. This wrap fee is not the same as an advisory fee, although the two are experienced similarly by families. Note that brokers may be paid a commission on some products or accounts, and a wrap fee on others.

The Advisory Professional

The advisory professional and the brokerage professional are often confused with one another, for two reasons: 1) many financial professionals are both brokerage and advisory professionals, and 2) the various titles carried by these individuals are similar (if not identical). The following is a short summary of distinctions about an advisory professional.

Who they are: The advisory professional is typically a seasoned financial professional, usually a broker and/or insurance professional who may still maintain those licenses and activities, but who typically works on a fee basis, rather than a commission basis. Their fee may be charged as a fee on assets in an investment advisory engagement, or an hourly fee for consulting, research, projects, etc. Note that "fee-based" normally references an advisory professional that works under a combination of fees and commissions, with a priority on their fee business. A "fee-only" advisor, by comparison, works without *any* commissions from insurance or investment activities.

What they do: The primary distinction of an advisory professional is they are in the business of giving advice. Remember that advice does not generate a commission; only products carry commissions. Purchasing products and receiving advice are often delivered together; however, products are still products and advice is still a service. It is important to note that a "fee-based" (advisory and brokerage both) or "fee-only" (advisory only) professional is putting their advisory work ahead of their brokerage business.

Advisory professionals must adhere to the Investment Advisors Act of 1940, which, among other

requirements, mandates that Investment Advisors and their representatives conduct business under a fiduciary standard of practice. In other words, these professionals must act "as if a trustee" for their clients. From the Latin word "fides," Fiduciary literally means "faith," and "trust." By comparison, the 1934 Act requires brokerage professionals to maintain suitability ("good fit") standard, but not necessarily a fiduciary standard.

With the 2010 passage of the Dodd-Frank Act, Congress took steps towards unifying financial professionals around a common fiduciary standard, giving the SEC authority to impose such a universal requirement on all retail investment professionals. As of this writing, such a uniform standard has *not* been enacted, due in large part to ongoing debate about the enforcement, compliance, and business implications for brokerage firms and their brokers.

How they think: The advisory professional often views their role as that of a partner to their clients. The phrase "personal CFO" is used frequently, likely because of the strong relationships that advisory professionals build with their clientele. They normally do not view themselves as salespeople (and while most want to grow their business), selling for the sake of generating revenue is often not necessarily their drive. They are driven instead by new client relationships that are mutually fruitful over time.

How it sounds: Advisory professionals have a genuine desire to better the lives of others, hence their decision to work under a fiduciary standard. As a result, you may hear about them talk about "helping others" or "doing work for others." This is a genuine belief (as opposed to a sales pitch, which some financial salespeople also use). The easiest way to identify the advisory professional

is to meet with multiple financial services offices. Those that do not immediately invite you to do new business or discuss products, are likely the true advisory offices. Rather than concerning themselves with generating revenue, they instead ask questions to learn about you and your family, and probably schedule a follow-up appointment to discuss risks and opportunities.

How they are paid: Advisory professionals are paid a fee on assets or a fee for planning, perhaps both. As a result, they do not think in terms of products, transactions, and commissions, but in terms of the asset base or plan that they are following. This is an important distinction for those seeking an advisor, versus a brokerage professional that refers to themselves as an advisor. Also note that some advisory professionals are also brokerage professionals. These “hybrid” professionals most often advertise a “fee-based” relationship, where an advisory-only professional typically advertises a “fee-only” relationship.

The Wealth Management Professional

The wealth management professional or “wealth manager” was born out of the advisory profession and shares many characteristics with the advisory professional. The primary two distinctions of a wealth manager are education and experience. These professionals typically carry advanced financial designations and have a long-term background in financial services. Consequently, the wealth management profession is occupied by the most capable professionals, although they are often unlikely to take credit for this fact.

Who they are: The hallmark of wealth management is strategy design and implementation. Wealth managers operate primarily (or entirely) under the Advisors Act of 1940 and share the same

relationship-based approach as advisory professionals. However, their ability to deliver strategy is what sets them apart from the other types of financial practitioners. Strategy capabilities may not be easy to identify, especially given that advisory wealth management professionals share most of the same traits. Perhaps most confusing, advisory professionals will often employ similar marketing terminology or even call themselves wealth managers.

What they do: True wealth managers do what they advertise – manage wealth. In doing so, they provide a big picture financial view to higher-net-worth clients, than do other financial professionals. This holistic view is based in comprehensive planning but provides the estate, tax, retirement, insurance, and investment strategy needed to navigate that big picture. Other financial professionals do not tend to provide holistic strategy.

How they think: Wealth managers tend to view themselves as a resource for their clients. They do not view themselves as product distributors or salespeople. Many do not even carry brokerage licenses and therefore charge only an hourly and/or asset-based fee as opposed to accepting a commission for their work. They think in terms of building lasting relationships with their clients, through regular communication and meetings.

How it sounds: It may be impossible to tell the difference between the advisory professional and the wealth management professional on the surface. One sure way to know is to ask if the professional offers holistic planning, in addition to investment management. If tax, estate, retirement and insurance are all discussed – in addition to investments – then you are likely working with a true wealth management professional. Also look for advanced financial

designations such as CFP® (CERTIFIED FINANCIAL PLANNER™), CFA® (Chartered Financial Analyst), and CPA/PFS® (Certified Public Accountant/Personal Financial Specialist), which require professionals to successfully complete comprehensive exams to become designated. Although there are many impressive professionals and other available designations, these are examples of designations often found with advanced financial professionals. Remember that years of experience and advanced designations are also strong indication of whether "wealth management" describes the actual client experience or is simply a marketing approach.

How they are paid: Wealth managers are paid in a variety of ways, though most often on a fee-basis like advisory professionals. However, actual Wealth Management is a multi-disciplinary profession so may include more services with varying methods of compensation, which depend upon the client engagement. For example, some wealth management firms are fee-only regarding their handling of assets and their planning activities but offer insurance as a means of completing business and estate plans. This translates to a "fee-based" (versus "fee-only") method of compensation.

The Family Office Professional

This type of professional is the one you are least likely to meet or hear about. This is because they work for a very small number of clients, or perhaps just one. For example, Bill and Melinda Gates have a family office that handles their financial concerns – including trust administration, paying bills, filing taxes, conducting planning, handling assets, and any other work relative to the family's financial well-being. As you might guess, there are few of these professionals (mainly because there are few clients in this category). Their practices vary widely and are less generally less

regulated than other areas of the financial industry. As a result, some hedge funds have considered re-filing with the SEC as family offices to lessen their regulatory requirements. This area of the financial services business is evolving quickly and is one that many long-term professionals aspire to. However, it remains much less commonplace and is therefore largely beyond the scope of this text.

In summary, there are five distinct types of financial professionals: 1) the Insurance Professional, 2) the Brokerage Professional, 3) the Advisory Professional, 4) the Wealth Management Professional, and 5) the Family Office Professional. Understanding these groups is critical to identifying the right fit for your family's financial needs. Even families who self-direct portfolio assets need a variety of financial services, so an understanding of these groups is paramount. The decision to engage with a given professional or firm will determine the nature of services, the family's experience as clients, and the financial outcomes that unfold. As a result, the decision to engage professionals is often the most significant decision a family makes in handling its financial affairs.