SENSIBLE FINANCIAL PLANNING

Sensible Financial Planning: A Lifetime Approach to Financial Peace of Mind

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The basic financial planning problem is simple: you'll live longer than you work. You'll have to move income you earn while you're working into your retirement, when you're not working or earning.

The best financial planning goes beyond those basics, however. Your lifetime plan should help you reach your life goals, not just your financial goals. Your quality of life depends on factors that go beyond your financial spending power. Your health, relationships and family are all extremely important.

Sacrificing now so you can live better later isn't attractive. For example, working longer to fund your retirement may cause you to miss opportunities to spend time with family, to travel, or to undertake charitable or other activities. A decline in lifestyle once the paychecks stop arriving isn't attractive either.

Conceptually, your Sensible Financial plan is very simple. It begins with your life goals and financial resources. It adds up all your financial resources and subtracts the costs of your goals. The difference is available for everyday living. At your **sustainable living standard,** you spend that "everyday living budget" evenly over your lifetime.

Matching your financial resources and sustainable living standard with your life goals produces a saving plan to build the assets you will accumulate over your lifetime. You will draw upon those assets to pay for later one-time financial goals (such as college for your children or a down payment on a second home) and throughout your retirement.

Developing a solid financial plan can be analytically complex, but the plan itself can be simple and clear. We believe that if you understand your financial plan so that you can feel comfortable with it, you'll actually use it.

Introduction

Life Phases and Financial Issues

From the perspective of financial planning, you can look at your life as a series of phases. Each phase offers its own opportunities, and poses its own set of challenges.

In reality, your life phases are not neatly distinct from each other. They may overlap or occur in different sequence. Some may even recur.

Sensible Stories

Adam and Jennifer

By Frank Napolitano, Senior Financial Advisor

Adam had just turned 40 and was a successful engineer. Jennifer left the workforce a few years earlier to raise their three children. They had many reasons for making a financial plan, but the one issue that kept coming up was the relationship with their current advisor. They were concerned that their portfolio hadn't grown as it should. Even though their advisor was primarily a money manager, they found it hard to speak with him about their investments. Conversations were friendly but not substantive. And worst of all, they didn't understand how they were being charged. They wanted some level of fee transparency.

There are several broad categories of fee arrangements. Fee-only financial advisors are compensated solely from fees that clients pay (directly) to the advisors. In contrast, commission-based advisors are compensated based on the financial products that they sell. ("Fee-based" advisors charge a client fee and receive *compensation from selling products, not to be confused with "fee-only"). Adam and Jennifer decided that they preferred a fee-only arrangement as being less likely to lead to conflicts of interest in product recommendations.*

Secondly, there are two standards of care in the financial industry. A fiduciary standard requires that an advisor act in a client's best interest. It is the highest standard of care under the law. Alternatively, a financial advisor may be subject to a suitability standard. Under this standard, an advisor need only make recommendations that are suitable based on the client's situation. Recommendations don't have to be in the client's best interest. Adam and Jennifer, who hadn't been aware of the distinction, decided that they preferred a fiduciary advisor.

Frank Napolitano
Senior Financial Advisor

When you start to plan, it's helpful to identify which phase you are in, and which elements of that phase are most relevant to you.

We'll use the following seven phases to organize the discussion:

1. School

2. Young adulthood

3. Committed adulthood

4. Child rearing

5. Pre-retirement

6. Early retirement

7. Late retirement

In addition, four financial issues are common to all phases of your life:

Human Capital Management

Living within Your Means

Cash Flow

Asset Allocation

Human Capital Management

As we'll see, the school phase is all about Human Capital Management. Once you leave school, you continue to make decisions about your human capital – where to work (which job to take) and how to advance your career. Human capital management has a major influence on your financial life – it largely determines the financial resources you will have. You decide whether to take the remunerative job that requires you to travel and work long hours or the one where you earn less but have a more attractive work/life balance. You decide whether or not to accept projects that will require you to work late, whether or not to accept promotions or transfers to other cities. You decide whether to take time away from work to raise your children or to care for your parents. These decisions affect both the money that you earn at the time and your future earnings as well – your work experience and your network of work relationships are important factors in your earnings growth.

Living within your means

You can't spend more than the resources available to you. This sounds deceptively simple. Unless you can figure out how to die bankrupt (owing more than you own), you can't spend more in your lifetime than you earn (plus any gifts you receive or inherit). So, this is something you are forced to do. How hard can it be? Two factors contribute to the complexity of living within your means: credit and lifetime budgeting. Being able to borrow allows you to spend tomorrow's money today. If you do too much of that, you'll find out tomorrow that you have fewer resources left to spend than you thought you might. Lifetime budgeting requires saving for retirement, spending less today so that you'll have something left to spend when you are no longer earning.

Third, there are two broadly different approaches to mutual fund management – active and passive. For a long time, the passive approach has been growing and the active approach has been shrinking. Academic analysis strongly suggests that passive funds tend to produce higher net returns, primarily because they are less expensive to operate. In addition, they tend to be less risky than actively managed funds (they have less "tracking error"). Neither Adam nor Jennifer is a financial expert, but both understood that fees matter. They admitted that they didn't even know their current funds had fees. We showed them how easy it is to look up the information themselves on Morningstar or Yahoo Finance.

A detailed analysis of their current holdings revealed that they were paying over 3% in fees annually. The mutual funds they owned had an average expense ratio of 1.4%. Additionally, their advisor was charging an advisory fee of about 2.25%. Adam and Jennifer felt embarrassed that they had no idea how much they were paying their advisor. Nothing to be embarrassed about, since many, perhaps most, people do not understand how their financial advisors are compensated. Unfortunately, *there's an incentive in the financial services industry to obscure fees and distract clients from what's going on in terms of return.*

Like every family, Adam and Jennifer still have financial issues, but understanding their fees is not one of them.

Cash flow

Managing cash flow just means making sure that the money you want to spend is available when you want to spend it. If you have savings that are illiquid, e.g., a house or a retirement account, you may be living comfortably within your means (not planning to spend more in your lifetime than you can afford), and yet not be able to come up with any cash. This can force you to borrow when you'd prefer not to, or simply to do without. It's helpful to have an emergency fund – readily available cash – to help you deal with situations you don't expect and can't predict. An emergency fund can enable you to meet such situations with confidence, if not exactly with a smile on your face.

Asset allocation

Asset allocation is choosing how best to invest your savings so that the resources you need will be available when you need them. This includes being sure that you have an emergency fund large enough to allow you to cope with unforeseen contingencies. It also means deciding how much you invest in stocks and bonds in your retirement accounts and in your other investment accounts. Doing asset allocation well requires understanding both your risk capacity (how much you can afford to lose) and your risk tolerance (how much you could bear to lose). Your ideal asset allocation varies throughout your life. In your early working years, your human capital or earning power represents a very large proportion of your wealth, significantly larger than your financial assets. In this phase, how you invest your financial assets will have little impact on your overall risk profile. As you get older, and save more, your human capital diminishes in relative importance, and your stock/bond choice looms larger.

With all this in mind, let's take a closer look at each of your life phases.

1. School

Before you work and earn, you learn. You go to school, you go to camp, you play sports, learn to play musical instruments – you grow into your adult self.

Economists have a grand formal name for this phase – “Human Capital Accumulation.” They’ve spent a great deal of time and effort developing the human capital concept, and they use it to explain many aspects of economic life including who works, how much they earn, and when they retire. Simply put, however, human capital is earning power.

School, even elementary school, has financial implications for you. First you learn to read, and write, and to figure (the famous three Rs, the last one being ‘rithmetic). You also learn much more that is essential to being a working adult: how to interact peacefully with others, how to work productively with others, etc.

Education is expensive. There are two broad categories of costs. The one you usually think of is tuition (and for some higher education, room and board). Schools need places for classes to meet: buildings and classrooms (even virtual schools need office space, production studios and websites). They need teachers to teach (and teaching assistants to help, and administrators to keep the school managed). And they need teaching materials – books, lesson plans, teaching apps, etc. for students and teachers to work with.

The second cost is the student’s opportunity cost. You could work instead of attending school, and the earnings that you forego in order to study are a significant element of the total cost of your education. In this country, the importance of opportunity cost is most obvious for post-secondary education. High school graduates may explicitly consider starting work as an alternative to attending college. College graduates often take their work options into account directly when considering graduate school.

From a financial planning perspective, school is an investment. This gives rise to three questions:

Don and Chiyako

By Laura Williams, Junior Financial Advisor

Don and Chiyako selected a financial advisor to help them with a small number of important objectives: to organize their financial lives, to understand whether their spending was reasonable, and to get a consolidated view of their combined financial assets.

Laura Williams
Junior Financial Advisor

As a two earner household with one young child, Don and Chiyako have busy schedules. They were interested in getting assistance to “steer the ship” given their financial goals. In the short-term, they wanted help with stock option planning, education planning and to worry less about their finances. Over the long-term, they wanted to maintain their current lifestyle, to have sufficient resources in retirement and to understand *what asset allocation would be appropriate for them.*

They found that a full financial plan was a very useful construct for accomplishing their objectives and financial goals.

First, Chiyako focused on creating a 10b5-1 plan that would allow her to exercise stock options she received from her company while complying with the rules against insider trading. This plan is updated over time, as necessary.

Next, Don and Chiyako considered scenarios for their daughter's education, given their potential retirement ages, housing, and future earnings. The analysis showed that they had a lot of flexibility given their current and future resources. For example, there were two education-related scenarios: staying in their current home and paying for private school vs. moving to a different town and sending their daughter to public school. Both scenarios were affordable, but moving to a different town was less economical than sending their daughter to private school.

They coordinated with an insurance broker to ensure that they had proper insurance coverage in case of death or disability. The insurance broker

What kind of education is right for you?
You can think of this question most directly in the context of college and graduate school – liberal arts or engineering? Law school or medical school? It shows up much earlier, however, even for pre-school. Will your children go to pre-school or stay in day care? Should they be in the gifted group? Should they take Advanced Placement courses? International Baccalaureate? When you make these decisions for your children, you are comparing costs and benefits either implicitly or explicitly. You incur the financial and opportunity costs now, and your children will reap the benefits later. Many of those benefits are economic or financial – e.g., entering a lucrative profession, earning more money, or marrying someone who will contribute to your family's success.

How much education is right for you?
This is the most explicitly financial of the questions. Each additional year is another year of cost for you – another year of tuition and other expenses, and another year without earned income. Schools with higher tuition costs also purport to offer more or better education. Will it be worth it? From a purely financial perspective, you can consider incremental earnings (the extra earnings from one more year of school, one more level of school, or a more expensive school) as the return on your investment. Most analysts continue to find that education is an excellent investment, and the return on your investment in a college education is a very popular subject, with many publications competing with each other to provide you current information.[1]

How should you finance education?
After you've decided on the kind of education and how much, you must decide who will pay, and how to finance it. Will parents pay the out-of-pocket costs from savings (past or future)? Will the children contribute financially (at least by college age, children are contributing the opportunity cost, at least in part, as they would be keeping and spending the earnings)? The student loan crisis (which was an issue in the most recent presidential election) reflects the fact that students are playing a large role in funding higher education for themselves. Very few students will have been able

[1] *E.g., to name just two: http://www.bestcolleges.com/features/best-roi-colleges/; http://www.usnews.com/news/articles/2015/02/10/college-grads-question-the-return-on-investment-of-todays-degrees*

to save enough resources beforehand to fund college tuition and fees. If their parents aren't paying, the students will have to borrow. Transferring college funding to students forces inexperienced investors to make major financial decisions very early in their lives.

2. Young adulthood

After you graduate from school (the highest education you obtain, whether that is high school, college, or graduate school), you are officially an adult. You move out of your childhood home, find your own place to live, get your first job, open a bank account, get a credit card, and have your own financial life, independent of your parents. You are on your own, by yourself.

In this phase, you are still an individual from a financial perspective. You may have a significant romantic relationship, but you are not yet committed.

As a young adult, you are on your own for the first time in your life. You are making your own financial decisions – which job to take, how much to spend on housing, food, clothing, transportation and entertainment, and how much to save. These tend to be very difficult decisions both because they are new and because your time horizon is so long. Retirement seems very hypothetical in your twenties, and even when you hit your thirties.

Saving is a habit, and the beginning of your working life is the perfect time to start living within your means. There is a lot of uncertainty about how your earnings will change as your career develops, and about how long you will work and how long you will live. Nevertheless, you can still commit to spending less than you earn so that you will have resources available once you retire, whenever that is.

How much should you save? There is no simple answer, unfortunately. In general,

- If your earnings are high, you should save a larger percentage of them. Social Security benefits replace a smaller fraction of earnings for those with higher earnings.
- If you expect lower returns on your savings, you should save more. Interest rates have been low recently. If interest rates and stock returns stay low, your savings will grow more slowly, and more savings will be required.

helped create a life insurance ladder for Chiyako based on specific recommendations from their financial plan. Don and Chiyako also both obtained proper disability insurance coverage.

Don and Chiyako's accounts are now managed as one consolidated portfolio including their retirement accounts, 529 plan for their daughter, and brokerage account. They chose an appropriate asset allocation given their risk capacity and risk tolerance.

Don and Chiyako also decided to receive ongoing financial advice. This has helped to reduce the uncertainty and worry that they felt previously about their financial activities. Their advisor can address their questions as they arise.

Jay and Toby

By Rick Fine, Senior Financial Advisor

Jay and Toby both work outside the home while trying to raise three children. They own a home in a classy (read: expensive) suburban neighborhood. Despite their generous incomes, they really stretched themselves financially to move to this town, which boasts an excellent public school system, and an enormous property tax bill to match. They joke that they have the worst house on the nicest block. Their list of planned home renovations stretches to the moon and back, and most projects seem urgent, or at least important enough to tackle in the next few years. Meanwhile, their oldest child is now applying to colleges, with the other two not far behind. There is little chance of obtaining need-based college grants given their family income. With very little free cash at their disposal, and a reluctance to put off some of the more urgent home renovations, they have been scratching their heads trying to figure out how they will finance all of these expenses.

A thorough analysis of their financial resources and obligations revealed that they have actually saved quite a

- Start by saving **10%** of your earnings.
  - o If you earn more than **$60,000,** move toward **12%** as your earnings approach **$100,000** and **15%** at **$150,000, 17%** at **$300,000.**
  - o Add **2%** or so to your savings rate for each **.5%** you expect your real (after inflation) returns to drop below **2.5%.** You can reduce your savings by **2%** for each **.5%** you expect real returns over **2.5%** per year.

In brief, **10%** is a good baseline. Increase to **15%** for really low returns, and **20%** for low returns and high income.

Where should you put your savings? Again, it depends. Bear four simple factors in mind (tax deferral, liquidity, employer match and investment choices). Evaluate your choices based upon how they stack up on these factors and the importance you assign to each factor.

<table>
<tr><th>Account Type</th><th>Liquidity</th><th>Tax Deferral</th><th>Employer Match</th><th>Investment Choices</th></tr>
<tr><td>Traditional IRA</td><td>Liquid only in special circumstances before 59½</td><td>Taxes paid only on distribution – best if you expect to pay lower taxes after retirement</td><td rowspan="2">None</td><td rowspan="2">Several brokerage and mutual fund firms offer low costs and excellent investment choices – choose one that does</td></tr>
<tr><td>Roth IRA</td><td>Principal contributions available without penalty after 5 years</td><td>Taxes paid only on contribution – best if you expect to pay higher taxes after retirement</td></tr>
<tr><td rowspan="3">Employer account, e.g., 401(k) or 403(b)</td><td rowspan="3">Liquid only in special circumstances before 59½</td><td rowspan="3">You can pick Traditional or Roth – see above</td><td rowspan="3">Many (but not all) employers match</td><td>Varies by plan</td></tr>
<tr><td>Some are excellent</td></tr>
<tr><td>Some are terrible</td></tr>
<tr><td>Brokerage account</td><td>Requires security sale – can take up to one week</td><td>Capital gains tax-deferred until realization</td><td rowspan="2">None</td><td>Most brokerage firms offer excellent choices – choose one that does</td></tr>
<tr><td>Savings Account</td><td>On demand</td><td>Tax owed each year on interest earned</td><td>Standard savings account or CDs</td></tr>
</table>

You should definitely have an **emergency fund,** for which liquidity is a paramount consideration. A savings account (including a CD) is likely to be your best choice.

If your employer offers a 401(k) or 403(b) match, you should almost certainly contribute enough to get the full match. Otherwise, you are not maximizing your compensation! Invest more than enough to get the match in your employer retirement account only if the investment choices are excellent (otherwise, choose an IRA), and if you can manage without liquidity (otherwise, choose a savings or brokerage account).

Now that you are on your own and self-reliant, you may have noticed that your most important asset is your ability to earn. You pay your rent and all of your expenses from your earnings. But what if you couldn't work? What would you do then?

If you couldn't work for a day or two, it's likely that you wouldn't have a problem. Your emergency fund would enable you to manage for a few days, weeks, even months. But a serious illness or an accident might make it impossible for you to work for months or even years. For a young person, an extended disability would be a relatively rare event. If it were to happen to you, though, it would be financially devastating, and saying that you were really unlucky would be cold comfort.

Fortunately, long-term disability insurance is a straightforward way to protect yourself. Your employer may provide it as part of your benefits package. Disability benefits funded by your employer are subject to FICA (Social Security) and Federal and state income taxes. Good coverage should replace at least two thirds of your after-tax income. If your employer-provided benefits don't reach that level, you may be able to purchase a personal or individual long-term disability policy. Benefits from a policy you pay the premiums for are not taxable.

Ensuring that you have enough long-term disability insurance may be the most important financial decision you make at this point in your life.

Now that you have an income, banks will notice you, and suggest that you should have a credit card (one that they issue, of course!). Credit cards represent pre-approved short term loans from the issuer. They can be quite useful. For certain purposes, like renting a car, they can be essential, or at least very advantageous.

bit of money over the years. They followed the conventional wisdom of maximizing their retirement account contributions; most of their savings are in tax-deferred accounts such as 401(k)s and IRAs, which impose a penalty for early withdrawals. Although from a long-term perspective they can afford all of their financial goals and still have enough remaining for a comfortable retirement, they might have to borrow a substantial amount of money now to fund their upcoming expenses in order to avoid drawing from retirement accounts and incurring penalties. In retrospect, it would have been better to have decreased their retirement plan contributions somewhat in order to build a larger cash base in their bank accounts. When the larger expenses were behind them, they could have ramped up their contributions again. As the saying goes, hindsight is 20/20.

Jay and Toby's savings dilemma brings to light an important consideration: there is a difference between "affordability" and "sufficient cash flow". College may be affordable when considered in the context of one's entire life, but one might have to borrow to fund it due to limited immediate access to *cash. Jay and Toby certainly have enough money to fund their goals, but most of it is tied up in accounts they cannot easily access without some financial hardship (i.e., the tax penalties). When it comes to saving, the conventional wisdom of "maxing out" retirement accounts each year does not always apply. The difference between retirement and college is that one can often delay retirement a few years if one is short on savings. It is more difficult to tell a child that he or she will have to postpone college a few years because the money is not easily accessible. So, it is important to choose the right saving accounts, as well as the right saving amounts .*

Rick Fine
Senior Financial Advisor

The first option they considered as a way to provide additional

If you use them primarily as a convenience, credit cards are harmless. Borrow during the month, pay at the end of the month, and you will incur no interest charges. However, if you begin to "carry a balance" by paying less than the full amount you owe every month, you add a regular interest payment to your monthly budget. Especially if you use your card for regular expenses like groceries, clothes, and even vacations, carrying a balance can indicate that you are living beyond your means.[2]

If you find that you tend to carry a balance on your credit cards, you may benefit from using a debit card or cash instead. A significant body of research indicates that debit cards and cash both make users more conscious of and careful about their spending.

3. Committed Adulthood

Once you commit to a romantic partner, you learn about how to live with another person, and you make plans for the future as a couple. Alternatively, you may decide that you want to live as a single adult, and plan for the future in that mode.

Your life after this decision is qualitatively different than what has come before. Your commitment forms a foundation upon which you can make important decisions that previously seemed impossibly complicated.

Committed adults have "settled down." You have a life partner, or you've decided you want to live without one. You (or your partner, or both) have a career. You can make plans.

Your financial situation includes all the elements we've already discussed, including living within your means, long-term disability insurance, and an emergency fund.

As a committed adult, you begin to think more seriously about your living arrangements. You may think about buying a home. In fact, there are several decisions for you to make – whether to rent or to buy, how large a home you want, and if buying, how you will finance the purchase.

[2] *Mr Micawber's famous, and often quoted, dictum: "Annual income twenty pounds, annual expenditure nineteen [pounds] nineteen [shillings] and six [pence], result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery." Charles Dickens,* ***David Copperfield.***

Buying a home is a major decision. Owning a home implies a much higher level of responsibility than renting. As an owner, you are responsible for maintaining insurance, paying taxes, and maintaining the property. Renters are responsible only for paying rent.

Homes are illiquid – you incur large transaction costs when buying and selling. That is, it's expensive to buy a house, and expensive to sell it. You don't want to do either very often. Accordingly, if you know you won't be living in a particular place for very long, or you aren't certain you'll be staying, buying a home can be an expensive choice.

When you buy a home, you are buying the ability to live in it for as long as you own it. In effect, you are paying a lifetime's worth of rent. That is likely to be a great deal of money, and probably more than you have saved. If you have enough income to persuade a bank that you'll be able to repay the loan, you can borrow money (take out a mortgage) to buy the house.

A mortgage is a collateralized loan, with your home as collateral. That is, as the borrower, you promise to pay back the money you've borrowed, with interest. You also agree that if you don't pay, the bank can take your house (foreclose on the collateral) and sell it to pay themselves back.

There are two tax advantages to owning your home. One is well-known, and less valuable than commonly believed. That would be the tax deduction. You can deduct your mortgage interest from your income. Effectively, this means that you pay a lower interest rate after-tax than before. For example, if you pay 4% interest, and you are in the 25% tax bracket, after tax you are paying 3% interest. Note, however, that you are still paying interest. The lower after-tax interest rate (in this case, 1% lower) is the entire tax benefit.

The second, larger, benefit is that you pay rent with pre-tax dollars. As the homeowner, you are both the landlord and the tenant. You receive your home's living space services tax-free. In addition, you get some of the tax advantages that landlords get (the largest probably being the ability to deduct real estate taxes from your income).

Whether or not you purchase a home, you have important assets to protect. In the event of an auto accident or some other misfortune in which someone else is hurt, they might sue you. Fortunately,

cash was a Home Equity Line of Credit (assuming they could qualify). However, a HELOC for this couple would likely be small because of their large mortgage. It would certainly be insufficient to fund all of their upcoming expenses.

As it turned out, one of Jay's retirement accounts was an IRA he inherited from his father, who had passed away years ago. An Inherited IRA is different from a Traditional IRA in that you can draw from it before 59½ without incurring an early withdrawal penalty (although you do still have to pay taxes on the distributions). Jay and Toby decided to use this account to fund their most urgent home repairs, and then delay all non-essential home renovations until at least two of their children have graduated from college. In addition, they were open to the idea that their children should apply for college loans and expect to pay them back after graduation. They believe that children should have some "skin in the game" when it comes to financing their college education. Of course, the other advantage is that it would ease their cash flow crunch over the next several years. Still, they reserved the right to help the children pay off some of their loans after graduation, *once their cash flow situation has stabilized.*

It turned out that this two-pronged strategy of inherited IRA distributions and student loans would provide them with sufficient cash to put their children through college and keep the house from falling apart. And they would avoid incurring tax penalties on early withdrawals. Moreover, despite redirecting money (the inherited IRA) that they originally thought they should set aside for their retirement, their other retirement assets along with future savings would be enough to secure a very comfortable retirement. They were thrilled, not to mention quite relieved. However, their youngest child, upon learning that he would need to pay part of his college education, is now considering becoming a rock musician. The parents figure that they have another five years to change his mind.

you can purchase "umbrella" insurance (it covers all of your assets, including your human capital) to protect you from this contingency. Umbrella insurance contributes additional liability coverage to your homeowner's or renter's insurance. It is inexpensive, costing in the low hundreds of dollars for each million dollars of coverage.

If you have made a commitment to a life partner, you may wish to purchase life insurance to protect them against the unlikely possibility that you may die and not provide the income that is an essential support for your and your partner's lifetime financial plan. Your human capital is a valuable asset for you and for your partner. Life insurance makes it safer for your partner to rely on your income.

Now that you have assets, you should make a plan (an estate plan) for what to do with them after you are gone. Your estate plan specifies who will receive your assets if you die and with what restrictions, if any.

People usually think of a will as an estate plan, but even simple estate plans often have multiple components. Some of these components are important and valuable even if you are still alive. Estate plans should contain at least:

- Mechanisms for transferring your assets:
    - For employer and individual retirement accounts, the mechanism is your beneficiary designation. (Your will cannot change your beneficiary designations. Trusts can affect distributions from these accounts only if the trusts are your beneficiaries.)
    - A trust governs the distribution of all assets you title into it, but no other assets.
    - A will governs assets you own outside of trusts and retirement accounts.
- Power(s) of attorney, which authorize designated individuals to act on your behalf. You are likely to wish these powers to be limited to circumstances when you are incapable of acting on your own behalf. These include:
    - Financial power of attorney, for transacting in financial accounts and making other financial decisions on your behalf.
    - Health care power of attorney, for making health care decisions on your behalf.

- Living will or advance directive – provides explicit instructions about medical treatment to be administered if you are terminally ill or permanently unconscious.

Many people avoid making an estate plan. It requires thinking about (your) death. Death and taxes are the only things in life we can be sure of, but we don't like thinking about them. Nevertheless, making an estate plan is an important marker in your journey as a committed adult. It says to your partner, your family and to yourself that your commitment is important enough that you are willing to work through difficult emotions to keep it.

4. Child rearing

Once you are a committed adult, you may decide to start a family.

Children are wonderful! They can add joy and richness to your life. They are also expensive, and they introduce many financial complexities to your life. You will spend a lot of your financial (and emotional) resources on raising and launching your offspring.

From the outset, you must decide how you will care for your children. If both you and your partner work outside the home, one or both of you may reduce the amount of time you spend on the job. Or, you may decide to pay for child care, using any of a wide variety of providers – family members, neighbors, religious institutions, childcare centers, schools, au pairs, nannies, etc.

As a parent, you will need to consider both the direct financial costs and the opportunity costs of raising your children. If you reduce your working hours to care for your children, you will incur opportunity costs as your earnings decline. When considering the trade-off between for-pay childcare versus providing care themselves, many parents compare their take-home pay to the direct cost of childcare. This is an incomplete comparison, however. If you stop working completely, you can lose your connection to the world of work, and may find it difficult to rebuild your skills and networks. If you think you'd like to go back to work after your children reach a certain age, it may be worth working part-time just to "keep your hand in," even if your net income after child care costs is small.

Dana and Elizabeth

By Frank Napolitano, Senior Financial Advisor

Investment vehicles come in many flavors. They run the gamut from plain vanilla (think Vanguard index fund) to goat cheese beet swirl (think variable annuity with a guaranteed living withdrawal benefit).

Dana and Elizabeth came to Sensible Financial to get their financial life in order. They had some fairly common concerns: to save enough for their young daughter's college, to make sure they had the proper insurance to protect their family, to know how much house they could afford.

Frank Napolitano
Senior Financial Advisor

What struck me most about their situation, however, was why they had decided to do a financial plan now.

We talked around the issue for a bit, and after a while it came out *that they had recently made a number of investments and were concerned that they had made mistakes. It had nothing to do with investment performance, per se. Rather, they really didn't understand the investments. They were embarrassed, but they were also concerned. The advisor they had been working with recommended they buy variable annuities in their three accounts. Additionally, the advisor – acting simultaneously as a financial advisor and an insurance agent – sold them two whole life insurance policies. They were paying about $10,000 per month in insurance premiums. Those were only the expenses Dana and Elizabeth knew about. They had no idea what other fees they were paying in their investment accounts.*

We told Dana and Elizabeth we'd help them figure out what they owned and what, if anything, they should do differently. With their permission, we called their advisor and collected as much information as we could about the investments and the life insurance policies. After several follow ups we had enough data to analyze their accounts.

First, we explained to them how whole life insurance works and that, although it's appropriate in certain situations, term

You'll also want to update two important "committed adult" financial elements once you have children:

- You'll probably need to increase your life insurance coverage to protect your children. Your partner might have increased child care costs if you aren't around to help, and your children's college plans likely depend on your future earning power.
- Your estate plan should include specific guidance for the care of your children should something happen to you. This includes both guardian arrangements and financial management. If the guardian that you and your partner select is not very good with money, you may want to select an additional person to help with the finances.

Your children go to school. School is rarely "free". Although public education is readily available, and frequently of very good quality, you may want to enrich your child's education with music or other performing arts lessons, sports coaches, or tutors. You may want to send your children to private schools for pre-school, high school, or even elementary and middle school. Needless to say, private school is expensive. Even if you decide to teach your children at home, you may have out-of-pocket costs for books and other course materials.

After high school, it's time for college. This may represent the largest single out-of-pocket expense your family will ever make. Many private colleges cost over $60,000 per year these days, and "more economical" public colleges and universities can cost $25,000 or more annually. So, how do you prepare for and fund higher education for your children? And how can you be sure to get your money's worth?

You should begin with the understanding that each child is different, and no single higher education solution is best for everyone. The best solution for your child is higher education that your family can afford and that is well suited to him or her. Higher education is an arena in which this country excels, and the variety and quality of options on offer is almost limitless.

Higher education is also a very competitive business. Colleges and universities work hard to attract and enroll diverse student bodies that will reflect well on them. Work with your child to identify schools that will be good matches (academic programs, region of the country, sports and activities, size, competitiveness, etc.).

Schools for whom your child is an attractive candidate may offer financial support.

Decide how much you will pay (parents don't always agree about this), and how much your child will contribute. Even if your child has little in the way of financial resources, he or she can still work summer jobs and do work/study during the academic year, and can also shoulder responsibility for some of the cost by taking out loans. Even if you decide that ultimately you will pay the loans, your child's direct involvement in paying for higher education will help him or her to appreciate just how much it costs and to make the most of the opportunity.

Setting aside some money every year before college can help make the payments more manageable. College saving or 529 accounts offer the additional advantage of sheltering income from tax if it is used for post-secondary education. Federal I Bonds (inflation-protected bonds) offer a similar advantage.

You may have a child with special needs, which often poses financial as well as emotional challenges. Although many states offer education specifically designed for children with special needs, it is not always easy to access (you may require legal assistance), and you may incur extra costs anyway.

You may also be concerned about how your child will live after school, and whether extra financial support will be necessary. Identifying workable solutions can require a lot of time, effort and money. Once identified, the solutions may require ongoing funding. Many special needs children are eligible for financial support from the state. Providing funding yourself while maintaining the child's access to benefits can be tricky – legal counsel is essential.

Many families with children consider buying a second home. If you use your second home a lot, and your children develop fond memories of it, it can be a very worthwhile investment. If you use your second home infrequently, you may find that taking extra vacations in a variety of locations is both less expensive and equally effective for "making memories."

life insurance was a more appropriate solution for them and their plan. Term life insurance is less expensive and, when properly implemented, provides just the coverage that's required at the lowest possible price. We put them in touch with an insurance broker and helped them find replacement life insurance coverage (disclaimer – Sensible Financial does not sell insurance. Sensible Financial is a fee-only financial planning firm). Once it was in place, they had significantly more life insurance at a (significantly) lower cost. They also understood how much life insurance they needed and why whole life was not a good solution for them.

We then examined their investment accounts. The advisor they had worked with recommended variable annuities. While it's fair to say that not every annuity is bad, variable annuities can be quite complicated and are only rarely appropriate for individual investors. Dana and Elizabeth thought they had purchased the annuities for tax deferral. Dana is a high earner and wanted a way to defer taxation of her investments to sometime in the future, when taxes might be lower.

Unfortunately, two of the three variable annuities they purchased were in their IRAs. We explained to them that IRAs are automatically tax-deferred, i.e., there is no tax benefit to owning a variable annuity in an IRA. They were paying a lot of money for something they didn't need. We then analyzed their non-qualified annuity (a "non-qualified" annuity is simply an annuity purchased with after-tax dollars). Although these annuities can provide important tax advantages, in their situation it was an unnecessary expense. It took a few months, but we were able to help them surrender their annuity contracts and open new accounts for them that were both less expensive and simpler.

While it's true that financial products can be complicated and every family has different needs, it's very possible (and we believe essential) for investors to understand what they own and why. For Dana and Elizabeth, it took some time and effort to figure out what they needed and to make the changes. In the end, they realized that the right products don't have to be opaque, and that understanding what they own is valuable in and of itself.

5. Pre-retirement

Once your children are grown and emancipated, you can focus more on your own life and personal concerns. You are probably well along in your career, perhaps at your peak earning rate as a family unit, whether as a single or a couple. However, you can see the end of your working life approaching, whether you like it or not.

As you begin to contemplate retirement, the most obvious questions are

"when?" and ***"how?"***

"When?" has both financial and non-financial components. From a financial perspective, you want to be sure when you retire that you'll be able to meet your financial commitments to your family and yourself. Ideally, you'd like to be able to maintain your living standard. You want to be confident that the assets you've accumulated, along with the income you are promised (mostly Social Security and pensions), will allow you to do just that.

From a non-financial perspective, it's complicated. Many factors play a role. How much do you like what you do for work? Do you have a clear idea about what you would do once you retire? Do you prefer that to what you do for work now? What about your partner? When do they plan to retire? Can you coordinate?

Perhaps the most important issue is what you would do after retiring. For many people, especially men, their identity and sense of self-worth links directly and strongly to their work outside the home. Without a similarly meaningful set of activities for you to engage in after retirement, you may struggle.

Then there is "how?". You could just quit "cold turkey," with the retirement party one day and full retirement the next. Or you could slow down or phase out, moving from full-time to 80% and so on. Yet again, you could move from a very demanding role to one that is either easier for you to manage or more fulfilling -- especially if you have been working at a job you don't like but can't afford to leave.

At this point in your life, you may have grown children who have not completely "launched." If this is the case, you need to decide how long to support your children, and in what ways. You might help with cellphone bills, health insurance, or even rent. This can give your child the opportunity to experiment with a strong safety net.

Your children are probably your most important life projects. You want very much to see them succeed. It is very difficult for you to watch them struggle. Your biggest challenge at this point is to identify how best to be helpful. It can be difficult for you to choose between helping your children financially and ensuring that you will be able to live comfortably in your own retirement.

Long-term care insurance. Long-term care is not medical care, but help if you find it difficult or impossible to live independently. You probably won't need long-term care in the pre-retirement phase, but you may have the experience of helping to care for or manage care for your parents. If this is the case, you know that long-term care can be very difficult and very costly.

LTC Approach	Advantages	Disadvantages
Family Delivery	Familiar relationships; less costly to you	Financially and emotionally burdensome for caregiver
Self-Funding	More control over quality of care	Risk of depleting assets prematurely; less to leave to heirs
Medicaid (for the impoverished)	Financial burden transferred to state	Lower quality of care
LTC Insurance	Preserves retirement assets; offers peace of mind; more likely to seek care	You might never use the benefits

If someone you love needs long-term care, they can receive help at home, in assisted living, or in nursing facilities. You and your family can deliver care yourselves, or you can hire professionals. If you hire professionals, you can pay for the help yourself, use long-term care insurance benefits (if you have them) or depend upon the state through the Medicaid program. The table provides an overview of the pros and cons of each approach.

Craig and Joan

By Laura Williams, Junior Financial Advisor

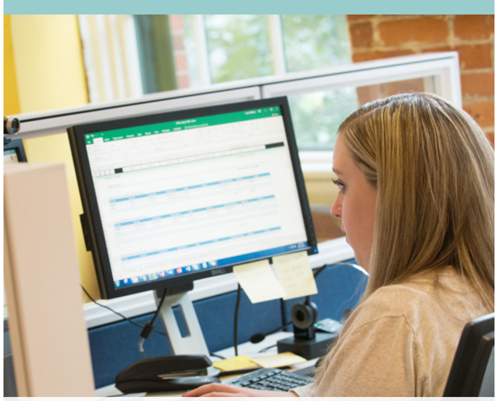
Craig and Joan contacted a financial advisor to gain clarity on how major life decisions would impact their living standard. Craig had used financial planning software himself in the past but wasn't sure if he was using reasonable assumptions.

Craig and Joan wanted a financial plan to address the following questions:

- *Could Craig retire at 56?*
- *Could they afford to purchase a bigger home?*
- *Could they afford for Craig to change his job and move to a different state?*

The analysis in their financial plan allowed Craig and Joan to understand how different retirement ages and earnings would affect their sustainable living standard as well as their ability to purchase a larger home. It turned out that Craig probably could retire at age 56 if he stayed at his current job and they continued to live in their current home. Pushing out the age of Craig's retirement allowed for more financial flexibility and the ability to purchase a larger home.

Craig also got advice on some of his employee benefits including a pension plan and a deferred compensation plan. Taking his pension as an annuity stream would allow for an additional source of guaranteed income in retirement that would continue for as long as he and Joan lived. Craig's employer also offers a deferred compensation plan. This plan provides Craig with a method to move income to a later date. For Craig and Joan, this would allow them to defer income from their current high marginal tax bracket into a lower tax bracket once Craig stops working for his current employer.



Laura Williams
Junior Financial Advisor

Their financial plan also highlighted risks and helped identify methods of mitigating those risks. For example, Craig's group long-term disability insurance policy covered only about one-third of his total

6. Early retirement

Even after you retire, you still have to make financial decisions. One change dominates the landscape – your earned income stops! There is little if any steady, predictable income comparable to the paycheck you were used to. It becomes harder to calibrate if you are living within your means. You have assets – the savings that you so carefully accumulated. But how do they relate to income? How much can you safely draw?

Social Security benefits are something of a bridge between your working life, with the steady paycheck, and your retirement, when you are drawing down savings. Choosing when to start Social Security benefits is your first retirement financial decision.

Your benefits represent regular income, and starting benefits early appears to be an attractive option. After all, you paid taxes for a long time to be eligible for Social Security, and your benefits don't seem to increase much if you wait to take them. The standard analysis calculates the payback period for waiting to start your benefits – you have to live into your eighties to make waiting pay off.[3]

Hold on! Social Security isn't just income, it's insurance. You will receive benefits as long as you live. That sounds just like a pension, and it is. The standard analysis doesn't recognize the insurance aspect of Social Security. The more direct comparison for waiting to take your Social Security benefits is to an income annuity. When you do this comparison, waiting to take benefits until you are 70 is the winner, hands down! Of course, comparing Social Security to an annuity assumes that buying an annuity would be a good choice for you. That won't be true if you have a significantly shorter than average life expectancy.

There are a few actions you can take with your assets that make it easier to understand how much income you will have available -- without the risk of running out of money. You could choose to annuitize assets – that is, you could buy an income annuity that will provide regular (usually monthly) payments for as long as you live. You could also purchase a bond ladder, a set of bonds scheduled

[3] *By the way, it is extremely likely that you'll live well into your eighties and even beyond, especially if you are a non-smoker and you have a college education.*

to mature each year. If those bonds are TIPS (Treasury Inflation Protected Securities), they will provide you stable purchasing power, unaffected by inflation. Both of these mechanisms (annuities and bond ladders) turn your assets into predictable income.

Once you've gotten a better sense of your income, you can think about how to spend it. You'll probably want to do things that you didn't have time for when you were working and raising your children. If you have children, grandchildren may begin to arrive and vie for your attention.

You may decide that you want to change where you live, and this will have a major impact on how much you spend. You may have a relatively large home when you retire. You've raised your children, and you probably chose your home with that in mind. Now that your children are grown, you may not need such a large place.

In addition to considering how much space you need, you may also think about where you want to live – someplace warm? Near your children? In the city? Apartment or single family? All of these possibilities will have financial implications. Some will require more capital, and others will have larger ongoing costs.

You'll also want to consider whether you want to spend at a higher rate early in your retirement. You'll probably have more energy now than later on. You'll be able to do more travel and other activities that take stamina, and do them more easily than you will in the next phase of your life. This can require some careful planning to ensure that you don't spend so much now that you threaten your ability to live comfortably later on.

7. Late retirement

Your energy diminishes as you get older. Thinking and planning carefully about where you would like to live, seriously considering the choices available, and making a move while you can are essential elements of successful financial planning in this life stage.

Your living arrangements may change. You may find that you don't have the energy or the desire to maintain a home, condo or apartment. You may consider moving into senior housing, including independent living and assisted living. The advantages can be

earnings. If Craig were to become disabled, their family would experience a substantially reduced living standard. Craig decided to obtain an individual long-term disability insurance policy to protect more of his earnings and to purchase retirement plan protection insurance to provide coverage for his and his employer's retirement contributions.

Craig and Joan also decided to retain their financial advisor for portfolio management and ongoing plan updates as their personal circumstances and goals change over time. While Craig is an accomplished analyst, they both find it helpful to have an objective and experienced third party help them think things through.

Arlene
By Rick Fine, Senior Financial Advisor

Arlene, a 70-year-old widow, lost her husband to cancer five years ago. Although she had been through the grieving process and was ready to face the world again, she constantly worried that her money would not sustain her throughout retirement. Her husband had been the sole wage earner and had saved as much as he could while working. He also managed the family finances while he was alive. However, their investment portfolio had taken a beating during the 2008 market crash, and in hindsight some of the investments he had made were questionable, which made the losses even worse. When he died, Arlene felt totally overwhelmed by her investment portfolio, not having been involved in the process from the start. Truth be told, she was scared to death about money and was convinced she would end up, in her words, "a bag lady". So, at the urging of a friend, she decided to seek financial advice.

We began with a full inventory of her assets, liabilities, income, and expenses, and then helped Arlene prioritize her goals – things she would like to accomplish over the course of her life. The first item on her list was to sell her

significant. Support is readily available. In many cases, a dining room provides meals if you don't want to cook. A ready-made community makes it much easier for you to enjoy a fulfilling social life.

On the other hand, you may have planned your home with the difficulties that can emerge in this stage firmly in mind. In the Boston area there are several neighborhoods that are striving to be excellent places to age in place. Beacon Hill Village was one of the first in the country, and now there are others.

Given the choice, you would probably prefer to remain at home. But home (the home you raised your children in, the home you retired to) is not always a good option. It may be more than you can manage. It may have stairs that are now daunting or even dangerous for you to climb. It may be very expensive for you to get the help that you might be loath to admit you might need. You may find it difficult to maintain social connections – it's harder to travel to see your friends, and it's harder for them to visit you.

You don't want to wait too long before you make a change of this sort. Change is hard, and it's even harder if your energy levels are lower than they used to be. Moving takes a lot of energy – deciding what to keep, packing it up and getting rid of the rest. Deciding where to go also takes a lot of energy – making a list of options, visiting them all, picking the best one, making the agreements, writing the check.

If you put this decision off for too long, however, you may find that you do not get to choose, that the decision is made for you. If you are injured in a fall or become ill, your physician may say that it is not safe for you to return home. Then someone other than you will have to choose a place for you to go, and it is unlikely to be the place that you would have chosen.

You also do not want to be a burden to your children, if you have them. Unfortunately, getting to the point where you must move but cannot do it by yourself is doing exactly what you say you don't want. Your children want you to be safe and happy, and they worry when you're not.

You may also find it helpful to have arrangements in place for assistance with your financial and healthcare decision-making.

Financial decision-making and even just paying the bills can take more energy than you would rather devote to them. You may find that you are just less interested in your finances. It is also true that while your confidence in your financial wisdom may grow as you get older, your ability to make decisions in your own best interest may diminish somewhat. This can be a risky combination.

This is an area where your children can be helpful, if they are willing and if they enjoy your confidence. Or, it may make sense for you to hire a professional to help.

Similarly, you may find yourself in a situation where you simply can't make decisions about your own healthcare. Here is where having your healthcare power of attorney document up to date, and having in-depth discussions with the person(s) who would be making decisions on your behalf really pay dividends.

As you reach late retirement, you've been to many of the places in the world you'd like to go, and you've done many of the things you'd like to do. As you approach the end of life, you begin to think about your legacy. What will you leave your children, grandchildren and other heirs, both in financial and non-financial terms?

Your estate plan specifies which of your assets will go to each one of your heirs and to any charities you may wish to support. Speaking directly with your family and loved ones about your wishes can be a greater gift than the assets themselves. Inheritances can have great emotional resonance, and by their nature, you will not be there to explain what you meant when your heirs receive them. You can ensure that everyone understands by telling them directly. Individual and, even better, family meetings with your children and other heirs can be very meaningful ways to communicate what you want and why. You can anticipate and address potential disappointments, and most importantly, you can identify and possibly rectify any conflicts that might otherwise occur.

You have experienced much and learned a lot in your life, and your family can benefit only if you are willing to share. Written down or recorded in audio or video form, your important memories, your values and the lessons you have learned allow you to share your accumulated wisdom with your loved ones, and with generations to come. Strictly speaking, this is not financial planning – it has nothing to do with money. Broadly construed, however, your wisdom and memories are a very valuable asset, a wonderful gift for your family.

large suburban home and move to a more manageable one-floor condo in the city where she could take advantage of everything the city has to offer. Her home, as it turned out, increased in value over the decades she lived there and provided her the flexibility to buy a smaller home with money to spare. Arlene contacted a real estate agent to determine a price range for a condo she would be comfortable living in. A cash flow analysis of several housing scenarios told her that she could afford a mid-range condo in the neighborhood she was interested in, leaving enough financial assets to maintain her current lifestyle. She wouldn't be rich, but she could be comfortable. After months of searching, Arlene finally found the perfect place for her and her two cats. With the housing market on a tear, she was able to command top dollar for her suburban home within a week of putting it on the market. She paid cash for her new home and was thrilled with her purchase.

The second item on Arlene's list was to feel more secure and stop worrying all the time about her finances. The stock market gives her the willies. After exploring alternatives, she sold some of her mutual funds and bought an inflation-protected bond ladder – U.S. Treasury Inflation-protected *bonds with varying maturity dates. The bond ladder generates safe, predictable income that preserves purchasing power over time (important for retirees concerned about inflation eating away at their nest egg). The bond ladder does not depend at all on stock or bond market performance, as long as you hold the bonds to maturity. Both the bond's principal amount and the semi-annual interest income adjust upward with inflation. Along with Social Security (the best inflation-adjusted income source around!), Arlene would have a stable income floor to fund most of her non-discretionary spending for the rest of her life. She then invested the "discretionary" portion of her portfolio in a less stock-heavy allocation of low-cost mutual funds for some potential upside.*

Once we put the plan in place, Arlene's money worries subsided considerably as she saw her bank account fill up every month with Social Security income and income generated by the bond ladder. She can't spend it fast enough. Whereas she used to call weekly in a panic about money, now her advisor rarely hears from her. When they do talk, she is usually about to go out and do something fun in the city. She is having the time of her life.

Summing up

Financial planning need not be complicated. Much of it is arithmetic – living within your means, managing your cash flow. Your focus should be on what you can best control – your human capital and your saving and spending decisions – rather than on what you can't. For example, your investment performance will be whatever "the market" allows (an unpredictable and uncontrollable mystery).

We have discussed how you can make the best use of your financial resources to enrich your life. Money is not an end in itself – it is valuable only for the experiences it supports. It is very sensible to use your earning power in a balanced way to support the life you want, and to accumulate assets so that you can educate your children and enjoy a comfortable retirement. By the same token, investing is a mechanism for you to transfer purchasing power from the time you earn it to the years in which you want to spend it. Your earning power, not your investing acumen, largely determines your financial wealth.

It is wise to protect yourself against misfortune, managing insurable risks with appropriate insurance products and avoiding unnecessary investment risks. A few carefully selected and constructed legal documents suffice to protect you and your family in the event of unexpected disability or premature death.

Unfortunately, financial planning is not magic. It can't make you rich. It can't spin straw into gold.

Fortunately, however, a sensible financial plan can help you find peace of mind. Life is too short to worry about money.

Rick Miller
Founder

Thank You!

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