Sound Financial Bites 025 - Paul Adams

Episode Transcription

What I'm going to talk about and what we can do is not something that's widely known you're going to see a lot in financial publications because, unfortunately, it just doesn't work for the financial institutions to have you spend down all your money that you have. It works much better for them if you leave all of the money intact.

Hello, this is Cory Shepherd, vice president of Sound Financial group and I'm excited to welcome you to Sound Financial Bites, where we bring you bite-sized pieces of financial knowledge to help you design and build a good life.

Hello and welcome to Sound Financial Bites. This is Paul Adams, president and CEO of Sound Financial Group. I'll be your speaker today on today's podcast, we've talked about how we separate the podcast into 4 different sections, 4 different types that we're going to have the personal financial philosophy podcast, analytical financial cast, personal philosophy about living life, designing and building a good life, and the career in business philosophy podcast. Well today, we're going to do an analytical financial cast, but wait, don't just turn it off and skip to the next one right away. We're going to be short, sweet, deep with data, but I think it's going to be something you'll take away, something very different than what you'd normally think about being able to retire. I'm going to try to keep it, for the sake of this being audio only, as conceptual as I possibly can to give you the greatest ability take away some new thinking.

"The reason why we work is so that one day we don't have to work."

In the meanwhile, I'd encourage you to engage in our website if you haven't yet, find out about our live events, download the first 3 chapters of our book. You can have that downloaded by Kindle before this podcast is even over, love to see you engage on the Facebook page. Send us in questions or topics you'd like us to talk about, and we'll do whatever we can to serve you and get that in a lineup. If you haven't a chance to have that 30-minute conversation with one of our advisers, I would encourage you to do so. Lastly, as you hear one of these podcast, it seems really deep and meaningful to you, then just stop after you pull your car over and you get to where you're going, and just use the app on your phone to text it to 7 or 8 friends. Here's why, if your friends are thinking more effectively about money, it will help you think more effectively about money. It's very simple, there's some wonderful data out there from guys like Nicholas Christakis in his book Connected, that can put you in a position to think differently about all kinds of areas, if the people around you think differently. That works on everything from healthy marriages around you, to healthy -- people with healthy bodies around you, to something as simple as people being responsible with their finances to your left and right as you move through life. So let's get to the topic today.

Today, we are going to talk about what I'm going to call, lovingly, The Fallacy of Four Percent. So 4% is a financial mechanic that you'll hear me talk about it is true, it's just incomplete, so that's why I call it an illusion or a fallacy for the sake of the rest of our conversation. When you invest money, you're investing and saving money so that you can be in a position to one day, no longer have to go to work to produce cash flow, which doesn't mean you'll stop doing things. You might want to serve in your church, you might want to serve your community, or you may just keep doing what you're doing and just not worry about how much money you make. But someday, you're working for the expressed and specific purpose to not have to work one day. Let me say that again. If we graph it out, and I've done this conversation with people, if you graph it out, think about it, reflect on it, what you're going to find over and over and over again is the reason that we work and so one day we don't have to work. Not that we wouldn't still, but so that we don't have to work.

So while you're working if the end of goal, always boils down to once you've drawn it out on a white board, and had somebody asks some deep questions come back to, I do it because I don't want to have to do it. Then are we doing the things necessary to create the capital based required, the capital at work can one day do the job that people at work are doing now, or you at work are doing now, that's the difference. Can we get our financial capital to take the place of the human capital we're bringing to the marketplace every day, and that's where the 4% rule comes in. Largely most financial writers and speakers now have gotten back to the fact that it's max, 4% a year that can be distributed from a portfolio, to make sure that that portfolio, despite it going up and down over time, you can take out 4% a year, and taking out 4% per year will put you in the position that your portfolio should last your lifetime and not run out of money.

Now, quick pause, I do need to explain this. Now I know I told that called it a fallacy at the beginning, it is true, and what I just said is true and it's a financial mechanic. I'm going to talk about the fallacy portion in a few minutes. What happens when you're saving up enough money trying to create this asset based, and you take out 4% a year, you may save up whole. I thought my portfolio would average 8% over time, and because my portfolio's going to average 8, why can't I take out 8? The reason is, because the market -- whatever market you're in, you could be in real estate, it doesn't matter, the values of those assets climb and fall periodically, so they go up and down. If you're taking out your "average rate of return", what can happen is that you could accelerate the erosion of your capital in the down years. It's possible it could work out, but it may not. So because it's possible it could work out but it may not, we can't take out more than 4% a year. If we have to take out 4% so that we're always leaving enough -- a little bit of my country background, it's real easy for me to say, "I got to leave enough seed corn in the field every year so the crop is there and I could take out 4% next year."

"Are you doing the things necessary to create the capital-base required?"

So, 4% distribution means that for every $40,000 of income that we want in retirement, we have to have a million of assets. Simply put it if what you want to replace is $200,000 a year, then you need 5 million of capital at work, that's outside of home equity, that's outside of any part of your net worth, that's a boat or an RV, that is capital at work, somewhere in your balance sheet that is an investment that is able to have a 4% distribution taking off of it every single year.

So, if you want to have $400,000 a year replaced, then you got to have $10 million capital at work. So that's the mechanic at work that we have to work against. Now here is the part that's a little bit of a fallacy that people missed, what people missed is that it's 4% if what you want to do is never invade principal on that money. So if you want to take effectively interest only, or the thing that our grandparents taught us that you want to keep your nest egg intact, and take just 4% a year, that will work. Most people are relegated to having to do that because they haven't built any backup plans behind their assets that were allowed in the spending of principal.

Here's the thing I want you to consider, if you're saving up money that's outside of retirement plans. So you've got money that's just in a set of mutual funds that's titled in your name or in the name of a trust that you control, that money is being taxed every year to your balance sheet. All the growth is being taxed every year on your 1040, you're getting things like 1099Is and 1099Ds every year, that are showing you what your portfolio growth was, and you're paying taxes along the way. One day, you're going to retire and you're going to use that for income, and all that income in years where the market's gone up is going to be taxable. So you still have a tax burn throughout retirement. The thing that people don't talk about is let's go to my $5 million example to this. Somebody saved up $5 million outside of a retirement plan that's on their balance sheet, and they're thinking I'm going to take $200,000 a year. The potential problem is that we don't think about or I just say the lost wealth we don't think about, is it 5 million of the principal of that money is all tax free.

We pay taxes on it during its entire accumulation. So what we could do if we had the backup plan that allowed us to do it, is really actually spend all the principal over time. Strategically and methodically dig into the $5 million of assets and no longer be bound by that 4% rule. We could literally strategically spend it over time, save out to our mortality at age 85. If you look at the math and anyone of our advisers can show you how to do this math, we have a calculator we call the Liner Asset Paydown. You can draw the money down and we can show that at between the ages of 65 and 85, you've entirely spent down the money, the money is gone but you would have spent and enjoyed twice as much money, and a big factor into why is because we're spending that tax free principal, or what you would call from a tax perspective basis to your spending your tax basis in the asset. As you spend it down, you end up in the spot where in the long run, you spent twice as much money as $5 million would in a 4% distribution, but that also means is if held strategically, being careful, using an adviser, getting coaching and education. What you could do is have $2 and a half million spend as well as $5 million, if the $5 million is locked in an interest only strategy.

So what gives us the ability to spend the money differently? Well, before I share with you what it is that allows you to be able to in retirement, spend your money differently, have the opportunity to spend down principal. Let me talk about a few other benefits that it can exist if you have this permission slip. So if you have the ability to do this spend down type strategy, not only might you get the opportunity to spend down the principal like we gave the example of $2 and a half million spending as well as 5 million could, because we're able to spend it down, you actually have a lesser susceptibility to changing interest rates and changing taxes, because the basis of the account is a known entity. It works really well for the financial institutions to not have you in the strategy, because as long as you're in the interest only mentality, they get to continue to manage that money on your behalf because you're not spending it down over time. They get to enjoy the fees, everything else on that money.

"If you make a large charity contribution, you can actually get a unitization from the charity."

So, what I'm going to talk about what we can do is not something that's widely known. You're going to see a lot in financial publications because unfortunately it just doesn't work. For the financial institutions to have you spend down all your money that you have it Vanguard, or all the money that you have with Janus, or Oppenheimer. It works much better for them if you leave all of the money intact. It's actually a big movement in the financial services industry to get to know your client's children, because we want to have your client keep the money under management with you during their entire life, and leave it to their kids and then you can manage it for their lifetime too, having them never had spent the principal.

So, let's talk about a couple of other ways you could do that. Think about a reverse mortgage. If most people, they explore reverse mortgage, they're exploring it as a last resort financial tool. But if you think about it, a reverse mortgage might be a wonderful financial tool for somebody with a great deal of financial success. They can live in their house for as long as they want. If they borrow more money than what the house is worth, then all the bank gets is the house and it's a completely tax free set of distributions that are coming to the client throughout their lifetime. The only thing is that when they die, the mortgage is either due, or the bank gets the house. So we'll talk about how that could be solved.

Other things people can do to consume principal is make large charitable contributions. If you make a large charitable contribution, you not only get a large tax write off, but you can actually get an annuitization from the charity itself. You could go to your church, you could say "Hey I have a million dollar piece of real estate, I'd like to give it to you so you can sell it." Well, the church doesn't pay any taxes, so you give it to the church, they sell it and they give you a lifetime income stream in return, and that can be done. Then they just get to keep the corpus of the asset when you ultimately passed. They'd give you a lifetime income and they get to keep the corpus of the asset, and that's called a charitable annuity.

But you can also go get a commercial annuity and do something very much the same to garner lifetime income and have a great deal of tax free basis return to you in that account. So all those things are available but you'll notice every single one of them leaves your heirs with no money. So how could you solve that? Well the way that you solve it is you solve a permanent problem with a permanent solution. You see so often we're being taught by the same financial media that would say "Keep all your money intact in a mutual fund," is also teaching us broadly to only buy term insurance and nothing else. Term insurance is terminating insurance, it's temporary and last for a term of time. If it only last for a term of time, we have this permanent problem which is "I'm going to die someday," like not an if, and, or maybe, like absolutely one day I'm gone. So that's the one thing that I'm definitely going to have a claim on one day. That one insurance policy will absolutely one day, without a doubt, pay a claim. It's the one way that a large amount of the talking heads in the financial services industry, tell us, we should solve that problem temporarily with term insurance. They don't ever tell us there's a day we should drop our car insurance, there's no guarantee we're going to be in a car accident. They don't tell us we should ever drop our fire insurance just because our home is paid off, go and cancel your homeowner's insurance and there's little to no chance we're going to have a homeowner's insurance claim.

For the advisors that recommend disability insurance, they never say "Well, go and drop your disability insurance now," because now, they like you keep that as long as you're earning money. Literally, the one place that they say you should solve a permanent problem with a temporary solution is term insurance. So if you solve the permanent problem that is the fact that one day I'm going to die, I'll no longer be here on this earth with my family, and I solved that with a permanent solution with something like whole life insurance. Now, as controversial as some people might view that, what I've actually done is give myself permission and spend every other asset differently. Meaning, when I retire I can actually go ahead and consume money. I can give a lot more money away, because there's a replacement strategy on my balance sheet. They'll replace the income. If I outlived aged 85, there's a compounding occurring on the cash based that give it the potential to be able to give me my lifetime income stream after that.

If I decide to give it to charity, I don't have this pull on me of am I leaving my kids and grandkids the legacy I want. If I choose to leave it to my church, I can have both. It's not either or because back when I was in my working years, I solved the permanent problem with a permanent solution. Why do they call it whole life? Well, let's think about why they called it term insurance? It's terminating, it's going away, they call it what it is. These insurance companies long, long time ago didn't have great marketing department so they called it what it was. Whole life insurance is exactly what is sounds like. It's insurance that last your whole life, and because it lasts your whole life, it can be the replacement strategy, the backstop backup plan to being able to actually enjoy all your other assets.

Now there's all kinds of calculations that should be done before you determine if this is right for you. So if you're working with an adviser and you're talking with them about the potential of whole life insurance as one of the strategic financial tools you're going to use, what I want to recommend is that you understand both the math and the scholarship behind that decision. It shouldn't be made upon opinion, it should be grounded in disputable math and independent scholarship. So consider, if you want to design and build a good life, I think one of the biggest things to keep your mindset on, is that you need to be able to actually enjoy your money. Meaning, you spent a lifetime saving and building assets and we should have the ability to actually enjoy the assets that we built over our lifetime. The ability to enjoy those assets can lead to a better estate planning outcomes, can lead to be leaving more effective assets to the children and the assets that we built, better tax situation during distribution, and maybe better things for the community because of what we were able to give, because we literally made the decisions years ago, to put ourselves in the position in retirement to spend much more of our money that we spent saving and building.

It's a big part of me in my family strategy, we own a fair amount of whole life insurance, we put a little over a hundred thousand dollars a year into just that strategy, because it's part of our plan to match up the death benefit of the life insurance with a whole bunch of assets that we're building, and we're going to spend down all the other assets, not the life insurance, leave that on the shelf to grow and cook and compound, like a crock pot, still working. Then the other assets, we're going to be able to spend those down, give those away and enjoy them during our lifetime rather than just waiting around, hoping that the 4% interest only holds out.

Well, I'm glad that you all could be here today. I'm glad that we could talk about the mechanics of the 4% rule, and how it works for us, but then also be able to talked about where it's a fallacy that we could actually distribute much more money off of the same asset as long as we have the backup plan in place. That we have another financial tool that has guarantees backing up our other financial decision. As always, I hope this podcast today helped you better design and build a good life. I hope you all have a great day and it's great having you with me.

Hey, this is Cory again. I just wanted to say it's been great to have you here listening to this episode. You can find out more information about us on our website, www.sfgwa.com, or you can find us on Facebook under Sound Financial Group. We'd love to hear any questions or comments from you there. Who knows? You may hear one on a future episode. For our full disclosure, you can go to description of our podcast series, this episode's description, or our website.

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