Personal Financial Stewardship

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Disclaimer: The information presented in this seminar is for "education purposes only" and not intended to be personal financial planning or investment advice. Please consult your financial or tax professional before acting on this information.

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1. Risk Protection

Main Goal with insurance is to protect against catastrophic loss

a. **Life Insurance:** Creates an estate

   i. Three basic types of Life Insurance: Term, Universal and Whole Life

   ii. 90% of the time Term insurance is the best bet.

   iii. Depending on your age, Life insurance should equal approx. 10-15 times your annual income.

b. **Disability Insurance:** Replaces income, usually a maximum of 60%

   i. IMPORTANT: If you can help it, never deduct disability insurance premiums as a business expense so benefits will pay tax free.

c. Health Insurance:

   i. High Deductible plans, 2020 HSA plan limitations:

      1. Deductible for Single >$1,400 and <$6,900

         a. Maximum deductible contribution is $3,550 (deadline 4-15-2021)

2. Deductible for Family >$2,800 and < $13,800

    a. Maximum deductible contribution is $7,100

3. If Age 55 or older add $1,000 to deductible contribution

ii. Better to make tax deductible contribution, invest and let grow for a long time versus using up every year. These **Medical IRA account** Funds can be used for Medical, Nursing, Dental, Vision, Prescription Medication, Chiropractor, Long Term Care, etc.

d. **Long Term Care Insurance:** (Non-Medical Custodial Care)

i. Home care, Assisted Living Center and Nursing Home

ii. Long Term Care Insurance Premiums are deductible on Schedule A, Itemized Deductions

LTC Insurance Premium deduction limits:

	2019	2020
Age 40 or less	$ 420	$ 430
Age 41 but not more than 50	$ 790	$ 810
Age 51 but not more than 60	$ 1,580	$ 1,630
Age 61 but not more than 70	$ 4,220	$ 4,350
Age than 71	$ 5,270	$ 5,430

e. Property Casualty Insurance:

i. Liability limits should be commensurate with one's income and net worth.
ii. Auto coverage - Starting point for a young professional's auto coverage 100/300/100 with the same limits for Uninsured Motorist Insurance.
iii. Home coverage – Typically $300K in liability protection plus protects your dwelling and contents.
iv. Personal Articles – jewelry, art, collectibles, family heirlooms, etc.
v. Renter's coverage – still important at least for the liability protection which follows you around.
vi. Umbrella Policy - excess liability protection which comes over all Real Estate and motorized vehicles and water craft. Starts at $1M.

f. **Financial:** (SIPC, FDIC, Pension Benefit Guarantee Corporation, Florida

Insurance Guaranty Association)

g. **Identity Theft:**

i. Shred hardcopy personal information

ii. Check statements regularly for unauthorized transactions

iii. Credit monitoring services - know your credit score.

iv. Freeze your credit

1. To place a freeze, contact each of the nationwide credit reporting companies below:

    a. Equifax — 1-800-349-9960
        i. www.trustedid.com
    b. Experian — 1-888-397-3742
    c. TransUnion — 1-888-909-8872
    d. Innovis — 1-800-540-2505
        i. www.innovis.com

v. In the age of computer viruses and ransomware – use virus protection software and back up your files periodically.

2. Savings, Debt and Cash Flow

a. Living within one's means. Millionaire Next Door 1996, Stanley & Danko

Identifies under and over accumulators of wealth

b. To retire comfortably and not have to rely on Social Security?

i. **Save 10% per year in your retirement plan or IRA(s)** and invest at least 75-100% in diversified stock market investments and you should do well.

ii. Over a career of nearly 40 years this would equal to about $250K in savings (today's dollars) resulting in an account sufficient to support yourself and your spouse through to age 90 and keep your lifestyle level. For every dollar saved through your working years, your final account balance would be 6-8 times that amount at retirement.

iii. Credit card balances, please pay in full every month. Interest rates can get ridiculous.

c. Be your own bank:

i. Short Term Reserves (3-6 months on standby in a Money Market)

ii. Long Term Reserves (future large purchases)

iii. Home Equity Line of Credit (HELOC) – key source for emergency funds

iv. When reserves are used goal #1 is to replenish before you increase personal spending.

d. Mortgages, refinancing and prepaying principal.

e. Rule of 72, the Rule of Doubling money.

   i. 72 is always in the numerator

   ii. Example: I hope to make 10% per year. How quickly will my investment double?
      1. Solution: 72 / 10 = 7.2 years

   iii. Assume that you are 25 years old and invest $2,000 in a diversified stock mutual fund that is expected to average 10% per year return. What would your $2,000 grow to by age 67?

      1. Solution: Based on the Rule of 72 we know your money will double every 7.2 years. Age 67-25=42. 42 has six 7-year periods. So, we will hopefully achieve 6 doubles.

      2. $2,000 → (1) $4,000 → (2) $8,000 → (3) $16,000 → (4) $32,000 → (5) $64,000 -> (6) $128,000

      3. By age 67, your original $2,000 will grow to $128,000! This is one way wealth is created!

"Compound interest is the eighth wonder of the world. He who understands it, earns it ... he who doesn't ... pays it."
Albert Einstein

3. Retirement Planning

a. The old three-legged stool of Retirement Income has lost one leg and another looks shaky

   Leg 1 - Company Pension Plan – a thing more of the past

   Leg 2 - Social Security – concerns continue for further reductions and delays in benefits, especially for those with higher income when they retire.

   Leg 3 - Personal Investments – will have to make us the difference.

b. Think ahead and build a long term financial model - This is best when done with the assistance of a **CFP® Professional**. Better online retirement modeling offerings include **Blackrock** and **Vanguard**.

c. Monte Carlo financial modeling

d. Use realistic assumptions in a financial model, e.g.

   i. Inflation (can be the slow and silent killer of a financial plan) (3%)

ii. Rate of Return for Investments that's defensible (8-10%)
iii. Expenses – now and especially when one retires
iv. Current average life expectancies:
    i. From birth — Male 76, Female 81
    ii. From age 65 — Male 83, Female 86
v. Social Security
vi. College Expenses for children
vii. Future Medical Expenses in retirement years
viii. Retirement Age

Important Note: **The Time Value of Money**
Nominal dollars vs. Real inflation-adjusted dollars

Inflation at 3% per year means that $1 million dollars at retirement in 30 years will only have the purchasing power of $400,000 today.

4. Retirement Funding Vehicles

a. Pension Annuities (a thing of the past)

b. Social Security (will only meet a fraction a retiree's needs)

c. Cash Balance Plans (increasingly popular in Corporate America)

d. 401(k), 403(b), 457 plans (Cornerstones for personal retirement accumulation)

e. Deferred Compensation Plans (usually only for top executives)

f. IRA and Roth IRA accounts (contribution limits can be a problem)

g. Fixed Annuities, Variable Annuities, Equity Indexed Annuities, Cash Value Life Insurance policies

    i. These generally aren't great options. Problems include: fees, limited investment options, penalties for early withdrawal, ordinary income taxes on all gains, insurance companies who hold the annuity can fall into hard times risking the return of your funds, tax free income sales pitch can turn into an income tax time bomb if policy lapses.

h. Immediate Annuities can make sense as longevity insurance.

i. Defined Benefit Pension Plan – Tax savings and retirement accumulations can be very large especially if someone is the only employee of their own company.

5. Education Funding

a. **Coverdell Education Savings Plans** (Education Savings Account ESA)

i. $2,000 per year limit, AGI phase out $110K Single, $220 JT Return
ii. Use for primary, secondary and post-secondary education

b. **529 Plans**, post-secondary education expenses only.

   i. Two types of 529 plans
      1. Prepaid Tuition Plan and Savings Plan.
   ii. 529 Savings Plan
      1. There are many different plans offered by nearly every state. Rules can vary per state and some states offer a state income tax deduction for contributions. Not Florida.
      2. The Utah 529 Savings Plan is very good. Investment options are strong and the plan has low fees, etc.
      3. $15,000 per gift limit (5-year rule allows $75,000 in one calendar)
      4. Tax free growth of money when used for tuition, books, room and board!
      5. Expanded to now include K-12 education expenses
      6. The Plan Holder controls the account and names the beneficiaries. Beneficiaries can be changed in the future based on actual needs.

c. **UTMA accounts** (potential "Kiddie Tax" up to age 18 and then when a full time student, ages 19 to 23.
   i. For 2020 unearned income (investment income, dividends and capital gains) first $1,100 no tax, next $1,100 child's tax rate, greater than $2,200 taxed at parent's highest marginal tax rate.

   ii. Remedies for 2018 and 2019 are available for those who paid higher trust tax rates which was fixed in SECURE Act 2019.

d. Can use IRA accounts for education and avoid 10% penalty, but still pay ordinary income tax on distribution.

e. Fund education costs from Current Income or Student Loans

f. **Education Tax Credits** available with certain AGI limits:

   i. <u>Hope Scholarship Tax Credit</u> now known as the American Opportunity Tax Credit (up to $2,500 nonrefundable tax credit), for 4 years of post-secondary only. 100% of the first $2,000 and 25% of the next $2,000 qualified education expenses. Income phase outs apply - $80,000 to $90,000 Single, $160,000 to $180,000 Married Filing Jointly

   ii. <u>Life Learning Tax Credit</u> ($2,000 tax credit), post-secondary and trade school, job skill improvement, for an unlimited number of years. Must be an eligible institution per the IRS. Income phase outs apply - $56,000 to $66,000 Single, $112,000-$132,000 Married Filing Jointly

iii. Claim one or the other, not both

6. Investments

a. Let's be clear - There are no gurus and there are no crystal balls!

b. Two DALBAR studies

   i. 20 year returns through 2013

      1. S&P 500 index returned 9.22% per year
      2. Average Equity Fund Investor returned 5.02% per year

   ii. 10 year returns through 2015

      1. S&P 500 index returned 7.31% per year
      2. Average Equity Fund Investor returned 4.23%

   iii. Why is there such a difference?

      1. Investors are trying to time the market. They tend to sell after the market drops and proceed to miss the rebound. And they tend to load up on equities at market tops when they should be selling and rebalancing their portfolios.

c. Greater than 90% of portfolio performance is the attributed simply to the allocation of funds to Stocks, Bonds and Cash. (Source: Brinson, Singer & Beebower study entitled "Determinants of Portfolio Performance" two ten year studies, ending in 1983 and 1987)

d. Allocation to the Asset Classes of **Stocks, Bonds and Cash** more important than:

   a. Individual security selection
   b. Market timing

e. Selecting proper Asset Allocation

   Two primary considerations: - Target Rate of Return
   - Risk Tolerance of Investor

f. Typically allocations to Stocks should be higher percentage of the portfolio of the younger investor and then reduced to a more balanced mix at and during retirement; typically 50% or 60% in Stocks.

g. Five-year rule for stock investing – over most 5 year periods of time, Stock markets generally breakeven.

h. Common Portfolio Asset Allocation Classes and Long Term Historical returns:

Stocks:	Long Term Return	Net of 3% Inflation
U.S Large-Cap Stocks	9.8%	6.8%
U.S. Mid/Small-Cap Stocks	11.4%	8.4%
Foreign Stocks	9.6%	6.6%
Real Estate Investment Trusts	10.9%	7.9%
Bonds:		
Short-term Bonds	3.8%	0.8%
Intermediate-term Bonds	5.3%	2.3%
Cash:		
Money Market Funds	3.5%	0.5%

The value of adding Commodities, Alternatives or Hedge Funds to these basic asset allocation categories is dubious.

i. Timing the Market vs. "Time in" the Market

"The market timer's Hall of Fame is an empty room"
Jane Bryant Quinn, author and syndicated columnist:

"I never have the faintest idea what the stock market is going to do in the next six months, or the next year, or the next two." Warren Buffett

Market Timing techniques can look quite sophisticated but at best they are **pseudo-science**.

j. The merits of Buy and Hold:

"Buy and hold is a very dull strategy. It has only one advantage --- it works, very profitably and very consistently."
Frank Armstrong, author

k. "Wealth is awarded to those who can tolerate the inherent volatility of investing in the stock market."

l. Rebalancing one's portfolio:

i. As asset class returns vary over time and as the investor works to maintain a targeted allocation for each asset class, the investor will by default **buy low and sell high.**

ii. Maintaining target asset allocations controls volatility of the portfolio.

m. Mutual Funds

i. Diversification eliminates the risk of a single stock or bond going belly up.

1. If an investor holds an individual stock it is best to limit it to a maximum of 5% of the entire portfolio.

ii. **Index funds are better than actively managed funds**

1. Expenses are lower
2. Asset class discipline is very high, no style drift
3. Tax efficiency is higher
4. Most index funds are highly diversified

iii. Rating services and newsletters, beware

1. *Morningstar* 5 Star rated funds (the Top 10%).

> **"The predictive performances of different rating systems used by Morningstar do not beat a random walk."**
> Ten-year study from the University of Amsterdam concluded in January of 2007

2. When a mutual fund manager lands on the cover of Mutual Fund magazine, it's often times the Kiss of Death for their fund's performance for the next few years.

iv. **Load** vs. **No Load** mutual funds

1. 12b1 fees and other somewhat hidden expenses
2. A shares, B shares, C shares, etc.

v. Asset Allocation Funds and Target Funds are fine for smaller balances. Once the account is over $10,000 to 15,000 in value it's better to using separate funds to accomplish diversification between asset classes.

vi. Exchange Traded Funds are extremely efficient index funds with very low if any capital gain distributions! They are excellent especially for taxable brokerage accounts.

7. Tax Planning Strategies

a. Annual Income Tax limitation changes:

i. Retirement account contributions. Phase-out limitations may apply.

	2019	2020
IRA & Roth IRA	$6,000	$6,000
IRA (age 50 & up)	$7,000	$7,000
401(k), 403(b) and	$19,000	$19,500

457 Plans		
401(k) (age 50 & up)	$25,000	$26,000
401(k) EE and ER	$56,000	$57,000
SEP IRA	20% of net Self Employment Income reduced by ½ of SE Tax to a maximum of $56,000 in 2019 and $57,000 in 2020.	

b. Long Term Capital Gains and Qualifying Dividends:

For 2020 using 2017 tax brackets:

For taxpayers in the 15% bracket or less, Capital Gains tax is 0%. This is where Taxable income is less than $37,950 (Single) and $75,900 (Joint)

For taxpayers in 25% bracket and higher, Capital Gains taxes apply starting at 15% and then up to a maximum of 23.8% with the Medicare surcharge.

c. **Zero Capital Gains harvesting** is when an investor in the 15% tax bracket (or less) sells long term capital gain positions and pays no capital gains tax. This is basically accomplishes a free step-up in the basis of one's investment.

d. **Back-Door Roth IRA** technique

e. **Roth Conversions** are often advisable if income is in the 12% marginal tax bracket or lower.

f.

g. IRAs and 401(k) plans

i. Distributions are normally 100% taxable income.

ii. 10% penalty applies if money is withdrawn before age 59½

iii. Avoid 10% penalty with the following exceptions:
1. First time home purchase ($10,000 max)
2. Higher education expenses
3. Death
4. Disability
5. Medical premiums while unemployed
6. Medical Expenses per Schedule A AGI limits
7. Military active duty
8. Substantial Equal Periodic Payments (SEPP) distributions

iv. **Age 55 Rule** for 401(k), 403(b), 401(a) and 457 plans. This means that if you retire during the year you turn 55 or older you may withdraw funds from your retirement plan and avoid the 10% early withdrawal penalty. Funds must stay in the company retirement plan and must not be rolled to an IRA where this rule doesn't apply.

v. **Required Minimum Distributions start at age 72**. This is new in 2020 as a result of the SECURE Act. If you have already started RMDs in 2019 you must continue even if you don't reach 72.

vi. **Inherited IRAs a.k.a. "Stretch IRAs" are no longer available starting in 2020.** Currently existing Stretch IRAs are grandfathered, but going forward the payout period for inherited IRAs is limited to a maximum of 10 years. In other words, the inherited IRA must be completely distributed with taxes paid by the year that is the 10th anniversary of the death of the grantor of the inherited IRA.

h. **Capital Losses offset Capital Gains**. They can also offset ordinary income by $3,000 per year. Unused losses can be carried forward indefinitely.

i. **Year-end tax loss harvesting**, be careful to avoid 30 day Wash Sale Rule. Must look back and forward 30 days.

j. Estate Taxes (Maximum top rate is 40%)

   i. $11.58 Million exclusion in 2020 (per person)

   ii. Increases with inflation each year

   iii. New law is permanent, as of January 1, 2013

   iv. Spouse can everything to surviving spouse with no Estate Tax.

   v. 2020 maximum gift amount per year $15,000 (person to person)

k. **Sale of Personal Residence**. First $250,000 of gain is tax free for individuals and $500,000 for Joint Filers if the home was the primary residence during 2 of last 5 years.

l. Sales Tax deduction for Florida residents, **Floridians can deduct extra sales taxes for large purchases like cars**.

m. **Household employee** (housekeeper or babysitter) wages threshold for 2015 is $2,200. If income is greater, then a W-3 must be filed, ½ of FICA taxes must be paid and a W-2 must be provided to the household worker.

n. **Gift appreciated stock** to one's church or favorite charity and avoid capital gains tax altogether. Friends don't let friends give cash when appreciated stocks are present!

o. **Donor Advised Funds** are becoming very popular now that the Standard Deduction has been increased so high which has left far fewer itemizing deductions on 1040 Schedule A. DAFs can be used to double up deductible contributions in a single tax year to Itemize deductions and then grants can be spread out over time.

p. **Savings Bond interest becomes tax free for Higher Education Expenses** if one's Modified Adjusted Gross Income MAGI isn't too high:

For 2020 MAGI phase-outs:

Joint Filer $123,550 to $151,600
Single Filer $82,350 to $97,350

q. The Tax Cuts and Job Act of 2017 **suspended "Miscellaneous Deductions**" on Schedule A Itemized Deductions starting in tax year 2018. No longer are CPA tax prep fees and Investment management fees deductible. This also eliminated deductions for Unreimbursed Employee Expenses.

8. Estate Planning

a. Very important in the event of Incapacity or Death

b. **Last Will and Testament** (distribution of tangible assets, some intangible assets, names Personal Representative to oversee transfer of property to heirs and assigns **Guardianship for children**)

IMPORTANT NOTE: Joint Titling on accounts and Beneficiary designations on IRAs, Retirement Plans, Life Insurance policies and Annuities are critical. These designations supersede directions stated in the decedent's Last Will and Testament!

Joint brokerage accounts can be held in Tenants by the Entirety (TBE) which provides further asset protection for a married couple in Florida.

c. **Durable Power of Attorney** (financial and business management)

d. **Health Care Surrogate** (general medical authority)

e. **Living Will** (End of life, life support and resuscitation)

f. Trusts:

i. Living trust vs. Testamentary trust

ii. Bypass trust, Q-TIP trust, Dynasty Trusts, etc.

iii. Important protections afforded to trust beneficiaries

1. Orderly transfer of wealth
2. Protections from Bankruptcy, Divorce and Civil Litigation

iv. Estate Tax avoidance and portability of estate tax exclusion between spouses.

9. Choosing a Financial Planner

a. If you want to do your own financial planning, just be prepared to learn and keep up with changes in industry and changes in the law.

i. Do you have the Time, Temperament, Training, Tools?
ii. Robo Advisors can help, but these are still primitive beyond basic and simplistic investment management.

b. Questions to bring when interviewing a Financial Planner:

i. Do you operate as a fiduciary with **all** of your financial advice?

ii. What are the licenses and certifications that you have and how are they relevant to your services for me? **Highly recommend that you seek the services of a Certified Financial Planner™ professional**.

NOTE: Be aware of the Alphabet Soup of financial planning designations that exist today. For financial planning, the CFP® mark, PFS and ChFC are the three most reputable.

iii. Formal education and experience in the profession?

iv. How do you keep current with the industry, continuing education?

v. How exactly are you compensated? (Commissions, Fee only, Fee and Commission, Fee based, etc.)

a. If Fee based, ask the planner what percentage of their income is derived from Fees versus Commissions?

vi. Will I ultimately work with you, if not who will I work with?

vii. Do you have restrictions on the kinds of clients that you work with?

viii. Do you have any minimum requirements for someone to become your client?

ix. How many clients do you serve?

x. Can you provide references?

Note: The key word is Trust. Are you confident that the planner is ethical, competent and cares for you?

c. **CFP® Professional** or **Certified Financial Planner ™**

i. Requirements:
1. Bachelor's degree
2. Educational coursework: 7 courses – covering the following:
    a. General principles of financial planning
    b. Insurance planning
    c. Investment planning
    d. Income tax planning
    e. Retirement planning
    f. Estate planning
    g. Interpersonal communication
    h. Professional conduct and fiduciary responsibility
    i. Financial plan development (capstone) course
3. Pass CFP Board Exam (6 hours)
4. Background check
5. 3 Years of Experience
6. Commit to Ethical & Professional Standards
7. 30 hours of Continuing Education every 2 years
8. Maintain a clear professional record
9. Disciplinary and Ethics Commission - Enforcement

d. There are 2 standards of care in the profession:

i. A **Fiduciary** must provide advice for the benefit of the client rather than for the professional's own interest or profit. The advice must use proper care, skill, prudence and diligence. Disclosure documentation must also be provided to the client at the beginning of the relationship and annually. The disclosures must clearly explain the advisor's business practices, all sources of compensation, fee schedules and material conflicts of interest. CFP® Professionals are required to deliver a Fiduciary standard of care to their clients.

ii. **Suitability** is a lesser standard of care than a Fiduciary standard. Recommendations are suitable when the investment and insurance products that are sold meet the general objectives and financial means of the investor. Required disclosures of business practices by a registered representative or an insurance agent are typically minimal if any.

e. **Recommended Reading:**

i. <u>Money, Possessions and Eternity</u> by Randy Alcorn

ii. Financial Fitness Forever by Paul Merriman

iii. The Investment Answer by Gordan S. Murray

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