EXPANDED EDITION

THE LIFE CYCLE OF WEALTH™

DECISION-MAKING THROUGH FOUR PHASES OF LIFE

AARON KOLKMAN

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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 III – 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 X – 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 a Certified Kingdom Advisor.® 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 with his family: boating, camping, and biking.

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DEDICATION

Dedicated with gratitude to my family tree:
generations past, present and future.

ACKNOWLEDGMENTS

Thanks be to God - Father, Son and Holy Spirit –
for your amazing grace, and for lighting my
path that I might live with purpose.
May any glory that comes from this work be yours.

Thank you to the many family members and friends who gave
time and energy in support of this project. You
have been generous beyond measure.
I pray this work would be a blessing to
you and others around you.

Thank you to the team at Boulevard Wealth
Management in Minneapolis.
You are professional soldiers dedicated to high-
quality, long-term planning for families.
May you continue to steward financial
resources for purposeful living.

Thank you to the College for Financial
Planning® which provides the
technical training necessary for professionals
to deliver advice and offer perspective.
Your mission to equip the financial
services industry is essential.

FOREWORD

During 2009 and 2010, I transitioned out of the brokerage industry. After nearly 10 years of institutional settings, my desire to transact business on behalf of a brokerage firm, a bank, or an insurance company, was quite low. My desire to continue working with families around the intricate details of financial plans, however, was stronger than ever. At that time, I had begun to explore ways of communicating the common truths about personal finance within a family, for at least one generation – 1) the experience of it, 2) the risks inherent in it, and 3) its impact on future generations. As I looked for ways to convey these concepts without losing the underlying technical aspects of sound financial planning, I recognized there at least four distinct phases of our financial lives. While these phases could be greater in number, the dispersion of financial risks between phases was clearest using four.

This work gives significant attention to conservative and comprehensive planning with trusted advisors. By conservative, I mean careful, intentional, and risk-managed. By comprehensive, I mean integrated and complete*, not modular (Chapter III – About the Cycle). Additional attention was paid to issues that can disrupt high-quality financial planning, misconceptions about planning, risks that require decisive action, and family dynamics. Specific detail is also offered around what I have come to see as the most significant financial decision a family makes: which financial professional(s) to engage (Chapter XI - Finding Your Fiduciary). Overall, my intent is for the discerning reader to attain a clearer view of personal finance, to plan from the heart, and move forward with peace.

* *A complete plan will detail a family's cash flow, retirement, taxes, investments, insurance and estate.*

CONTENTS

“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)

FUNDING YOUR PURPOSE FOR LIFE

Money is the only universal language on earth. In the words of Rabbi Daniel Lapin: "wealth suffuses every aspect of your existence" (Thou Shall Prosper, 2010). If you can accept this statement as true, you can begin to appreciate the influence that money has on our lives - the decisions we make, the relationships we maintain, and ultimately, the kind of lives we lead. Despite its substantial influence, however, money is but a tool for fulfilling life goals. Anything else is ultimately unsatisfying. Herein lies the importance of quality long-term planning: we have a responsibility to steward the financial resources that fund purposeful living. Moreover, failing to develop (or follow) that plan can lead to terrible consequences.

In a broad sense, financial planning has been shown to positively correlate with goal attainment. David Blanchett (2015, pp 42-50) found that the very presence of financial goals increased household wealth significantly. One prior study by David Blanchett and Paul Kaplan (2013), also found that total wealth increased with the presence of goals-based financial planning. Each year, I encounter numerous families without a financial plan of any kind, with a disposition towards money that generally falls into two groups: 1) indifference, or 2) uncertainty. Indifference is an attitude that disregards the role of finances in attaining life goals. Common messages I receive from this group are: "it will all work out", "God has a plan for me and my family", or "it's not proper for me to focus on money." Hearing such messages reminds me of planning calamities I have witnessed where a parent died without a will, a breadwinner became disabled without adequate insurance, or a decedent left retirement assets to the wrong person. If you are indifferent about the role of money in your life, reconsidering your position can greatly benefit your family.

Unlike indifference, uncertainty is usually less difficult for families because it does not represent a refusal to engage in planning. Uncertainty usually just underscores a need for perspective – a better understanding of the financial risks involved in daily living, concrete answers to managing them, and trusted professionals to facilitate a comprehensive planning process. If you are uncertain about your finances or about how to pull certain pieces together, you may be ready to begin a planning process.

Whether indifferent or uncertain, it can be difficult to admit that "I am not trained in building my own comprehensive financial plan to integrate my cash flow, taxes, retirement, estate, insurance and investments." Instead of recognizing that self-directed comprehensive planning is nearly impossible to execute, modular planning often replaces comprehensive planning* (e.g., retirement projections are run, investment analysis is performed, insurance policies are installed). To make matters worse, the financial services industry has added confusion by allowing financial professionals to communicate in nuanced ways about their product/service offerings (Chapter XI - Finding Your Fiduciary).

Before attempting to sort through the confusion, I encourage you to first develop a stronger perspective about the role of your finances. For starters, try thinking of your complete financial life as funding your purpose. If your overall finances are a resource for funding life goals, then you would necessarily be a steward of those resources. Further, you might be more likely to pursue professional advice around comprehensive planning (Chapter III – About the Cycle).

In this analysis, knowing your purpose is essential. If you do not know your purpose, a great source of such wisdom exists in a single reference: The Bible. Whether you are a Christian or not, the Bible can help you better understand your purpose, and establish direction for your life. Of course, there are many other resources related to discovering your purpose, though none quite as complete. Given that Biblical scripture can be a challenge to read, many options are available to assist your learning. A local church is likely to have a Bible study in which you can participate for little or no cost. There are also many self-directed websites to assist your learning, such as www.biblegateway.org, www.biblehub.com, and www.studylight.org.

In her article, *Discovering Your God-Given Purpose*, Sarah Schutte said:

> Consider that your purpose is not just about you; it's about what God wants to do through you. Therefore, if you ignore or neglect your dissatisfaction, what others say about you, your gifts and your passions, you are not only betraying yourself, but betraying God; because

> He has called you to a purpose and wants you to walk in it — for others and for your own joy. (Schutte, 2008)

In Schutte's analysis, understanding your purpose means understanding God's will. In such context, evaluating one's own life story is essential. This means combining a series of experiences that, when pieced together, tell a story. If you examine this story closely enough to identify the patterns that exist within it, you can quickly identify those times of strength where you moved with purposeful direction - that is, direction aligned with your purpose. Moving with purposeful direction does not always mean following the direction others have suggested, the direction you may be tempted to take, or the direction that resulted from external events in your life. Further, these times of strength are distinct from times of trial, which can hold value of their own by equipping us to again move in a purposeful direction – usually with renewed strength.

Moving in a purposeful direction means working through three progressive stages: 1) seeking that which you were created to be, 2) understanding it to the best of your ability, and 3) becoming it with passionate abandon. So how will you know when you are moving in a purposeful direction? Stress and anxiety decline. Your productivity improves. Your relationships strengthen. Perhaps you even become Surprised by Joy (C.S. Lewis, 1966). Soon, your life stops being a random pattern of events, and starts becoming a cohesive story filled with contentment and discovery. Continuing this way over time, you may observe the drive for personal satisfaction being replaced with the joy of giving to others. Ultimately, you can expect that living with purposeful direction will lead to a peace beyond your wildest imagination (Philippians 4:7, The Holy Bible, 1984).

THE LIFE CYCLE OF WEALTH™

Every household has two primary financial statements: a balance sheet and an income statement (or "cash flow"). A balance sheet summarizes what you own and what you owe. It is the foundation of a family's finances. Cash flow refers to the combination of income and expenses; it represents the additions/subtractions to/from the foundation. *The Life Cycle of Wealth*™ approaches money in relative terms because the numerical value(s) of the two components (balance sheet and cash flow) can vary widely from one household to the next.

> *For example:* I provided planning services for a couple in *Phase II* with an $80,000/year total expense budget. Their primary goal was to build a $2 million nest egg with which to enter *Phase III*. This goal included 1) preserving the value of the $2 million through *Phase III* and *Phase IV* and 2) funding their $80,000 annual budget, without accounting for social security

benefits. For them, being wealthy meant having a 4% income from $2 million, and an annual inflation-adjusted total return high enough to render a positive return after fees and expenses, on a long-term basis. *Their ability to be financially established hinged upon their ability to meet their budget and preserve their capital for a lifetime.* While this $2 million in assets is a significant sum, there are many affluent families who would not consider it wealth.

Another example: I once worked with a couple who had recently entered *Phase III* requiring $60,000/year for the first 10 years of this phase, then $45,000/year for the remainder of *both* of their lifetimes. The asset base required for them to be "wealthy" is a present value of around $1.4 million. If this couple had the $1.4 million in assets, they would be considered wealthy in terms of their financial independence. However, for the previous couple needing $80,000 throughout *Phases III and IV*, $1.4 million would be a good start, but certainly not real wealth.

A final example: I once worked with a *Phase II* client who inherited a sum of $500,000 but needed a $50,000 annual income to live comfortably for the remainder of her life. This inheritance was not sufficient to make her "wealthy", because the roughly $1.25 million asset base required to fund her *Phases III and IV* had not yet been achieved.

In each of these examples, the people involved had distinct financial situations and therefore different ideas about financial independence (though their experiences of moving from one Phase of their *Life Cycle*™ to another was quite similar, and so were the risks they faced). Another common element across these examples was the stress each client carried – not because they faced unusual adversity, but because they were anxious about financial outcomes. This stress comes out in several ways. Common symptoms include: "Where should I put my money?" or "How can I get a better return?" or "I pay too much in taxes." This general financial anxiety illustrates the need for a strategy. Specifically, it argues for a comprehensive financial plan aimed at financial independence for at least the current generation.

On separate occasions, two of my closest colleagues have each admitted their concern about the level of anxiety present with certain clients. Each of those professionals is well-educated, experienced, and highly regarded in their communities as outstanding practitioners. Yet each of them admitted certain clients "did not sleep well enough" – particularly between review meetings. Both professionals stated that these clients would become stressed between meetings to nearly the same degree as the onset of their advisory relationship - despite having a sound strategy, making informed decisions in meetings, and making marked progress towards their financial objectives.

Indeed, this pervasive recurrence of financial worry is the norm in our culture, certainly during challenging economic times. Its source? According to both professionals, the financial stress their clients experienced generally amounted to a lack of *perspective*. In rational terms, a lack of perspective can appear paradoxical when discussing a topic as universal and substantial as *money*. However, our personal financial lives are not rational, they are emotional; so the key to building perspective around money lies in how we relate to it. To simplify this analysis, let's consider three distinct "financial types", each with a unique way of relating to money and therefore, a unique method of building financial independence.

The Givers are the first group. They are the people that think and act for others, often putting themselves out to contribute to the world around them. They seem to do so effortlessly, often with utter disregard for their own needs. They are typically successful spouses and business partners. They are also wonderful providers. When it comes to financial matters, they are a generous group, limited only by their own balance sheets and income statements.

The Takers are the second group. This group tends to pursue wealth for its own sake. Takers are often excellent business professionals. In their personal relationships, Takers typically address their own needs before contributing to the needs of others. Overall, they are usually comfortable with their disposition, and seem indifferent when they put someone else out.

The Pretenders are the third group, and the most difficult group to recognize. This is a group of Takers disguised as Givers: they appear as Givers, but cleverly take from others to further themselves or their agenda. Pretenders have more self-awareness than traditional Takers – enough to recognize they must appear giving to succeed in certain areas of their lives. Pretenders are also often highly successful in business. They may or may not be successful family people. In general, Pretenders are a confusing group to interact with because they lead others to believe in their giving nature, only to further their own cause(s).

Givers, Takers, and Pretenders each bring a different perspective towards money, and therefore a different disposition towards achieving financial independence. This perspective determines each group's interest and use for *The Life Cycle of Wealth*™ – a decision-making framework for a lifelong journey towards financial independence. Specifically, Givers normally demonstrate ease in navigating *The Life Cycle*™, while the Takers and Pretenders are often skeptical of the model (or even misunderstand the concepts altogether), because the model does not represent a short-term process. That is, Takers and Pretenders tend to prefer shorter-term solutions (often with wealth-building as its own end), and so have difficulty applying longer-term concepts inherent in *The Life Cycle*™ model.

How can we understand ourselves with respect to these three financial types? Consider the example of a not-for-profit, charitable organization. Many non-profit charities employ Givers - talented, educated, yet modestly-paid workers who spend a career trying to better the community around them in some way. There are donors for these organizations who are equally Givers – philanthropic with their time and financial resources. There are also many Takers and Pretenders who donate time or money to the charity for the good publicity or the tax benefits involved. Unlike the Givers, their contribution was made with the requirement that they or their organization benefit from their own actions.

Returning to the topic of needed perspective, both of my previously mentioned colleagues explained that modular planning (planning in a singular focus area – e.g., retirement, investments, taxes, etc.) was initially the basis for each client families' planning engagement. Eventually, each family completed a comprehensive financial planning process. As time passed, both professionals reported their client families had progressively less anxiety about the future and was better able to focus on other areas of their lives. Marriages improved. Family time relaxed. Business partnerships grew. Everyone won. According to both professionals, the achievements of their client families required that each family: 1) develop a common understanding the role of money in supporting life goals, and 2) engage in comprehensive financial planning as a method of allocating resources to fund those goals.

ABOUT THE CYCLE

Understanding the form and the function of *The Life Cycle*™ are two different exercises. In form, *The Life Cycle*™ is a picture of four distinct Phases of our financial lives surrounding a Pin Oak tree - a tree that lives to be centuries old. In function, the *The Life Cycle*™ provides families with a decision-making framework designed to facilitate a long-term planning process with competent advisors. More specifically, the following list itemizes those functions *The Cycle*™ does and does not serve.

What *The Cycle*™ does

1. It proposes an approach to wealth that is connected to (but secondary to) life goals.
2. It provides a decision-making framework for families to use in considering financial decisions.

3. It sets expectations about the experience of each phase of our financial lives.
4. It assists families with managing risk present in their comprehensive plans.
5. It assists families with receiving services from the right professionals.

What *The Cycle*™ does *not* do

1. *The Life Cycle*™ framework does not offer a short-term method of accumulating wealth.
2. *The Life Cycle*™ does not propose one financial strategy over another.
3. *The Life Cycle*™ does not refer to any financial product(s) or service(s).
4. *The Life Cycle*™ does not provide a behavioral finance methodology.

Consider this real-life example of how *The Life Cycle*™ functions*:* You can buy life insurance in several ways, to protect a family or a business, in the event of premature death. This financial product is important, with many questions that need to be answered: what benefit amount is needed? What carriers are a match given health and lifestyle factors? How should the contract be structured (i.e., owner, insured, beneficiary)? Such important, tactical questions exist with any insurance, investment, or other financial product decision you make during your lifetime. Answering them correctly requires that you have a strategy – a clearly-defined plan that addresses your financial life in a comprehensive way.

Modular vs. Comprehensive Planning

Modular planning addresses a single area of your financial life. It can answer important questions like: *"How should I build a life insurance plan?"* or *"What asset allocation should I pursue for my investments?"* or *"How can I lower my projected estate tax liability?"* Modular planning is the most common for salespeople in the investment and insurance industries, most often occurring when planning is a function of distributing products. Modular planning is also often self-directed by families. While there is nothing fundamentally wrong with modular planning, it is critical to recognize that such a plan is incomplete. For example, families frequently develop a *modular* investment plan that identifies which areas of the global marketplace to invest (asset allocation). Similarly, a comprehensive plan would include an investment plan, though it would integrate that investment plan with the family's cash flow plan, income tax plan, retirement plan, estate plan, and insurance plan.

It is easy to mistake modular and comprehensive planning because the vernacular used to describe them is so similar. For example: "retirement planning" is a modular form of financial planning. It usually includes aspects of comprehensive planning, such as investment analysis, cash flow modeling, and insurance. Such integration is certainly a step in the right direction, but still not comprehensive. For example, the family that does retirement planning also has critical estate planning decisions to make – before retirement even begins, as the withdraw rate from portfolio assets during retirement affects the size of the projected estate. As a result, the family with a patriarch and matriarch retiring typically needs to cement a wealth transfer plan between generations, by doing more than beneficiary designations on retirement accounts (e.g., updating wills, building and funding a trust, retitling assets, etc.).

Not only are modular and comprehensive planning different in scope, but modular planning often inadvertently destroys wealth instead of creating (or maintaining) it. There are many common scenarios where such destruction occurs. Examples include:

1. Personally-owned life insurance creates excess estate tax liability.
2. Retirement cash flow projections are made without planning for long-term care events.
3. Investment planning is done without attention to income tax consequences.

Decision-Making: Products vs. Strategy

Whether comprehensive planning or modular planning is occurring, understanding the difference between *strategic decision* and a *product decision* is essential. The following paragraphs illustrate the dynamics of strategic and product decisions. As you consider these points, remember that a financial product is any instrument that meets a specific need. A financial strategy is the overall *direction* of your financial affairs. In short, products are the pieces that comprise the strategy puzzle. Great financial decision-making requires that you:

1. Have a strategy
2. Know whether a given decision is regarding product or strategy
3. Know if a given product fits with your overall strategy

So, ask yourself: do I have a strategy? Am I making a product decision or a strategy decision? If this is a product decision, does it fit with my overall strategy?

Making Great Product Decisions. If the product decision involves a trusted advisor who was first engaged for reasons other than proposing products, and who is focused on the successful completion of your strategy, reviewing the pros and cons should be a matter of communicating with your advisor. However, if you are making a product decision separate from a strategic advisor, there is often a salesperson involved, and it is important to review the pros and cons objectively.

The following is a short checklist of questions you can ask when making product decisions for yourself, your family, or your business. Applying these four questions to any product decision you make will greatly improve the clarity with which you proceed.

1. Which of the four phases am I in?
2. Will this product impact my current Phase?
3. Will this product provide the desired long-term effects for future Phases?
4. In what manner and how much am I paying for this product?
5. What are the risks involved?

Product decisions are generally much easier to make than strategy decisions. While they require you to have a good understanding of the product itself and its risks/rewards, these decisions do not typically require you to evaluate changes to the overall well-being of your family or business to proceed. A *strategy* decision, however, requires a more complex decision-making process.

Making Great Strategy Decisions. If you are unsure about what type of decision you are making, remember that strategy decisions do not usually start with a product discussion or a transaction. Examples of questions requiring a strategy decision would be: *"At what age can I reasonably afford to retire and not outlive my money?"* or *"How do I efficiently transfer wealth to future generations?"* Think of strategy decisions as "big picture" decisions.

So why have a strategy at all? Why not just find the products and services you need when you need them? Psychologist David Campbell, PhD, titled one of his most popular texts *If you don't know where you are going, you'll probably end up somewhere else*. (Thomas More, 1974). In it, he said "…when you are planning your future, you should plan it in a way that will give you some choices, and this is particularly important if you aren't really sure right now what you want to do. Some people when they are uncertain have a tendency to do nothing, and this substantially restricts their future choices." Dr. Campbell's observations are hard to dispute, however incomplete. His comments do not address the importance of having plans that are *written*. Consider the following study which demonstrated why written plans are so essential.

In 1979, a group of researchers interviewed new graduates from Harvard's MBA Program and learned the following details:

- 84% had no specific goals at all
- 13% had goals but they were not committed to paper
- 3% had clear, written goals and plans to accomplish them

In 1989, the researchers again interviewed the same graduates. As you might expect, their research found the following:

- The 13% of the class who had goals were earning, on average, twice as much as the 84% who had no goals at all.
- Even more surprising, was the 3% who had clear, written goals were earning, on average, ten times as much as the other 97% put together.

(McCormack, 1984)

Dr. Campbell stressed the need to develop a plan and avoid the great risk of doing nothing, while Mr. McCormack emphasized that our plans need to be written. When it comes to having a written financial strategy, though, the process can be daunting. Anyone new to such a process asks questions such as: *What information is needed? What tools should be used? Is it just about the money? What about values?* While there is no single way to handle a strategic planning process, being aware of a few planning pitfalls may provide some direction.

Planning Pitfall #1 – I did it online. There is a common perception among do-it-yourselfers that comprehensive planning is possible using self-directed tools on the internet. To be sure, there are many planning *modules* you can find online, many of which will give you meaningful information about your financial life, from taxes to investing to insurance, even retirement. However, in my 14 years of financial industry experience, I have yet to find a single self-directed planning platform for individuals, which can deliver detailed, comprehensive financial plans. The absence of such a tool may be due to a lack of desire or training for end users to navigate it. After all, such a tool would be akin to an architectural firm offering online blueprints for homes based on someone's preferences. Without end users becoming home builders, it is doubtful that many would take the necessary steps to construct the home themselves. Even with proper training and years of experience, would they want to spend their time and energy this way? Or might they want to hire someone with the proper training and experience to build it according to their wishes?

Planning Pitfall #2 – My product salesperson does planning. To follow the previous analogy, this would be like saying, "my electrician did the blueprints and overall construction of my house." It is true that your electrician may do planning *activities* related to their area of expertise. However, electrical work, while essential, is *modular* in nature. It does not ensure the overall home construction is sound.

Planning Pitfall #3 – My portfolio is in good shape. This statement implies that investing and strategic planning are one in the same. Investment planning is indeed a form of planning. However, this is also a *modular* form of planning - just like taxes, insurance, retirement, and estate planning. Having a good portfolio or investment plan does not mean the same thing as having a well-written, overall strategic plan.

> *For example, actor James Gandolfini passed away at age 51 with an estate worth approximately $70 million. It is possible that Mr. Gandolfini had a terrific investment plan. However, without a comprehensive strategic plan, the investment-only plan would have done*

nothing but contribute to an already large estate tax bill of around $30 million in federal tax.

Another word about investing: it is unique from other modes of planning given it can make or break the funding of your overall strategic plan. Therefore, it is essential to get outstanding advice in this area. Low-cost, self-directed investing is a nearly impossible method of supporting a planning process. It is ripe with unmeasured risk-taking and serious consequences when markets move quickly against a given position. With an investment advisor involved, also remember the difference between trading and investing. *Trading* refers to using the financial markets to do regular transactions – taking risk to attempt short-term profits. *Investing* refers to using financial markets to match your preferences and risk tolerance with a strategy to generate consistent long-term results to fund your entire financial strategy. Comparatively speaking, investing is a low-risk method of developing long-term financial independence.

Planning Pitfall #4 – I am already financially established. This is perhaps the most dangerous mindset to take regarding financial planning with established resources. It suggests that those resources will not dissipate: that is, be spent in a lawsuit, lost to medical bills, paid out in taxes, squandered, poorly invested, or some other unseen (or unmanaged) risk. Especially if established resources are closely-held business assets, the idea of being "set" without a drafted strategy is likely to have negative consequences.

Meet Darren. A retired general contractor of 30 years, Darren had a written strategic plan, but was still disappointed in his income results when he decided to retire in 2009. He simply did not have the assets he expected to have, from which to pay himself. His corporation was worth substantially less in 2009, following the real estate and construction boom which had peaked in 2006, and his financial assets had lost value during the 2008 U.S. financial crisis. To make matters worse, his strategic plans did not account for two important facts: 1) the appraised value of his business meant the company represented over 40% of both his asset allocation and net worth (he had no debt), and 2) the economic conditions at his retirement meant that his business was difficult to sell and even more difficult to sell anywhere near its appraised value.

So, planning with business assets means addressing high-risk, non-liquid assets on the family balance sheet. In Darren's case, he did eventually sell his business, although for much less than he hoped. Had he not, his estate would have carried significant liquidity risk. Although such an issue is beyond the scope of this text, it is important for successful business owners to recognize that they have liquidity issues (and perhaps related tax issues) in their estate plan that must be addressed in a detailed fashion. The alternative can be disastrous for one's heirs.

To review, strategy decisions need to be based upon a comprehensive, written plan. Ideally, the plan should be drafted and managed with competent, trusted advisors who make a full-time living providing the right guidance on “big picture” issues. When you go to write a check for advice, remember that getting quality advice at critical moments throughout your life will usually bring financial outcomes that far outweigh any fee you paid along the way.

Meanwhile, the following is a short checklist of questions you can ask when making strategy decisions for yourself, your family, or your business. Applying these five questions to any strategy decision you make will greatly improve the clarity with which you proceed:

1. What do I expect to accomplish during this phase?
2. What does the next phase look like?
3. When do I realistically expect to enter the next phase(s)?
4. What are the current financial considerations that come into play?
5. Who are the other people that my decision(s) will impact?

PHASE I – PREPARE

During the first phase of *The Life Cycle*™, there is a quiet period in a family's financial life. Too often, professional advisors do not engage younger adults, due partly to the perception that younger adults do not have sufficient assets and/or income to warrant much planning. This is a misconception. If cash flow - a significant Phase Risk at this point (see Chapter VIII - Managing Risk) - can be well-managed, there is no better time to build infrastructure and cement it with great habits. Like the other phase of *The Life Cycle*™, there's no "right" way to approach Phase I. However, the following four steps are critical to building infrastructure for a family's financial life: 1) get organized, 2) develop a routine, 3) insure the future, and 4) install an initial estate plan.

Step #1 – Get organized. Set some initial life goals. Where do you want to live? What are your career objectives? What type of family life do you want to have? This gives context to your financial life. Be sure not to apply numbers to these discussions until *after* you have clarity on what you wish to accomplish.

Second, create a household budget. Either a simple spreadsheet or a budget plan using software, itemize your income (before and after taxes) and the costs of your lifestyle on paper. Get a consensus among key decision-makers as to the validity and the sustainability of these numbers, and then set a course to follow the budget going forward. Last, review it at least once annually (or as often as necessary for your household to stay on track).

Step #2 – Develop a routine. Establish the accounts necessary to promote your objectives. There's no such thing as the perfect set of accounts or funding plans, only the need for you to have your accounts deal with the short-term, mid-term, and long-term realities of your life goals. A trusted financial professional can help with this task, relative to funding levels (given your budget), investment outcomes, and tax management. At this point, it's most important to have the infrastructure in place, and "just do" the work of putting money away each month. This infrastructure and routine promotes great habits for Phase II of your financial life, where the production of income and the accumulation of assets becomes the primary focus.

Step #3 – Insure the future. Buying life and disability insurance amounts to transferring major risks (Chapter VIII – Managing Risk). Conceptually, then, risk transfer argues for carrying statutorily maximum benefits. A maximum amount of life and disability insurance does not mean the most offered by your employer, although those amounts (and the price) are important to know. It means carry as much as you can reasonably justify and is allowed by law. Most people must purchase a life and/or disability insurance supplement to reach these limits.

If you buy life insurance or a life insurance supplement, be aware that transferring the risk of your death is going to get much more expensive as you age (and get closer to your life expectancy), so buying early means a lower long-term premium. To determine your need for benefits, two general approaches exist: 1) the replacement cost method, or 2) the human life value method. The first method requires calculating the amount of money needed to replace your income for a specified number of years (usually 3-7 years), pay off outstanding debts and educate your children, as well as fund any other substantial goals. By contrast, the second method establishes and insures the total value of your lifetime income, arriving at what is typically a higher coverage level. Which approach you use is between you and your insurance professional. Just know that if you die prematurely, there will not be any explanation needed as to why you carried the maximum death benefit under either approach.

Long-term disability insurance or a disability insurance supplement should also be purchased as early in life as possible, although for a different reason. This is a health insurance product that insures your income against morbidity risk (the risk you are unable to work for health reasons). If you do not purchase the amount of long-term disability insurance needed to reach the legal limit (approximately 2/3 of your pre-tax or "gross" income), and then have any major health problems, you may be unable to attain the needed coverage. Also, maximizing a long-term disability plan does not just include present benefit levels (based upon your current income), but future levels as well. It is possible for your current policy to offer increase options that would accommodate future growth in your income without requiring you to get a new policy.

Finally, working with an experienced, independent insurance professional on these matters is of the utmost importance. These are the professionals that can access more than one insurance company and create a competitive scenario that benefits you (not the insurance company). In terms of experience, the ideal independent life/disability insurance professional would have 5 or more years of experience and carry a related professional designation (Chapter XI - Finding Your Fiduciary). However, if your professional can assist you in finding the most cost-effective options for a given level of benefits, you are normally getting excellent help. No matter who you work with on this part of your planning, be sure to ask your professional to analyze your employer-based options and your current budget before you apply for private coverage.

Step #4 – Install an initial estate plan. The pieces of a basic estate plan include: a final will, powers of attorney, and a living will. A final will directs the probate court after you have passed away, identifying personal representatives, naming physical and financial custodians, designating beneficiaries, and generally directing the distribution of your estate. Powers of attorney give specific authority to other individuals to handle your affairs while you are alive, yet unavailable/incapable of representing yourself. Finally, a living will (also called a "medical directive" or "health care directive") directs your physicians regarding your "end-of-life" decisions. If the end of your life is imminent, a living will instructs physicians regarding the use of life support and/or artificial nourishment.

Like other forms of modular planning, it is possible to get basic estate planning documents from the internet. However, an estate attorney will offer experience and customization not usually available from a web-based template framed from a question and answer session. As an alternative to attempting a self-directed estate plan, find an estate attorney that offers a free consultation, then determine your options and the necessity of an attorney/client relationship *prior* to drafting anything yourself. Another cost-cutting measure would be to explore the question-and-answer portion of the self-directed estate planning websites, and perhaps even pay for drafted documents. You will then have spent the time developing your intentions and getting an understanding of the process before you meet with an attorney – particularly if they charge by the hour.

No matter how you arrive at which documents to employ in a basic estate plan, be sure those documents are executed. Most states require a notary public and/or witnesses to your signature(s), to validate the endorsement of your documents. Once executed, store your estate plans in a safe deposit box or a fireproof safe, along with other vital records (e.g., life/disability insurance policies, birth/marriage certificates, social security cards, etc.). Also, inform the key people in your plans about the location of your records, and about their role in your plans - during and after your life. Like any other part of your plans, your insurance and estate plan should both be reviewed regularly to accommodate updates and changes to your life - especially if there are major life events, such as a divorce or the death of a family member (or other key person in your plans).

The four steps outlined in this phase were: 1) Getting organized, 2) developing a routine, 3) insuring the future, and 4) installing a basic estate plan. While these steps do not comprise all that could be done to build the infrastructure of your financial life, they do lay the groundwork needed to move comfortably into Phase II. During Phase II, then, you can better focus on funding the infrastructure created during Phase I. Most importantly, you can give more attention to the beginning of your comprehensive plans.

PHASE II – PRODUCE

Transitioning to Phase II is typically a seamless, even unnoticeable process. Like other transitions, there is no exact age at which Phase II occurs, and like other Phases, it is unique in its characteristics. These characteristics often include: a higher income, a new home, and perhaps children. While such life changes are positive and exciting, they also represent complexity, even chaos – a new development that can last for years.

To build upon Phase I, the process of developing a written plan needs to be undertaken during Phase II. This process first means maintaining cash flow established during Phase I. Managing cash flow effectively carries two primary challenges: 1) managing expenses (given income is normally less variable than expenses), and 2) maintaining your savings habits.

Challenge #1 – Manage expenses and invest the cost savings.

I have met many multi-millionaires who never made a six-figure income. Instead, they focused on managing their expenses first. You don't hear enough about these people. They typically have the following habits in place:

1) They have a written budget that household decision-makers are all informed of and generally follow. Of course, exceptions are made where necessary (Chapter X: The Power of Cash Flow).
2) They make a point to live on one income (if there are two incomes present).
3) They buy used cars. The operative words here are *buy* and *used*. Financed or not, many millionaires make a point to own their vehicles, and acquire them used, letting someone else accept rapid, initial depreciation. With rare exception, they do not rent (i.e., lease) these depreciating assets that are relatively expensive to maintain in the first place.
4) They use savings from the previous three activities to build their assets by investing their money. Successful asset-builders leverage a company retirement plan (especially where a match and/or profit sharing is present), as well as fund IRAs, College Savings Plans, and non-qualified investment accounts.

Challenge #2 – Focus on systematic habits, not holdings.

Unfortunately, you rarely hear the guests at a cocktail party discussing their great investment habits. Instead, you hear about the latest strategy for success, usually centered on a specific holding. Of course, this makes great conversation. However, holdings are infinitely less important than the *habit* of investing regularly.

Meeting these cash-flow related challenges successfully allows for new focus areas to be addressed during Phase II: 1) investment planning and 2) tax planning. *Contemplating* the relationship between cash flow and these two new areas is not difficult: a family's income is generated, taxes are paid, and net income is available for asset accumulation. However, *coordinating* cash flow management, tax planning, and investment planning, is far more difficult during, especially given this phase occurs at hectic time of life (e.g., families are young, schedules are demanding). For example, families often overlook critical questions that integrate their planning:

1. At what point in my financial life should I pay non-essential income taxes?
2. What is the present value of my life goals? Based on those values, what is the amount of accumulation needed each period (weekly, bi-monthly, monthly, etc.)?
3. What amount of income do I need to produce (in the first place) to provide for my family?

Not considering such questions can result in missed opportunity and/or excess risk. Worse, many Phase II families coordinating their own advisory team (insurance, financial, tax, etc.), which can lead to inconsistent planning, higher fees, and perhaps conflict. To add consistency, try working with a primary advisor (firm or individual) for your comprehensive plans.

To improve your work in Phase II, consider a few additional points about investment planning. Recall from Chapter III that having an investment plan does not mean you have a comprehensive strategy. Instead, the investment plan funds your larger strategy long-term. To maintain a steady investment plan, it is essential to treat market cycles as repetitive, which means acknowledging the current market cycle is *not* different, even if it *feels* different. The economic circumstances, headlines and even the extremity of market movements may be different, but the market cycle itself is not. Indeed, short-term trends have little bearing on your long-term results in the financial markets – markets which have repeated the same general historical pattern since returns have been recorded and analyzed dating back over 80 years (Morningstar/Ibbotson, *Stocks, Bonds, Bills & Inflation 1929 - 2016*).

Of course, it is possible your investment plan is not working. Below are eight questions to consider regarding any portfolio deficiencies that may exist. Answering these questions may help reveal any issues affecting your portfolio. The answers to these questions will also distinguish between problems with your portfolio and problems with your financial professional(s).

1. Have I viewed all my assets in one place on an ongoing basis?
2. What is my overall asset allocation plan?
3. What are the relevant areas of the market with which to compare my portfolio?
4. What is the role of my financial professional(s)?

5. Does my financial professional(s) see a deficiency?
6. What are the recommended changes to be made?
7. If I have an actively managed portfolio, who are the ultimate asset managers (i.e., daily decision-makers)?
8. How have the decision-makers managed risk/reward versus relevant market categories?

Having answered these questions about your portfolio, the investment plan and tax plan that were integrated with your cash flow, can be built upon. Specifically, remaining areas of your comprehensive plan need to be integrated: the insurance plan (Phase I), the retirement plan (Phase III) and the Estate Plan (Phase IV). To maintain clarity and ensure a peaceful transition to Phase III, each of these components be brought together with as much detail as possible. Coordinating these 6 areas – cash flow, investments, taxes, insurance, retirement and estate - is a strategic planning exercise that requires many focused hours from the right professional(s) (Chapter XI - Finding Your Fiduciary). This construction of your comprehensive plan is critical to better understanding your family's ability to achieve financial independence. Indeed, a completed comprehensive plan is necessary to navigate the transition into Phase III, and the time spent in Phase III and IV.

PHASE III – PROSPER

The third phase of *The Life Cycle*™ is special. Known as the "golden years", Phase III is full of freedom. Children have become young adults, careers have matured, and balance sheets have improved. More time, energy and financial resources are available than any previous phase. For many, financial independence has become a reality.

Phase III can also be full of stress, given the life changes involved. Many crossing from Phase II to Phase III struggle with the mental and emotional paradigm shift involved. Phase I and Phase II are about using income to build assets (i.e., using net income to build the balance sheet). Phase III requires the opposite flow of wealth: using assets to provide income (i.e., using the balance sheet to provide income). This change makes the most fundamental financial transition that occurs in a lifetime. The following case study illustrates the challenges involved with entering Phase III:

Meet Martin: a partner in a successful office equipment business. Martin and his wife, Carly, were both in their young 60's. Their kids were grown and starting families. They had reached financial independence – the necessary amount of wealth was available to live comfortably without having to produce income. They had goals for travel, for hobbies, house projects, and other activities they had waited years to pursue. Martin was so invested in his business, however, that he failed to enter Phase III as he planned – twice. For someone who established himself and his business as an industry leader over a 30-year period, leaving Phase II was especially hard. Martin would call and commit to a transition date, then repeatedly back away from it. His first attempt was a false start. With his second attempt, Martin completed the sale of his company, and began spending time at his ranch property in Southern Arizona. At his next review meeting, he informed me planned to consider a position from a previous competitor and may be headed back to Phase II. I listened, then explained that there was no financial reason for him to make such a move. He agreed but said "I'm too full of spit and vinegar to quit now!" His third attempt was finally a success, and he remained in Phase III with his wife. Years later, he called me and shared that his wife had just successfully beaten cancer. He was elated that he had remained in Phase III and had a *chance to spend quality time with his wife of 45 years –before and after her cancer battle.*

The point here may be obvious: you can choose *how* to navigate *The Life Cycle*™. If your pursuit of financial independence has been secondary to the pursuit of your contribution to the world around you (family, friends, and other loved ones), you will likely have little emotional difficulty transitioning from Phase II to Phase III. However, to struggle is also normal. Many entering Phase III find themselves needing to re-examine priorities before moving forward. The questions below form a short list of considerations that must be addressed to successfully make the mental and emotional leap into Phase III. Answering these questions takes time and energy. It also requires good professional guidance from your financial professional(s).

1. How does my *new* budget look?
2. What are my *new* sources of income?
3. What is the tax treatment of the assets involved?
4. What about health insurance? Long-term care insurance? Life Insurance?
5. What are the risk/reward requirements of my investment plan to ensure I have enough assets to live comfortably through Phase IV?
6. If I am successful in Phase III, then how does that affect my estate strategy in Phase IV?

As with other phases, the questions and the answers are often more complex for business owners. Much like retiring employees, most business owners not retaining control of their enterprise(s) during Phase III can find clarity about their decisions by answering the six questions above. However, the transition to Phase III may still be difficult, as business owners have both a financial and emotional investment in their businesses. Though many have more than earned financial independence, it can be hard to reinvest elsewhere - to simply let go. Also challenging, many were not accustomed to investing in an investment portfolio, and grapple with the concept of liquidating business interests.

In some cases, business owners maintain control of their business assets and remain on the company's payroll/benefits plans for as long as possible. For those individuals, a Phase III transition just means working a little less, and may not require a great deal of new thinking or planning regarding "retirement," except for making pension plan and government entitlement program elections. However, there are many longer-term planning issues for business owners who continue holding their business assets in Phase III and IV, which are outside the scope of this text. It is essential that these individuals seek focused attention regarding their business succession plan from competent, experienced advisors.

Phase III is an extraordinary time of life that many spend decades preparing for. While its onset often represents the largest financial and emotional paradigm shift in a lifetime, the financial independence that Phase III represents can be a joy. With *The Life Cycle*™ in mind, the transition into this phase is easier. You can better and the joy that comes from doing those activities that have been less available during Phase I and Phase II. Having completed your comprehensive plans prior to entering this Phase, only regular reviews and occasional adjustments are necessary. Doing so can make the "golden years" a reality and deliver you to Phase IV with confidence.

PHASE IV – PRESERVE

The final phase of *The Life Cycle*™ is different from the others. Many life goals have been accomplished. Assets remain readily available for planning. Changes in physical health may have presented new concerns. Adult children may be more involved. These distinctions make living in Phase IV unique. Consider the following example of one family's Phase IV experience.

> *Meet Jim, a dear client and friend. He and his wife Jenny ran a multi-million dollar contracting company for decades and established about $8 million of new wealth for themselves in Phase II. They delayed their entry into Phase III until they were confident they had a well-handled succession plan for their company.*
>
> *At age 70, they both fully retired and began the process of using their assets to fund their*

income. Five years later, Jenny's health began to deteriorate. They agreed to re-build a complete estate plan with me and a local estate attorney, then did the hard work of funding that plan. Jim and Jenny had two children and six grandchildren. They chose a trust-based estate plan and proceeded to draft a Revocable Living Trust with bypass provisions and an Irrevocable Life Insurance Trust – both to help mitigate potential estate tax liability. They funded those trusts by organizing assets and retitling them into trust name, according to their financial plans. They also began making annual gifts to their kids and made tuition payments to educational institutions for their grandchildren's post-secondary schooling.

Jenny passed away at age 80. Since then, Jim has been able to maintain his standard of

living, and despite his grief, has continued an abundant retirement in the company of his children and grandchildren. His entire family is completely debt-free, highly educated, and productive members of society, pursuing their own Life Cycles.

Unfortunately, the success that Jim and Jenny enjoyed during their own *Life Cycle*™, as well as the time, energy and money they spent to ensure their wealth would last for generations, is rare. It is rare because most of us think in terms of what is happening today and relate to it based upon our past experiences. Therefore, thinking in terms of what lies ahead – seriously considering the risks and opportunities present in our own lifetimes and the lifetimes of our children and grandchildren – does not come naturally to most of us.

Jim and Jenny's situation is also rare because not everyone chooses to pay for the advanced planning that characterized their story. Jim currently pays his wealth management firm around $60,000 per year to manage $6 million of investable assets, out of his total net worth of about $9 million. He has a minimal time commitment for the 99% of the gross returns he receives (the firm charges approximately 1% per year) and gets comprehensive financial planning and an optimal portfolio – something he would have difficulty handling completely on his own. Further, his firm and Jim's outside advisors (estate attorneys, tax accountants) have regular communications with him and his family members about the transition of wealth to future generations, not to mention review meetings with Jim each year. Finally, when the next serious bear market comes, Jim stands a better chance of maintaining his capital with an advisory firm involved than without one (*Quantitative Analysis of Investor Behavior*, Dalbar, 2018. Print.) Arguably the greatest value of a wealth management firm is its ability to manage risk across an entire plan and the portfolio that supports it.

While Jim and Jenny were not typical Phase IV clients, their concerns were quite typical. In review meetings, they were consistently interested in the following: 1) how to efficiently transfer wealth from their generation to the next, 2) transferring wealth with minimal administrative and legal requirements for their heirs, and 3) minimizing tax liability in the process. Like any estate planning, their concerns were complex and required input from all other areas of the overall strategic plan – tax, retirement, investments, and insurance.

Detailed estate planning is a process. It is arguably the most comprehensive *type* of modular planning a family can undertake. Recent financial statements must be updated in to establish net worth and cash flows, and the gross estate must be analyzed. To analyze a gross estate accurately means valuing assets – a process that can take months, particularly where illiquid assets are involved, which require an appraisal (e.g., real estate, personal property, business assets, etc.). After valuations are complete, strategic plan documents can be finalized. After the strategic plan documents are complete, legal documents can be drafted and funded – all which reflect the intended passage of wealth.

If you have developed wealth in your lifetime and wish to preserve that wealth for your beneficiaries, remember there is a cost. It is true you can spend very little time and money downloading a will from the internet, fill in the blanks, and executing it at the local bank. However, this does not constitute estate planning. It simply instructs the probate court regarding: the appointment of your personal representative, the care of any minor children, and the ultimate beneficiaries of your assets. While completing a final will is an important step for any family (See Phase I – Prepare), planning your estate requires a time commitment and usually advice from financial, legal and tax professionals.

Any discussion about building a legacy would not be complete without mentioning trust planning. The decision to build a trust-based plan is different for everyone, although there are four primary scenarios where trust plans are employed: 1) to accommodate pre-nuptial or other marital agreements regarding asset distribution to separate beneficiaries, 2) to manage state and/or federal estate tax risk, 3) to provide for the care of special needs beneficiaries, and 4) to provide beneficiaries with creditor protection from claims against assets being inherited.

There are generally two types of trusts: revocable and irrevocable. A *revocable* trust is a grantor trust, meaning the grantor(s) or settlors (the people who established the trust) are generally in control of the assets placed in trust title (i.e., ownership). Further, the income generated from the trust is usually taxable to the grantors at their personal income tax rate(s). Normally, the death of a grantor will trigger the distribution of assets according to the wishes of the grantor(s), to named beneficiaries. By comparison, an *irrevocable* trust is not controlled by the grantor(s), but instead by a party outside the estate - either an individual, a trust company, or both. Therefore, assets owned by an irrevocable trust are usually income taxable to the trust at trust tax rates. Also, as a separate entity (i.e., controlled away) from the grantors, assets placed in this type of trust are usually deemed outside the estate of the grantor(s). Hence, irrevocable trusts are often used to mitigate estate taxation by transferring assets away from the grantor(s) during life.

Whether an estate plan requires a revocable or an irrevocable trust (or both), is a decision that is usually reached with one's advisors. A CERTIFIED FINANCIAL PLANNER™ professional is trained to properly "map" an estate's projected outcomes, while estate attorneys are trained to draft the legal documents that support these projections. Both professionals tend to be skilled at assisting with trust funding – the process of moving assets into trust. No matter who assists with trust funding, it is imperative that a trust-based estate plan be funded. An unfunded trust plan means that estate mapping and drafting efforts were completed, but were never used, and the reasons for a trust-based estate plan were not addressed.

One common reason for engaging in trust-based estate planning is to direct closely-held business interests. This planning effort can be a challenge. For most successfully self-employed families, their family business simultaneously represents a significant risk and an important opportunity. On one hand, concentrated, illiquid business assets do not tend to transfer as efficiently as liquid assets (especially to more than one beneficiary). On the other hand, the proper transfer of long-term, closely-held business interests can help mitigate any estate tax issues, as well as provide the next generation with wealth from business operations and future growth. The most advantageous steps that established business owners can take in estate planning is to know the value of what they have, develop a written plan to transfer it and to protect it prior to transfer (in the event of a premature death), and then to fund those objectives.

This chapter began with this statement: "the final phase of *The Life Cycle*™is a very different phase from the first three…" To consider the movement of wealth forward from Phase IV is the only financial transition that involves an entire family. Due to current tax law, there is also no other transition point in *The Life Cycle*™ where a family risks losing such substantial wealth. Many years of hard work, planning, investing, and overall good decision-making can quickly be decimated by taxes, asset sales, and family infighting. Consider the example of Estee Lauder: When the cosmetic mogul died in 2004, her family was ultimately forced to liquidate 11 million shares of the company in order to meet a $55 million tax liability. (Forbes, 2004)

Whether or not closely-held business interests are part of a family's balance sheet, a *written* and *funded** strategic estate plan is a critical form of modular planning. In quantitative terms, the cost of inefficient wealth transfer between generations of a family can far outweigh other financial risks. In qualitative terms, the emotional investment required of a family engaged in a thorough estate planning process is significant.

For the passing generation, estate planning requires a selfless effort. Choices made at all other phases of *The Life Cycle*™ were driven by more self-centered, "single generation" concerns: cash flow, business operations, portfolio management, real estate, taxes, etc. Other than naming beneficiaries in financial records and in a basic estate plan (Chapter IV - Phase I: Prepare), there was no concentrated attention given to the needs of their heirs. For the succeeding generation, wealth transfer planning usually brings an acute sense of mortality and responsibility.

As this Chapter has demonstrated, completing the transfer of wealth between generations is a significant, emotional, and rewarding exercise. Doing so effectively requires communication between (and sometimes across) generational lines and can insulate the family's hard-earned financial value from the single largest risk in Phase IV: family dynamics. Fortunately, a completed estate planning process usually leaves family members with new appreciation for one another and the sacrifices made for the greater good of the family unit. When the matriarch/patriarch pass, wealth transfer can happen efficiently, and financial value can remain second to the more important story of a life lived with purpose.

**In estate planning context, the term "funding" takes on unique meaning, referring to the re-titling and the changing of beneficiaries associated with a family's assets – personal property, real estate, and financial assets associated with the plan.*

MANAGING RISK

At any phase of *The Life Cycle*™, the biggest risk you face is not understanding the risk you already have. To understand risk, you must see it, and then manage it. When you think of risk management, picture a cartoon character trying to plug holes in a leaky dam. As more and more leaks develop, the character is less able to plug each of the holes adequately, jumping from one to the next, attempting to minimize the damage being caused. Eventually, the overall dam becomes less stable and more susceptible to external (secondary) risks like high winds or tornadoes. The dilemma here is obvious: as more leaks occur, the cartoon character cannot plug all holes, and will eventually fail. Eventually, the dam becomes weak and can collapse entirely. Ideally, the character would have identified any areas of weakness *before* the leaks developed - by stepping back from the dam, examining the big picture, and solidifying the locations of any potential leaks. Such a process would have prevented the leaks, and perhaps even avoided a total collapse.

This analogy holds true for managing risk in your overall strategic plan. It is impossible to identify weakness without completing a comprehensive plan – that is, an integrated analysis of each of your finances – tax, retirement, investments, insurance, and the estate. The very existence of a written, comprehensive plan gives you the ability to see the big picture. This clarity brings about two important opportunities: 1) qualitative life goals become aligned with the quantitative reality of your family's finances (i.e., goal-setting is measured), and 2) risk management priorities become clearer (see Primary vs. Secondary Risks below). With respect to the former, having measured goals often means making necessary adjustments to your life goals. With respect to the latter, the family discussion can turn to *doing* risk management – making critical decisions about how to handle the risks present in your plans. Examples include: adjusting retirement account contributions, buying insurance, making lifestyle changes, updating wills, etc.

There are many different financial risks that need to be identified and managed. Probably the best-known example of financial risk is market risk (i.e., non-diversifiable, systematic risk), which comes from supply/demand, prices, inflation, interest rates, and other economic forces. Another important type of risk borne by investors is unsystematic or "business" risk, which is specific to a company or industry, and which can be managed through diversification. Examples include: competition, management, innovation, etc. Unrelated to investing, other important financial risks include: mortality risk (the risk that you might die), morbidity risk (the risk that you might become disabled), tax risk (the risk that you might unnecessarily pay too much in taxes), longevity risk (the risk you might live too long), and inflation risk (the risk that your purchasing power might erode over time).

Comprehensive Planning = Risk Management

Managing risk is an important bi-product of comprehensive (i.e., strategic) financial planning (Chapter III). If financial risk is not well-managed, you may be engaged in *goal-based* planning (versus comprehensive or *risk-based* planning). Goal-based planning is typically more modular in nature (that is, more focused on a specific objective). For example, a goal-based planning process normally includes questions such as: *"When would you like to retire?"* or *"How much of an inheritance would you like to leave?"* Depending upon your responses, a specific set of recommendations are given in support of successfully funding your goal(s), with little (or no) attention paid to the major roadblocks involved. By contrast, the risk-based approach will identify and prioritize goals, but will rely on a complete diagram of your financial life to answer important questions. The risk-based process answers questions for you, rather than you answering questions for it.

Moving from a goal-based to a risk-based approach means doing more than running calculations from a series of data inputs. It requires the interactive exchange of information designed to provide the optimal answers to big questions – with help from the right advisory team. Finding the right advisory team is critical to a successful risk management strategy long-term. Unfortunately, the search for financial, tax and legal professional advisors is often confusing and time-consuming. A firm that does risk management through comprehensive planning is usually an advisory firm, a wealth management firm, or a family office. Financial professionals that may practice comprehensive risk management include CERTIFIED FINANCIAL PLANNER™ professionals, CPA/PFS professionals, or other comprehensive financial advisory professionals. For a complete review of the various types of professionals and firms available to you (Chapter XI - Finding your Fiduciary).

Primary Risks vs. Secondary Risks

For the sake of simplicity, we will consider financial risks as either primary or secondary. Primary risks are the major and "plannable" risks that you face at each stage of your Life Cycle™. These are the risks that, when recognized, can be managed. By contrast, *secondary risks* are external events beyond your control. These risks are more difficult to manage because they are relatively unpredictable – they are not associated with any given stage of your *Life Cycle*™ and have a lower probability of occurrence than primary risks. Examples of secondary risks would be: car accidents, lawsuits, natural disasters, war, acts of God, etc. Some secondary risks are insurable (e.g., car accidents or natural disasters), while others are not (e.g., War or acts of God). Most primary risks can be insured. For example, disability risk refers to the risk to a family's ability to earn an income, on either a short-term and long-term basis. A short-term disability means you cannot work for up to 120 days, while a long-term disability extends beyond 120 days.

Phase Risks vs. Full-Cycle Risks

Importantly, primary risks can be handled through a strategic planning process because they can be planned for. The chart below summarizes primary risks associated with each Phase of *The Life Cycle*™. Consider the following points about this diagram:

- This summary is not intended to be an exhaustive list of the possible primary risks during a given phase.
- Some primary risks are *phase risks* (e.g. cash flow in Phase I) meaning they are associated primarily with a given phase, while others are *full-cycle risks*, which are associated with multiple phases (e.g., inflation risk in all phases).
- A risk associated with one phase or another does not make it exclusive to that phase, but rather represents the point at which, should the worst happen, it would have a devastating effect on your overall plans.
- The correlation between the four phases and the primary risks identified will vary from one family to the next. As a result, there cannot be a finite list of phase risks.
- The summary was created from a list of risks that commonly arise in a strategic planning process.

PRIMARY RISK SUMMARY

Phase I – Prepare
Cash Flow
Business*
Morbidity
Mortality
Unemployment
Market
Inflation

Phase II – Produce
Accumulation
Income tax
Business*
Morbidity
Mortality
Unemployment
Market
Inflation

Phase III – Prosper
Distribution
Income Tax
Estate Transfer
Business*
Longevity
Market
Inflation

Phase IV – Preserve
Distribution
Income Tax
Gift/Estate Tax
Estate Transfer
Business*
Longevity
Market
Inflation

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* *This is a unique risk carried by families with little or no diversification, and/or by owners of closely-held businesses.*

To further distinguish between phase risks and full-cycle risks and consider the following example regarding market risk – a well-known, full-cycle risk.

> *In 2006, I worked with a client named Jamie. I drafted her financial strategy and then worked with her to fund the strategy - aligning her assets and cash flows with her financial plan documents. She called the next year (between review meetings) and informed me that she had attended a seminar for equity indexed annuities and that she needed to re-position half of her $600,000 nest egg into an equity indexed annuity (at the suggestion of the seminar host, an insurance professional). She said, "it just [felt] like the safe thing to do."*

Jamie had become fixated on managing just one type of risk, rather than managing overall risk in her strategic plan. Why? Financial decisions are emotional decisions. Emotions are not rational, and so risk management can quickly become impossible, without the right advisor(s) *and* the right strategic plan(s).

Jamie was trying to manage market risk late in Phase II (pre-retirement) by transferring the market risk to the proposed insurance carrier, using a deferred annuity contract. The tradeoff? Although her principal would not move downward during a declining market, she was limited to 5% growth over a 10-year period, during which she would have limited access to her capital. She was 60 years old at the time, retiring in less than 5 years. With returns limited to a maximum of 5%, her average expected contract return was approximately 2-3% over the 10-year period – perhaps enough to cover the effects of inflation on her principal. Not only did her strategic plan require a minimum annual return of 6% on her assets over time, but this limited return potential meant any withdraws she took would be taken from principal. Both points made the annuity contract contrary to decisions she made in the strategic planning process.

Furthermore, if managing market risk was, in fact, the only consideration (i.e., Jamie was completely uncomfortable taking market risk in Phases 3 and 4), the annuity would be one option to protect the principal value of her assets. For principal protection, Jamie might also consider some alternatives: Bank CD's, bonds, Unit Investment Trusts (UIT's), or principal-protected notes, to name a few. The takeaway: whether she made decisions in line with her strategic plan or not, Jamie was dealing with a full-cycle risk. She could manage market risk many ways using many vehicles (all of which have benefits and drawbacks). The key for Jamie to navigate these options: knowing her current phase, which primary risks are involved, and then deciding – considering her overall strategy – upon the best possible course of action to manage those risks.

Phase risks and full-cycle risks must be treated with the same amount of careful consideration. Remember that *any* primary risk – phase risk or full-cycle risk – is primary because it represents the possibility of an entire strategic plan being ruined. Consider the following example of *long-term care risk* - a primary risk in Phases III and IV.

> *Matthew and his wife Cathy made great strides in their financial independence late in Phase II. Now in their mid-sixties, and having successfully crossed into Phase III, they consciously decided to self-insure the financial risk of needing*

long-term care later in life. They understood that the average risk for their situation would have a 70% chance of occurring if they both reached age 65, and that the average cost of such events would range from $150 - $250,000 based on the lifestyle they intend to maintain. To completely self-insure such a need, they established a separate account and funded it with $200,000. The funds are invested to grow for their heirs unless needed during their lifetimes to fund care expenses. To be clear, Matthew and Cathy identified a risk and dealt with it in a realistic fashion. In fact, the additional $200,000 they needed to manage long-term care risk was built into their retirement picture to ensure they did not retire with assets less than was needed to handle both their retirement cash flow projections, in addition to their long-term care risk.*

By contrast, I have talked with many individuals who wish to self-insure their long-term care risk without separate funding like Matt and Cathy. Even knowing the amount of expense and likelihood of occurrence, they chose to self-insure using the same assets intended to fund their retirement income needs. Clearly, this scenario means accepting too much primary risk. Should any need for care arise – assisted living, nursing home, custodial, or hospice care – the strategic plan is compromised because assets intended to provide retirement income are spent

* *2013, US Department of Health and Human Services (www.longtermcare.gov)*

down, and longevity risk (the risk of outliving one's assets) becomes a major issue.

Risk Retention vs. Risk Transfer

It is essential to understand two distinct options that exist with primary risks: 1) risk retention, or 2) risk transfer. To retain risk means to carry it, or to "self-insure." To transfer risk means to remove it - in full or in part. Managing risk, then, means consciously doing one or the other. In the context of comprehensive planning, managing risk means having a full picture of the family's financial statements, recognizing primary risks, then making decisions to retain or transfer those risks. Before deciding whether to retain or transfer, the risk must be quantified. In the case of Matt and Cathy, they decided to self-insure long-term care risk with an invested balance of $200,000. They could have instead transferred long-term care risk through the purchase of insurance. With insurance, they would have paid premiums into a policy that would pay benefits in the event of a need for care.

There are many financial professionals who practice risk management: some who sell risk transfer products (i.e., insurance products), and some who practice risk management (i.e., strategic design and implementation). The person *selling* risk transfer is interested in your outcomes but has an inherent conflict with his/her role as a salesperson. The person who *practices* risk management is formalizing a strategy and usually works under a fiduciary standard of practice. Most everything about these two groups is different: the regulations that govern them, their methods of compensation, and the experience you have as a client. Unfortunately, as of this writing (2017), both professional types may call themselves "advisor."

To review, risk management involves understanding present risks and making conscious decisions about how to address them. Risks can be primary or secondary, phase-specific or full-cycle. A written strategy can identify, measure and manage primary risks. From the current generation's phase in *The Life Cycle*™, financial statements are generated, helping to answer important planning questions quantitatively.

OPTIMIZING YOUR ASSETS

Some content in this chapter originally appeared from 2015-2017 in THE RISK MANAGER as part of a portfolio management series on Mean Variance Optimization, by Aaron Kolkman and Troy Noor.

The purpose of financial planning is to the support the achievement of life goals. The purpose of the balance sheet – a summary of what is owned and what is owed - then, is to support those plans. Importantly, our portfolios represent just one type of asset on the balance sheet – investable assets. These assets are distinct from personal and real property in that they are usually liquid (accessible), because they are priced according to the market for those financial assets (stocks, bonds, funds, etc.). As such, our portfolios change in value and a risk-reward analysis of these holdings becomes necessary. In purely investment terms, this analysis can occur at various levels: individual holdings, groups of holdings, accounts, or the overall portfolio.

Much of the last 100 years of academic and professional discussions about investing have focused on holdings, fees, and returns – and usually not in context of a comprehensive (i.e., strategic) financial plan. Planning-driven portfolio analysis treats portfolio assets are part of an overall balance sheet designed to meet life goals. While holdings fees and return always matter to a point, such metrics still do not drive strategic decisions. Instead, planning-driven portfolio analysis necessarily focuses on the overall portfolio – the titling of assets, the choice of asset classes, the location of asset classes (across accounts), income tax consequences, beneficiary designations, and the like. As such, concepts discussed in this chapter focus on the aggregate portfolio, instead of individual holdings, various vehicles, or account types.

Portfolio management for planning purposes needs to seek *consistency of returns*. Seeking consistency means "tightening" the actual returns around the average – a concept known as Mean Variance Optimization (MVO). I often use the phrase *"not all 8% average returns are created equally."* An average return of 8% (after all fees) is just that, an *average*. No one earns an annual 8%/year (after all fees) in a linear fashion, hitting 8% (after all fees) every year. Instead, actual annual returns fall along a scatterplot around the average and contribute to the average result. To achieve better consistency in the planning process, then, families must focus on achieving long-term average results wherein each set of annual returns is as close to the average as possible. Importantly, that average needs to be sufficient to meet the requirements of a comprehensive plan, while taking as little risk as possible.

Support for MVO

There is a relationship between portfolio optimization and goal attainment. In their study titled *Life Cycle Goal Achievement or Portfolio Volatility Reduction?* M A H Dempster, Dwayne Kloppers, Igor Osmolovskiy, Elena Medova, and Philipp Ustinov

(2015) found that dynamic forms of portfolio optimization held advantages over other approaches with respect to goal attainment (p. 33). Separately, Alexander Izmailov and Brian Shay (2015) evaluated the effectiveness of Markowitz-based MVO techniques, and concluded that portfolio optimization has value when covariance is filtered. Izmailov and Shay did not, however, address goal attainment in their work (p. 4). Based upon these two studies, it appears that noise-filtered MVO techniques are valuable with respect to investment results (Izmailov and Shay, 2015), and that some forms of portfolio optimization (of which MVO is one), are correlated to goal attainment (Dempster, Kloppers, Osmolovskiy, Medova, and Ustinov, 2015).

Interestingly the latter study utilized gamma – a measure of increased wealth resulting from financial planning, from Blanchett & Kaplan's definitive study "Alpha, Beta, and Now… Gamma" (2013). Specifically, the Demptster, Kloppers, Osmolovskiy, Medova and Ustinov study (2015) identified a relationship (though not causal) between portfolio optimization and gamma (increased wealth from planning). This finding supports the hypothesis that a positive correlation exists between portfolio optimization and goal attainment.

The Origins of MVO

In the 1950s, Professor Harry Markowitz of the City University of New York developed an approach to investment analysis that has become known as Modern Portfolio Theory (MPT). Instead of traditional asset management using just fundamental or technical analysis, his system looks at the performance of a portfolio of assets based on the combination of its components' risk and return. His hypothesis and subsequent work was so revolutionary that Markowitz was a joint Nobel Laureate for economics in 1990. Markowitz' "Efficiency Frontier" - and the resulting Capital Asset Pricing Model (CAPM) – made it possible to determine whether a portfolio is optimal in its risk/reward characteristics or not. Markowitz referred to this determination as Mean Variance Optimization (MVO).

Covariance and MVO

Although the objective for MVO is clear, a universal method of measuring MVO is yet undeveloped. This writing suggests the following MVO process: managing, optimizing, and measuring the aggregate portfolio. The aggregate portfolio is the entirety of a family's investable assets – across accounts. Once accounts are viewed together as a single investment plan, covariance analysis can occur. The objective of covariance analysis is to lower covariance among asset classes, giving no preference to the merits of any specific holding(s). Lowering covariance means investing in low-correlated asset classes that "offset" the risk in other asset classes. To execute covariance analysis, each holding in each account is identified as part of a specific asset class (e.g., emerging market stocks, domestic high-quality bonds, U.S. small cap stocks), and a correlation matrix is developed (to maintain technical accuracy, a covariance analysis consists of multiple calculations that support the correlation matrix, but the correlation matrix can be the result). The correlation matrix, in turn, identifies which asset classes can be maintained, increased, or decreased. The resulting lower-correlated asset class mix becomes the optimal mix.

Portfolio Construction and MVO

If the overriding goal of portfolio construction is to carry out the proper allocation to meet the risk/reward expectations of the family, and the optimal mix of classes has been determined, then only 2 questions remain: 1) should the family follow an indexed investment approach, or an actively-managed approach to each asset class? and 2) if actively managed, who should manage those assets? The answers to those questions lie in the measurement of MVO and are addressed later in this chapter. For now, we know anecdotally that a well-constructed portfolio (with relatively low covariance among asset classes), should render a risk-adjusted result that is preferable to the alternative: an asset base that is not built with optimization in mind. This truth is evident in a review of a portfolio's aggregate Sharpe Ratio. Developed by William Sharpe in 1966, a low (or negative) Sharpe Ratio – net of fees - indicates that a portfolio is performing below expectations on a risk-adjusted basis, while a positive Sharpe Ratio – net of fees – indicates outperformance. Think of Sharpe Ratio as a return premium (or discount) for total risk taken. It answers the question: *"did the family receive any excess reward for the risk taken?"*

The Sharpe Ratio is calculated as follows:

$$\text{Sharpe} = \frac{mean\,(R_{0\ldots n} - B)}{std(R_{0\ldots n} - B)}$$

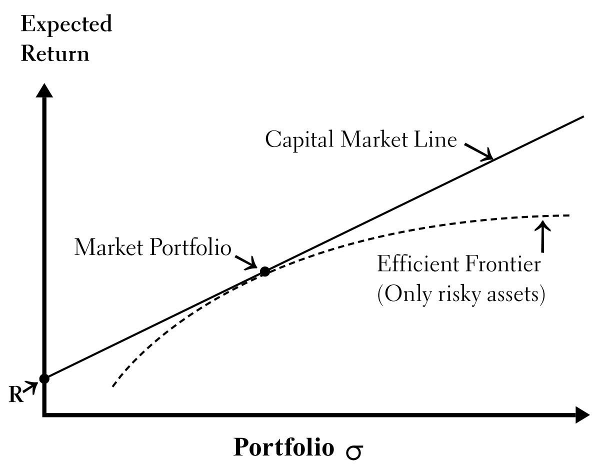
Where:

$R_{0\ldots n}$ Annualized returns over the period

B Risk-free rate of return

Recognizing the value of *aggregate** Sharpe Ratio is the first step to developing an MVO measurement model, because a Sharpe Ratio does not just compare a set of holdings to an index in attempt to isolate performance (Alpha) or market risk (Beta, aka volatility). Instead, Sharpe Ratio accounts for the total risk taken (market and business risk combined, or "standard deviation" in technical terms) for the return achieved. Integrating risk and reward, Sharpe Ratio provides a more complete method of comparing two separate sets of holdings to each other, or a set of holdings to relevant indexes. Although William Sharpe originally created his formula for security-level analysis, not aggregate analysis, Sharpe Ratios can still quantify the risk/reward characteristics of their aggregate portfolio with relevant indexes, by comparing the Sharpe Ratios of the portfolio to that of the index.

The indexes or "market return" can be measured according to the Capital Market Line (CML), which is calculated as follows:



* *aggregate and account-level Sharpe Ratios are rarely the same*

$$r_p = r_f + \sigma_p \left(\frac{r_m = r_f}{\sigma_m} \right)$$

Measuring Aggregate MVO

It follows from a portfolio-to-market Sharpe Ratio comparison, that any formula for measuring Aggregate MVO should quantify the success or failure of achieving this risk-adjusted (net of fees) outperformance. Further, the MVO measurement should attribute any outperformance to the asset classes involved. Finally, the measurement should attribute any outperformance to the holdings within each asset class. This final point is the crux of long-standing debate regarding active vs. passive (index) investing.

Recall that using Sharpe Ratios can provide a complete view of total risk/reward for a portfolio – that is risk/reward measurement encompassing diversifiable (aka "business" or "unsystematic") risk, and non-diversifiable (aka "market" or "systematic") risk/reward, the latter of which is often measured against a relevant benchmark, using Beta/Alpha. The distinction between total risk/reward measurement and market risk/reward measurement is especially clear when asset prices fall (1973-1974, 1987, 1991, 2000-2002, 2007-2009, etc.), with entire asset classes (and their benchmarks) in flux. Therefore, using market-based measurements of risk/reward – particularly when discussing aggregate portfolios – is at best a volatile proposition. By contrast, employing Sharpe Ratio to measure an aggregate portfolio can be effective when comparing to the Sharpe Ratio of a relevant (strongly and positively correlated) benchmark. Importantly, the comparison between two Sharpe Ratios does not mean comparing the portfolio to the benchmark directly. Consider these examples – stories of families who have undergone an MVO process, and their results.

Case Study #1: A Tale of Two Portfolios

Portfolio 1 –Tom and Sally. During one recent engagement, our firm provided analysis for approximately $3 million of investable assets. The families involved were convinced their holdings were strong, having generated consistent double-digit returns over the recent 5-year period measured. They were right. Based upon a rolling 5-year history, of June 30, 2015, their portfolio results according to Morningstar were as follows:

Risk and Return Statistics	5 Yr.	
As of Date 6/30/2015	Portfolio	Benchmark
Standard Deviation	10.04	5.42
Mean Return	11.42	7.04
Sharpe Ratio	1.12	1.27

All data provided by Morningstar, Inc.

What do we know from this analysis? We know that Tom and Sally's 5-year historical Mean Return reported is substantially higher than the relevant benchmark return (using a benchmark with a correlation co-efficient of 85.14 over the same period). We also know that the portfolio variance (i.e., total risk) was substantially higher, based upon its Standard Deviation. The combination of these two points provides a return premium (or discount) for total risk taken – the Sharpe Ratio. Clearly, the risk premium achieved by Tom and Sally was inadequate compared to the Sharpe Ratio available to them in relevant areas of the marketplace. This is all helpful information for Sally and Tom, and provides evidence that risk is too high for the return achieved, when compared to other relevant options available to them. The argument for indexing stops here and asserts that Tom and Sally should "buy the relevant index" through low-cost investing and achieve the same total risk/reward as the benchmark itself. This method of improvement is both accurate and viable for Sally and Tom. However, it does little to explain the efficiency of their portfolio. Enter MVO scoring. MVO scoring measures the mean return of the aggregate portfolio based upon the risk taken. It answers the question: given the risk taken, did the overall portfolio perform as expected? Or, was it better/worse than expected? Further, an attribution analysis can identify the level of contribution each holding made to the overall score.

In our case study, Sally and Tom can now understand if their portfolio achieved better or worse than an aggregated portfolio risk/reward continuum known as the "Capital Market Line" (CML), and what adjustments can be made to optimize their assets. Tom and Sally's MVO Score was: (1.62) or -1.62. This score indicates the family's portfolio was less efficient when compared to the CML. Note that the CML represents the intersection of risk and reward, so itself is perfectly efficient (it cannot be more or less efficient than itself). We therefore assign the CML score an MVO score of zero. As such, a relevant indexing strategy would carry a portfolio MVO score of zero, less the internal costs of the vehicle used (Mutual fund, ETF, etc.). In Sally and Tom's case, a negative MVO score indicates either excess risk, insufficient reward, or both. Other than investing their entire portfolio in an indexed fashion, what else can Sally and Tom do to achieve a more optimal aggregate portfolio? Let's look at another example.

Portfolio 2 – Mark and Sara. Another recent engagement our firm accepted included an MVO analysis for a family with approximately $4.5 million of investable assets, approximately $1.5 million of which was highly-concentrated stock in a U.S. blue-chip company. For comparison purposes, we will set aside this stock position, and focus on the other $3 million in assets. Like the previous case, the families were proud of the results of their holdings over the 5-year rolling period, as follows (according to Morningstar):

Risk and Return Statistics	5 Yr.	
As of Date 6/30/2015	Portfolio	Benchmark
Standard Deviation	7.45	5.42
Mean Return	10.47	7.04
Sharpe Ratio	1.37	1.27

All data provided by Morningstar, Inc.

In this case, the benchmark correlation coefficient was 89.11 over the period measured, indicating a strong positive correlation, and therefore a relevant comparison point. Once again, when the index itself is inserted into the CML formula will again render an MVO score of zero, being neither less efficient nor more efficient than itself. Sara and Mark's portfolio MVO score was the focus of this project and was: .79 or +.79. This score indicates the portfolio measured was superior over the period measured, when compared to the CML (previously defined as the intersection between risk and reward for the entire portfolio). What does this mean for Mark and Sara? It means they received reward above the risk taken – at the aggregate level. How did they achieve this? The interactions between portfolio holdings (i.e., covariance) allowed them to "elevate" their results beyond that of the index or any individual holding. Not unlike a competent college basketball coach identifying which player(s) contribute to and detract from overall results (when viewing the overall team on the court), a competent portfolio manager can create a portfolio MVO attribution analysis, which measures the contribution of each asset class (and even each holding) to the overall MVO score and can thereby isolate and remove poor MVO contribution.

Scoring MVO

In conclusion, an MVO analysis can provide necessary insight into the assets in the portfolio mix, their interplay, and their combined efficiency. In the two cases discussed, both couples held different types of vehicles with different levels of underlying fees (advisory fees were not applied). Also, both couples felt confident with their results, and were generally comfortable with the direction of their asset base. The MVO scoring process gave both households an added dimension of clarity, and necessarily, a starting point from which to work with their advisors on the underlying cause of any inefficiency identified.

Regardless of who is managing your money, regardless of the overall fee structure, and regardless of whether indexing is deemed sufficient to optimizing assets, consider measuring the efficiency of the aggregate first. If you have an MVO score, you can better decide how to proceed with any remaining analysis. To appreciate the value of aggregate Mean Variance Optimization (MVO), the family must first recognize that a large majority of portfolio theory achievements relate to security-level analysis, not portfolio-level analysis. These achievements include work by talented researchers and investors such as Benjamin Graham, Sir John Templeton, Warren Buffet, Kenneth French and Eugene Fama – all of whom focused their work on the analysis of individual holdings. One notable contrast to this group is the "Wizard of Wharton" – renowned professor Jeremy Siegel – who inches closer to measuring aggregate portfolios with a focus on asset class behavior. Siegel's work is primarily focused on areas of the marketplace compared to each other in terms of their risk/reward characteristics (e.g., stocks versus bonds versus gold). Despite the many achievements of all the individuals mentioned, there remains a shortage of information and practice around portfolio-level analysis. Importantly, this "aggregate" analysis is requisite to any portfolio supporting a family's financial plan or a company's strategic plan. Any technically-drafted financial or strategic plan relies on aggregate portfolio assumptions, for the plan to function as intended. Therefore, more precise assumptions mean greater predictability during the planning process, and often, better long-term funding for the plan.

In this chapter on MVO, we have intentionally bypassed portfolio diversification techniques, and treated portfolios as sufficiently diversified. That is, diversifiable (non-market) risk was assumed to be managed. Also, we assumed the portfolio was sufficiently correlated to its relevant indices (aka the "blended benchmark") and was therefore exhibiting risk/reward characteristics reflective of the blended benchmark. Further, we have implied (and will continue to assume) that the portfolio's total risks (i.e., non-market and market) are sufficiently managed. Recall that Parts II and III of this series suggested 1) using the standard deviation-based Sharpe Ratio to measure aggregate risk/reward, and 2) comparing the portfolio's Sharpe Ratio to that of the blended benchmark – different from the direct portfolio-to-market comparison made with Alphas and Betas, related only to market risk.

The reason for assuming the portfolio is healthy overall? Good portfolio advice is readily available from technical advisors doing the hard work of portfolio construction, asset allocation, and asset location. After this work is complete, aggregate MVO can begin. The purpose of this edition of The Risk Manager is to provide a process for aggregate portfolio MVO, after traditional portfolio management techniques have been executed. To illustrate this optimization process, consider another recent case study that explains how aggregate MVO works.

Case Study #2 – Portfolio Optimization Project

Carrie was recently introduced to our firm, through her accounting office. Carrie is a wife, mother, and successful realtor in her early 50's. Throughout her career, Carrie has built a total portfolio of approximately $1 million across 7 total accounts. To begin the project, Carrie's portfolio was aggregated: the 7 accounts were combined, then measured against a relevant, blended benchmark for moderate families. Next, the aggregate results were compared to an optimized model for moderate families.

For Carrie's current portfolio*, the aggregated risk/reward data were as follows:

Risk and Return Statistics	5 Yr.	
As of Date 9/30/2015	Portfolio	Benchmark
Standard Deviation	7.72	7.57
Mean Return	6.84	6.52
Sharpe Ratio	0.89	0.87

All data provided by Morningstar, Inc.

* *Advisory fees for the current portfolio were not available. All data are shown without the impact of advisory fees.*

For an optimized moderate model, the aggregated risk/reward data were as follows:

Risk and Return Statistics	5 Yr.	
As of Date 9/30/2015	Portfolio	Benchmark
Standard Deviation	6.62	7.57
Mean Return	7.66	6.52
Sharpe Ratio	1.14	0.87

All data provided by Morningstar, Inc.

Aggregate Risk/Reward Findings: we can observe from these data an Alpha of 1.27 and Beta of .85 (on an R-squared of 70.14) meaning Carrie's portfolio was well-diversified and achieved superior results when compared directly with the relevant, blended benchmark. Her 6.84%/year return versus the 6.52%/year return for the benchmark clearly demonstrates this reality and suggests that traditional portfolio management techniques have been implemented (either per account or on the aggregate, or both).

Optimization Findings: comparing the aggregate portfolio to an optimized model for the 5-year rolling period through 09/30/15, a different theme emerged. During the period, risk could have been slightly lower, and return slightly higher. Consequently, the Sharpe Ratio of .89 could have been 1.14, for a moderate family. Further, comparing the aggregate with an optimized model from a pure return standpoint, the portfolio lagged .82% per year. That's .82% per year – every year for 5 years - or 4.1% overall. For Carrie, this 4.1% on $1 million invested (assuming a constant value) totaled approximately $41,000 in lost opportunity.

Unfortunately, many families will continue to miss the opportunity to aggregate and optimize their portfolios, often to the detriment of their overall plans. In fact, the planning conversation quickly devolves into a portfolio management discussion, focused on modular (investment-only) issues:

- What was the risk/return of just one asset class?
- What benchmark should I use to measure that asset class?
- How did my vehicle(s) compare to that benchmark?

Fortunately, the processes for portfolio aggregation and optimization can be very straightforward. In as little as a few hours, the portfolio can become "one" investment plan. By addressing these topics, families are given holding, product or vehicle references that can be used in making investment-only decisions (and not at the aggregate level). While engaging in modular investment analysis is not necessarily a fruitless effort, it just does not qualify as the aggregate investment analysis requisite to comprehensive planning.

Here are the suggested steps for aggregate analysis in support of financial planning:

Portfolio Aggregation Steps.

1. Gather statements showing holdings and quantities (shares or units) of holdings
2. Integrate the holdings and quantities
3. Evaluate the correlation among holdings
4. Compare the aggregate data to a relevant, blended benchmark

Portfolio Optimization Steps

1. Measuring aggregate risk/reward against optimized models
2. Adjusting the portfolio accordingly

At the beginning of this chapter, it was stated that investable assets 1) are part of a family's balance sheet, and 2) need to be managed for consistency of returns in the context of comprehensive planning. Further, this chapter has proposed that an aggregate portfolio can be measured with respect to its optimization. Given a current dearth of research in portfolio-level MVO measurement, the only interim answer to optimizing an entire portfolio is to approach the measurement process systematically. To begin, the family and/or professional advisor(s) need to aggregate. Then the aggregate portfolio can be optimized and adjusted as needed. Without aggregation and optimization, the family may be completely unaware of the substantial missed opportunity to add value to a comprehensive financial plan. Far worse, the comprehensive plan may suffer from invalid assumptions, a lack of long-term funding, or both.

THE POWER OF CASH FLOW

If a balance sheet is the financial foundation on which a family operates, then cash flow is either a builder or a destroyer of that foundation. Over the past 17 years, I have increasingly conveyed a common truth to families engaged in a comprehensive planning process: "If Cash is King, Cash Flow is Queen." Put simply, if you have cash, you are better positioned than if you do not; and if you do not have cash, you can build it by simply spending less than you make after taxes. Dave Ramsey has become a wildly successful personal finance coach by offering household cash flow management advice with his Financial Peace University and related programs (2017, daveramsey.com). This and other behavior modification programs like it can provide valuable insight into how to manage cash flow as a family, through disciplined living and decision-making. Such insights can simplify life, reduce stress, resolve conflict, even improve relationships - outcomes that underscore the importance of managing cash flow wisely.

In initial meetings, often ask prospective and new clients of our firm *"do you have a written budget?"* and (if not) *"are you willing to create one (with or without assistance)?"* The reason I ask these questions early in conversation with prospective client families, is the same reason my team spends many hours each week on cash flow analysis: cash flow affects all other areas of a comprehensive plan: 1) tax planning, 2) retirement planning, 3) insurance planning, 4) investments planning, and 5) estate planning. In short, cash flow will either fund your purpose or hinder it.

This area of planning is so fundamental, it often gets missed or becomes outdated. Chapter IV of this text (Phase I – Prepare) outlines the importance of having a written budget – an itemized list of recurring expenses expected to continue in the future. Expenses are half of the cash flow equation. Net income is the other half. Therefore, the complete cash flow equation is:

Net Income – Expenses = +n / -n

n = the nominal surplus or deficit for a given period

Do you know your "n"? If not, this is likely your single greatest planning opportunity – across all Phases of life. Knowing your "n" requires you to have a complete understanding of your net income. Your net income simply refers to the sum of the following items after all applicable taxes:

- Wages/Salaries/Tips
- Dividends/Interest
- Alimony/Child Support
- Rental Income

- Business Income
- Gifts

Conversely, your Expenses refer to the sum of the following types of items:

- Housing/Basic Living
- Insurance Premiums
- Savings/Investment
- Debt Service

Managing income can be important from a tax planning perspective. From a cash flow standpoint, however, it is only necessary to *know* the amount of total net income (i.e., not much management is required on a regular basis). Managing expenses, however, is a different matter. It can be time-consuming and exhausting to turn an expense budget into a finely-tuned instrument. However, families that invest the time and energy necessary to establish a written set of expense protocols (and then follow them), usually have incredible success at building their balance sheet long-term. It is worth noting that a certain level of passion must be maintained around the discipline of expense management. Building a budget not followed by long-term action is normally a fruitless exercise.

Most of the newer client families I serve find cash flow management tedious, at least initially. No matter the dollar amounts, I invite them to spend 1 month finding their “n”, and another 1 month of managing expenses. During this 60-day period, the family usually becomes accustomed to the “new normal” of their financial lives – whether major changes were needed or not. After the initial 60-day period, a major challenge is the social-cultural aspect of income competition. Income competition is a way of thinking about cash flow that positions families against each other based on the income component of cash flow. The presupposition that more income = a larger "n" is accurate. However, the real art of family balance sheet building occurs when *expenses* are identified and managed. If you struggle with the issue of income competition from friends, neighbors, or others, you are not alone. While there is no simple solution to addressing income competition, one effective technique I have recommended is to respond by discussing your excellent expense management habits! Although you may cause some initial confusion, the story of finding your "n" often helps those around you in ways you never imagined.

Finding your "n" does take time and energy. You can do it on a self-directed basis, or work with a CPA or CFP® professional. Whatever your approach, include savings/investment as a routine expense wherever possible (your family's future depends on it). Once you know your "n", share it with stakeholders in your family and remember it – especially during the initial month of expense management. Most importantly, use it to your advantage long-term. It is the basis for all other forms of planning, and perhaps the single greatest determinant of your family's financial outcomes.

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* (2018, www.dalbar.com). This advanced research has consistently demonstrated that over the past 30 years, individual families who did *not* work with a financial professional have underperformed major market indexes more than 5% per year, 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 18 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.

CREATING RECURRENCE

Most financial offices I have experienced have talked about multi-generational wealth transfers, though few offered strategic planning in this area. It is usually a long and emotional process where the current generation discusses their views and expectations around money. Most importantly, it's where money is most often attached to family values. As such, I encourage families to add to their financial and legal estate records a letter to the next generation(s). There is certainly no right way to draft such a letter, however, common components include:

- Family history and stories
- Experiences of the current generation
- Expectations of the future generation(s)
- Explanation about "why" certain decisions were made
- Vision for the family's future.

The legacy letter is a game changer. It personalizes the financial picture of a family. It keeps wealth in perspective as a tool to fund purposeful living. It has a lasting effect on beneficiaries. In nearly 20 years of financial services industry practice, I have yet to see a legacy letter not become a focal point of estate settlement meetings (which are otherwise highly technical).

With or without a legacy letter, there exists a substantial risk that excellent estate planning can break down quickly. In 2003, Roy Williams and Vic Preisser interviewed 3,250 families, and discovered that 30% of estate plans generally succeeded, while 70% of wealth transitions failed (*Preparing Heirs*, Robert D. Reed, 2003, Print.). Rather unexpectedly, Williams and Preisser's work demonstrated that such failures were *not* caused primarily by planning mistakes, poor advice, complexity, health problems, or even economics. In fact, tax, legal and legacy planning issues contributed to only 15% of the failures involved. The other 85% of wealth transition failures were caused by two *qualitative* factors:

- 60% of all wealth transition failures were caused by a breakdown of communication and/or trust within the family unit in general, across generations.
- 25% of all such failures were caused by inadequately prepared heirs, which also stemmed from a breakdown of communication and/or trust, this time among beneficiaries.

So, for 85 the 85% of those families whose estate plans failed, a proper plan design and execution *had* been completed. Despite having a written strategic plan, legal drafting and proper funding, the failure still occurred - due a breakdown in *family dynamics*.

There is no easy answer to managing the family dynamics involved in an estate planning process. However, there are two simple points which will assist managing this challenge. First, family dynamics must be considered a primary risk in Phases III and IV (Risk Summary Chart, pg. 51). Second, professional advisors must recognize that qualitative risks cannot be managed through a technical planning process. In general, advisors must facilitate a shift from quantitative planning to qualitative planning.

To summarize, Williams & Preisser found that 15% of wealth transfer failures are caused by inadequate technical planning (i.e., quantitative factors), while 85% of such failures are attributable to family dynamics (i.e., qualitative factors). This means that 85% of the largest financial risk involved in The Life Cycle *of Wealth*™ – Estate Transfer Risk – is driven by internal family relationships. If family relationships are the cause of so much financial breakdown, families must recognize and manage this risk if wealth is to successfully move from Phase IV to the next generation(s).

Addressing Estate Transfer Risk

To address the risk of being in the 15% of failures due to inadequate planning, families can first develop and a written and funded estate plan. This process requires a complete inventory of assets and liabilities (i.e. a family balance sheet), an examination of the titling of assets and liabilities, a review of the beneficiaries listed on assets, the implications of probate, and of course, an understanding of the tax consequences of a given plan. Once the estate is detailed in this manner, legal structure can be added or changed, to accommodate the "flow" of the estate as determined by the estate design. Finally, the new legal structures must be given life – they must be funded. This can be as simple as rearranging beneficiaries, or as complex as placing property in trust title and re-recording deeds. It may also involve the purchase of insurance, or other financial products needed to provide the liquidity and/or income needed to make the plan work. These steps – strategy, drafting, and funding – are the cornerstone of a technically sound estate plan. While they may take many months to complete, doing so means that 15% of the Estate Transfer Risk has been managed.

Second, to address the risk of being in the 85% of estate transfer failures, families must simply connect with each other. In general, families need to communicate *across* and *within* generational lines of the family, to review details of the plan. Communicating across generations means having open conversations with your children and grandchildren about what has been done, what is intended, and what is expected of both participants and beneficiaries. Communication within generational lines means a couple talking intentionally with each other, or with their siblings, even close friends – also about what has been done, what is intended, and what is expected of everyone involved in the plan.

These communications may seem awkward at first, as the subject of estate planning does not often arise during everyday conversations about the weekly weather forecast. However, those who spend focused time discussing the big picture plan will insulate themselves from 85% of the greatest financial risk in *The Life Cycle*™. As a matter of practice, consider doing the following: set aside 15-20 minutes during a holiday meal, driving in the car, talking over the phone, or sitting at coffee. Start the initial conversation with something as simple as "I want to make sure you understand what is happening with our family's finances, so we can all be on the same page…"

Then talk about what work has been done to develop, structure, and fund an estate strategy. Also, explain the reasons that the strategy was built the way it was, and what is expected of the key participants and beneficiaries. Finally, avoid closing the door to interactive discussion about the strategy, and try to welcome feedback. Others may have a new idea to better the plan, or perhaps even a different mindset about what is expected of them.

In some cases, there may be short-term conflict, which can often lead to better overall results for the plan. Such conflicts can bring forward those family dynamics that might otherwise destroy the estate strategy and provide an opportunity to resolve those issues during the lifetimes of those who are building the plan. Whether initial conversations are pleasant or not, welcoming honest feelings and discussion about the family's plans not only provides for better relationships within the family unit, it helps protect the family from Estate Transfer Risk. In the end, a collective peace with the direction of the family's wealth and values is possible. Using the *Life Cycle*™ model in this dialogue can help guide the conversation and contribute to a common view of "money" and its role in the family tree. Furthermore, the model can facilitate a more rapid understanding about the concepts involved in an estate strategy and reveal the recurring nature of wealth across generations. Perhaps most importantly, the participants in an estate planning process can better comprehend the bigger picture and where they fit in *The Life Cycle*™pattern of their own family.

In 1993, "Robert Avery and Michael Rendall [of Cornell University] estimated that the baby boomers would receive at least $10.4 trillion in inheritances from their parents between 1990 and 2040. (The Wise Inheritor, Ann Perry, 2003) Avery and Rendall's analysis was done using the value of a dollar in 1989. Applying a 3% inflation rate, the equivalent value of wealth transfers in 2013 is approximately $18.8 trillion. This enormous inter-generational movement of assets – a process I will refer to as "the great transition" – is the largest of its kind in American history. If 70% of these wealth transfers are subject to fail during the great transition, then an estimated $13.1 trillion in total value can be deemed at risk. It has already been stated that managing this risk has something to do with written strategic planning, drafting, and funding, and everything to do with maintaining open lines of communication within your family.

Ann Perry wrote from her own experience as a beneficiary, having inherited rights to the classic game "Go Fish" from her grandmother's estate. Throughout her story, Perry makes multiple references to the need for expert advice in the strategic planning process, especially relative to estate planning:

> *"It always amazes me that people who would never dream of wiring the electrical outlets in their house or replacing the carburetor on their car will fail to seek financial help. As a society, we believe we should know how to manage money because it's such a part of our everyday lives. Well, so are light sockets and cars, but I'll rely on electricians and mechanics to help me with major repairs. Hiring professionals... to assist you with your investing, taxes and estate planning should greatly help maximize your inheritance."*

If you are the matriarch or patriarch of a family, the process of planning multi-generational wealth means seeing a balance sheet as only "yours" for only a short time. Achieving such wisdom means engaging in a selfless planning process that benefits others, without a guarantee that your vision will become reality. However, managing estate transfer risk substantially increases the likelihood of your wealth doing everything you imagined and more. In his classic book *Simple Wealth, Inevitable Wealth*, my colleague Nick Murray reminds us: Wealth is the absence of financial worry, an income you cannot outlive, and an inheritance for your children and grandchildren (2010). To take this thinking one step further, Rick Warren offered this thought in his best-selling text, *The Purpose-Driven Life*®: "Real security can only be found in that which can never be taken…" (2002).

As your *Life Cycle of Wealth*™ unfolds, there are many choices to be made - choices about your relationships, your housing, your car, your career, your service providers, your advisors. Every life and every story are unique, and so, therefore, are the financial considerations. Understanding wealth as *financial independence* and viewing it as a resource to fund purposeful living, will equip you with the wisdom needed to make great financial decisions. Putting your purpose on paper by developing a written strategic plan with your trusted advisor(s) means you enhance your clarity and add technical knowledge from which to make those decisions. Finally, remembering The *Life Cycle*™ image as representing a long-term process of managing risk that ends with an optimal transfer of wealth to the next generation, brings the perspective you need to complete the journey with peace.

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APPENDIX I – QUANTITATIVE ANALYSIS OF FAMILY BEHAVIOR (DALBAR, 2018.)

APPENDIX II - QUESTIONS TO ASK A FINANCIAL PROFESSIONAL

1. What is your general background and how many years of experience do you have?
2. What are your specialties, and which designations do you carry?
3. What process or approach do you use in serving clients?
4. How do you manage financial risk for your clients?
5. What product or service offerings do you have?
6. How are you paid?

APPENDIX III – FINANCIAL CERTIFICATIONS

Visit http://www.investopedia.com/articles/01/101001.asp#axzz276h4JNMm

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BUSINESS - ECONOMICS

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 professionals 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.

The Life Cycle of Wealth gives you an unprecedented look at the natural process of developing wealth over a lifetime, and the challenges involved with passing it on.

Instead of the usual tips about 'What to do when…," *The Life Cycle of Wealth* teaches you to think strategically, so you can align your plans with your values, and your actions with both.

Once you read it, you will reference it often. Again and again, *The Life Cycle of Wealth* will deliver truth to your financial life, so you can make great decisions that lead to achieving real wealth in your lifetime.

This book offers both knowledge and wisdom in a timeless, simple fashion that leaves you inspired to move forward with confidence and to pass your wisdom to future generations.

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