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The first edition of The Savage Truth on Money *was named one of Amazon's "Ten Best Money Books of the Year."*

TERRY SAVAGE is the nationally syndicated personal finance columnist for Tribune Content Agency, a regular on national television and radio, and the author of four best-selling personal finance books. She has won the National Press Club award for Outstanding Consumer Journalism. Terry's expertise comes from experience. She was a founding member of the Chicago Board Options Exchange, and a member of the Chicago Mercantile Exchange's International Monetary Market. She serves on the Board of Directors of CME Group, Inc. Visit Terry's website to post questions and read her latest columns.

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TERRY SAVAGE

Nationally Syndicated Financial Columnist

The SAVAGE TRUTH *on* MONEY

THIRD EDITION

THE SAVAGE TRUTH ON MONEY

THE SAVAGE TRUTH ON MONEY

Third Edition

TERRY SAVAGE

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For Harry

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PREFACE

A simple Savage Truth opened the first edition of *The Savage Truth on Money*: *If it were that easy to be wealthy, we'd all be rich.*

It's a lesson that each generation must learn for itself—whether it's a belief that home prices can never decline, that stock prices won't drop, or that student loan debt will assure financial success. Every unrealistic expectation includes a nugget of fact—but the most basic fact is that you cannot ignore the truth.

Today, technology is a good example. Yes, blockchain will definitely change the world, bringing speed, security, and efficiency to global transactions. But Bitcoin and other cyber-currencies are unlikely to make you rich overnight. Or marijuana may be legalized, but most cannabis stocks will likely provide "wealth" that goes up in smoke.

Every generation finds its own easy ways to get rich—or live as if it were rich. At one time, it seemed simple to make a fortune in the stock market. That was before the 1929 stock market crash, or the bursting of the dot-com bubble in 2000.

Then it seemed easy to get rich in real estate, not only on your own home, but by buying and "flipping" new homes and condos. And if you didn't invest your way to easy wealth, you could always borrow your way to riches—living beyond your means via home equity loans and credit card offerings. That unrealistic hope crashed in the financial crisis of 2008.

Sadly, every generation learns its own lessons about unrealistic expectations the hard way.

It's an old SavageTruth: The lessons that cost the most, teach the most.

At the peak, there is unrealistic optimism. Then, dreams and illusions are shattered, and a sense of pessimism abounds. The Savage Truth is that neither extreme is correct, but we are always carried to extremes by our own belief that what is current will continue into the future. That's why we need to understand the basic Truths about money, markets, and human emotions.

Truths don't change like fashion or emotions. The Savage Truths you could have learned in the first edition of this book have not been dented by the market volatility or economic boom or recession. That's not to say you could have avoided all the negative impacts of the past decades. But those who were unable or unwilling to see the basic Truths found that their personal finances took a much larger hit than those who had more perspective and more discipline.

The first edition of *The Savage Truth on Money* was written before the dot-com bubble burst. The second edition came out after the global financial collapse and the mortgage crisis, which shook our faith in financial institutions and our own financial future.

We are entering a new cycle. Since the last edition of *The Savage Truth* America's national debt has grown from $14 trillion to $22 trillion! It's a number that is impossible for the human mind to conceive and will likely be almost impossible to repay. (If you want to know the real dimensions of our debt, which includes earned promises to future Social Security and Medicare recipients, go to www.TruthinAccounting.org. The number keeps relentlessly ticking higher, and is more than $118 trillion at this writing.)

Global belief in the strength of America is based not only on our economic and military might. It is rooted in a global acceptance of the U.S. dollar as the "medium of exchange."

That strength helped us lead the world out of the global crisis in the first decade of this century. And now, despite attempts to withdraw or set barriers, we are inextricably linked to the rest of the world through global trade interdependency. There are few places to hide. So you must remain alert when thinking about what to do with your money.

That doesn't mean you have to be an economic expert or a daily market trader to manage your money successfully. Quite the contrary; *The Savage Truth on Money* is designed to help you create a financial plan for your future—using all the resources of technology, the best people in the financial planning industry, and your own good judgment based on sound principles and basic Truths.

Understanding these Savage Truths won't change the economy. That is a function of political power and human nature. But knowledge and perspective can change your financial future and allow you to be successful, or at least to survive, the changing times in which we live.

These Truths are even more relevant today. Context may change, but principles remain the same. We've become more accustomed to technology, more used to instantaneous access to financial information, and more accepting of the fact that every day brings a new financial decision. But human nature has not changed, especially when it comes to money.

You may be skeptical that these Truths will still work in the "new America." We've seen people who played by the rules lose their homes as real estate values collapsed. We've seen hardworking employees lose good jobs as technology replaces human resources. And we've seen students graduate from college with insurmountable debts—a burden that keeps them from contributing to economic growth by purchasing homes and starting families.

Yet, in spite of the headlines and discussion about the extremes of wealth and poverty, the American dream is not dead. It is being reinvigorated by the creative and inventive spirit of our people, who are building new businesses and creating new products and services. The American Dream was never about "getting rich quickly," despite the headlines of tech billionaires today or the robber barons of the late nineteenth century. The real strength of our country is created by hard-working people who follow basic principles of slowly building long-term wealth through productive work, savings, and investing.

In every economic cycle, those who were most devastated were living beyond their means, borrowing on their homes, taking on unprecedented debt, and demanding more from their government. We are approaching that point again today. Consumers have once again taken on more debt than at the 2008 peak. Student loan debt is more than $1.5 trillion. And I have already highlighted our national debt.

Our entire economy—from individuals to state and federal government—have violated the most basic Savage Truth that headed Chapter 1 in the first edition of this book and remains unchanged: *Live within your means. Don't spend it all.*

Think of how different our economy would be if we had all learned that lesson, especially both parties in Washington! It's a story as old as the grasshopper and the ant—and the moral remains the same: During the good times, prepare and save for the tough times or they will devastate you.

Now we begin a new cycle. Are you prepared? Have you hedged your bets on your financial future? Are you ready to be a survivor who goes on to become even more successful in the next economic boom? Only by taking responsibility for your own financial future will you have the resources to help others who do need our help.

There *will* be good times ahead for America, make no mistake about that. Surely your grandparents, or great grandparents, who may have lived through the Great Depression of the 1930s, must have been pessimistic about the future. Similarly, those who faced a deep recession in the early 1980s—with interest rates at 20 percent and unemployment at 12 percent and the Dow Jones Industrial Average under 800—found it difficult to believe our economy would recover, and even boom.

In the global panic of 2008–09, which sent the Dow down to 6700, few were predicting a recovery that would send the stock market soaring to 27,000, push unemployment to record low levels, and create low mortgage rates not seen since the 1960s. Back then, few had enough belief in the future to keep investing in stocks when the outlook was gloomiest. But those who did believe in the future—and invest for it—were well rewarded.

Now if *you* give up in the midst of the current unsettled economy and political divide, you're likely to miss out on the next great economic upswing.

It's a Savage Truth: *No one ever got rich betting against America.*

Sure, you might at some points want to hedge your bets—on growth, on the dollar, and on your career. But never give up believing in a better future for yourself, your family, and our country.

By now, we've all learned the Truth about believing that "this time it's different." The financial lessons of the past decade prove a simple Savage Truth: *Human nature never changes.*

To be financially successful requires that we withstand the emotions that destroy financial plans and goals. We must understand the lessons of the market and then create plans that control our natural tendencies to be motivated by fear and greed. But all of that is a waste of energy without the self-discipline to stick with those well-made plans.

Perspective is critical. We can always see our mistakes in hindsight. Now it's time to look forward, recognize the new realities, and apply the Savage Truths to create a prosperous future for ourselves and our country.

THE SAVAGE TRUTH ON MONEY

CHAPTER

THE SAVAGE TRUTH ON GETTING RICH

Financial Security Demands Smart Choices

Everyone wants to know the secret of getting rich. And lately, people are wondering if it's even possible to get rich—or at least to live well and then retire confidently. The perceived wide differences between the ordinary American and the very wealthy have created not only financial but political divisions that seem to threaten our future. But those divisions mask the opportunities that are still very much in existence and will be the foundation of our next wave of prosperity.

America faces real challenges, given our country's burden of debt and our political extremes. It's tempting to give up, to forget that this is not the first time America has surmounted challenges and gone on to prosperity.

So here's the Savage Truth: *The American Dream is still within reach.*

Achieving financial security will require personal traits that have always worked: optimism, persistence, and self-discipline. If you're willing to try, or try again, you can succeed. You need only to understand the basic Truths, which have not changed despite market volatility, economic uncertainty, and divisive politicians on both sides of the aisle.

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It's a tribute to America that over time there have been many roads to wealth in this country, and they are open to all. It may seem as if barriers and inequities have increased in recent years, but in fact, quite the opposite is true. Technology has given access to new ways of educating our younger generations, who are no longer subject to the limitations of neighborhood schools to find knowledge.

Access to higher education (despite the burden of student debt) has given opportunity to build careers and fortunes in areas incomprehensible to the baby boom generation. (Okay, how many of you boomers know that participants in eSports gaming earn six figures and are sponsored by major corporations?)

Forget the Forbes 400 list of wealthy Americans. There are 183 tech billionaires on the Forbes most recent list—and they control more than $1 trillion of wealth. Nearly half are Americans, but the Chinese are catching up. Most have been minted in the past 30 years of our technology revolution, and very few started with inherited wealth.

Youth seems an asset, not a barrier to creation of great wealth. Bill Gates was in his early 20s when he and Paul Allen founded Microsoft, and he was a billionaire by age 30. Michael Dell founded his computer company at the age of 19, and by age 34 was worth $16 billion. Jeff Bezos quit his job at age 30 to found Amazon. And Mark Zuckerberg famously started Facebook in his Harvard dorm room.

Today, all are deeply involved in giving their fortunes away to good causes, as well as continuing to grow their businesses and seed others with venture capital. All had those three basic characteristics: optimism, persistence, and self-discipline.

But the path wasn't easy. They started in a slow-growth economy, weathered booms and busts (think dot-com in 2001 and global financial crisis in 2008), but they never gave up.

The Savage Truth: *Even in tough economic times, entrepreneurs with good ideas can build companies that defy the most pessimistic mood of the nation.*

There is no one template for success in America, but building a business does require an entrepreneurial spirit born of optimism. In America, age, race, and gender do not stand in the way of success—nor does the economic climate.

As entrepreneurs build businesses, they create opportunities for others—either by creating jobs or by selling shares to public investors. Even as jobs in more traditional manufacturing have disappeared, millions more jobs have been created by today's new technology entrepreneurs and the businesses that develop around their technology. That's how success spreads and an economy grows.

And that growth opens the door to your own personal opportunity to create wealth. While you may not start a billion-dollar company, you can invest in those who do. And, you may find a career path that suits your own talents and enthusiasm.

Technology has truly leveled the playing field by illuminating the opportunities for individuals to profit while providing services and cutting costs for those they touch. Progress is painful for those who cannot change—but it's empowering for those willing to embrace the future. Whether it's blockchain or a cure for dread disease or simply a safer way to drive a car, technology is changing our lives, quickly. And it's impacting financial services dramatically, spreading knowledge, creating cost efficiencies, and saving money for investors.

So whether you're a retiree wondering if your investments will carry you through your life expectancy or a college graduate looking for the best way to pay off your student loans, an employee trying to choose appropriate funds in your 401(k) account or a young parent trying to save for college for your children, technology will help you achieve your goals.

Yet, while technology is changing the game of wealth creation, it cannot overrule the human element. It can provide tools to structure your future, but only *you* can provide the human ingredients that are the basis of the Savage Truth.

First, though, you need the capital to invest. That's a matter of simple mathematics.

You *Can* Get Rich on a Paycheck If You Don't Spend It All

There are two simple rules for amassing investment wealth:

1. Spend less than you make.
2. Invest the difference—both money and time—to maximum advantage.

Here are two stories that illustrate these truths:

RETIRED SECRETARY LEAVES $18 MILLION TO HOSPITAL

Chicago *Sun-Times*—A secretary who made her fortune investing bonuses from her salary, which hit an estimated high of $15,000 a year before she retired in 1969, left her fortune to Children's Memorial Hospital. Few friends suspected that Gladys Holm, who lived in a modest two-bedroom apartment, was wealthy.

Holm's boss, the company's founder, had advised her to invest her yearly bonuses in the stock market, a longtime friend said. "If he bought a thousand shares of some company, Gladys would buy ten shares of the same thing. Nobody gave her that money; she earned it."

NEW YORK UNIVERSITY TO GET ONE-FOURTH OF COUPLE'S $800 MILLION ESTATE

Associated Press—Professor Donald Othmer and his wife, Mildred, lived modestly in a Brooklyn townhouse and rode the subway. In the 1960s, they each invested $25,000 with an old friend from Nebraska, Warren Buffett. In the early 1970s, they received shares in Berkshire Hathaway, then valued at $42 a share. When the couple died at ages 90 and 91, the stock was worth $77,200 a share—making their fortune worth an estimated $800 million.

All of these successful investors lived modestly all their lives. At no point did they decide it was time for an expensive vacation, an impressive vacation home, or even a new car. Thus, they were able to accumulate, invest, and leave behind a huge fortune. Surely, there must be a happy medium between living daily on credit card debt and dying with a huge fortune. Most people I know would like to live in that middle ground.

There is one other similarity to note: Neither Gladys Holm nor the Othmers had children. Children may be nature's way of making sure that we can't possibly die with a fortune!

Most important—neither Gladys Holm nor Professor and Mrs. Othmer ever sold any of their stock. Think of the temptations. As their fortunes grew, there was surely the temptation to spend just a little of their profits. And at times of stock market crisis, surely there was a temptation to sell and cut their losses. But they stuck to their long-term plan.

Don't doubt that this kind of investment success can happen again in the coming decades. Think what a great leap of faith it was for these ordinary people to invest in an uncertain future. Their profits were built slowly, but were accelerated by the fact that they were investing when others were skeptical.

Today's true headline success stories are the current generation of technology entrepreneurs. They built businesses, and their wealth is scored by the value of the stock they sold to the investing public and the shares they still hold. But behind each "overnight" success story is the truth that they followed the two principles at the top of this chapter. They lived frugally—primarily because they were too involved in their businesses to spend time on recreation and consumption. They also invested their resources, mostly their time, in building their businesses.

Steve Jobs, who founded (and later rescued) Apple, was renowned for starting the business in his garage. Only *after* his company proved itself did he share in the rewards. Bill Gates built his mansion after he built Microsoft. And then he started giving his money away through strategic philanthropy. Mark Zuckerberg and his wife Dr. Priscilla Chan have vowed to give away 99 percent of their Facebook stock to a charitable foundation they started. And Jeff Bezos is giving $2 billion to homeless charities and not-for-profit preschools, while his ex-wife, Mackenzie Bezos, has promised to give half of her $36 billion in Amazon stock to charity.

At some point, it's not the money that motivates. As one successful entrepreneur remarked to me on the occasion of a new accomplishment: "After a certain point, it's not the money. It could be lollipops. It's just the way you keep score!"

For most of us, it *is* the money. We need it to take care of our families, to put our children through college, to plan for retirement. But we can take lessons from these success stories. And even if we may not reach that pinnacle of great wealth, we can participate. It would be nice to give money to our family members who need it, or to causes we value.

There's no question that their inherent brains and timing (sometimes referred to as luck) helped make these entrepreneurs rich. Their success stories are notable because they took a relatively short time to build dramatic wealth. But they followed the basic principles: They invested their time and money *before* they reaped the rewards. Yes, they dreamed, but they didn't buy lotto tickets or create extravagant lifestyles before they were financially successful. They worked to turn their dreams into reality instead of living as if their dreams

had already come true. And they didn't quit when things got tough. Many of those tech multimillionaires (even billionaires) saw their paper fortunes melt away in the stock market declines of 2001 and 2008. Others lived through the declines and went on to amass even greater wealth.

It's a Savage Truth: *Persistence pays.*

So, how can the Savage Truths in this book get you on track—or back on track—to financial security? Life doesn't come with guarantees, but it does come with opportunities.

The secret of getting rich is to make choices that help your money work *for* you and stop working against you. If your money works at least as hard as you do, and if you have a sensible plan you can stick to, over time you'll come out a winner. And that's the Savage Truth.

The Savage Truth on Your Relationship with Money

Money Is Power

Before you make any investment or saving decision, before you set financial goals or choose a career, you must come face to face with the power of money in your life. Your relationship with money must be reevaluated as you reach different stages in life. Only by facing money issues directly can you become comfortable with so many other personal decisions that confront you.

In an earlier era, it might have been possible to coast along, expecting pay increases and a comfortable lifestyle that would lead to retirement. Now we've all seen a compelling demonstration of the importance of financial security, and the importance of financial planning. The millennial generation will be forever changed by the steepest recession since the Great Depression. Today's children will never take money for granted the way their boomer parents might have done. And out of these experiences comes a new respect for the power of money.

Recognizing the power of money can be exhilarating or intimidating. If other people have money, and therefore a degree of power over your life, you may react negatively. If your boss holds the power of the paycheck, you may feel forced to work certain hours or perform unpleasant tasks. If your parents hold the power of the purse, you may feel coerced into making concessions about your lifestyle.

However, if *you* have the money, you are empowered to choose how you spend your time as well as your cash. You may choose to work even harder, to enjoy more leisure, to become philanthropic or artistic, or to devote more time to making your fortune grow. Money certainly isn't the only powerful force in your life, but having money can empower you to take greater control over your lifestyle.

Saver or Spender?

You know who you are, when it comes to your money personality. Are you a *saver* or a *spender*? I'm not quite sure where our money personality is created. It could be from the experiences you had as a child. But, then, how do you explain two children, growing up in the same household, who have completely different money personalities? Give each an allowance, and one hoards every penny while the other can't wait to go to the store!

Whether it's determined by heredity or environment, by this stage of your life your money personality is firmly ingrained. If you realize how hard it is to change yourself, you'll know how impossible it is to change your spouse or partner. So the entire concept of money management is to set up systems to deal with your inner self—your fears, your compulsions, and your desires. If you can channel all that energy into a disciplined plan, you can be successful financially no matter what your basic personality traits.

The Most Powerful Money Emotions Are *Fear* and *Greed*

Decisions about money unleash these two powerful emotions, which are frequently the cause of financial downfall. Noticing the symptoms and gaining the courage to surmount these emotions is the first task in managing money. Lack of emotional control will negate all the benefits of good advice and good planning.

Greed is understandably dangerous because it is the emotion that makes us take risks we cannot afford. Greed convinces us that we *need* instead of simply *want* to make that purchase. Greed urges us to spend for today instead of investing for tomorrow. It can distort investment decisions and blind us to long-term consequences and risks.

Fear can be equally dangerous. Fear keeps us from taking appropriate risks or making changes to improve our lives. It paralyzes us

and blinds us to opportunity. Indeed, this paralysis can be an actual physical reaction to making money decisions. It's as difficult to conquer a fear of money as it is to rein in overwhelming greed.

These emotions may be triggered by our childhood conditioning about money, by cultural expectations, or by recent experiences with money decisions. There's no doubt that people have money personalities. By nature or nurture, they become savers or spenders.

Inside each of us is a small persuasive voice that dictates how we respond to fear and greed. Those twin emotions assault even the wisest investors and smartest traders. Taking control of your financial life requires not only knowledge of money, but also the self-discipline to use your knowledge to conquer fear and greed. What good is a financial plan if you don't have the self-discipline to stick with your decisions?

Self-Discipline Is the Essence of All Decision Making

Self-discipline should not be confused with self-denial. Self-discipline means making knowledgeable decisions based on a rational assessment of likely results and then sticking to your decisions in the face of emotional upheaval. That principle applies to every financial decision—from buying a car or a dress to investing in a stock or mutual fund. People recognize the importance of discipline when they turn to financial advisors for help—not only in determining the appropriate investment, but in sticking to that decision in the face of market reversals. It's human nature to seek advice, reassurance, and counsel about when to alter a decision based on new realities.

Can you do it alone? Most people are capable of managing their own finances, given the knowledge and tools that are now easily available. You'll learn how to use Quicken or Mint to gain control over your everyday spending and to plan for the future (see Chapter 2).

However, I know that many people who post their questions on my blog at www.TerrySavage.com are overwhelmed by their relationships with money. Just as all the desire in the world cannot help alcoholics or gamblers to overcome their compulsions, all the investment books and rules cannot make the fearful bold, or the greedy self-controlled.

Help is available in many forms. As you'll see in Chapter 3, there are several national, nonprofit consumer credit and spending counseling services. Your local community college may offer classes or

help in setting up a budget and managing your money. Later in this chapter I'll show you how to find a qualified and certified personal financial planner *who will put your interests first.* Automatic monthly investment plans can create the structure to override your emotions and build an investment program, just as automatic deductions can be used to cope with debt repayment.

Keep in mind that knowledge is one ingredient of your relationship with money, but conquering your emotions is quite another aspect of financial success. Smart people do fail, but failures can always be overcome. Impulsive and irrational people rarely find financial success.

Bulls, Bears . . . and Chickens—Your Relationship with Money Is Unique

No matter how smart your advisor, or how sophisticated your investments, your personal relationship with money is unique, and it affects the decisions you make. No one else has quite as much insight into your desires, anxieties, and tolerance for risk. The most difficult task is to step back from your emotions and calculate the risk it is appropriate for you to take.

This is a process of self-discovery that I have long referred to as "sorting out the bulls, the bears, and the chickens." In any financial market, the *bulls* invest believing that prices will move higher, while the *bears* sell out in fear that prices will drop. But the *chickens* stay on the sidelines, unwilling or unable to risk their capital. There's a little bit of chicken in all of us, and it's nothing to be embarrassed about. In fact, those who had adequate savings were cushioned from the impact of the previous recession and job losses.

Sometimes it's wise to be chicken because you have a very short time horizon. If college tuition is due next fall, or if you're saving for a down payment, you don't want to risk investing in the stock market. Short-term losses could jeopardize your significant long-term goals. It's important to sort out the portion of your finances that can, and should, be exposed to the opportunities that risk provides. But it also takes discipline to set aside a portion of your assets and keep them safe from risk.

Sometimes you're forced to be a chicken because this is the only money you have. While it's tempting to risk doubling your resources in some exciting investment, you can't afford to lose even a portion of your capital. There's an old saying in the markets: "Desperate

money never makes money." The world is littered with losing tickets from racetracks and lotteries. Long-shots and jackpots make news when they pay off because it's so rare. Those huge lottery pools are created by all the people who buy losing tickets.

Risk and reward are two sides of the same coin, but unlike a coin toss, on which the odds are always 50–50, risk and reward are not always equally balanced. The science of money management is built around understanding your own tolerance for risk and acting when the rewards can objectively be considered to outbalance the risks. Unfortunately, this is not a subject for intuition.

At the top of the market, an investment seems least risky and most enticing. At market bottoms, it appears most risky to invest your cash—but hindsight shows that's just when you should have taken the risk. The big money is made—and lost—at the extremes. But an ongoing and disciplined program can keep you from being wrong at those turning points. And some "chicken money" sitting on the sidelines can give you courage to follow your plan.

Never be chicken out of ignorance. There are objective ways to balance risk and reward. Nobel Prize–winning economists created the concept of *beta,* a way of measuring inherent risk and volatility in individual investments. And computers can theoretically measure and limit portfolio risk, when markets run true to form. But no one has yet developed a way to measure the risk inherent in human emotions. So let's just set aside some "chicken money" and follow the old market saying: "Sell down to the sleeping point." If it keeps you awake at night, it isn't worth the risk.

The Savage Truth on the Consequences of Choices

In the midst of life's turbulence, you're reminded of the consequences of the big choices you made over the years: the choice of a college, a marriage partner, or a career, or a decision about having children. These turning points stand out as defining moments that changed the direction of your life. But small decisions, compounded over time, can have an equally significant impact on how your life turns out—especially when it comes to money. Little choices along the way have big consequences.

Your money can work *for* you or *against* you. It all depends on the choices you make. If you make the correct choices, even a small

amount of money can grow to become a powerful ally. If you make the wrong choices, your money will leverage its power against your own best interests. One thing to keep in mind: It's never too late to change course for the future.

Every day we're faced with money choices: *Spend or save*; *buy or sell*. They may appear to be decisions of the moment, but today's choices can have long-lasting consequences. That's because the consequences of our financial decisions are magnified over time.

Think of the problems NASA has in sending a rocket to Mars. Sure, the planet is a huge target. But if the navigation calculations are off by just a fraction of a degree at the launch, the rocket will miss Mars by millions of miles. Small errors, magnified by distance or time, can take you very far off course. Nowhere, except in astronomy, are those dramatic consequences illustrated better than when it comes to money decisions about spending versus investing.

My favorite story about choices shows the long-term effect of time on money when it comes to spending decisions. Suppose you charge $2,000 on your credit card this month and make only the required minimum monthly payments on your bill. At an annual finance charge of 19.8 percent and a $40 annual fee,

It will take you 31 years and 2 months to pay off that $2,000!

Along the way, you could pay an additional

$8,202 in finance charges.

If you had made a different decision, the results would have been equally dramatic and far more pleasing. If you had *invested* that same $2,000 in a stock market mutual fund that returned the historical average of 10 percent and placed your investment inside a tax-sheltered individual retirement account (IRA), in 31 years—about when you'd be paying off your final credit card bill—

Your IRA would be worth $38,389.

If you made that same spending-versus-investing decision every year and set aside $2,000 in your IRA for 31 years at the same rate of return,

Your IRA would be worth $364,000.

Special attention to twenty-somethings: If you started your annual $2,000 IRA contribution *now* and averaged a 10 percent annual return, in 50 years

Your IRA would be worth nearly $2.5 million!

This is a classic example of how small choices, leveraged over time, can change your life. You may not remember every small spending or saving decision as you look back over your life. They may not compare with the major life-changing choices you agonize over. But these small decisions reveal one of the greatest money secrets: *The power of time in compounding money*. Money makes money.

In recent years, regulations have offered some protections against many credit card practices, including requiring higher minimum monthly payments. Still, the average rate being charged on outstanding balances is 17.5 percent, and many consumers who have missed payments or charged over the limits are paying rates over 30 percent.

By way of comparison, the average long-term annual rate of return, including dividends, on large-company American stocks is 10 percent, going back to 1926, according to Ibbotson, the market historians.

The basic Savage Truth is more valid than ever: *Debt will destroy you*.

If you'd invested that money in stocks—over the long run—you would have come out far ahead, despite the scary setbacks in the market. And you can do that by putting your 401(k) money or IRA into an S&P 500 stock index mutual fund. (I'll show you how in Chapter 7.)

Sadly, too many people learned the lesson about the dangers of debt the hard way. Fortunately, America does not have debtors' prisons. Bankruptcy—a last resort—allows you to start over. But this time, learn the lessons and do things differently to get different results.

Here's a reminder of an important Savage Truth: *The lessons that cost the most teach the most.*

One Step at a Time

I've often told this story of how you could easily turn a $2,000 IRA into a million dollars or more by investing conservatively in a mutual fund that just matched the performance of the stock market averages. But some people who post at my website are buried in debt, wondering whether to take the bankruptcy route or continue to struggle with bills. Where would they ever find the money to make a monthly investment in the American Dream?

That's the problem with big numbers like a million dollars. They're so overwhelming. So let's make it more realistic. Just in case

you were intimidated about finding that $2,000 a year to set aside in your individual retirement account, let me point out that

$2,000 a year is only $38.46 a week.

Surely, you can adjust your spending—or your earnings—to find an extra $38.46 a week.

If you're already buried in debt, then an extra $38.46 a week will pay down $2,000 of your debt within one year, to say nothing of the interest payments you'll save. Perhaps finding that weekly sum will require working in a restaurant instead of dining out. Or consider sharing expenses with a roommate or friend. How much do you spend mindlessly on the Internet? A weekend or part-time job may bring in more money if you can't possibly cut back your spending. But don't give up, because it's always easier to earn more than to cut back.

Do you still think you can't afford to get out of debt and start investing for your future? Take a quick look at your paycheck. For sure, there's a deduction for Social Security taxes that's much larger than your $38.46 weekly target. You get along fine without that money—and you're not likely to see much, if any, of it at retirement. Doesn't it make sense to put an equal amount away every paycheck in a savings and investment plan that will pay off in the future?

A $2,000 debt seems relatively insignificant now, in an era when households average more than $7,000 in credit card debt (or nearly $136,000 if you include mortgage debt), and students graduate from college with an average debt burden of $37,000. But the principle remains the same: Break it down into monthly and then weekly chunks and attack the problem one step at a time.

In Chapter 3, you'll find specific resources for dealing with debt—from counseling you can trust, to bankruptcy procedures, to recognizing and avoiding scams such as debt negotiation offers. And even if bankruptcy is your only way out, you'll want to do things differently next time, so read on.

Time Is Money

You may have heard the story about the boy who was asked whether he'd rather have $5 million in 31 days—or 1 penny doubled every day for 31 days (see Figure 1.1). The boy chose wisely.

Day	Dollar Amount
1	$ 0.01
2	$ 0.02
3	$ 0.04
4	$ 0.08
5	$ 0.16
6	$ 0.32
7	$ 0.64
8	$ 1.28
9	$ 2.56
10	$ 5.12
11	$ 10.24
12	$ 20.48
13	$ 40.96
14	$ 81.92
15	$ 163.84
16	$ 327.68
17	$ 655.36
18	$ 1,310.72
19	$ 2,621.44
20	$ 5,242.88
21	$ 10,485.76
22	$ 20,971.52
23	$ 41,943.04
24	$ 83,886.08
25	$ 167,772.16
26	$ 335,544.32
27	$ 671,088.64
28	$ 1,342,177.28
29	$ 2,684,354.56
30	$ 5,368,709.12
31	$ 10,737,418.24

Figure 1.1 Growth of a Penny Doubled Daily

One penny, doubled every day for a month, will grow to $10,737,418.24.

That's certainly a huge consequence from a small choice. Although this book won't show you how to double your money every day, you will certainly learn how to invest very small amounts regularly to create dramatic long-term growth.

Taxes Impact Tomorrow More than Today

No one likes to see the bite that taxes take out of a paycheck or to compute the amount owed to the government every April. Despite the business and individual tax cuts enacted in December 2017, federal spending continues to soar. More than $1 trillion of that annual spending in recent years has come in the form of deficit spending—money borrowed by selling IOUs—Treasury bills, notes, and bonds.

And as our population ages, more of this annual spending becomes nondiscretionary. Currently this non-discretionary

spending consumes 70 percent of the federal budget. Within a very few years, government spending on mandated programs and promises such as Social Security, Medicare, Medicaid—and interest on the national debt—will consume every penny of income taxes collected. That will leave nothing for national defense, roads, education, or any of the other programs we'd like government to provide.

We confront some devastating choices as a nation. While income tax *cuts* could help our economy grow out of its problems, the political reality is that Congress is likely to increase taxes in your lifetime. Or they will push the Federal Reserve System to create more money, devaluing the dollars you've saved for retirement.

That turns some standard investment advice on its head. You'll want to plan ahead for the potential impact of inflation on your retirement savings. Since we save and spend in dollars, it will become very important to consider what those dollars will buy in 20 years or more.

When it comes to tax decisions, you'll also have to reconsider your historic plans. Traditionally, the idea was to invest in tax-deferred programs such as an IRA, because you assumed you'd be in a lower tax bracket at retirement when the money is withdrawn.

But if you believe income tax rates will rise in the future, you'd want to pay taxes now, and invest your money for tax-free growth, in a Roth IRA, for example. At the very least, you might want to split some of your retirement savings into before- and after-tax types of plans.

Whether you save pre-tax or after-tax, the most important thing is to *save*. Set some money aside from every dollar you make. Later in this book, you'll learn how to hedge your bets on the buying power of those dollars in the future. (More on that in Chapter 7.)

The Savage Truth on Goals and Choices

Now that you know financial independence is within your reach—if you make the correct choices—it's time to set some personal financial goals. These are your most important choices because they create the framework for all your other investment and lifestyle decisions. These are the beacons to keep you on target; they are the guardrails that keep you from taking emotional wrong turns. Your goals are your most personal financial decision.

Whether your goal is getting rich or simply having financial security (which I define as not waking up at night worried by money issues), it's important to define that goal on your own terms. Take a moment to think about your own definition of being secure enough to not worry about money on a daily basis.

For some people, financial security is defined by being out of debt; others total up the amount of their investments to get a perspective on their current and future situation. Some people define financial security as being able to live for six months to a year without a job; others define it as having their money last as long as they do—a secure retirement income.

Some may put a specific dollar figure on their target; others recognize that the possibility of inflation or changing health needs requires a flexible financial cushion. For some, getting rich implies having enough money to do whatever they want—and they have an extravagant list of wants. Still, most multimillionaires will tell you that money can't buy freedom from problems.

The best—and worst—thing about setting goals is reaching them. That means you have to set new, higher goals. Keep in mind when setting goals that you're posting both a target and a direction. You may reach milestones along the way to your ultimate goal of financial freedom. The day you've paid down all your debt will certainly be an exhilarating one. Now you can travel further down that same road, using the money you set aside to pay bills to start investing. I never heard anyone complain about retiring with too much money! I hope your biggest problem is that you've reached all of your financial goals.

Set No Goal You Can't Control

The key in setting goals is to set targets you can control. If your goal is to set aside a certain amount of money every month to pay extra on bills or to start investing, don't count on a pay raise to make it happen. A raise is up to your boss. But you could reach your goal by spending less on dining out each month. That's a decision under your control.

Since the whole idea of goal setting is to motivate yourself, you'll need some financial targets that you can reach in a far shorter period of time than it will take to hit more distant targets such as retirement. Start by listing your short- and long-term financial goals.

Your short-term goals might include paying off all your credit card bills or student loans. You might set a goal of saving enough money for a car or a down payment on a first home. Short-term goals might take anywhere from six months to five years.

At the same time, you should also be setting longer-term goals such as college for your children or retirement savings. Those numbers may seem larger, and more intimidating—but you have the advantage of time on your side if you start working toward those long-term goals now.

Tape your list of goals to your mirror, where you'll notice it every morning and evening. Your goals should be motivating, not intimidating. Be realistic about your expectations, and set goals in manageable increments. Your short-term goal of paying off your credit cards might start with paying off the highest-rate card, or the largest balance, first. Then move on to the next objective.

Remember: No matter what the time horizon or size of your financial goals, you'll never reach them if you don't get started. The first two letters of the word *goal* are "go."

A Goal without a Plan Is Just a Dream

Only in fairy tales do castles get built without a plan. In real life, you have to hire an architect to create a drawing and then engage the services of a builder to help you achieve your dream home. Then you have to have a reasonable financial plan to make your mortgage payments, consider rising property taxes, and have savings to pay for repairs. And as millions of Americans have now learned, you can't plan for rising home prices to automatically take care of these needs.

A financial plan is not engraved in stone; it can always be adjusted to fit your circumstances. But having a plan is the only way to put the odds of achievement on your side.

Life doesn't come with guarantees. When you define financial security for yourself, you'll need to make some assumptions. How long will you live? How much money will you need to maintain your lifestyle? How much will your investments grow? How much will inflation erode your savings?

Those projections will change as you redefine financial security and as the economy changes. You may have lifetime goals but be forced to revise your plan because of current events. Always keep your actions on track to meet your goals.

In Chapter 2, you'll find links to programs that can help you plan for the impact of inflation, or changing tax rates or investment returns, to help you decide how much you should be saving now.

Your financial plan is a framework that needs to be adjusted—but not entirely replaced—as circumstances change. If you are self-disciplined and willing to invest the time to stay current, you can certainly do this yourself. But you are likely to decide that you need professional help, if only to mitigate the emotion that can overwhelm you in both bull and bear markets, in good economic times and bad.

Finding Trusted Help

Don't be led astray by salespeople who call themselves "financial planners." In recent years, all sorts of financial salespeople have started calling themselves "advisors" or "planners." Even the most recent SEC rule that says advisors must act in the "best interests" of their clients, has a huge loophole that will allow them to continue to recommend expensive products with high commissions and fees.

The most important word in your search for financial advice is "fiduciary." A fiduciary is a person who promises two things: *to fully disclose all fees, commissions, incentives and rebates—and to put your interests ahead of his/her own.*

If an "advisor" won't sign the pledge to be a fiduciary, look elsewhere. This concept of "fiduciary" is so important I've devoted an entire chapter to the subject, Chapter 5.

Financial planning is important for *everyone*—young or old, rich or poor. The most basic spending and saving plan doesn't have to cost you a thing. In Chapter 3, you'll see how to reach the nearest office of the National Foundation for Credit Counseling. They'll work with you to create a spending/saving plan (okay, a budget!) and it won't cost you anything. But it's a good start preparing you to move on to more sophisticated investment and financial planning advice.

Do It Yourself?

I've written extensively in Chapter 5 about finding good advice, because in my experience a successful financial plan is about more than setting up a diversified investment portfolio and checking the boxes for planning issues from life insurance to estate planning to

college savings. Yes, given the resources available today, you could certainly become the "general manager" of your own financial future. In fact, you *should* always remain intimately involved in decisions that are so important.

But having a good financial planner brings a certain discipline to the process. It's easy to decide to allocate a certain portion of your investments to the stock market when the headlines are rosy. But will you be confident and disciplined enough to ride it out when the market makes headlines on the downside? The most significant mistakes are made out of emotion. And a computer program won't hold your hand when panic is in the air.

It's a Savage Truth: *Good advice is worth paying for*. But like common sense, it's not always easy to find. You'll learn how to find advice you can trust in Chapter 5.

Economics: A Very Short Course

A financial plan exists to provide context for change, yet nothing changes circumstances like a change in the economy. That's why you need to understand some basic truths about the economy and politics—and how they affect your financial plans. No one expects you to forecast GDP or tax laws. But keeping an eye on the trends, and adjusting your planning rationally, can improve your chances of success.

> No man's fortune is safe while Congress is in session.
>
> —*Mark Twain*

No one has said it better than this eminent observer of our society and its politics. Although the words were written generations ago, they ring true in our economy even today.

The subtitle of this section should be: *What you don't pay attention to can destroy you.*

All the goals you set and the plans you make are affected by the general state of the economy. And that is determined by two separate sources of economic power. The legislative and executive branches have the power to tax and spend, while the independent Federal Reserve System governs banks and sets monetary policy by controlling the supply of credit and its price (interest rates). That's why it's so important to keep an eye on Washington and how actions there are affecting your future wealth.

As a result of the global financial crisis in 2008, both the Fed and the government have assumed new, greater economic powers justified by the need to "rescue" our financial system. The Federal Reserve injected trillions of dollars in liquidity into the system, by purchasing debt and mortgage obligations, paying for them with newly created credit. In its effort to keep the U.S. financial system from collapse, the Fed kept interest rates artificially low for nearly a decade.

In 2017, Congress enacted a huge tax cut that affected both individuals and businesses. The Tax Cut and Jobs Act, passed in December 2017, promised to simplify the tax filing system and create more jobs. Many of those potential benefits were impacted by the tariffs and trade war with China that started in 2018. Then the Fed wavered on its interest rate policy and became somewhat embroiled in political controversy. As a result, uncertainty hovers over the global financial markets.

The past few years have given you even more reason to keep an eye on the politics of Washington, if you're trying to plan for your own future. While you don't have to be an economic forecaster, you should understand the basic forces that will impact your investments and retirement plans.

What is Inflation—and Why Do I Care?

The Federal Reserve has the power to create more money and put it into circulation. It's a little more complicated than running the printing presses, but easily understandable if you've ever played Monopoly. Suppose the game is moving slowly, so the banker decides to change the rules and give everyone an extra $500. Then, whenever someone lands on a property like Boardwalk or Ventnor Avenue, an auction is held and the highest bidder gets the property.

Suddenly, with more money in the game, property prices rise as extra cash goes into purchases. The value of the old money you saved—just in case you landed on Park Place—declines. With more money in circulation, your savings have less buying power. Prices go up, even though the illusion of wealth had been created only because the banker distributed more money.

That's the phenomenon of *inflation*: money creation pushing prices higher. Thirty years ago, the United States had a taste of how inflation can destroy a country. Given the amount of money the Fed created in the wake of the financial crisis of 2008, we may get

another close-up look at what happens when too much money or credit is created. We should learn from past experience.

Inflation was rampant in the early 1980s, rising to double digits and causing people to trade their cash for real assets that would hold their value. Everything from soybeans to houses to gold coins increased in value as more dollars purchased fewer goods. People were fearful that money held for the future would continue to lose value. It took a decade of total discipline, along with a deep recession and high interest rates, to regain people's faith in the future value of their money.

Truly, a belief in the future value of the currency is the key ingredient in real economic growth. Even a small amount of inflation can have devastating long-term consequences, as seen in Table 1.1 below.

If you think you need $100,000 today to maintain your lifestyle, take a look at the long-term impact of even a relatively small amount of annual inflation—3 percent. In 10 years, you'd need nearly $135,000 to match today's spending power. In 20 years, the number jumps to over $180,000. That's why you must make plans that include

Table 1.1 Effects of Inflation

How Inflation Impacts $100,000 Over Time (amount required to equal today's spending power)

	Inflation Rate	
Years	**3%**	**5%**
1	103,000	105,000
2	106,090	110,250
3	109,273	115,763
4	112,550	121,551
5	115,927	127,628
6	119,405	134,010
7	122,987	140,710
8	126,677	147,746
9	130,477	155,133
10	134,392	162,889
15	155,797	207,893
20	180,611	265,330
25	209,378	338,635
30	242,726	432,194

the impact of inflation on your retirement, on your life insurance benefits, and on the cost of anything you will need to purchase in the future.

Even a small amount of inflation can devastate your retirement planning if you're living on a fixed income. An annual inflation rate of only 3 percent cuts the spending power of your dollar in half in less than 25 years.

Is inflation coming in the future? Despite the very low inflation of the past decade, it's likely that inflation will return. It's a phenomenon that has been mostly forgotten in recent years, as even the stimulating actions of the Fed (and other central banks) in the past decade have so far failed to reignite inflation. The U.S. dollar has remained strong, as other economies and currencies have been perceived as riskier assets. But any lack of faith in the American government—or in its currency—could pose the devastating risk of inflation. And that, in turn, could derail all your financial planning.

The Danger of America's Debt

The ongoing financial crisis that was ignited in 2008 has created a new Savage Truth: *You must think beyond the dollar to the global picture.*

> It's a small world, after all!
>
> —*Walt Disney*

If you've taken children or grandchildren to Disneyland, it's a phrase that rings in your head. It's a small, small world! And it applies even more dramatically when it comes to money and markets. That's because the United States is so much in debt, and because so much of that debt is held by foreign central banks. China and Japan each hold more than $1 trillion of our IOUs.

How did that happen? Well, actually, you helped the process along every time you went shopping. We buy "stuff" from China and send them dollars to pay for our purchases. Much of their profits is invested in our IOUs—Treasury bills, notes, and bonds. They are helping to finance our annual budget deficits—our national debt, which is now over $22 trillion!

If the Chinese economy slows because we stop buying their products, they won't have those extra dollars to invest. We might have a difficult time finding buyers of our ever-growing debt—unless we increase the interest rates we pay. And higher interest rates could

devastate the U.S. economy. It is becoming a much smaller world, after all.

When you're making financial plans and investment decisions, you must look beyond America's borders. Technology has created a globally interdependent financial system. With the click of a computer key, vast amounts of money can rush into a country to purchase its stocks or to invest in its real estate or industry. Similarly, money can be transferred out easily when prices move too high for economic reality.

For many years, the dollar's strong buying power has meant lower-cost imports for Americans, keeping a lid on domestic price inflation. But those cheap imports provided competition for domestic manufacturers of the same goods. As business slowed, domestic manufacturers were forced to lay off workers. The jobs went overseas, destroying much of our traditional industry.

Fear of global competition raises the issue of restrictions on imports—something that hurts both U.S. consumers and foreign producers. A decline in world trade because of protective tariffs has the potential to create a global depression. The financial crisis early in the past decade gave a very frightening demonstration of how small and interrelated the global financial system has become.

More recently, as China has grown to become a formidable competitor as well as supplier of products imported into the United States, that balance has become even more fragile. And as Europe struggles with its common economic system, there is even more risk of global disruption or coordinated slowdown.

Those who do not learn from history are destined to repeat it.
—*George Santayana*

We are often so caught up in our current economic circumstances that we forget to take a step back and gain perspective. Unfortunately, history never repeats itself in exactly the same way. We know from nature that there are regular cycles. Spring inevitably follows winter—no matter how long winter drags on. Many historians and market technicians perceive long- and short-term cycles in the economy and the stock market, which serve as a guide to the future.

Others refuse to acknowledge any patterns of repetition. But are we doomed to repeat the past because we do not learn the lessons? Those of us who are optimists, focused on a better future, believe that intelligent planning can build on lessons from the past, instead

of repeating past disasters. And that kind of planning requires a global perspective.

Human Nature Never Changes

There's no question that scientific knowledge and technological developments have the power to create and redistribute both power and wealth. But one factor that remains constant across history is human nature.

Those two basic forces—fear and greed—always rise to the surface when it comes to making money decisions. How else to explain the extremes to which markets always swing? When human nature gets involved in the decision-making process, all the rules of behavior are set aside along with all of the facts and statistics that determine where markets "should" go.

Neuroscientists have established that our emotional reactions move through our sensory systems faster than our intellectual, rational decisions. You can't afford to let your financial plan become a victim of human nature. It is at these extreme moments that both you and your money are tested.

Historic averages blend in the highs and lows of price and emotion. Market technicians use charts that smooth out the variations in behavior caused by emotional extremes. But when you are living through one of those extreme periods, it is difficult to resist joining the crowd in either buying or selling at exactly the wrong time. After all, it's only human nature!

So that is your challenge today—to develop perspective both historical and global to withstand human nature and make sensible plans for your future. One thing is sure: The future will come. Will you be ready?

TERRY'S TO-DO LIST

1. Examine your attitudes toward money: power, fear, and greed.
2. Set three realistic financial goals—some short-term and some longer-term targets.
3. Pay attention to what's going on in the economy, politics, and the financial markets. All will affect your best-laid plans.

CHAPTER

THE SAVAGE TRUTH ON MONEY AND TECHNOLOGY

Knowledge Is Power

Technology has taken over the most tedious tasks of money management, freeing us to make important decisions that will have long-term impacts on financial success. In earlier editions, I focused on the basics of financial technologies we now take for granted: online bill payment, buying stocks, filing taxes, and instant, secure credit reports and scores. How quaint it seems that people once balanced their checkbooks using pencil and eraser.

Financial technologies have also created new potential liabilities. Data breaches have impacted the most trusted repositories of financial data—from the Equifax credit bureau to the Marriott hotel database, from Capital One to Target stores—to the IRS itself. The potential for identity theft creates an entirely new set of responsibilities around safeguarding your financial information. Phishing is a word that has been added to our vocabularies in the past decade, as global scam artists intrude into lives. And secure Wi-Fi is a tech concept that is as vital to communications as oxygen is to breathing.

Technology creates transparency—for better or worse. It allows you instant access to your investment portfolio and lower-cost products that give your long-term investments an extra boost. But, on its own, technology won't create wealth or protect against losses. It must

be used judiciously. I hope we have come far enough that I don't need to give anyone a pep talk about the importance of using technology in managing personal finances. If people trust their dating lives and their political opinions to public platforms, surely everyone should be willing to take the plunge into secure online money management.

I recognize that many of my readers take technology for granted. But your parents, and grandparents, may be overwhelmed or unwilling to take advantage of the tools, apps, and websites that appear throughout this book. So here's my personal challenge to those of you who are wondering why technology earns a separate chapter in my book: Take all of these lessons and try to help the elder generation in your family. Whether it's going online to choose the best Medicare drug plan or saving Grandma from becoming a victim of a phishing scam, it's in your own best interests to share your knowledge. After all, you might inherit all the money she doesn't lose!

But don't think these encouraging words about financial technology apply only to your elders. Gen Z clearly needs some lessons as well. This generation, variously described as being born from the mid-1990s through mid-2000s, has some of the worst money management habits, according to a survey sponsored by Visa. It shows that 61 percent of Gen Z forgot to pay a bill in the past 12 months, compared to a 46 percent average for all Americans, and only 34 percent of seniors. In fact, more senior citizens (53 percent) than Gen Z (39 percent) use the web for info on their bills.

So no matter what your age or stage in life, it is vitally important to use technology to manage your everyday money, your plans for the future, your credit, and your investments.

Incorporating Tech into Personal Finances

Think of all the money decisions you must make every day. Technology has kept its promise to make life simpler and more efficient:

- There's no need to wait for a bank statement, when you can go online during the day to make sure of your balance—or of the up-to-the minute purchases on your credit card.
- There's little reason to buy stamps or get writer's cramp, when you can pay your bills securely online.

- There's little reason to use a certified check or cashier's check when you can use PayPal or Zelle to transfer money securely to pay for a product or service—or repay a loan from a friend.
- There's no reason to wait for your credit report in the mail—or mail a letter to dispute something that's on your credit report—when you can go online to www.AnnualCreditReport.com to get a free copy of your credit report (see Chapter 3).
- There's no secret to knowing your credit score when you can go online to www.CreditKarma.com or www.Discover.com or your own bank's website to check out that once-secret but very important number.
- There's no reason to wonder what your eventual Social Security check will be, at any age, since you can get a personal profile at www.SSA.gov.

The list goes on and on. Younger readers may be amazed that we once spent lots of time and energy on these chores. So, be sure to take advantage of the tools and apps that give you more power over your money, more knowledge about where you stand—and where you're headed. But also heed these warnings about online security.

Make sure your home computer is connected to the Internet with a secure connection. Make sure that if you're using WiFi, you're hooked up to a secure connection. That will require a password at the minimum to access your data. Each website that you contact should have the designation "https"—with the "s" at the end standing for secure.

And use common sense. It's fine to access the Internet at Starbucks to read the latest news or check stock quotes. And it's great to get financial reminders texted from Mint to your smartphone in a restaurant. But save sensitive transactions that require passwords for connections that you are absolutely certain are secure. Use VPN encryption software (Virtual Private Network) to protect your privacy when using public WiFi. Search for free software at www.VPNMentor.com. And as for those e-mails that look like they really came from your bank or credit card issuer, follow this rule: *When in doubt, delete.*

One more warning about technology: Technology has made financial advice easy to find. The problem is sorting through all this information and finding trusted guidance in making choices. A huge financial services industry has grown up in the past decades to influence your decisions and sell you products and services. Still, *you* must make the ultimate decisions about whom to trust and where to allocate your money. More about that in Chapter 5.

Take a deep breath if you're new to this subject. But if this chapter is already well-known to you because you grew up in this new era, then use your proficiency to help others make their financial lives more efficient. What a great gift you can give. New technologies give you more power over your personal finances if you choose to use them wisely. It's up to you to pick and choose how to put technology to work on your behalf. But you can't hide from these opportunities or be intimidated by them.

Speaking of technology, throughout this book I'll mention various websites and apps, where you can get financial information, services, and tools. If you get lost, just come home to TerrySavage.com and you'll be directed to my latest columns and links. At my website, you can click on my blog to post your personal finance questions and receive a prompt online response.

Getting started: Online Banking

Getting organized is essential to reaching your financial goals. And there is no better way to start using technology than with online banking. It is the cornerstone of all the subsequent tools that give you control you're your spending, saving, investing, and planning.

When I started writing about online banking many years ago, it was an uphill battle to convince people that they could (mostly) do away with paper checks and pay their bills online—securely. Now, Americans pay more than half their bills online, with payments valued at more than $5 trillion a year. The use of paper checks has plummeted, and 44 Federal Reserve check processing centers have closed. Even paper checks are processed electronically, which is why you can deposit a paper check in an ATM, where it is photographed and then shredded. We are saving a lot of trees!

You simply can't afford to be left out of this trend—not only because it saves you time, and the money spent on stamps, but because enabling these online transactions forms the basis of controlling your cash flow and empowering your savings. As a reminder, you are 100 percent protected against loss from fraud in your online banking transactions—as you are from credit card and debit card fraud.

The first step is to start online banking and bill payment at your own bank's website. It's a simple process to set up access to your

existing checking, saving, and bank-issued credit card accounts by choosing a user name and password. Just look for the "enroll now" link, which will likely be near the "sign-in" box on the home page. There is always toll-free telephone access to online banking help, no matter which bank you use.

But don't try calling your local branch for assistance. This is an entirely different process than dealing with the friendly bank teller behind the counter. (I start with this basic instruction because first-time users are typically fearful of dealing with online banking technology. There's a reason banks still find it profitable to have brick-and-mortar neighborhood offices. But they are not typically the technology experts you need to get started.)

Once you've opened your online banking account, it's easy to enter your usual payees—from large companies such as utilities to your dog groomer or friends—adding the payment address and account number found on your bill. When you give instructions to pay a bill, the large companies receive a direct transfer of funds. But smaller businesses and individuals will receive a computer-written paper check in the mail.

You can set up automatic monthly payments for fixed, regular bills such as mortgage, rent, or a car payment. But most recurring payments such as utility and cell phone bills will vary from month to month. So you'll have to enter those payments individually—or have these bills automatically charged to your credit card, where you'll earn points. Then you can easily pay your credit card bills online. If your credit card is issued by your bank, it will appear on your online banking home page. If you have a card issued by American Express or another bank, set up online, password-protected access at the issuer's website.

There's another way to pay your bills online—by going directly to the biller's website. Utilities and insurance companies are among those that enable you to view and pay your bills online. And many companies are working toward online bill presentation, which means that you'll be notified securely by text or e-mail to check in and pay. The debit will show up on your bank balance. And since you will get in the habit of viewing your banking online every day or two, you'll be on top of your finances far sooner than if you waited for a monthly paper statement.

As with all technology, there's a quick period of learning, followed by familiarity and appreciation for the benefits. You can still elect to receive your monthly statements by mail, if you're addicted to paper.

Or you can trust the fact that you can always access previous months' and years' statements online. And it will become routine to check in online to see your bank and credit card balances frequently to make sure everything is as you expect.

Once you have experienced online banking, it's time to graduate to online money management and control. The next step is easy and the incentives are great. Think of the fees you'll save by avoiding late charges and overdrafts. Think of the anxiety that will be relieved when you know where you stand financially and how to deal with your bills. And think of the money you'll save at tax time when you present your accountant with a file detailing your financial information, instead of a shoebox full of receipts!

Money Management Software & Apps

What do you need to get started with online money management? Start with one of the best programs or apps, and let it guide you through the process. Here are some of the best:

Quicken

The next step is figuring out how to use the information that already resides in your online bill payment, banking, and credit data. For many years, I recommended using Quicken—a money management program that is now downloadable for an annual subscription fee at www.Quicken.com. You must renew every year to keep the program active. They will send you an automatic renewal reminder.

It's easy to get started. When you download the program, you create a secure user name and password. Then you can easily link Quicken to your existing online bank, credit card, and investment accounts. It takes just minutes, requiring you to securely input your user name and password for each financial institution. The program makes the direct connections. Then with a click of your mouse, all your information is updated instantly in the Quicken program.

Start by setting up your payees in Quicken and paying a few bills. Most banks allow you to pay bills directly from Quicken. Or pay some bills online at your bank website, and click the button to download into Quicken. The program suggests budget categories for each payment, or you can create your own.

Quicken gives you amazing power to organize and plan your personal finances. It will automatically categorize your spending, based on the bills you pay online and on the charges you make on your credit cards. You can actually link your bills from major companies and Quicken will automatically track the due date and the amount due.

It allows you to search payment history—easily tracking how much you paid to the utility or physician or any other payee, creating an instant report. The budgeting tools are also instantaneous, allowing you to see in a pie-shaped graph or linear report just how much of your spending is going toward entertainment or shopping for clothing. It looks inside your credit card charges to create its reports. Plus, beyond knowing where your money went, it can help you plan a budget for the year ahead.

And when it comes to tracking all your investments from different companies, whether an IRA or stock brokerage account, or your retirement plan at work, the information can drop into the Quicken investment section. Using Morningstar's Portfolio X-Ray ™ feature, you can see how well you are diversified within your mutual funds, making sure you're not overexposed to technology or energy or other categories. Quicken also connects easily with Intuit's popular TurboTax program. That lessens the work of importing your data into your tax return.

Quicken has long been the leader in personal finance software, but its primary drawback has been that the information resides only on your desktop computer. The latest version of Quicken does allow secure web access to your information, but with limited functionality to take actions such as bill payment. But if you want everything safely stored on your desktop computer (and automatically backed up on a Dropbox account), Quicken is the way to go because it offers the most tools and the broadest money management view.

Mint

Mint is an app that you can download free onto your phone or tablet. You can even view its data on your Apple watch. Mint is owned by Intuit, and it led the way into mobile personal finance software. In recent years, Intuit sold Quicken and has concentrated on making Mint the leader in personal finance software. Learn more about it at www.Mint.com.

The advantage of Mint is that it lets you stay on top of your personal finances, your spending and your budget—anywhere and anytime. It's easy to sync up and download the information from your bank, credit cards, investment accounts, and loans. Then every time you visit the site or use the app, your financial data is updated automatically.

Mint sorts your transactions into automatic budget categories, which you can refine to set up your own sub-categories. Like Quicken, it has budgeting tools. It's all clearly displayed in colorful graphics, right on your phone. And it monitors your credit score.

You can sign up for text messages that arrive when a bill payment is due, when you're about to max out on a budget category or when a large purchase is made. It's all done in real time—helping you avoid late fees or overdrafts. And you can track your investments, with assessments of your asset allocation across all your accounts—from your 401(k) and IRA to non-retirement accounts. It calculates your net worth and displays it at the top of your screen. Consider that an incentive to good financial behavior!

Mint now has more than 15 million users. It is free because it is supported by advertising from financial services firms, offering users new credit cards, bank CDs, or mortgage refinancing, from which Mint gets a referral fee. Also you'll find some banner ads on your screen.

While you can't currently pay bills from the app, a separate Mint Bills platform allows you to track and pay bills through your bank or credit or debit card. You do get a dashboard of your entire financial and investment picture on your home screen. Information on Mint is securely encrypted. Not only do you create a password, but it offers multi-factor encryption (two forms of verification, such as a verifying text message along with your PIN) to add to your security.

Personal Capital

If you're looking for a more sophisticated approach to online money management, consider signing up at www.PersonalCapital.com. This fintech company is known as a robo-advisor (more on that in Chapter 5) but it also offers free, sophisticated tools for watching your spending. You can access it securely on your computer or mobile device. Like the other companies in this section, you can seamlessly download your information from your bank, credit card, or investment

company sites. Its tools offer an analysis of your spending, as well as recommendations to adjust your habits.

Personal Capital also has some incredibly sophisticated free investment tools. They include: an in-depth retirement readiness calculator, a tool that analyzes the impact of the fees you are paying in your 401(k) account, guidance on tax-efficient retirement withdrawals, and an asset-allocation advice tool. All of this is free—part of an attempt to get you to sign up for their "robo" money management—a process that combines computerized advice and a personal advisor—all for a low fee of less than 0.9 percent annually for assets under $1 million. It's been an incredibly successful approach, as at this writing Personal Capital has more than $10 billion under management. But you don't need to use their money management service to access their free money management tools.

Your life isn't static, and neither is money management. Whether you travel for business and need access to your information, or are perhaps a snowbird with residences in two states, or even if you want to keep track of an aging parent's finances, these money management tools give you access and control—two critical ingredients in financial organization.

The Challenge: Getting Started

Now you have all the basic information you need. It's up to you to get started. There's a huge incentive to do it.

There's an old Savage Truth: *Cash flows easiest down the drain.*

Knowledge gives you the power to redirect your money before it disappears. And, that same detailed knowledge of your spending and saving can help you reach your goals of financial independence and a secure retirement.

The true advantage of using technology to compile, track, and update all aspects of your current financial life is that you can create scenarios for your financial future. Are you saving enough for retirement? Do you know how much you'll have to save to send your child to college? Can you reach both goals at your current pace? Information that's already in your plan from the savings and investing section will be transferred automatically to the planning section of your program. You'll be able to see how a slight change in amounts, timing, taxes, or rates of return can affect your future.

Are you ready to take control of your finances? It's not just a matter of having the tools or getting organized. This is a mental challenge and it requires you to stay on top of your finances on a regular basis. Knowing where you stand with all of your personal finances, being able to organize that knowledge, and being able to access the latest information to make decisions are key parts of the Savage Truth—the parts that set you free.

If you're ready, it's time to get started—or to start over.

TERRY'S TO-DO LIST

1. Download either Quicken (Quicken.com) or Mint (Mint.com or the app).
2. Contact your bank to set up online banking. They'll explain how to download your check payments into your program.
3. Go through your banking information for the past few months and assign each purchase a budget category. (You can use the categories supplied by Quicken or Mint, or create your own.)
4. Actually use your new tools every day, because familiarity breeds empowerment.

CHAPTER 3

THE SAVAGE TRUTH ON SPENDING AND DEBT

You *Can* Control Your Cash Flow

Getting control over spending is the first step toward wealth and financial independence. For many people it is a larger hurdle than the second half of the formula: making money. Indeed, some people earn far more than others even dream of, but they still spend their lives in financial bondage. Creating financial independence starts with exerting control over your own cash flow.

That process is becoming easier every day. We are well on the way to a cashless society. New technologies ranging from online bill payment to immediate money transfers via technologies including PayPal, Venmo, and Zelle mean that a generation that never lived without smartphones will be followed by a generation that never handled paper money.

Yet the basic requirements for money management remain the same. Whether you stack coins in a piggy bank or introduce your young children to saving habits via apps like iAllowance or TheBusyKid, managing your money is a learned talent and an important habit. The earlier you start managing your money—and diverting some to paying down debt, then saving and investing, the better off you'll be.

Remember, it's a Savage Truth: *Cash flows easiest down the drain.*

As demonstrated during the government shutdown in early 2019, the number of Americans with reasonably good government jobs, but still living paycheck to paycheck, was substantial. That's a sad situation for the wealthiest country in the world. Too many Americans are one paycheck away from a crisis. This is not a political argument about wealth distribution; rather it is my effort to help people maximize the income they have—and move beyond midnight worries about providing for their families and their future, living on the edge of financial disaster.

It's not the size of the paycheck that matters most—but how you handle the money you earn. In the depths of the modern Great Recession in 2008–2011, when people were facing foreclosure and job loss, they promised to get out of debt—and stay out. Yet by 2019, the amount of credit card debt outstanding surged to new highs—$1.04 trillion in outstanding balances, on which consumers pay an estimated $122 billion in interest and fees!

That says more about human nature than anything else. After a record 10-year period of economic recovery, and the lowest unemployment in modern history, people went back to overspending, under-saving, and financing on credit cards. Even acknowledging the reality that many high-paying jobs disappeared because of technology and trade patterns, we did not adjust our lifestyles. When the next recession hits, it will be doubly painful.

There's an interesting story about the red deer that live in central Europe. It's well known that even more than 25 years after the Berlin Wall came down, the deer on the formerly Czechoslovakian side of the border will never wander across the grassy median that was once guarded by an electric fence and sharpshooters. Somewhere, ingrained in their DNA, is a learned warning against this risky behavior—a lesson that persists in generations of deer born well after that border fence came down.

Why can't human beings take the same lessons of boom and bust, bubbles and crashes that are clearly described in history books—and learn from experience? Money management is a lesson best taught at home, but sadly, one that must be relearned, sometimes painfully, by each generation.

The principles in the following section are unchanged from the original editions. My advice still stands. Times may change, technology may offer new tools for money management, but the Savage Truths about spending and saving are unchanged—whether you're digging out from under or just starting on the journey to financial independence.

The Savage Truth on Spending

A *Savage* Truth: *We Can All Spend as Much Money as We Make*

A hedge fund tycoon recently made headlines by purchasing the most expensive homes in cities around the world—New York, Chicago, London and Palm Beach—totaling $724 million in residential real estate—in a two-year period. Beyond any other commentary on this phenomenon, lies the Savage Truth that no matter how much money you make, you can find a way to spend it!

Did you ever think that if you earned as much money as you're making today, you'd be in great financial shape? Somehow our list of wants and needs always seems to grow faster than our paycheck. That's just human nature. There's always a way to spend the money we make, and rarely any left over at the end of the month. And if you don't currently have enough money to pay for your purchases, it's all too easy to create money by simply charging them.

Where does all that money go, and how can you reorganize your finances to make sure you reach your goals? If you're just starting out in your working life, the opportunity to set goals and make a plan is exciting. If you're one of the millions of Americans who are buried in debt, it's tough to contemplate your present situation, yet it must be done if you want to move forward. If you're living on the edge, where one major expense could push you over, there must be a way to build a financial security blanket. And if you're starting over, it's important to do things differently this time around.

The first step is the hardest because it requires making the commitment to take charge of your financial life, instead of being carried along by circumstances. It's also the easiest because the first step is simply figuring out where you are right now. Start by creating your own personal balance sheet—and don't be surprised if it doesn't balance.

Balancing Your Financial Life

Take a sheet of paper and draw a line down the middle. (Or use your online money management program for this task.) At the top of the left column write the words *I Own,* and at the top of the right column write the words *I Owe.* Then list the items in each category.

For instance, many people would immediately list their largest asset—a home or condo—in the left column. In the right column,

under "I Owe," you'll list the amount of your mortgage balance. This is your personal balance sheet, even if it doesn't exactly balance.

Not everything you've purchased over the years counts equally as an asset. On the "I Own" side of the page you may list your car, furniture, smartphone or tablet, clothing, jewelry, 401(k) retirement plan, IRA, or anything else you've been spending money on over the years.

You'll notice that some assets maintain their value over the years, or even increase in value. Except for very unusual economic circumstances, you can probably sell your home for more than the purchase price. Similarly, your retirement plan investments should increase in value over the long run.

Now look at the other things you own. Your car may lose value each year, yet it contributes to your wealth because you use it to drive to work and earn money. But your old furniture and clothing lose value quickly. Just check eBay or similar sites to see what most designer clothing or used sporting goods are worth if you try to sell those items, unless they are truly unique.

Some of your past purchases may have an intangible or sentimental value, but for the purposes of this personal balance sheet it's enlightening to see the current cash value of all your assets. Are you surprised at the total? Are you surprised at how little value there is today in things that were originally such expensive purchases?

The Heavy Burden of Debt

Now it's time to list your debts in the "I Owe" column. Your largest debt is likely to be your mortgage—a debt that has some interesting advantages. First, it is probably the lowest interest rate you will pay on any money you borrow. Second, your mortgage interest is deductible on your income tax return (up to certain limits). And third, that borrowing supports an asset that is likely to grow in value. Finally, your mortgage payment is likely to be equal to or less than the amount you'd pay in rent, so it's money you would spend anyway to have a roof over your head.

You can make a similar argument about the debt you take on to finance your education—as long as it isn't excessive. The problem with student loans is that they are easy to acquire—and very difficult to pay off (see Chapter 12). Yes, a good education pays off long-term in the job market. But like all debt it can pile up quickly. And interest on student loans is only minimally deductible.

Other debt is less beneficial. Your car payment may come with a high interest rate, and that interest is not deductible. Still, your car gets you to work, which brings in your income. (If you're not using your car for commuting or business purposes, or if you could easily substitute public transportation, you might reconsider the overall costs of owning a car and decide the monthly payments are not worth the convenience.)

As you continue on down the "I Owe" column, you'll have to confront the rest of your monthly bills, mostly from credit cards and retail stores. Gather all the current bills and start making a list. Include the total balance outstanding, the annual percentage interest rate for the finance charges, and the minimum monthly payment. For many people this is a startling, even frightening, amount. It keeps you up at night. But knowing—and acting to fix it—is the best cure for money insomnia.

Here's an important Savage Truth: *It's not the initial amount of the debt that burdens you; it's the cost of the debt over the long run that counts.*

Until the debt is repaid, you could end up paying five times the original purchase cost in interest charges.

Your Income Is Not Your Paycheck

If you ask most people how much they earn, they'll probably give you a nice round number—thousands of dollars a year. But think again. That's your top-line number, your bragging income. It's not your *real* income—your *after-tax* spending income. Let's take a closer look at the money that comes right off the top of your paycheck: *taxes.*

In 1948, when your grandparents were just starting out, the median-income American family paid just *2 percent* of its income in taxes to the federal government. In 2019, the median-income American family worked 109 days—until April 19—to reach Tax Freedom Day. That means they spent more than three months working to pay taxes at the federal, state, and local level.

Working the 109 days until Tax Freedom Day means taxes add up to more than the same family spends on food, clothing, and health care combined. It's money that you earn but cannot allocate to either spending or saving.

The government insists it gets paid the taxes you owe—and it doesn't like waiting. If you earn a salary, the company will deduct withholding taxes and pass them along to the government regularly.

The year after the most recent tax cuts many Americans were surprised they received no refund—or even owed money. That's because many employers adjusted withholding to reflect lower tax rates.

If you are self-employed or withdrawing from a retirement account or have additional income from rents or dividends, you should arrange for withholding to be taken out of the payments you receive—or file a 1040-ES quarterly estimated tax form, along with a check for the money owed.

The penalties for failing to make substantially equal payments of taxes owed over the year are steep. The only way to avoid this penalty is if you owe less than $1,000 in tax after subtracting withholdings and credits, or if you paid at least 90 percent of the tax for the current year, or 100 percent of the tax shown on the return for the prior year, whichever is smaller.

Some people have the opposite problem. In an effort to avoid penalties, they over-withhold—essentially giving an interest-free loan to the federal government all year, until they get the amount overpaid as a refund the following year. That's typically a mistake, because you can do more with the money than the government can—perhaps paying down expensive debt.

To figure out exactly how much you should be withholding, use the IRS calculator, which can be found online at www.IRS.gov.

Even with the correct withholding, the bottom line on your paycheck is far from the top line that the company is paying you. There may be other deductions for insurance, retirement plans, and other company benefits. It might make you feel a little better to know where a huge hunk of your income is going, but your challenge is to organize what's left of your paycheck to reach your financial goals.

An Irregular Paycheck Doesn't Justify an Irregular Budget

Millions of Americans have given up the security of a regular weekly paycheck—or been forced to survive—by starting their own businesses or doing side jobs. Working on your own doesn't alleviate the problem of payroll deductions for taxes, insurance, and retirement plans, but it does make the income side a lot less predictable. On the plus side, becoming your own boss gives you flexibility and the opportunity to reap larger rewards from your efforts.

Whether you consider yourself an entrepreneur or an independent contractor, the inability to forecast your income precisely makes it all the more important that you have a safety margin of

savings to provide for the unexpected. That contradicts the entrepreneur's need to be willing to risk it all for the future of the business. Entrepreneurs and their families need to have a lot of faith—and some savings and investments on the side. Or they need to be desperate enough to recognize that this is the only way out of their financial woes.

No matter what the reason you find yourself working for yourself, understanding cash flow is a basic requirement, so don't skip the next section. Remember, even severance pay and unemployment benefits are taxable on your state and federal tax return, depending on your overall income.

All Income Is Disposable

It's possible that more than $1 million, and perhaps as much as $10 million, will flow through your checkbook over your lifetime. Think of it this way: If you make $50,000 a year on average over a 25-year working career, your paychecks will total $1.25 million. You may not have control over about one-third of that cash, which is deducted for taxes. Still, the spending, saving, and investing choices you make along the way will have a big impact on your future financial security.

Economists call what's left of your paycheck after taxes and mandatory deductions your *disposable income.* It's true that all the money is going *somewhere,* but the essence of controlling your money is deciding just where that somewhere is. That involves making choices based on a clear distinction between needs and wants.

One way to make that process easier is to assign a time value to your money. Suppose you work a 40-hour week and take home $500 after taxes (roughly equivalent to earning about $42,000 per year). That means you must work one hour to take home $12.50 after taxes. You might think twice about spending $50 on a dinner at a nice restaurant if you knew you worked four hours to pay for it.

Try dividing your paycheck—after taxes—by the number of hours you worked each week to get a per-hour value for your time. I call it the *worth quotient.* Think of all the effort that went into your job—everything from smiling at your boss to finishing a project on time. Is what you're about to purchase worth the effort that went into earning that money?

Even worse, if you charge that purchase and make only minimum monthly payments, you may pay one hour's work for the product or service plus another four hours' work in future interest payments.

Now consider the alternative: If you invest the money instead of spending it, it could compound in a mutual fund at perhaps 10 percent per year—the average historical average returns of the stock market over the past 60 years (see Chapter 6).

At that rate, in 10 years that same $50 you didn't spend on dinner would be worth $129.69. It's as if you worked another 6.4 hours and earned about $80 (after taxes). But *you* didn't do the work; *your money did!*

Suddenly, it's easier to decide how to dispose of your income. In the context of your worth quotient it will be easier to make decisions about what you want and what you really need.

Budget Is Not a Verb

Before you can make changes, you need to figure out where all of your money is going. If you deposit your paycheck in the bank or have it deposited directly instead of cashing it, you'll have a much easier time tracking your spending: You've used your debit card, charged your purchases on a credit card, or spent actual cash.

The most frightening financial word is *budget.* It becomes less intimidating if you think of it not as that overwhelming process that implies financial austerity, but as a snapshot of what's currently coming in and what's going out. Yes, there may be a gap in your cash flow. That's probably the part of your lifestyle you're financing on your credit cards. There are some easy ways to fill that gap, but first you need to take a realistic look at what's been happening to that money you work so hard to earn.

To get started, take advantage of the recommended financial programs like Quicken, Mint, and PersonalCapital (explained in Chapter 2). Or if you're determined to use old-fashioned methods, take out your checkbook register and look over the checks you've written for the past few months. It's time to set up some categories. It's easier to do this with a computerized money management program, which offers pre-set categories or lets you create your own. But, if you want to see it all on paper, I recommend the latest version of Judy Lawrence's *The Budget Kit: The Common Cents Money Management Workbook,* available on Amazon.

Some expenses such as rent or mortgage payments remain the same every month. Other monthly bills will vary. You might spend more on electricity during the hot summer months, or on your heating bill in the winter. Make an average of those amounts for

each category and enter it on your budget statement if doing this process in a workbook. (It's done automatically by computerized programs.) Then start hunting for expenses that do not arrive on a monthly basis. For example, your auto insurance bill might arrive quarterly and your homeowners insurance or life insurance bill may come semi-annually. Or you might spend a lot of money on holiday gifts at year-end. All of those "must-spend" items must be factored into your plan.

Track Your Spending

The next step is to count the actual cash that you spend out of your pocket every day. You're probably in the habit of withdrawing cash from an ATM. Keep those receipts and add them up at the end of the week. Or pay attention to them in your online bank account. You may be surprised to see how the money you spend buying newspapers, magazines, coffee, lunch, or lottery tickets can really add up.

One solution to the problem of disappearing cash is to use your debit card instead of cash or a credit card. The purchase amount is withdrawn automatically from your checking account, as long as you have funds available. You won't receive a bill at the end of the month, so you'll never pay interest, but you will be able to track your cash spending more easily. And you won't dribble away the extra cash, as you do from an ATM withdrawal.

If you're banking online, your debit card purchases will be downloaded with your other banking transactions and automatically categorized into your budget in your money management program. That program also sorts and categorizes your credit card purchases. You want to know where the money went and how the expenditures fit into—or strain—your budget.

If you've come this far with me, you've done the most difficult part of all financial planning. You've prepared yourself to confront the gap between what's coming in and what's going out. It's easy to say that those credit card balances are the result of unexpected events such as a car repair or the need for a new winter coat, but the unexpected always happens in life. You need to close the spending gap so you can build a savings cushion that allows you to reach your short- and longer-term financial goals—and cover the inevitable emergencies.

There Are Only Two Ways to Close the Gap—*Spend Less* or *Earn More*

I'm sorry there's no magic wand to wave. Unfortunately, only the federal government can solve its budget problems by creating new money, and even that eventually has its limitations. You'll have to attack either the spending side or the income side of your budget—or both. Unless you win the lottery (a long shot and the worst investment), you must figure out how to either earn more or spend less.

SPENDING LESS

Once you know where the money is going, it's easier to set up a system to make sure it gets diverted to the proper places. If spending cash is your problem, carry your ATM card only on Monday, when you'll make one cash withdrawal to see you through the week. If writing checks causes the most unplanned spending, take your checkbook out of your purse or briefcase. If dining out is the big problem, set aside one or two nights a week for restaurant meals. Or eat dinner at home and then go out for coffee and dessert.

Sometimes it pays to make major spending adjustments. If public transportation is an alternative to driving to work, you might consider selling your car. You could use the cash proceeds to pay down your credit card debt and simultaneously cut your monthly budget expenditures on insurance, fuel, maintenance, and garage fees. Similarly, it might be smart to take in a roommate or, heaven forbid, move in with your parents while you pay down your credit card debt.

The hardest part about cutting back on your lifestyle is the emotional feeling that you "deserve" to live in the style you've become accustomed to. Cutting back on your lifestyle to pay down debt on past purchases feels like a double emotional punishment. But it is the fastest way to financial freedom.

EARNING MORE

I think it's easier to attack the income side—except in the midst of a recession. After all, you can cut back only so much because so much of your income is going toward basic necessities. But on the income side there's always the potential to earn more money.

Obviously, you can't ask the boss for a raise if the company is planning layoffs or if your job is insecure for other reasons, including the intrusion of technology or global competition. As an alternative, you and your family members might find a temporary evening or

weekend job to help pay down your current bills. It's easiest to do this when unemployment is low and there is demand for qualified workers.

Since the last edition of this book, the opportunities to earn money have expanded, with Uber, Airbnb, TaskRabbit, and eBay offering you the opportunity to monetize your assets, talents, and time. Technology and the "gig economy" allow you to multi-task and multi-earn. You may use Wag or Rover to set up your dog-walking business or search for apps for elders to become a senior caregiver. This extra work may not be your preferred lifestyle forever, but it can go a long way to solving the financial problems of the moment.

The rewards of earning more to pay down debt are more than financial. When you climb out of debt, you'll look back on the experience as a motivating force for the future. And if your debt problem is still overwhelming, read on for sources of trusted help.

The Savage Truth on Using Credit and Debt Wisely

The first critical issue you'll face as you take control of your finances is creating a balance between the wise use of credit and the dangers of debt. Every day you'll be faced with choices whose long-term costs are not readily apparent. Unless you look at the far-reaching consequences, it will be all too enticing to accept the temptations of debt.

No matter what the enticement, the Savage Truth is that avoiding debt is a personal responsibility. Although unexpected events sometimes make it necessary to borrow in order to survive, addiction to debt is a dangerous disease. And like all addictions, including alcohol, drugs, and gambling, it's hard to kick the debt habit without good help.

Credit Counseling or Bankruptcy

If you're caught in the downturn through forces beyond your control—uninsured medical expenses, divorce, an accident or simple bad luck—there is always an opportunity to start over. Many of America's original settlers were refugees from debtors' prisons in Europe. The United States has always operated on a different principle: the chance to make a fresh start.

That do-over is called bankruptcy, which comes in several forms to remove most, but not all, of your debts—and most of your remaining assets, as well. Despite the longest economic recovery in modern history, more than 717,000 people filed for individual bankruptcy in the United States in 2018.

But before you rush out to find a bankruptcy attorney, or jump into the dangerous hands of credit consolidation companies, you owe it to yourself to get some trusted and easily available help from one of the agencies belonging to the national, nonprofit National Foundation for Credit Counseling (800-388-2227 or www.NFCC.org). Calling this national hotline number will put you in touch with the nearest member agency. These are people you can trust to evaluate your situation.

The *only* debt counseling services I recommend are those affiliated with the National Foundation for Credit Counseling. They will meet with you either in person or over the phone. The meeting is typically free, or at a nominal cost. These NFCC member agencies can offer several services. Sometimes, a simple meeting is enough to put you on course. They can help you organize your bills, suggest expenses to cut, and help you track your progress.

They also offer a debt-repayment service. This is not help in reducing your balances. But they will contact your creditors, which will sometimes reduce interest rates, waive late charges, or “re-age” your account. Then you will send one monthly check to the agency, and they will pay an agreed-upon amount to each of your creditors.

The NFCC member agencies receive a fee from the credit card issuers for providing this service at no, or very low, cost to consumers. In recent years, these programs have helped more than six million people repay $6.8 billion in debt, through counseling and payment plans.

If you simply meet with a member agency to discuss your situation, it does not go on your credit report. If you do enter a repayment program, it will be reported on your credit report, but it doesn’t carry the stigma of a bankruptcy. Sometimes, your situation is so dire that the agency will recommend bankruptcy and introduce you to an attorney you can trust to handle the process.

Bankruptcy won’t solve all your problems. Student loans (even for co-signing parents) are not discharged in bankruptcy. And, subject to certain limitations—whether the bankruptcy is filed under Chapter 7 (complete discharge) or Chapter 13 (a workout plan that allows you to retain some assets)—most recent taxes owed are not

discharged in bankruptcy. So it's worth getting unbiased credit counseling before considering this route.

So, first you get the warning about debt, then the advice about how to use it wisely.

Credit Cards: Dangers and Opportunities

There's nothing inherently wrong with using credit cards to facilitate all your transactions. Credit cards have the advantage of convenience and security. They can simplify record keeping and budgeting. Many offer rewards or discounts or cash back. If you travel and might miss payment deadlines, you can arrange to have payments for utilities or your cell phone automatically charged to your credit card—earning rewards for your spending.

Credit cards give consumers power in disputes with merchants because the card-issuing bank can intervene on their behalf. Credit cards are a basic necessity for making reservations. And credit cards give flexibility to stretch out payments on major purchases.

Best of all, the appropriate choice and wise use of credit can earn rewards ranging from cash back on purchases to airline miles or points that reflect your good spending and repayment habits. Some cards, described below, even facilitate easier repayment terms by allowing you to transfer balances from higher rate cards to a period of a year or more of zero interest rates.

But credit cards used unwisely can contribute to ongoing financial problems. Making only the minimum required monthly payment is the most expensive way to pay for merchandise and services. You'll wind up paying interest on the interest, building a mountain of debt that will crush you—as many have now learned the hard way.

We've all become far more sophisticated about credit cards and their dangers. Your credit card may have a Visa or MasterCard logo, but the card *issuer* is one of more than 5,000 individual financial institutions that belong to card-issuing associations. Within federal guidelines, each card issuer has its own rules and rates regarding finance charges, over-the-limit charges, and late payment fees. Some charge annual fees. Others compete on offering lower rates, more benefits, or larger credit limits.

Credit card companies make most of their money on the volume of charges (for which the merchant pays a small fee) and on the finance charges they assess on unpaid balances. According to data from Gallup, in 2018 nearly 30 percent of American adults didn't

have any credit cards. But those who did have cards carried an average of 3.7 cards. That's a lot of opportunity to pile up balances and interest charges, making the credit industry very profitable.

If you're looking for more information on the best credit card to use in your circumstances, either based on finance rates, annual fees, or reward points, go to either www.Bankrate.com or www.CompareCards.com to begin your search. At these sites, you can compare annual fees, interest charged on balances, best rewards—either cash back or points, and the best balance transfer cards (offering the longest interest-free grace period and lowest rate if not repaid in full).

A Secured Card Starts—or Rebuilds—Credit

Perhaps you're ready to start over after a bankruptcy. Or maybe you're a student with no credit history or one who can't get the required parental cosigner. That's where *secured cards* come into the picture.

A secured card looks and works like a regular VISA or MasterCard. But your line of credit is secured by your deposit in a savings account in the issuing bank. The minimum is typically $200 or $1,000. The amount of your deposit becomes your line of credit. If you miss making a payment, the bank has the right to dip into your savings to cover your debt. And the interest charges on unpaid balances are very high.

You'll earn a low rate of interest on the savings account, but you'll get a chance to establish a credit history of regular repayments since your payment habits are reported to the credit bureaus. You'll soon be offered other credit cards that do not require a security deposit. To find issuers offering secured cards, go to www.Bankrate.com or www.CompareCards.com.

The Savage Truth on Getting Out of Debt

Managing your debt makes sense. Adding to your debt is nonsense—no matter what form it takes. And it takes self-discipline to evaluate tempting offers that seem like an easy out to your credit woes. Here are some of the common traps—and a look at the ultimate consequences

of taking these routes to dealing with debt. And then, the Savage Secret for paying down your credit balances quickly.

Beware Debt Consolidation Offers

The latest scams in the world of consumer debt revolve around debt negotiation firms that promise to settle your debt for pennies on the dollar. Debt negotiation can work—*if* you have money set aside to tempt your creditor to settle. Unfortunately, many of these services suggest you stop paying your credit card bills and put the money in a separate account so they can negotiate a lower-balance payoff. In the meantime, the cardholder's credit is further ruined. And in some cases card issuers have gone to court to get judgments against the borrower, garnishing wages and posting liens against personal property.

When the FTC took on these services and decreed that no up-front fees could be charged until a negotiation was successful, some of these companies changed to a "legal" model—collecting fees for legal services that were not covered by the FTC rules. However, most now charge only minor fees in addition to 25 to 30 percent of the amount you "save" by using their services.

Debt consolidation should be a last resort only to be used after your credit is already destroyed—not at the point when you realize that you're making minimum payments on a mountain of debt. Creditors are only likely to settle for a reduced payment when you are far behind on your payments and can demonstrate a life-changing event, such as job loss or illness, to show that you are unlikely to repay in full in the future.

If and when they do settle, your credit and credit score will be ruined for years making it difficult or very expensive to ever get another card. So you would want to reserve one fully paid card for future usage.

The Savage Truth is that you cannot negotiate a balance without some leverage. So if you do have cash set aside, a debt negotiation service is worth a try. But you might be just as successful negotiating on your own.

Transferred Balances Don't Disappear

Balance transfer cards offer a tempting alternative to dealing with credit card debt. And, used appropriately, they can give you breathing room to pay down existing debt. A balance transfer card typically allows

you to transfer a balance from an existing card and pay no interest on the balance transferred for a period as long as 18–24 months. That's the tempting headline, but there are many catches to these offers. Compare the following:

- Is there a fee for the transfer?
- How long is the interest-free period?
- Does the card charge an annual fee?
- What interest rate will be charged on new purchases?
- What rate will apply after the transfer period?
- Are there special offers, such as rewards, for new charges on this card?

The real issue with these balance transfer accounts has to do with your own self-discipline in paying down the balance during the interest-free period. If you don't, you've fallen into a bigger trap because the interest rates will jump to among the highest around if they know you are now trapped in debt! And it's unlikely that you can pull the same transfer trick more than twice.

Even worse, many people don't close the original card, but instead view the zero balance on it after the transfer as an open line of credit, to be charged up again.

Please remember that old Savage Truth: *When you're in a deep hole, stop digging.*

Your Home Is Not Your Piggy Bank

The lessons of the danger of home equity loans and lines of credit became very public in the financial crisis that began in 2008. Since then, home equity lending has become more regulated and less widespread. But lest you be tempted by current low interest rates, let me point out again that most home equity loans or lines of credit carry a floating rate of interest. If inflation returns, that affordable payment could skyrocket. And most of these loan payments are for interest only, leaving you with a big repayment burden down the road when the "bubble" bursts.

In 2018, the tax laws changed. Now, interest on a home equity loan is no longer deductible, unless that money is used to pay for home improvements ("to buy, build, or substantially improve") the home that secures the loan. In other words, if you take out money to remodel your kitchen or bath, the interest is deductible. But if you

borrow against your home to pay off credit cards or student loans, the interest is no longer deductible. (And in case you were planning to borrow a substantial amount, there is a new limit of $750,000 in debt on which interest may be deducted on a primary and secondary home.)

Your goal should be to pay down all your debt, and especially your mortgage, before you reach retirement age.

Don't Borrow from Your Future

Your company 401(k) retirement plan—or 403(b) plan for a nonprofit organization—may allow you to borrow up to 50 percent of your account value (to a maximum of $50,000), typically at an interest rate of 1 to 2 percent above prime. Since you're borrowing from your own account, the interest you pay will be credited to your account. Because it is a loan and not a withdrawal, there is no penalty or income tax due on the amount borrowed. That leads many people to conclude that borrowing from a retirement plan is the least costly way to pay down consumer debt. That's wrong.

Yes, you're paying interest to yourself. But the amount you borrow from your account is no longer growing at the investment rate you're earning on the balance of your plan. And when you lose today's investment returns because you borrowed from the plan, you also lose the larger asset base on which your account compounds in the future.

Even worse, if you leave your company (or if the company is sold and retirement plans merge) with a loan outstanding, it is considered a withdrawal, and it results in ordinary income taxes on the amount taken out, plus a 10 percent federal early- withdrawal penalty.

Also, these loans require regular monthly repayments over five years, made through your payroll deduction plan. If you can't make those monthly repayments, the entire amount may be reclassified as a withdrawal.

Yes, it's tempting to invade your 401(k) or IRA to pay down pressing debt. I suppose it would be equally tempting to invade your future Social Security benefits. You know that's not allowed! Try to treat your own retirement plan in the same context—unavailable and out of reach. (And actually, in most states retirement plans are out of reach of creditors.) It's better to confront your debt problems now, when you are young enough to make a fresh start, than run out of money when you are old and infirm.

Two Savage Debt Paydown Secrets

SECRET #1: Stop using your cards. Just stop.

Take your credit cards out of your wallet. And remove them from online buying sites like Amazon. If you've memorized your card (yes, I have!) then ask for a replacement card with a new number. Like quitting smoking or drinking, you have to go cold turkey!

You don't have to cancel your cards (see below on credit scores). You simply have to remove them from your daily life until your debt is paid down. In the meantime, you can achieve the convenience of plastic by using a debit card. Your debit purchases show up immediately when you download your checking account information or use your mobile app. You won't get rewards on your purchases, but you won't pay interest.

Of course, you can't debit more than the balance in your checking account to which the debit card is linked. A debit card allows you to break the credit overspending habit. If there's not enough cash in your account, your purchase will be denied right at the merchant's register unless you've authorized your bank to create an overdraft feature.

And your debit card is more secure than carrying cash. Here's the promise written on Visa's website:

> If your Visa Debit card is lost or stolen and fraudulent activity occurs, you are protected by Visa's Zero Liability policy. That means 100 percent protection for you. Whether purchases occur online or off, you pay nothing for fraudulent activity.

Once you've stopped adding to your credit card balances, you need a smarter way to pay them down.

SECRET #2: The Simple Debt Paydown Formula

It's a sad truth that the minimum required monthly payments on an outstanding credit card balance are designed to maximize the interest to the lender over the life of the loan, while making credit seem affordable to the consumer.

That minimum monthly payment may be as low as 2 percent of the outstanding balance. But if you're paying down 2 percent and adding on 18 percent in annual interest to your balance (about 1.5 percent interest per month), then you're really only paying down one-half of 1 percent of your balance every month.

At that rate, it will take most of your lifetime to repay your debt! You need a plan to shorten the payback period. In our earlier example of the $2,000 credit card debt that would take you 31 years and two months to repay (and would cost an additional $8,202 in interest), the implied minimum monthly payment is about $41—assuming you never charge another penny to the card.

- If you added $10 a month, you would repay that debt in 12 years and pay $2,085 in interest.
- If you added $25 per month, you would repay your debt in six years and pay $1,051 in interest.
- Now, here's the Savage Truth: *If you double your current minimum monthly payment to $82 and kept paying that same dollar amount every month, you would repay your loan in 2.5 years—assuming you don't charge another penny on that card.*

It's a technique that works, no matter what the balance on your card, or the interest rate. It does require two types of self-discipline: never using the card once you start the pay-down plan, and making that same original payment every month—*not* twice the new, lower, and more tempting minimum payment. Write the initial amount down—and keep paying it every month.

If attacking every balance requires too big a chunk out of your budget every month, try it with one card—the one with the largest balance and/or the highest interest rate. What a triumph to get the first card paid off and then move on to the next.

Try those calculations yourself in your Quicken or Mint. They'll guide you to regular repayments in your debt reduction program. Or there is an excellent instant debt repayment calculator at www.CreditKarma.com.

Once you see the impact of your plan in black and white, you'll get out of the red.

The Savage Truth on Credit Reports and Scores

Debt used to be a privately guarded secret—something people never discussed. Now it's a public conversation and a force in social media. Your credit score has become far more important in determining your future than your long-ago SAT score.

Your credit report and the score derived from it determine not only the interest rate you pay on your mortgage or auto loan, but the price you pay for auto and life insurance. They may help determine whether you get a job or a promotion at work. Your credit history reveals a lot about your personal work habits and ethics to the people who make those decisions.

Interestingly, in China, where personal debt is absolutely prohibited, social media apps on the popular WeChat platform now warn individuals if they are walking near people who may be in debt! It's the latest in a form of debt shaming—encouraging people to approach debtors and berate them!

While our society is far from this authoritarian approach, you can be sure that your credit score is a matter of reasonably public record for those who seek to employ you or with whom you have financial dealings.

Your Credit Report

Once upon a time, your credit report was a highly guarded secret—even from you. To see it, you had to request a copy in writing—and when you did get this bulky synopsis of your credit history, it was encoded in a jargon that few could understand. If you wanted to complain about a mistake, it was a long process that basically only allowed you to attach a short written statement to any business that requested your report.

We've come a long way. Now, you can instantly and securely get your credit report online, FREE, from each of the three major credit bureaus. And that report is easy to understand, You can register a dispute with a click of your mouse. But honestly, it can take some time to get disputes cleared up because the bureau must go back to the original credit grantor to search for the truth.

Every credit transaction—and its repayment—is reported to three national credit bureaus by the companies with which you do business. The job of the credit bureau is to compile the information—not to verify it.

There are three major credit reporting agencies. You can access their information at:

- www.Experian.com or (888) 548-7878
- www.Equifax.com or (888) 397-3742
- www.Transunion.com or (800) 916-8800

The three credit bureaus typically have all the same information, which is reported to them by your creditors. However, there could be discrepancies, which is why you should check all three—a process that is free, easy, and secure.

The *only* way to get the federally mandated free credit report is at www.AnnualCreditReport.com. That provides instant links to the three credit bureaus. Do not be misled by other websites that have the word "free" in their names; they all want to sell you some sort of credit monitoring and protection against fraud. (More on that to come.)

You might have some concern about how your credit report could be secure and still allow you instantaneous online access. The questions you're required to answer to access your report go far beyond information that would be easily accessible to anyone else. You'll be asked about previous addresses, car financings, and other transactions. And frequently the correct answer is "none of the above." You can be sure that accessing your credit report has a level of security that is well-tested. Just be sure you are operating from a secure WiFi connection to your computer or tablet.

Since you're allowed one free report from each company every year, it is wise to space out your requests, getting one report every four months, each time from a different company. That way you'll stay on top of any changes.

Credit Scores Your Life

Your credit score is a way of placing all the information on your credit report into one easily compared number. The best-known credit score is called the *FICO* score, from the name of its parent, Fair Isaac Corp. Several credit bureaus offer their own version of scores, including the Vantage Score, but none is as widely used as the FICO.

Credit scores typically fall in a range of 300–850. A credit score of 700 or above is generally considered good. A score of 800 or above on the same range is considered to be excellent. Most credit scores fall between 600 and 750.

Your credit score is derived from information on your credit report, which is why it's important to check your credit report regularly. The most significant factor in your credit score is on-time payments. The length of your credit history and the percentage of your credit lines being used also highly impact your score.

Your credit score is more than an arbitrary grade; it has a significant impact on your cost of credit. For instance, someone with FICO scores in the 620 range would pay $65,000 more in interest over the life of the loan on a $200,000, 30-year mortgage than someone with FICOs over 760, according to Informa Research Services. On the other hand, if you have a credit score over 750, you will likely qualify for zero-percent car loans or credit cards.

Of course, beyond being on time with your payments, lenders look at your overall debt burden to income before pricing credit. So you can often impact your credit score immediately by paying down outstanding balances before applying for a mortgage or car loan.

There's some debate about closing outstanding but unused accounts. Be sure to hang onto the oldest accounts, even if you don't use them, because they show stability. And if you carry balances, don't close too many accounts because it will increase your percentage of "credit utilization," which could actually lower your score.

It's easy to get your FICO score online at sites that offer either "free" credit scores or packages of credit reports and scores. Beware: Although the word "free" is all over these websites, the score comes with a subscription to their monitoring service. If you don't cancel within 30 days, you'll receive a monthly charge, that could be as high as $30 per month, depending on the services that are packaged along with your score.

The easiest, and truly FREE, credit score can be found instantly at www.CreditKarma.com. You'll be required to create a set of log-in credentials, which you can use to access your score securely and frequently, and it's always completely free. And you'll receive e-mail notifications when your score changes—up or down. Discover also offers completely free FICO credit scores at www.Discover.com/free-credit-score.

Protecting Your Credit Is Critical

Credit protection has become a big industry. Famously, in 2017 even the supposedly safest credit repository—Equifax—suffered a dramatic breach that exposed the credit history and information of 143 million people.

Every credit bureau and a number of independent companies offer some sort of credit monitoring and protection services. Many cover protective services that you could access for free at each bureau's website.

For example, you can put a freeze on your credit report for at least a year at no charge. A freeze means that no one can establish new credit in your name, without you allowing the freeze to be temporarily lifted. The bureaus give you a PIN to authorize access if you're applying for a mortgage or car loan or new credit card.

Using a credit freeze, along with getting in the habit of checking your account balances daily and noticing unauthorized charges, goes a long way to protecting your credit.

Many of these services promise to track your identity and social security number on the "dark web" to see if your information is in play. But since the massive data breaches that impacted so many consumers, it is safe to assume that someone is always trying to get access to your information. The most likely way for that to happen (once you've frozen your credit) is for you to simply give it to them—by responding to a "phishing" expedition by giving out your private information. Delete questionable e-mails and simply hang up on threatening or inquiring phone calls. Don't open the door to identity theft.

Never write your PIN on your bank card, and don't put your credit card number on the back of a check. Don't leave your debit card as a security deposit or for identification purposes. Decline a paper receipt for ATM withdrawals. Always take your credit card receipts and, if you aren't saving them in a file, dispose of them carefully.

Reconsider that overdraft line of credit on your bank account. You're 100 percent protected against fraudulent use of a debit card, but a thief might meanwhile have unlimited access to your overdraft line of credit through a stolen debit card. It could take a few days to get that money restored to your account.

The one aspect of identity theft protection that might be most valuable is a service offered by some of these companies: help *restoring* your identity and credit once your identity has been taken. You see, none of these programs offers a full guarantee that they can protect you completely.

My hope is that at this point you feel empowered to deal with the basic building blocks of your financial life—your spending, your debt, and your credit. Now, it's time to move on to saving and investing.

TERRY'S TO-DO LIST

1. Figure out where you stand financially right now. Make your personal balance sheet—I Owe, I Own.
2. Make a list of all your outstanding bills, including balances, interest rates, and monthly minimum required payments.
3. Use Quicken or Mint to track and categorize all your spending.
4. Start using a debit card in place of cash or credit.
5. Get reputable, local help in dealing with debt from the National Foundation for Credit Counseling at 800-388-2227.
6. Get your free credit report using the links at www.AnnualCreditReport.com.

CHAPTER
4

THE SAVAGE TRUTH ON CHICKEN MONEY

Nest Eggs Need Some Safety

How much money can you afford to lose? That's a startling question—and the first automatic response is likely to be: "Nothing!" But without risk, there is no opportunity for reward. Taking an appropriate amount of well-calculated risk is the essence of investing. But you may have more peace of mind in volatile markets if you have set aside some money that is safe from the ups and downs of the stock market.

That's where "chicken money" comes into the picture. We all have a certain percentage of our savings that we absolutely cannot afford to lose. Having some chicken money can give you the resolve needed to ride out the volatility in other investments that are designed to bring you growth in the long run.

Just how much money you should set aside depends on your personal situation—age, assets, time horizon, and risk tolerance. As noted in Chapter 1, chicken money is nothing to be embarrassed about; it's simply money that you're unwilling to risk. That may be because you have a very short time horizon. For example, you have almost enough for a down payment on your first house, or your child's college tuition is due in a few years. That cash does not belong in the stock market, no matter what your enthusiasm for stocks, because of your short time horizon.

Or you may have chicken money because you have a limited amount of assets that must last for an indefinite period of time. If you're already well into retirement and just want to be certain that your savings last as long as your lifetime, you won't want to take significant investment risks. After all, without a continuing income you have no way of replacing any losses.

In either case, you'll want to keep your cash in appropriate chicken money investments such as bank CDs, money market funds, and Treasury bills. Those chicken money alternatives will be explained and compared in this chapter. But first, you need to analyze your own need for this stash of safe money.

Bulls, Bears, and Chickens

Stock market headlines revolve around the "bulls" and the "bears." Bulls think prices are going higher, and they can give you good reasons for buying now—before prices rise. When you hear a bull talking about buying, it's hard to remember that there might be a risk involved in an investment. On the other hand, the bears seem like pessimists. They can give you many good arguments for selling out and staying out. Listening to both sides of an investment argument between the bulls and the bears is like watching a tennis match from midcourt.

Over the long run, stocks outperform chicken money. But in the interim, the stock market can be volatile and even scary. That's why I created a third category: bulls, bears—and chickens!

The mantra of the chicken money investor is:

> *I'm not so concerned about the return* ***on*** *my money as I am about the return* ***of*** *my money.*

That essential qualification limits your choice for keeping your money safe and reasonably accessible. But chicken money is not really about having cash, although holding some paper money for emergencies is wise.

We've seen bank ATM failures or Internet outages. In fact, the most crippling potential strikes against our country are no longer limited to missiles and warheads. Instead, a national electrical sabotage or an electronic crash of our banking system could wreak widespread hardship on modern society. Having a little cash in your pocket may tide you over for a few days or even weeks. But these days, there is less and less use for paper money—cash. So our definition of chicken money revolves around the safest, short-term investments.

Chicken Money Characteristics

It's the nature of stock market investing that you must make two decisions, or even three. The first is when to get in, the second is when to get out, and the third is when to get back in again.

Chicken money investments are one-decision investments: Once you're in, changes in market circumstances will never force you out. Since you won't have losses, you'll never sell in a panic. Since you won't have gains, you'll never have to decide when to take a profit.

Chicken money investments are short term—typically having a maturity of one year, or less. So you can usually get at your money easily. Some can remain in a money market deposit account, where you can write a check for instant access. Or you can stagger maturities of six-month Treasury bills, so you can access a portion of your investments on a regular basis.

Chicken money yields are typically the lowest around. The return on your investment may vary in line with interest rates, inflation expectations, and tax code changes. All of those factors will be relative to changes in the economy, which will have an even greater impact on riskier investments. So, in the end, your chicken money investments will always be the most conservative choice, carrying the lowest return among the alternatives.

What you give up in returns you receive in the assurance that you will not lose your principal to investment risk. But even chicken money investments carry a certain degree of risk: the risk that taxes and inflation will eat away at the buying power of your money.

Part of that risk can be set aside by keeping your chicken money in tax-sheltered accounts such as traditional IRAs or annuities, both of which defer taxes. But when you eventually withdraw the cash, you'll have to pay ordinary income taxes on the earnings, as well as on any of the original investment that was a pre-tax contribution.

The risk of inflation is defrayed because chicken money investments are by nature short-term instruments. If inflation brings with it rising interest rates, the interest rate on your chicken money investment will also move higher. But there's rarely a significant spread between the inflation rate and the rate of return on chicken money investments.

One other notable aspect of chicken money investments is the low transaction costs of getting in and out. So these easy-in, easy-out, chicken money investments are often used as a resting place for money in between other investment opportunities. Even if you

don't consider any part of your investment portfolio to fall into the chicken money category, it's worth learning the ins and outs of these temporary havens.

Chicken money creates dangerous temptations. It may be painful, and tempting, in times of low interest rates to search for higher-yielding but riskier alternatives. Those are the mistakes you regret most, in hindsight. Self-discipline is a key ingredient in all market decisions—but especially so when it comes to safeguarding a well-defined portion of your assets.

A Savage Truth: *If you truly can't afford to lose your principal, do not chase yield.*

There is always a reason behind higher returns, despite the sales pitch about the investment being "safe." Uncounted fortunes have been lost to the temptation to earn just a little—or a lot—more on a supposedly "risk-free" deal. Remember, no one would be out pitching it to you, if he or she weren't making some money on this deal. So you are never getting enough return to compensate for the hidden risks. By definition, you must seek out chicken money investments because no one can earn money selling them to you!

Chicken money by definition is kept in a safe, liquid, and secure investment like those explained below. But first, you must understand the one risk that having chicken money cannot completely erase—the risk of inflation.

The goal of chicken money is to keep you even in periods of rising inflation. And as a reminder to those who have not seen inflation in their lifetime, it can have a significant impact on your financial security.

Inflation and The Rule of 72

Inflation eats away at the spending power of your money. To put it simply, even at a low inflation rate of only 3 percent annually, the buying power of your money will be cut in half in less than 25 years! So a fixed pension or annuity payout that looks enticing today could have a devastating impact over a 25-year period of retirement.

The Rule of 72 is a simple way to calculate the effects of inflation on the buying power of your money and also the effects of interest returns on the growth of your principal.

The Rule of 72 says that if you divide any number that represents your investment return into 72, the result will be the amount of time it takes for your principal to double. If you're earning 7 percent on

your money, compounded, your principal will double in 10.2 years. Conversely, if inflation is eating away at your money at an annual rate of 7 percent, the value of your principal will be cut in half in 10.2 years. And if you're earning 3 percent, it will take 24 years for your money to double, or for your spending power to be cut in half.

So it's important to look at both sides of the equation. Interest compounded will build up your principal, while inflation will eat away at its buying power. Of course, if you spend your interest while maintaining your principal, you're just fooling yourself if you believe you're staying even.

Now you're ready to make smart chicken money choices. All of the investments listed below are appropriate. But they sometimes have a significant difference in yields. It's up to you to explore the differences.

In recent years, bank savers became used to very low interest rates, and got into the habit of leaving money in money market deposit accounts or automatically rolling over CDs at the offered rate. In the meantime, the more sensitive market for U.S. Treasury bills offered significantly higher rates to investors with the same degree of security. Banks exploited the inertia to earn far more on deposits than they paid to their customers. All your chicken "nest egg" choices do not pay the exact same rate at the same time.

Chicken Money Choices

U.S. Treasury Bills: The Ultimate Chicken Money Investment

When the world's money gets scared these days, it rushes to the safety of U.S. Treasury bills—short-term IOUs issued by the U.S. government. It wasn't always so, and given the huge debt the United States is building, it might not be that way in the future. Still, in any crisis, such as the financial meltdown of 2008—2009, the world's liquidity first turned to short-term U.S. government IOUs: Treasury bills. When buyers rush in, they push prices up, causing yields to fall.

In the past decade, we have lived in a period of extraordinarily low interest rates. The yield on six-month Treasury bills dropped to 0.05 percent in 2009. At one point, there was concern that rates would go "negative"—as happened in Europe. As of mid-2019 there was more than $13 trillion of negative-yielding central bank debt in Europe. That means people were "paying" banks to hold their money for safety! In times of global economic uncertainty, the United States has been the relatively safe haven for money, with demand for our IOUs pushing yields down.

On the other hand, inflation fears can cause short-term rates to rise rapidly, since the Treasury must auction new bills weekly to repay older, maturing debt—and to borrow more. Most people have forgotten that in the late 1970s and early 1980s, investors questioned the promise and ability of the U.S. government to repay its borrowings with dollars that had real buying power. So people rushed to buy gold, soybeans, and real estate. In order to get people to invest in its short-term government securities, the Treasury had to pay high interest rates that reached 15 percent for a period of six months.

Then, under Fed Chairman Paul Volcker, and later Alan Greenspan, the Federal Reserve convinced investors around the world that it would never again inflate the money supply by creating too many dollars to finance our budget deficits. As confidence in the future value of the dollar grew, inflation fears subsided.

The combination of confidence in the dollar and fear of declining values of other countries' currencies caused a rush to convert those currencies to dollars and to buy government-guaranteed Treasury bills. As a result of that demand, Treasury bill interest rates fell sharply and stayed low for decades.

Now, we're potentially at the stage where the world will question the value of the dollar once again. If the fear of inflation ignites, then interest rates will rise immediately. Or if political uncertainty undermines faith in the U.S. government, it could also trigger selling of our Treasury securities, pushing rates higher.

This time around, that would be particularly expensive for our government because our national debt that must be financed has grown to more than $23 trillion. Paying interest on those borrowings could easily become overwhelming.

That's why interest rates on Treasury bills have become a true barometer of inflationary expectations. Those rates are set at the weekly government auctions, where huge institutions around the world place bids through Treasury dealer firms. (Smaller individual investors agree to accept the average interest rate set by these public auctions.)

The weekly rate is determined by economic conditions, such as inflation expectations, as well as by supply and demand. When there is a great demand for its IOUs, the government can pay a lower rate of interest and still attract buyers. But when buyers are wary of owning dollars, the government must pay a higher interest rate to attract those buyers to finance our debt.

How to Buy Treasury Bills

Individuals can easily buy Treasury bills in minimum amounts of $100, through the website www.TreasuryDirect.gov. You don't get an actual paper certificate; all transactions are done online and your account is maintained electronically. It's really easy to get started. You'll need your bank account number and the bank routing number, since payment for your purchase and deposit of your interest is done electronically.

Treasury bills have maturities of one year or less. *Treasury notes* are initially sold in maturities of from 2 to 10 years. *Treasury bonds* have 20- or 30-year maturities. All are guaranteed by the full faith and credit of the U.S. government, a fact that makes them the safest investments—and the interest rate standard by which all other IOUs are compared.

Since Treasury bills are sold for such short-term maturities (13-week, 26-week, and 52-week offerings), the interest is actually paid up front in the form of a discount on the purchase price. That is, if you were to purchase a $1,000, 26-week Treasury bill that carried a 3 percent interest rate (as determined at the weekly auction), slightly less than $1,000 would be deducted from your checking account in payment. The difference is the interest you earn is paid upfront. And, notably, that interest is not subject to state and local income taxes.

When you purchase your Treasury securities, you can instruct that they be automatically *rolled over* when they mature. That is, the principal amount will be reinvested at the going rate in similar maturity securities. A deposit for the interest will be immediately credited to your linked checking account.

You can also change your mind at any time, and ask that the proceeds not be renewed, but instead be deposited into your bank account at maturity. But you should not plan to sell small amounts of Treasury securities before maturity, because there is a $45 fee.

Accounts can be registered in the name of one person, two persons, or an entity such as an estate, trust, revocable living trust, or corporation. But the Treasury does not act as a custodian for IRA accounts.

At TreasuryDirect.gov, you can also purchase Treasury notes (maturities from 2 to 10 years) and longer-term Treasury bonds. You can also track maturity dates and values and redeem your U.S. savings

bonds. And you can purchase TIPS (Treasury Inflation-Protected Securities). All are clearly explained at the website.

The Treasury department has made it easy for individuals to buy Treasury bills, notes, and bonds at the regular weekly and monthly auctions. You can track your holdings online and stagger the maturities for more liquidity. However, if you want the safety of Treasuries with daily liquidity, you are better off using a Treasury-only money market mutual fund or money market account in a bank.

Treasury-Only Money Market Funds

Banks offer money market deposit accounts that are fully insured up to $250,000. The rates paid on money market accounts change daily to reflect changes in the interest rate marketplace. Since bank accounts are backed by the full faith and credit of the government through the Federal Deposit Insurance Corporation, you're getting the same guarantee as someone who buys Treasury bills directly from the government. But there are occasions when Treasury bill rates might be a bit higher than bank money market rates. If there's little loan demand, for example, the banks will drop rates to make deposits less attractive.

In that case, you might turn to Treasury bills or to a mutual fund that buys only short-term U.S. government IOUs. Every major mutual fund family offers one of these Treasury-only money market mutual funds, with yields that may fluctuate every day based on the market rates for very-short-term Treasury securities. The funds are not insured, except for management malfeasance up to $500,000 per customer under the Securities Investor Protection Corporation (SIPC). But because they invest only in U.S. Treasuries, they are very safe.

The fund families' other money market funds might offer a slightly higher yield because of investments in commercial paper (short-term corporate IOUs) and mortgage-backed securities of a very short term. Treasury-only money market funds typically pay the lowest rate of interest and offer the highest degree of security. It's a distinction that would matter only in times of extreme crisis, but some investors feel more comfortable with that extra margin of safety.

In fall 2008, we saw one of those rare moments when the safety of money market mutual funds that invested in commercial paper was

called into question after the failure of Lehman Brothers. The government stepped in with a guarantee of those money market funds. The guarantee was lifted a year later, and only one money market fund suffered a temporary small loss. But for a few weeks, those who had accepted lower yields in Treasury-only money market funds slept better than those whose funds were temporarily threatened.

The Rate Search for CDs

Bank certificates of deposit are another form of chicken money investment. But, you're likely to find quite a disparity in rates offered by different institutions as well as rate disparities depending on the balance you have to invest. Internet banks have grown in popularity for offering higher rates, because they have fewer costs to cover. These days, with fewer personal banking connections to keep you at your local bank, it may pay to do a wider search for the best deal.

One place to search for the best interest rates across the country is www.Bankrate.com. Knowing the competitive rate environment may help you make a smart decision. But keep in mind that you might lose the edge of higher rates if the process of making a wire transfer keeps you out of the market for a few days.

Just make sure that you are buying a certificate of deposit that is federally insured by the FDIC. The standard insurance amount is $250,000 per depositor, per insured bank, for each ownership category. That means you could actually have more than $250,000 in insured deposits in each bank, depending on how the accounts are titled.

And for those who have amounts over the insured level, including small businesses or agencies, there is a way to automatically distribute your cash to a network of insured accounts at different banks. At MaxMyInterest.com, your deposits are automatically moved to online banks offering the highest FDIC-insured savings rates, while keeping your balances under insured limits. Just link your existing bank account securely to www.MaxMyInterest.com, and easily open linked deposit accounts. The rest is automatic, secure, and transparent as you can easily check your balances at their website. Wealthfront offers a similar service.

Create Your Own Bond "Ladder"

One problem with investing all your cash at one time is that you might regret that decision if interest rates move higher right after

you invest. The solution to that problem is to create your own *bond ladder*—staggering the maturity dates of the securities you purchase. For example, if you wanted to keep your portfolio fairly short term, you could invest in 13-week, 26-week, and one-year Treasury bills. Or you could purchase only 13-week Treasury bills but stagger your purchases every two or four weeks. That way some portion of your investment would always be maturing, and you could take advantage of higher interest rates.

A bond ladder can also be constructed with longer-term securities, perhaps adding two- to five-year Treasury notes. Under ordinary circumstances, this strategy will add more current yield while preserving the flexibility to take advantage of higher rates. Of course, this process has a downside: If interest rates decline, your overall yield on the portfolio will decline because maturing securities must be replaced with lower-yielding ones.

A Sad Savage Truth About U.S. Savings Bonds

Savings bonds originated as a patriotic way to help the government in wartime. For many years, they were a sensible chicken money alternative investment. But in recent years, the government has changed its formula for paying interest on traditional Series EE bonds. And the Series I bonds, which are designed to offset inflation, can lock you into an incredibly low base rate for the life of the bond. All of these issues make them far less attractive to investors.

But there are still huge amounts of money stashed away in savings bonds that were once the go-to gift for graduations and birthdays. Now these savings bonds are maturing—and they require you to act to cash them in appropriately.

You can track the final maturity of your savings bonds at TreasuryDirect.gov. At maturity, savings bonds stop earning interest. Even if you still have the old paper bonds, it is your obligation to present them to a major bank within six months of maturity. Because of historic floating rates, those bonds may be worth far more than face value at redemption. The Treasury has estimated there are more than $13 billion of matured savings bonds that have not been redeemed.

Collecting the money from a matured savings bond is a federal (not state or local) taxable event—unless you opted to pay taxes along the way, which very few people did. In fact, some seniors may find themselves in a higher tax bracket, or even subject to income

taxation of their Social Security benefits as a result of cashing in a significant amount of savings bonds in one tax year. Through ignorance, or benign neglect, you may be able to manage the redemption of the bonds to spread the income impact over two or more years. Just be aware of the amount of taxable income you're adding to your current income.

Beware redeeming bonds *before* maturity. If you have older Series EE bonds, dated before May 1, 2005, they still accrue interest on the old floating-rate formula, with a higher guaranteed base rate. So these bonds may be uniquely valuable, and you should think twice about cashing them in before they reach final maturity.

Also, before cashing in older bonds, make sure you know exactly when the next interest payment will accrue. You want to wait until after the interest is paid, or you risk losing out on the most recent interest earned. At TreasuryDirect.gov, you will find a "Savings Bond Calculator" tool that will help you create an inventory and find out what your older bond is worth today, based on the issue date.

Among the remaining attractions of savings bonds is the fact that the interest is always free from state and local taxes. Plus, for middle-income families who cash in bonds purchased after 1989 and held in the *parent's name* to pay for college tuition, all the interest earned is tax free. (For this purpose, "middle income" means income of roughly $93,000 on a single return, or $147,250 on a joint return.)

But for grandparents who remember the economic and patriotic practice of giving savings bonds as gifts, I highly suggest you instead open a 529 College Savings Account. (Learn more in Chapter 12.)

Savage Truth on Bond Dangers

The word *bond* conjures up an image of safety and security. But longer term bonds—with maturities longer than 2 years—are no place for chicken money. Even the safest, highest-rate bonds, such as U.S. Treasury bonds with maturities longer than two years, carry risks that make them inappropriate for investing money that needs to be safe and accessible.

Especially during periods of low interest rates on bank CDs, Treasury bills, and other chicken money investments, people are

tempted to look at longer-term IOUs, which usually pay a higher rate of interest. But bonds have their own risks. You can lose (or make) as much money in bonds as you can in the riskiest of stocks. So this is a good place to discuss the truth about risk in bonds. These Truths apply to all bonds, including bonds issued by the U.S. government, private corporations, or states and municipalities.

The Risk of Default

The first kind of bond risk is obvious: the risk of *default*. Would you lend money to your brother, adult child, or best friend? It all depends on your affection for them—and on your assessment of the risk that they won't repay. When it comes to investing in bonds, you can rule out affection and make your decision solely on creditworthiness. In fact, there are rating agencies that determine the likelihood of regular interest repayments and ultimate repayment of principal. Triple A is best, and the ratings move downward from there to triple B, the lowest investment-grade rating.

Higher-rated bonds pay a lower rate of interest because people are more willing to lend to governments or companies with stellar credit ratings. Ratings are no secret. Some bonds, called "junk bonds" or "high-yield bonds," have very low ratings and correspondingly high risk, but they also pay higher rates of interest to tempt buyers. If you're willing to take this higher risk of default, you can earn a higher return as long as they keep paying. Just understand that risk and return are opposite sides of the coin.

When I wrote the advice in the paragraphs above a decade ago, I had no idea that investors, including banks and sophisticated money managers, would literally throw caution to the winds and purchase debt backed by questionable mortgages. But it happened—and the losses were huge. Of course, some of those mortgage bonds were backed by quasi-governmental agencies: Fannie Mae and Freddie Mac. Still, the losses were huge as bond sellers could find no buyers willing to take on the risks of default that suddenly became apparent in many of these mortgage-backed securities.

Going forward, there has been much more attention paid to quality of the credit. (Just try to get a mortgage loan today and you'll see what I mean.) But there are still investors who are desperate for higher yields and willing to take on that additional credit risk. Astoundingly, in 2019, bonds rated BBB, the lowest rating of the investment-grade market, accounted for 50 percent of the

Bloomberg Barclays investment-grade bond index, versus 38 percent prior to the 2008 financial crisis. An economic slowdown could set the stage for defaults and restructurings. That's a real risk that bond investors should understand.

Another great concern is for potential defaults in the municipal bond market, as cities and states face huge budget deficits and pension obligations. Now, differences in credit quality are being more carefully examined. The "full faith and credit" of a state that cannot pay its bills is hardly comforting. At least the federal government can *print* money to pay its bills and the interest on its debt, while a state can only raise taxes or cut spending in order to have money to pay the interest on its bond obligations.

But risk of default isn't the only risk you take when you buy bonds. There's also the risk that your bonds will lose value in the marketplace because of changing perceptions of inflation. And even federal Treasury bonds are not immune from that risk.

Market Price Risk in Bonds

When it comes to bonds, there's another risk: *market price risk*. Even bonds from top-rated companies or governments can drop in value because of external events such as inflation. Here's a simple example:

Suppose you buy a $1,000, 30-year bond from a triple-A-rated company. The interest rate set on the bond is 4.5 percent—a very nice return compared to today's low inflation rate. That 4.5 percent rate is called the *coupon rate*. Every six months you receive a check for your interest. The company continues to prosper. Then inflation starts to rise. Three years later, when the same triple-A-rated company sells bonds in this inflationary environment, it has to pay investors a rate of 8 percent in order to get them to buy its new 30-year bonds.

Now, suppose you decide you need to sell your older bond to pay some bills. Don't assume it is still worth $1,000, even though the company is still doing very well and there is no question it will continue to pay the 4.5 percent interest until maturity, when you will receive your $1,000 back.

In the new inflationary environment, you'll find that no one is willing to pay you $1,000 for your 4.5 percent bond because they could take that $1,000 and get an 8 percent bond of similar quality. What is your old bond worth today if you sell it? About $750.

You've just seen a real-life demonstration of market price risk:

When interest rates move higher, the market value of older, low-yielding bonds moves lower.

That rule holds true whether you're buying government bonds, municipal bonds, or corporate bonds. Conversely, if you still had one of those 30-year Treasury bonds issued back in the 1980s, with a yield of 14 percent, it would be worth far more than its initial $1,000 cost. Of course, most of those older, very high-yielding bonds have matured. Still, in a period of low interest rates, even bonds from a decade ago have relatively higher yields. But to buy them, you'll pay a price higher than the $1,000 face value. That's called a *premium.* The price you pay—or receive—when buying or selling a bond depends on the interest rate paid on the bond and the length of time until maturity.

The market for interest rates moves up or down every day based on traders' and investors' views of the likelihood of future inflation, future Federal Reserve actions to raise interest rates, and myriad other economic factors. The market value of your bond may rise or fall every day as well. Of course, you can hold your bond until maturity, when you'll receive the promised return of your initial $1,000 investment. But if interest rates rise in the interim, you'll suffer by accepting a lower rate of return while you hold your bond.

A special note about bond prices: Unlike stock prices, which are easily found throughout the day and after the daily closing, bond prices have always been more opaque. If you are buying corporate or municipal bonds in amounts less than $100,000, you run the risk that the dealer will make extra money by selling them to you at a higher purchase price, or buying them from you at a price slightly less than the market price.

How can you as the individual investor find real-time current bond prices? At FINRA.org (the agency that protects small investors) there is a section called "Market Data." Click on that link and you can search real-time (or latest reported transaction) prices of all government, corporate, and municipal securities. That way you can avoid paying too much, or receiving too little, when you buy or sell individual bonds. Or you can make your corporate or municipal bond purchases through a mutual fund, as described later, letting the professional fund manager handle the pricing issues.

The Longer the Maturity, the Greater the Market Price Risk

Think about this intuitively. You lend someone money for two years at a fixed interest rate. In the meantime, inflation returns with a vengeance. When you get your money back in two years, its buying power has dropped dramatically. Thank goodness you loaned your money out for only two years. What if you had made a 30-year loan? If inflation really raged, by the time your money was repaid it would be worth a lot less.

The bond trading market factors in the length of time of the loan as well as the quality of the borrower in assessing changes in price. If you purchase a 30-year bond and interest rates subsequently rise 1 percent, the market price of your bond loan will drop a lot more than the market price of a two-year bond or note.

It's like playing "crack the whip." The momentum is greater the farther out you get. That's why there's greater risk in lending your money (buying a bond) that has a long-term maturity.

Event Risk

Interest rates usually move in tandem. That is, all top-rated bonds, no matter what the issuer, will either increase or decrease in price at the same rate and at the same time for similar bond maturities. Even differently rated bonds of similar maturities usually maintain a certain price differential. But special factors sometimes enter the marketplace. We saw that kind of risk develop on several occasions over the past few years. For example, in the summer of 2008, the relationship between different types of bonds moved to an extreme.

Seeking safety, global capital rushed into U.S. Treasury securities, pushing prices higher and yields lower, despite the well-publicized financial risk taking place in the United States. It seemed to investors that the United States was the least risky place in a world beset with the risk of default.

Since then, despite fears of inflation caused by the Federal Reserve's *quantitative easing* (a euphemism for "money printing"), investors have continued to seek relative safety in the United States, pushing bond prices higher and interest rates lower. The price spreads between dollar-denominated bonds and euro-denominated bonds increased dramatically. After all, the euro bonds included the debt of countries like Greece, Portugal, and Italy.

Similarly, while foreign buyers rushed into the U.S. Treasury market seeking safety, very few of them purchased tax-free municipal bonds and shorter-term notes, since they didn't need the tax benefits. The result was that municipal bond yields stayed relatively high, while Treasury yields dropped as buyers rushed into that market.

But municipal bonds—IOUs of cities and states—carry their own level of default risk in debt-burdened times. That's a risk that should be considered before buying municipal debt, as noted earlier. Municipal bonds are certainly subject to "event risk." Even if a few small municipalities were to default, it would impact the pricing of other state and local issuers.

When purchasing bonds, you need to be aware of credit quality, time to maturity, and event risk, which could impact one category of bonds more than another. Since many bond mutual funds are structured to invest in only one type of bond, you also need to understand the investment strategy of your bond funds.

Total Return Is Not Current Yield

It's worth noting here that the yield on a bond is not necessarily the same as its total return or value to an investor. One example is a tax-free municipal bond, which offers a lower interest rate coupon, because most individual investors can receive the interest totally free from federal income taxes and, in some cases, free from state and local taxes as well. So the lower-yielding muni bond might offer a higher after-tax return than a higher-yielding Treasury or corporate bond. It's the after-tax return that counts.

But the concept of total return typically has more to do with price than with tax considerations. Total return includes both the interest you receive and the change in price. Suppose, for example, that you purchase an older, lower-yielding bond at a discount to its face value of $1,000. Perhaps you paid only $950. Then your *total return* would be a combination of that low interest you earn for the remaining term of the bond, plus the gain of $50 when the bond is redeemed for the full face value of $1,000. (And, you'd have to factor in any tax impact on a sale that nets a profit.)

Traders frequently buy bonds simply to make money on the swings in price, based on the changes in interest rates. So you can have a combination of factors resulting in a short-term trading profit or loss. But if you're a long-term bond investor, you're probably most interested in the concept of *total return to maturity*, which takes into

account purchase price and the interest coupon you'll receive until the bond is redeemed.

Special note: Some bond issuers reserve the right to "call" the bonds and refinance them with lower-priced debt. In that case, your plans to lock in long-term high yields would be disrupted. Be sure to check on this call feature before buying a bond. In the current low-rate environment, it doesn't present much of a risk; corporate and government borrowers are glad they locked in low rates in the past.

Measuring both aspects of bond ownership to get total return is especially useful when considering the purchase of bond mutual funds. You could look at a bond fund that had a large total return last year because of falling interest rates. Buying that fund today, when rates have stabilized, would not give you anything like the return the shareholders earned last year when rates dropped and bond prices rose. It's important to note the difference between current yield and total return.

Reinvestment Risk

When you've been smart enough to buy higher-yielding bonds and are tempted to sell them at a profit, you're faced with a choice. You can sell the bond and lock in a very tidy profit even after taxes. But then, what would you do with the cash—reinvest it at today's lower rates? Or you can hang onto the bond and keep collecting your annual interest, but run the risk that bond prices will fall because interest rates move higher.

As you can see, even bondholders face risks and decisions about how to manage the rewards. Once you sell a bond, you have to figure out what to do with the cash. And there's another reinvestment risk. What do you do with the interest you earn on those bonds over the years if you're not planning to spend it? When rates have fallen, you can't reinvest and earn the same yield.

Today's bond investors do have a choice: zero-coupon bonds or TIPS. These zero-coupon bonds, issued by the U.S. Treasury and many corporations, are stripped of their coupons by investment bankers. Thus, they are sold at a discounted fixed price that represents the current value of future interest payments.

Instead of making regular interest payments, the value of the bond increases each year by the amount of the interest rate until the zero matures and is worth its face value. However, if a zero is sold before

maturity, there could be a gain or a loss, depending on the purchase price and the amount of interest that has accrued. Think of zeros working the same way old-fashioned Series E savings bonds did—purchased at a discount and building up to a certain face value by way of a fixed (or in some cases, variable) interest-rate addition every year.

Notice that the investor in zero-coupon bonds doesn't have the problem of reinvesting the interest check every six months. That reinvestment is built into the appreciation in the bond's value every year. But zero-coupon bonds don't solve the problem of market price risk. In fact, they're even more volatile because their owners don't have the cushion of a semiannual interest payment to offset changes in market interest rates.

That's where TIPS come in. They are zero-coupon bonds, but the amount that accrues each year is not fixed. Instead, it is based on a fixed rate plus an inflation adjustment to the principal value of the bonds. That inflation adjustment is based on the consumer price index (which may or may not correctly measure inflation). At the maturity of a Treasury Inflation-Protected Security, you receive the adjusted principal or the original principal, whichever is greater. This provision protects you against deflation.

TIPS can be purchased through TreasuryDirect.gov in minimum denominations of $100. TIPS with maturities of 5, 10, and 30 years are auctioned regularly and can be purchased electronically through your TreasuryDirect account. Or major mutual fund companies such as Vanguard, Fidelity, and American Century offer mutual funds that purchase TIPS.

Two key reminders: First, as with all bonds, when interest rates rise, your bond or bond fund will lose value. But since interest rates typically rise because of fear of inflation, at least a TIPS fund will lose relatively less in market value.

Second, it's important to keep taxes in mind when buying zero-coupon bonds or TIPS: *Even though you don't receive the semiannual interest payment, you'll owe taxes on that amount.* You'll receive a 1099 form every year for the interest that was accrued to the value of your account but was not actually paid out. That's why you're better off buying these funds in a tax-deferred retirement account.

Why Buy Bond Funds

The price risks of bonds may be offset by purchasing a bond fund, with professional management to adjust the types of bonds held by

the fund. These bond funds are offered by the major mutual fund companies with no commission cost to purchase and very low annual management fees.

Some bond funds are set up as a trust or unit investment trust or an ETF, which is a fixed package of bonds that will be held to maturity. Typically, those ETFs are traded on exchanges, and their price is determined by market perceptions of the future value of the assets in the trust, based on interest rate and inflation expectations, as well as the quality of the fixed bond portfolio. Your cost to purchase is merely the commission determined by the brokerage firm you use.

The price of a *managed bond fund* is determined daily by a market price valuation of the bonds held by the fund. It is the job of the fund manager to adjust the holdings in the fund based on changes in quality of the issuers, or based on an assessment of the future direction of interest rates. When the bond fund manager thinks interest rates will rise (and bond prices will fall) he or she may sell bonds and hold shorter-term securities, hoping to reinvest when rates are higher.

Each bond fund prospectus clearly states the quality and maturity range of bonds it will buy. Thus, you could find a short-term bond fund, an intermediate-term bond fund, or even a long-term bond fund. And the prospectus will tell you whether the fund managers must stick to a specific type or bond rating—Treasuries, high-quality corporate bonds, or even high-risk bonds. Obviously, the yield on the riskier bond fund is higher, a way to attract investors. But could you sleep at night, knowing that even though the portfolio manager is watching, there is a greater risk of default?

Here’s a reminder about the one Truth you must keep in mind when buying individual bonds or a bond mutual fund, this truth applies to *all* bonds:

When interest rates rise, bond prices fall.

That rule applies to all bonds and all bond funds in differing degrees, depending on the quality of the bonds and the maturity of the bonds. But don’t make the mistake of thinking that you can’t lose money in good bonds. If inflation returns, bringing with it higher interest rates, all the money you have in bonds is at risk of lower prices.

It works the other way, too. When inflation drops and interest rates fall, bond prices rise. That is, older bonds with higher yields than you could get in a low-inflation climate become more valuable.

From 1981 through 2018, we were in a bond bull market. That is, despite ups and downs in interest rates, the overall trend in rates was down for a very long time.

Today's bond investors have only distant memories of the huge bond losses that took place the last time inflation soared in the late 1970s. If inflation returns, there will be many expensive lessons to be learned by those who are now locking up money in 10-year Treasury bonds earning 1.5 percent.

Bonds versus Stocks

Although many investors seek out what they perceive to be the relative safety of bonds, there is a certain price to pay for this peace of mind. Over the long run, stocks have always offered superior returns. From 1945 through 2018, the S&P 500 Stock Index generated a compound annual total return of 10 percent, versus a return of just 5.8 percent for intermediate-term U.S. Treasury securities, according to an Ibbotson Associates study. Of course, for those with a shorter time horizon, a mixture of bonds and stocks can dampen volatility and provide income.

The assumption in building a portfolio that includes both stocks and bonds is that they tend to move in opposite directions. But famed Wharton School of Business professor Jeremy Siegel has demonstrated that stocks and bonds move together much more frequently than they diverge. And in his classic book *Stocks for the Long Run* Siegel makes the case that if you have at least a 20-year holding period, there is less risk in stocks than in bonds, saying:

> For 20-year holding periods, stock returns have never fallen below inflation, while returns for bonds and bills once fell as much as 3 percent per year below the inflation rate. During that inflationary episode, the real value of a portfolio of Treasury bonds, including all reinvested coupons, fell by nearly 50 percent. The worst 30-year return for stocks remained comfortably ahead of inflation by 2.6 percent per year, a return that is not far below the average performance of fixed-income assets.

Bottom line: Don't be blinded by the presumption that bonds are safer than stocks. The psychological effect, however, of having less-volatile bonds as a portion of your asset allocation cannot be underestimated. It may be easier to ride out downturns and stick with a stock portfolio over the much-vaunted long run of 20 years or more if an investor also has a component of bond holdings.

The real answer to the question of stocks versus bonds depends on the relative valuation of these alternatives. In fall of 2010, with the Dow Jones Industrial Average trading around 12,000, Professor Siegel remarked that the valuation of stocks trading at low price-earnings multiples was cheaper compared to bonds than at any time since the 1950s. Thus, while many investors were searching for higher yields by purchasing riskier bonds, the real advantage based on valuation was to purchase high-quality dividend-paying stocks. And, in hindsight, how correct he was!

It's a Savage Truth: *Everything in investing is relative.* Once you understand how bonds and stocks are priced to reflect risk, then you can make an informed decision on how to balance them in your own investment portfolio. Or you can seek help in the process of asset allocation—either from a qualified advisor or perhaps a robo-advisor. Read on.

GETTING STARTED

HOW TO BUY U.S. TREASURY BILLS

Go to www.TreasuryDirect.gov and click on "Individual" and then follow instructions to open an account. You'll need your checking account and bank routing account numbers, as everything is done electronically and automatically. The minimum amount is $100 for each purchase.

TERRY'S TO-DO LIST

1. Examine your own risk tolerance in light of investment alternatives.
2. Sort out your chicken money and put it in chicken money investments so that you can sleep at night. Let the rest of your money work harder for you in riskier investments.
3. Respect the value of compound interest.
4. Understand the market value price risks in bonds and the concept of total return.
5. Balance your investments between stocks and bonds—and the alternatives that will be explained in later chapters.
6. When buying bonds, either use a mutual fund or check the prices to make sure you are not paying a price that is too high or selling below the true market price.

CHAPTER 5

THE SAVAGE TRUTH ON FINANCIAL ADVICE

Not All "Advisors" Are on Your Side

The financial services industry has grown dramatically in the past decade. An aging population, a booming stock market, and literally trillions of dollars of retirement assets have created a demand for advice and services. They offer everything from investment advice and basic goal-setting to a complete financial plan, including guidance around retirement, taxes, insurance, estate planning, and more.

But how are you supposed to choose the most appropriate advisor, and the one you can trust? Some offer the personal touch in guiding your investments or designing a plan for your future, while others offer automated "robo" advice that can be very cost-effective in guiding you to financial success.

The industry spends billions on advertising to attract you to their firms. And where do they get the money to buy all those ads? They get it from the fees and commissions that you pay, often without even knowing the costs.

I'm not suggesting that you avoid all fees and commissions. After all, it's an old Savage Truth that good advice is always worth paying for. But how will you know if the advice is good? Even more difficult, how do you know what you're really paying? It's not always obvious. And how can you possibly know if the advisor has your best interests at heart?

You Need a Fiduciary Advisor

The dictionary definition of the word *fiduciary* is "a person who holds a legal or ethical relationship of trust with one or more other parties." When it comes to investing, there is a more specific definition embedded in the *fiduciary pledge*.

A fiduciary agrees to *fully disclose* all fees, commissions, and other inducements (such as that sales bonus or trip to Hawaii) received in connection with a recommendation to purchase an investment. And a fiduciary also pledges to put the *client's interests ahead of his or her own*.

Most brokers, agents, and salespeople are only required to make suitable recommendations. Or, in the case of recent SEC enhancements to the rules, they must make recommendations that are in the "best interests" (Regulation BI) of their clients. But, despite a new, complex disclosure form that must be presented to clients, there is still no requirement for full disclosure or a client-first provision if the advice provided is incidental to the sale of securities.

You can't tell which advisor is a fiduciary based on the name. In practice, many labels are used interchangeably with the term *advisor*. They include *financial planner*, *broker*, *investment representative*, and *financial consultant*. All of those terms may appear on the business cards of people who charge fees and commissions that are not required to be fully disclosed. And until there is comprehensive legislation defining the requirements for these salespeople, it's up to you to ask the right questions and demand the right answers.

Finding a Fiduciary Advisor

Selecting a fiduciary advisor may be the most consequential investment decision you ever make. A true fiduciary will agree to sign the fiduciary pledge, promising in writing and on company letterhead, to fully disclose all fees, costs, commissions, and incentives—and agreeing to always put your interests first.

The best place to get specific advice on choosing an advisor—and to research the background of any advisor, investment salesperson, or insurance agent through the Federal registration databases—is the non-profit consumer-friendly website, www.CampaignforInvestors.org.

There you can get a checklist of questions to ask when you have a first meeting with a financial advisor—and what questions to expect

the potential advisor to ask of you. The first meeting should be free. Use it to understand the advisor's style and procedures. And always trust your own instincts.

The most important question you can ask is: Are you a fiduciary? And the next question is even more important: Will you put that in writing on your company's letterhead? That will sort things out quickly. If your potential advisor won't agree to those commitments, because the "firm doesn't allow it" or for some other reason, then move on to another financial advisor!

Here's another important piece of advice when choosing any financial professional. You should always use the search feature at CampaignforInvestors.org to research the background of registrations, complaints, and disciplinary actions for any financial salesperson or advisor, including brokers, "advisors," insurance salespeople and financial planners. The link takes you to extensive databases of registrants in each industry. Or go directly to brokercheck.FINRA.org. And if you can't find the name and the history there, walk away!

To learn more about the importance of finding a fiduciary financial advisor, go to www.AdvisorOnMySide.org, a non-profit website created by several organizations dedicated to informing the public about choosing a fiduciary. There are links to helpful checklists and databases that will make your search easier and more productive.

Who's Who in the Financial Field

There are some registrations and initials that do make a difference, and you should know what they are and look for them.

- Certified Financial Planner (CFP). This is a designation for an investment advisor who has passed a series of complex tests over a wide range of financial planning topics, including investments, retirement planning, estate planning, taxes, and insurance. Anyone who earns the CFP designation must pass a stringent test. As of October, 2019 all CFPs, including brokers, will be held to the fiduciary standard. Search for a CFP at www.CFPBoard.org. But you should also check the background of a CFP at brokercheck.FINRA.org.
- Fee-only Financial Planner. The National Association of Personal Financial Advisors (www.NAPFA.org) is the trade association of planners who agree to only charge fees for their advice, plan implementation, and ongoing management of assets. They do not sell financial products on commission. They may be paid hourly, on a retainer, as a percentage of assets,

or with a flat fee. They meet stiff credentialing and educational requirements. You can search for a planner geographically at the NAPFA website.

Finding the *Right* Fiduciary Advisor

It all starts with your decision to trust a financial advisor. It's the most significant decision you have to make. You can ask questions, do background checks, and compare references. You can require your advisor to sign the fiduciary pledge. But you still wish someone would help you make this most important decision.

Now there is one online service that is designed to do just that. At Wealthramp.com, you can be matched with a CFP who is a fee-only planner—and promises to sign the fiduciary pledge. It's a serious "Match.com" for financial advisors. At this website, you are asked to make simple choices to reflect your planning needs and interests. The matching service can provide advisors who live in your area. If you say you don't need frequent in-person contact, the matches might include an advisor who specializes in your needs but lives in another city.

The advisors chosen for this program by founder Pam Krueger are thoroughly vetted. It's not like online lending platforms that generate leads for brokers. When you finish the questions, you'll be given a list of potential advisors, and information about their services and backgrounds. But they aren't given your name until you approve and agree to a meeting. Even then, there is no requirement that you follow through.

The advisors compensate Wealthramp with a small percentage of your first year's fees. There is no additional cost to clients. While there is no way to ensure a perfect match—in money or in marriage—this service gives you a head start by limiting your search to qualified, experienced advisors with a good track record.

The Savage Truth on the Cost of Advice

The Hidden Costs of Fees

If you're working with a financial advisor who is not a fiduciary, you may not be aware of where the fees and costs hide inside your account. Paying too much for your investments can devastate your

returns over the long run. And those costs are not always apparent. They may come in the form of up-front commissions on purchases, or ongoing management fees buried inside a mutual fund or insurance policy, or from hidden charges built into the purchase price of an investment, or from charges levied when you sell your investment in the future. Sometimes it's a combination of these charges.

Some financial salespeople are compensated by commissions, which may be separately disclosed on your purchase confirmation or may be hidden in the price of the product. For example, you can't be surprised that a life insurance salesperson is compensated out of the premium you pay, but nowhere is the amount disclosed separately. But if you purchase or sell bonds, the commission is typically buried in the price you pay or receive.

Even if your advisor works inside a bank, it is likely that she or he is a commissioned salesperson, not a fiduciary with your best interests at heart. No matter what the label, you must ask the questions about the contents.

Many investments carry the same name or a very similar name, but substantially different investment costs. For example, a mutual fund sold directly by Fidelity at its website could be purchased without an up-front commission, and would have the lowest annual management (10-b-1) fees deducted from your investment. But the very same fund could be sold by a broker in several more costly forms—either with an upfront "load" or commission, or with a back-end commission that will apply when you sell, or with higher annual management fees to cover incentives for the broker.

I recently wrote a column detailing how a $100,000 investment in the Fidelity Large Cap Fund would have grown to $411,580 over 20 years—if the investor had purchased the shares directly from Fidelity. But if an advisor had sold her the more expensive share class of the same fund, the account would have been worth only $ 332,809—a difference of $78,771.

You see, it's not just the initial fees, but the *opportunity cost* of what your money could have been earning over all those years.

It's not wrong to pay a commission. It's just wrong if you don't know you are paying it, if you don't know you can get the same or similar product for less, or if you don't understand the ongoing impact of fees and commissions.

Many perfectly good financial advisors do charge commissions or combine low commissions with fees based on hourly advice or annual management fees. It's not wrong to pay for good advice. But

(I hope) the days of 1.5 percent annual management fees are fading as consumers learn they can get equally good advice at a lower cost—either from an individual or a computer! (See more on "robo" investing later in this chapter.)

Good Advice Is Worth the Cost

The corollary to that statement is: "Free advice is worth exactly what you pay for it!" I'm frequently asked by my readers how much they should pay for a financial plan or for money management services. I wish there were a single right answer for every situation. But the true answer is: It all depends.

First, you need to sort out the type of advice you need. Do you just need investment advice for the money you already have—either inside an IRA or your company 401(k) plan—or in a brokerage account? Are you seeking advice about how to invest a rollover from a retirement plan as you prepare for retirement? Do you need help organizing the required withdrawals from your retirement plan?

Or are you searching for advice on how to plan for the present (a budget)—and the future—including investments, but also on reaching goals like buying a home, saving for a child's college education, and your eventual retirement? Do you need advice about life insurance or tax planning? All are aspects of financial planning and advice.

Don't be overwhelmed by the breadth of advice you need. But do be aware that in each case the financial services industry has a wide range of opportunities to provide you with both advice and services. And all have different costs. To understand those costs, you need to ask questions.

But first, figure out which services you need. All will be more fully described in the following chapters, but here's an overview of the areas of planning advice you might want to access.

The Savage Truth on Deciding What Planning Help You Need

Talking about the concept of financial planning can quickly become overwhelming. It seems there are so many different types of advice you need, and so many different experts in each field. If you've chosen a CFP who is also a fiduciary, you're on track to get a holistic view

of your situation. But even then you might want to also rely on your accountant or your estate planning attorney as part of your overall team. That's not an insult to your planner. In fact, these professionals should work well together to give you the best possible result. Here are some areas of planning expertise:

Investments

Decades ago, there were few choices for investors. You went to a well-known brokerage firm and paid the fixed commission to buy shares of stock. Now there's vast competition in the price you pay, the minimum amounts required to invest, and how you interact with the firm. Even major brokerage firms, under some pressure from regulators, are changing their models from commission-based to annual fees based on account assets.

Discount brokerage firms like TD Ameritrade often have special deals where not only do you get "free" trades, but a bonus for opening an account, with no minimum required. Charles Schwab, Fidelity, and Vanguard (while known for their mutual funds) offer discounted stock brokerage, typically charging as little as $4.95 per trade. Ally and eTrade offer low-cost services and discounts. Robinhood offers free trading, with no minimums but few research tools.

You are probably wondering how a firm can offer free trading. It's simple. Big institutional trading firms will pay for the order flow from retail investors. It's all perfectly legal and won't impact your purchase or sale prices negatively, but it does provide a source of revenue for discount brokerage firms.

If you know what stocks you want to buy, don't need investment advice (or hand-holding during volatile markets), and are computer literate, you'll probably want to open a brokerage account at an online discount broker. There's no reason to pay annual management fees for advice you don't use or on money held in reserve in a money market account at the brokerage firm.

You can also get free investment advice by opening an account directly with a mutual fund provider, such as Fidelity, Vanguard, T. Rowe Price, or American Century. They will help you choose a portfolio of their mutual funds, all of which are very low cost—typically less than 0.50 percent per year. Putting together such a portfolio of funds allows you to diversify your investment among categories such as large companies, small companies, tech companies, and even international funds. And these fund companies will help you set up automatic investment plans to keep adding to your mutual fund account.

This field of offering investment advice has become very competitive among the major mutual fund providers. In fact, they are so anxious to have your money that—depending on the size of your account—you may get all this advice free. Vanguard offers its Personal Advisor Services at a cost based on the amount of your assets. Fidelity offers its personal Portfolio Advisory Service to those with at least $50,000 in their accounts.

Schwab and its investment advisory division offer Schwab Intelligent Portfolios premium service. For an initial fee, and $30 per month, Schwab will manage your investments and provide unlimited access to financial planners and online tools for doing your own planning for everything from college savings to retirement income. This monthly subscription model, as opposed to fees based on assets, is evidence of the competition for lower costs for investors.

In the next chapter on the stock market, I'll show what you need to know to understand stocks and become a do-it-yourself mutual fund investor without paying large fees. And you'll also learn how you how you can start an investment program by literally rounding up the pennies on your everyday shopping, or give small dollar amounts of stock to your children and grandchildren.

The bottom line here is that selecting the right advisor—paying fully disclosed fees for advice and reassurance, or paying commissions based on transactions, or simply choosing to make your own investment decisions—governs how much you should be paying each year.

Retirement and Rollovers

As the baby boom generation reaches retirement age, with swelling assets in company 401(k) retirement plans, every corner of the financial services industry is reaching out to offer advice and products. More on that in Chapter 10, but suffice it to say here that many of those offers of advice come with highly commissioned products like annuities and mutual funds, along with substantial management fees. There's nothing inherently wrong with the products; it's just that you could likely access them with lower costs. That's where a fee-only financial advisor can really provide a valuable service.

Insurance

Insurance is another area where getting planning advice can save you money in the long run. I'm speaking primarily about life insurance, which will be covered in Chapter 10. Basically, though, there

are times when a policy that builds cash value can be helpful in building a savings reserve, as well as extending coverage to later in life. However, term insurance comes at a lower cost. So the appropriate policy depends on the circumstances—and the life insurance salesperson who gets a big commission on a cash value policy isn't exactly an unbiased source of advice.

Taxes

There's a big difference between doing tax planning and filing your tax returns each year. TurboTax (and its live help desk) should be more than adequate for most of my readers to prepare tax returns. But tax *planning* involves deciding how much to invest in tax-deferred retirement accounts versus after-tax accounts. (A lot depends on your outlook for tax rates at the time you will retire.) Tax planning comes into play as you decide when to take Social Security. And tax-planning involves making decisions about timing withdrawals from retirement plans or even choosing your state of residence during retirement. A CFP is fully trained to advise you on those issues and more. That kind of advice is best covered by a fee, either hourly or agreed to as a percent of your assets.

Estate Planning

In Chapter 16, we'll discuss estate planning at length. But this is one area where a financial planner can be helpful in coordinating your decisions. You'll always want to use an attorney who specializes in estate planning in your state of residence. But estate planning is more than deciding who gets what when you are gone. Making sure you have titled your assets appropriately, designated beneficiaries where required, and fully organized your financial records is something that a good financial planner can oversee and encourage.

The Savage Truth on "Robo" Advice

Could a computer possibly do all, or even most, of this planning for you? Not likely. But the "fintech" industry has developed to prove that a significant portion of financial planning and investment advice can be computerized—saving money for you and instilling discipline into the process.

It's easy to see how a computerized process can save money. Most robos charge annual management fees of less than one half of one percent (0.50%) annually. It's a great first step to investing, since most have no, or very low, minimum account requirements to get started. But don't make the mistake of thinking robo-advice is just for beginners. Robos are accumulating assets under management quickly—and much of it comes from money that is transferred from traditional brokerage firms.

Most robos focus primarily on giving you investment allocation advice—for money you are accumulating either inside a retirement plan or in personal savings. They individualize their advice by asking you questions about your current financial situation and goals.

This is a fast-changing industry, with new independent fintech companies starting—or expanding into new areas of financial advice and money management. Here are a few places you might consider, as they are widely regarded as the leaders at this point.

Betterment

Betterment.com is one of the original and fastest growing independent robo-advisor platforms, with more than $16 billion in assets under management. There is no minimum account and an annual management fee of only 0.25 percent for their basic digital service. It includes in-app messaging to consult with financial advisors. (Depending on the size of the assets you bring to Betterment, the annual fee may be waived for as long as one year.) There is also a premium service that offers unlimited telephone access to CFPs for a 0.40% fee and $100,000 account minimum.

Betterment offers a series of online tools—questions and graphics that help them (and you) better define your investment goals and planning needs. For their automatic investment recommendations, they use a portfolio of ETFs (exchange-traded funds; for more see Chapter 7) with annual expenses averaging only 0.13%. These funds represent a dozen different asset classes—including large company stocks, small companies, international, natural resources, and bonds.

Betterment is in a race with its closest competitor, Wealthfront, (see following page) to attract assets by offering FDIC-insured interest-bearing checking accounts and high-yield savings accounts that easily exceed rates offered by the banking industry. A generation of digital users of financial services may soon be able to bypass the traditional banking industry.

Your Betterment account can be opened as an individual account, a trust account, or a retirement account, such as an IRA. If you link a company retirement plan account, it will be coordinated in your asset allocation, although it cannot be directly managed. And important issues like taxes, socially responsible investing, and charitable giving of appreciated assets are all included in their advice model.

Wealthfront

This robo-advisor, accessed at www.Wealthfront.com, has a similar advice model to Betterment, automatically rebalancing your investments in ETFs as market conditions change or as you add new money or reinvest dividends.

Wealthfront has a minimum account size of $500 and manages your first $5,000 of assets at no fee if you sign up through NerdWallet.com. Above that level there is an annual management fee of 0.25% with no discount for larger accounts. The average annual charge for the ETFs they use in their portfolio is 0.11%.

Your account can be opened on a taxable individual or joint account basis, a trust account, or an IRA. They integrate your company retirement plan and your 529 college savings account in their advice model. And they manage your tax issues as well, offering a direct import of data into TurboTax. Their financial planning tools are accessible to all, even if you don't have a Wealthfront account. You can even link your investment accounts to use their free Path tools for financial planning, without signing up for their management service. Wealthfront has moved into offering banking services, including the highest-yielding insured CD products.

Ellevest

Here's a robo-advisor with a twist: It was created by women and designed to illuminate the special issues women face in both investing and retirement planning. Their advice model takes into account the fact that women still earn less and that their earning years may peak earlier, while they will likely live longer than men.

The Ellevest.com platform offers robo-advice that costs 0.25% for the basic digital service and 0.50% for a premium service ($50,000 minimum), which offers access to a certified financial planner and a career coach.

Ellevest investment offerings include 25 ETFs and mutual funds, covering a broad range of asset classes. Their core portfolios have

annual fees of between 0.06% and 0.16%. They are focused on both near-term money management and reaching longer-term goals.

Those women who have used Ellevest report a level of comfort with their understanding of not only the financial, but social and emotional issues that women face in making financial decisions. They offer features like direct deposit of paychecks and encourage creation of emergency funds outside their investment plans.

I heartily endorse the use of a robo-advisor. Any of these companies is a quantum leap ahead for those who currently get money advice from their parents, relatives, friends, co-workers—or their local bank teller! No one on that list is trained to inquire about your current financial situation and guide you to a more successful financial future. These programs help you build both your assets and your self-confidence. That's a powerful combination.

But there's one thing a robo-advisor *can't* do—and that's hold your hand when markets and the economy get scary. And if you know that you don't have the discipline to stick to your robo-plan, you might want to choose a fiduciary financial planner.

Special Needs—Special Advice

I don't think it's my imagination that more families are dealing with instances of special planning needs for incapacitated children or young adults. While parents can be there during the early years, inevitably issues arise as these children reach the state's age of majority and may no longer qualify for state or federal benefits. Additionally, parents worry about how money can be safely left for the care of their children when the parents pass on. These special-needs planning techniques are necessary for those with developmental, physical, and cognitive disabilities, as well as mental illness.

I highly recommend a great resource for this type of planning. You'll find it at www.ProtectedTomorrows.com. Founder Mary Ann Ehlert is a CFP who experienced these issues with her younger sister many years ago. She started not only a website, but also a network of experienced professionals, advocates, community family resources, online tutorials, and workbooks to involve the entire family in the planning process. At her site you'll gain access to the latest laws and techniques in financial planning for impaired children and adults. You'll certainly find all the resources you need to plan wisely for their future.

Financial Planning: Now What?

I don't want to leave you with the impression that you can just dump a shoebox full of documents on your chosen planner's desk and walk away after a conversation that lasts an hour or two. Financial planning is only successful if you are fully involved.

You'll have your own ongoing responsibilities to set priorities, provide documentation, update your situation based on life's changing circumstances, deal with the paperwork, and remain fully active in the process. That may mean meeting with your planner on an annual basis only or having more frequent discussions about your situation. You'll want to make sure your planner is available on an emergency basis—either when you're worried about market headlines or when the unexpected happens in your life.

I *never* recommend giving a blanket power of attorney to any financial advisor. You should always listen to recommendations and make the final decisions. Never ignore your instincts. Always introduce family members—spouse, adult children, and caregivers—to your planner in advance of an emergency. And I hope it goes without saying that spouses must participate equally in this process. It's tempting fate to remain ignorant of your financial situation under the belief that your partner is an expert.

Now, a final bit of advice: Don't procrastinate. Except for your health, what could be more important than getting organized and setting out on a path to a successful financial future? Take the planning process one piece at a time, and force yourself (and the planner) to stick to a timetable. Help the process along by doing your part as required.

I promise you'll feel much better when everything is organized. Actually, I'm a bit superstitious. If you're not organized, I think you're tempting fate! So here's your very first step. Go to my website, www.TerrySavage.com and click on the link on the home page to get my "Personal Financial Organizer" form. You can fill it out online and save it to your computer, or print out the completed form. Or just print out the blank form (and extra copies for your family members). Filling in the required information will give you a head start on your first planning meeting. And it will serve as a guideline to the plans you must make.

And now, in the next chapter let's move on to the basic information you need to know about investing in order to be a more informed client for your financial planner.

TERRY'S TO-DO LIST

1. Understand the importance of finding a fiduciary financial advisor at www.CampaignforInvestors.org and www.AdvisorOnMySide.org.
2. Search for a fiduciary financial advisor at www.NAPFA.org or Wealthramp.com.
3. Ask your advisor to sign the fiduciary pledge—in writing.
4. Organize your financial life online, checking out robo-advisors and online financial planning tools.
5. Get organized using the Personal Financial Organizer form available free at www.TerrySavage.com.

CHAPTER 6

THE SAVAGE TRUTH ON THE STOCK MARKET

It's Less Risky Than You Think

The stock market is not a casino or a game of chance. It is a reflection of our huge economy (and the global economy) and of the prospects of the business you work for, and all the businesses that provide jobs and products and services for consumers. You don't have to become an expert at picking which stocks will do well, or take a lot of risk to find the next Apple or Amazon. But if you're going to make decisions about your retirement plan at work, or even buying a few shares of stock, you owe it to yourself to understand a bit about how the stock market works.

Perspective is critically important when it comes to stock investing. Like the seasons and the moon and many other forces of nature, stocks move in cycles. But despite many efforts to chart past performance and predict the future, those cycles are never easy to identify—especially at tops and bottoms. Near the top, investors are overwhelmed with optimism about business, the economy, and the stock market. And the bottom is always marked by despair over those same factors.

I intend to make the argument that if you believe in the future of America—the country where you intend to live, work, retire, and hope to watch your children and grandchildren grow up—then you *must* invest sensibly in the stock market for the long run. You don't have to become a stock market expert to invest successfully. And you don't have to start with a lot of money.

Critically important, you don't have to "beat" the market to be a successful investor. All you must do is be there—invested *in* the stock market over the long run, which is defined as at least 20 years.

The Savage Truth on Stock Market Risk

Your experiences with investing in your 401(k)—or just following the newspaper headlines—may have convinced you that the stock market is a very risky place to put your money. Certainly, you know people who lost a lot of money in the market. Perhaps that's because they sold out at the wrong time. I'm sure you know people who tell you they *always* sell at just the wrong time. That's because they're ruled by emotion—not by long-term perspective.

Let's start this chapter with proof that, over the long run, the stock market—defined as the largest American companies, represented by the Standard & Poor's 500 Stock Index (S&P 500)—has

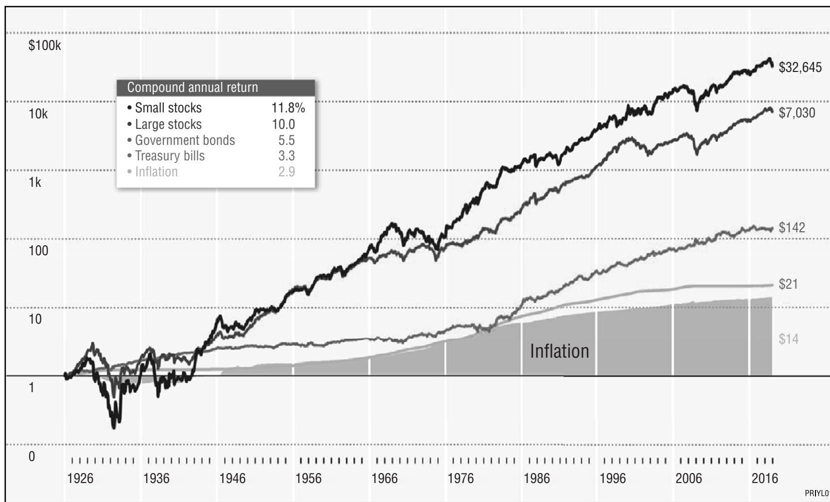

Figure 6.1 Stocks, Bonds, Bills, and Inflation, 1926–2018
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been a terrific investment. As you can see from Figure 6.1, one dollar invested in a diversified portfolio of large company American stocks has far outperformed other "safer" investments such as bonds or

risk-free Treasury bills or bank CDs. And it has also kept your money ahead of inflation.

Using the landmark Ibbotson research into past stock market performance from 1926 through 2018, you can clearly see how much wealth was created by taking the risks inherent in stock market investing as compared to leaving your money in the bank.

If you had invested $1 in risk-free Treasury bills in 1926, it would have grown to $21 by the end of 2018; the same $1 invested in stocks of major companies (the S&P 500 Stock Index) would have grown to $7,030, including dividends reinvested. Even adjusted for inflation, the stock investment would be far ahead of the Treasury bills

Yes, you would have encountered scary times along the way, including the market crash of 1929, the Great Depression, as well as the bear markets of 1973, 1987, 2001, and 2008. Like the Othmers and Gladys Holm (whose stories are described in Chapter 1), you would have needed tremendous self-discipline to stick to your investment plan.

That's where perspective comes in. For those without historic perspective, the volatile performance of stocks during the first two decades of this century has been especially challenging. But the short-term volatility that scares many investors out of the stock market is what creates opportunities for the long-term investor.

Stock Market Risk Diminishes over Time

Figure 6.2 gives a different perspective on stock market risk. It's statistical proof that risk actually diminishes over time.

Looking at this chart, you can see that if you invest in the stock market for only one year, there is substantial risk of loss. In fact, if you look at only one-year investment periods, according to the Ibbotson data, you'd have a one-in-three chance of sustaining a loss. If you remain invested for five years, then that risk of loss diminishes.

And if you stick with your diversified stock market investment for 20 years, modern market history, dating back to 1926, shows *that there has never been a 20-year period when you would have lost money in a diverse portfolio of large-company stocks with dividends reinvested—even adjusted for inflation.*

Even if you take into account the declining purchasing power of money caused by inflation, the longest period to break even was 20 years—from January 1973 to July 1993. Overall, it's easy to see that time diminishes risk—*if* you can discipline yourself to ignore the shorter-term fluctuations, which are sometimes quite large.

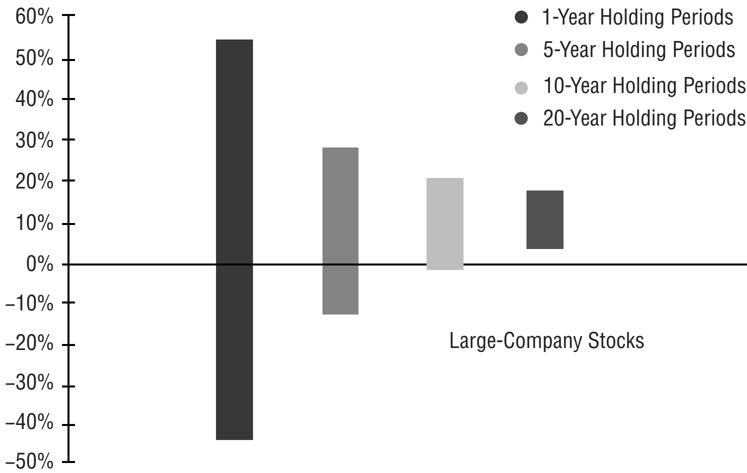

Figure 6.2 Reduction of Risk over Time, 1926–2018
Data Source: © 2019 Morningstar, Inc. All Rights Reserved. Reproduced with Permission.

Let's repeat to make this point clear: *There has never been a 20-year period—going back to 1926—when you would have lost money in a diversified portfolio of large-company American stocks (with dividends reinvested)—even adjusted for inflation!*

Over the years since 1926, of course, that large-company portfolio has changed. Today it is best represented by the S&P Stock Index—and you certainly will find that index fund in almost every company-sponsored retirement plan, or available for your IRA account at major low-cost mutual fund companies. So you are in a position to invest in the market on a regular basis, and to reinvest your dividends. Over the long run, that has proven to be the most secure path to investment success for the average investor.

Savage Truth: *You don't have to "beat" the market. You just have to "be" the market—by investing in the S&P 500 Stock Index fund.*

Plus, you have to have the self-discipline to stick with this plan through all the emotional extremes that are sure to come your way.

As Warren Buffett always says: "No one ever got rich betting against America!" No matter what you may think about the direction of our government, of political priorities, or the current economic outlook, America remains the best place in the world to live and invest. That's always been the case. And if that changes in the future, we will all have bigger worries than our retirement accounts!

Timing *Isn't* Everything

Wouldn't it be wonderful if you had the skills, insight, charts, or tricks to miss out on the worst periods of the stock market—the bear markets?

Trying to time the market is a recipe for disaster for the average investor. Market timing requires you be right three times: when to get IN the market, when to get OUT of the market, and when to get back IN again! Why put that much stress on yourself when you know that over the long run (at least 20 years) you will make money in the stock market, and likely do better than most other asset classes.

When the market turns—either up or down—it tends to move violently. By the time the change of direction is evident, the maximum opportunity for gains is lost. In fact, Figure 6.3, from market commentator Michael Batnick, whose articles at TheIrrelevantInvestor.com are highly recommended, illustrates his point that "if you missed just the 25 strongest days in the stock market since 1990, you might as well have been invested in five-year Treasury notes."

Yes, if you could have missed the *worst* days, you'd be much farther ahead. But do you want to bet your money on timing the market correctly—when the odds favor the success story of just continuing to invest on a regular basis?

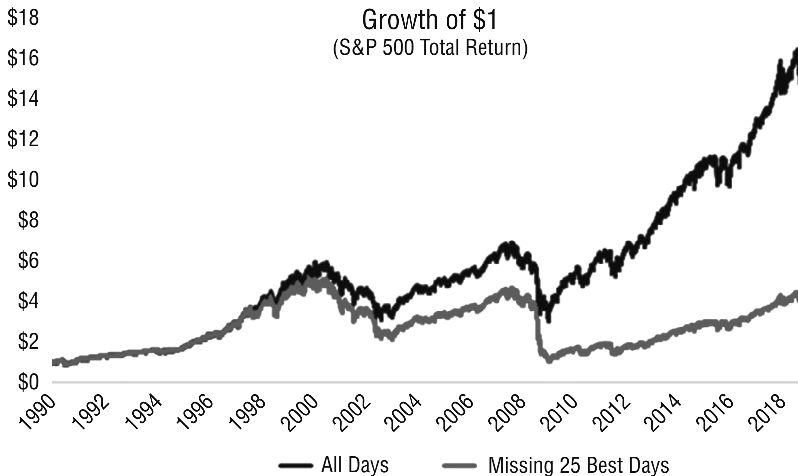

Figure 6.3 Difficulty of Market Timing
Source: TheIrrelevantInvestor.com. Reproduced with permission.

You don't have to take my word for how difficult it is to beat the market. Research from S&P Dow Jones Indices, shows that over the 15-year period from 2003 to year-end 2018, more than 90 percent of all money managers (large-cap funds, mid-cap, and small-cap) failed to beat their benchmark indices!

If the pros can't beat the market, is it worth your time and effort, not to mention your money? There's a reason that Warren Buffett advises ordinary investors to stick with index funds that represent different sectors of the market: The market does very well for you, over the long run.

If you are still anxious to try trading on a daily or even minute-by-minute basis, I suggest you set aside a small pool of risk capital to start. (I'll show you how to open a trading account in the next chapter.) And then stick to the basic long-term diversified investment plan in your retirement account. You'll only know in hindsight which strategy worked best. Just remember the old story of the tortoise and the hare. Tortoises enjoy a longer worry-free retirement, on average!

Beware of Averages

While this chapter has focused on the benefits of long-term investing by demonstrating average returns over the long run, there is a caveat that must be highlighted. It has to do with a Savage Truth regarding averages, which is also an old proverb.

Savage Truth: *The man who stands with one foot in a bucket of boiling water and the other foot in a bucket of ice water will tell you that on average he feels fine.*

Averages can mask extremes. And the most recent bull market is a classic example. For a decade, starting in 2008, the S&P 500 roared ahead. The example of long-term returns shown in Figure 6.1 shown earlier in this chapter shows an average annual return of 10 percent over many decades.

However, for the decade ending in March 2019, the S&P's 10-year annualized return was a whopping 17 percent, (see Figure 6.4).

It isn't going out on a limb to say that investors should not become accustomed to such outstanding results. In fact, the law of averages suggests that the coming decades might result in sub-par performance.

Figure 6.4 S&P Returns by Decade
Source: www.AdviserOnline.com. Reproduced with permission.

That isn't a problem for younger investors, who are investing for the "long run." But those nearing retirement might want to cut back on stock market exposure because their time horizon is shorter, and the will need to make required withdrawals during retirement. More liquidity ("chicken money") and less stock exposure, means they won't be forced to sell at the wrong time.

Stocks Don't Care about *You!*

It's a humbling thought, but an important one to recognize as you invest. The stock market exists for building wealth—but not necessarily *your* wealth! So don't take it personally when you make, or lose, money in the market.

Initially, the role of the stock market is to raise capital for companies that issue shares. Here's an example: XYZ company goes public and sells one million shares to investors. Let's say that 20 percent of that stock is sold for the accounts of the founders, and the remaining 80 percent of the money goes to the company itself.

The company founders, who have invested their time and personal wealth to grow the business, are suddenly well rewarded. Not only do they have cash to spend on houses, cars, and other investments, but

the market value of their remaining holdings has increased tremendously. The company can use its share of the proceeds to pay off debt, to build new factories, or to pursue other business purposes that will earn more money for shareholders in the future.

To the extent that the company is successful in growing its business, the stock price will rise and all shareholders will be rewarded. This capital-raising function of the stock market allows businesses to grow and expand. The fact that shareholders' wallets also expand, thereby also boosting the economy, is merely a byproduct of the capital-raising function of the market.

As the stock continues to rise, the only real benefit to the company is that the higher market valuation allows the company to sell more stock in the future to raise more capital. But all the shareholders now feel wealthier as the stock moves higher. When the stock falls, the converse is true. Plans for buying houses, cars, and even putting children through college may have to change.

Stock prices rise in expectation that the company's earnings will grow. Investors look forward to future earnings growth and are willing to pay higher prices for companies whose prospects are good. When both the real economy and expectations for the future are expanding, people are willing to buy stocks at ever-higher prices.

But when the real economy slows down, earnings expectations also decline. When real earnings decline, expectations of future earnings start to shrink, and people are less willing to pay higher prices for stocks. In fact, they start to sell. That's what pushes markets down.

There's general agreement that a rising stock market is good for everyone and a falling market that wipes out wealth is bad for everyone, and for the economy in general. So everyone is cheering for the winners—as long as everyone gets to share in the benefits of a rising stock market through retirement accounts and mutual funds.

The Fear Factor

If the relationship between stock prices, current earnings, and expected future earnings always remained the same, it would be easy to predict the direction of stock prices. But because individual decisions to buy or sell are made out of emotion as well as fact, the market tends to move to extremes. It's not easy to anticipate how far the extremes of sentiment will move the market in either direction.

It's healthy to have respect for the power of the stock market, but important to control the emotion of fear. As your stock market

investment grows, the discipline required to stick to your investment plan is greater.

If you have only $1,000 at risk, it should be easy to ignore the fear of loss, especially if that $1,000 is a very small part of your personal net worth. But as your portfolio grows in size and as you grow older, you'll notice that your stock market investment has become a far greater percentage of your total wealth. Market fluctuations become more difficult to ignore, and the temptation to deviate from your plan becomes greater.

The twin concepts of *fear* and *greed,* along with *risk* and *reward,* play an important role in your investment decisions. The better you understand your inherent willingness to accept risk, the more you will stick to investment decisions based on knowledge and your study of historic patterns.

It helps to look at patterns such as the chart in Figure 6.1. It's clear that even the most devastating market declines have been part of long-term economic and investment growth. But when that investment represents your entire future lifestyle (i.e., your ability to retire and live in comfort), it's harder to remain detached and disciplined during periods of market turmoil.

Your Time Horizon and Your Risk Perception

Do you know your real time horizon? You may tell yourself—or your stockbroker or financial planner—that your time horizon is a long one. You may announce that you're saving for retirement or your toddler's college education. You make your stock market investment decision armed with the knowledge that over a 15- or 20-year period you're likely to be far ahead if you stick to your plan.

Then you check the price of your stock or mutual fund every day or every week. When you view your statements, you tote up your gains or losses. If you hear that the stock market has dropped a record number of points, or a record number of days in a row, you get slightly queasy. Never mind that you planned to hold onto this investment for 15 years. Your *real* time horizon is your internal tolerance for loss, and that can be played out over a very short time period. Inevitably, you'll feel an irresistible urge to sell at just the wrong moment.

There is a way to mitigate this aspect of human nature. If you divide your assets into short-, medium-, and long-term investments, it's easier to close your eyes to the short-term fluctuations of the

stock market. This is not mental accounting, but a real process of designation. You may even create separate IRA accounts to help you compartmentalize your thinking. Or simply announce to yourself (as I have) that this particular well-chosen growth mutual fund investment is the last you will spend in your old age—or will be left to your heirs. You will not touch it under any other circumstances, and until that time you'll just forget it. Now that's a long time horizon!

One more thing to keep in mind: Your time horizon isn't necessarily the market's time horizon. You may have your investment horizon pretty well planned out—planning to take money out for college for your children, or for your retirement. But, the stock market isn't paying attention to your personal cash flow needs, so you can't expect the market to be at its peak levels just when you need to make some withdrawals. We'll deal with that issue in Chapter 8 on retirement planning

History shows that stock market optimism has always paid off, with equities far outdistancing safer, risk-free investments over the long run. But sometimes that's a longer run than most people expect.

Market Losses Go to Money Heaven

It's commonly accepted that the stock market can create wealth. But did you ever wonder what happens to the money that is lost when the stock market goes down?

Suppose, for example, that Facebook, Amazon, or Tesla had 10 million shares outstanding. (They actually have many more shares outstanding, but let's keep the math simple.) The market has a very bad week, and the share price of one of these companies drops by $20. Our easy math shows that the shareholders have lost a collective $200 million worth of market value. Multiply that by all the other companies whose stocks dropped during the week.

Individually the losses are painful; collectively they are huge. In just two days in October 2018, Amazon founder Jeff Bezos lost $19.2 billion dollars as the stock plummeted! At year-end 2008, before that bear market bottomed out, the broad-based Wilshire 5000 stock index had lost 37.23 percent, which translated into a loss of $6.9 trillion! Where did all that wealth go?

In the stock market, the only ones who profit from a decline are the very few speculators who sold shares short—shares they didn't own but expect to buy back at lower prices, generating a profit. But no one gets the money stockholders lose when prices fall; it's just gone. It's the same thing when stock prices rise, and wealth is created—but fewer people question the sudden appearance of wealth in bull markets.

When stock prices fall day after day, money simply disappears. Or as one wise old trader explained to me years ago when I asked where all the wealth had gone: "My dear, it went to Money Heaven!"

It's Never Too Late to Start—Again

Sure, it's scary to invest in the stock market, especially after you've seen huge losses, money down the drain. Or if you're just starting out, setting aside precious money that could easily have been spent on other things. But can you afford *not* to save and invest for the future? The most obvious way to build wealth is in the stock market, because it gives you the opportunity to choose a consistent and regular pattern of investing, often on a tax-favored basis.

The stock market reflects the opportunities in America, and around the world, for global growth that will solve today's problems, whether in energy, medicine, finance, housing, transportation, industrial production, or services. But you must still make choices about your investments. This doesn't have to be a full-time passion, but it does require understanding the basic Savage Truths about investing. If you've made mistakes in the past, that's no reason to give up on doing it better in the future.

Remember that old Savage Truth: *The lessons that cost the most teach the most.*

If you've "paid your tuition" it's time to go at it again—with better results. Even if you've moved closer to what you hoped would be your retirement age, you'll still need some opportunity for growth in your assets.

So here are some basic Savage Truths about the stock market and how to approach the idea of investing. I think these are important concepts to guide you along the way if you really want to understand the market. For those who just want to jump in, you'll find the easy ways to invest in the next chapter.

The Savage Truth on Stock Picking

If you want to pick winning stock investments—those that beat the market—you have to answer this question: What moves stock prices? You'll get a lot of debate on that subject. Some analysts say the best way to pick stocks that will go higher is to find companies with good fundamental valuations. That is, they look at a company's balance sheet, cash on hand, and business basics and compare this intrinsic

value to the company's current stock price in order to determine a stock that is undervalued. These *value* investors avoid companies whose stock *prices* (P) are high relative to their *earnings* per share (E); they search out *low P/E* stocks.

Other analysts pick stocks and manage mutual funds based on a *growth* outlook. They look for companies with rising earnings prospects and a regular string of past earnings that they can predict into the future. These analysts are not so concerned about how much debt a company has, or other fundamentals. High price-to-earnings ratios do not keep them from buying a stock if they believe that growth in earnings will continue.

Some analysts try to combine the two disciplines by purchasing stocks that will exhibit *growth at a reasonable price* (GARP). It's easy to get confused by these investment methodologies. After all, when a growth company posts disappointing earnings, many of its followers will sell. That pushes down the stock price to where it appears to be a value company with a relatively low stock price compared to where it once was. (But value investors will tell you that a low price is certainly not the only indicator of value.) Conversely, rising stock prices attract attention, creating their own momentum for future price increases.

In fact, the concept of *momentum* has its own disciples, who want to purchase only stocks whose prices are already moving in the right direction. Momentum investing is based on the law of inertia—the belief that a stock in motion will continue in motion in the same direction.

This momentum theory directly contradicts the *efficient market* theory, which postulates that stock market movements are random. In an efficient market, all new information is immediately available to all market participants. Thus, news is immediately reflected in stock prices. No one should be able to get an edge.

While all of these investment disciplines have advocates and critics, one simple Savage Truth rises above the argument: *Money moves markets.*

If buyers are not more aggressive than sellers, the stock price won't go higher. When there's plenty of money around to buy stocks, prices of most stocks will move higher, regardless of the popular investment style. And in light of the Federal Reserve's recent actions first to create money to fight a crisis and then, more recently, to suck money out of the economy, it might be wise to add that the overall supply of money does matter very much to the stock market.

Value Is in the Eye of the Buyer (and Seller)

The greatest debate in the stock market is the measurement of *valuations*. What is "fair value" for the stock market—and how do you measure it? One traditional measure of valuing companies is the P/E ratio of a stock, or the entire market. To calculate it, you need to understand

- *Earnings per share*—a basis for comparing the profitability of companies of differing sizes. Simply divide the total after-tax profits of the company by the number of shares outstanding.
- *Stock P/E ratio*—a comparison of the current stock price to the most recent (or expected future year's) per-share earnings. For example, a company selling at $10 per share and expected to earn $1 per share is selling at 10 times earnings. If a company has very small earnings and a very high stock price, the ratio will be very high. (To get the P/E ratio of the market, analysts take current prices and earnings expectations for all the stocks in a broad index, such as the S&P 500.) The traditional analysis of price-earnings ratios says that the higher the ratio, the higher the risk.

Another traditional measure of value for the entire market as well as individual stocks is the *dividend yield*—the ratio of stock price to the money paid to shareholders in dividends. For example, if a stock is trading at $50 a share and pays a $1 annual dividend, the dividend yield is 2 percent.

Certainly some stocks pay a very low or even no dividend, believing they can make better use of their cash in expanding their business. Or company executives may choose to use excess cash to buy back shares, boosting the earnings-per-share ratio (EPS), and typically leading to higher stock prices.

As an investor, you might choose to buy a stock with no dividend, assuming that management will make good use of their profits to grow the company, resulting in a higher stock price. Or you may chose high-dividend-paying stocks to have a stream of income from well-run companies.

(I highly recommend *The Little Book of Big Dividends* by Charles Carlson [John Wiley & Sons, 2010]. In this classic, Carlson explains how to choose stocks based on dividend yields, for creating wealth and income.)

Over the years the dividend yield of the S&P 500 index has been considered an indicator of valuation, since historically dividends have been responsible for 44 percent of the total return of the index over the past 80 years.

At market lows in December, 2008 the dividend yield of the S&P 500 was 3.23 percent. And at year-end 2018, the dividend yield of the S&P 500 was 2.09 percent. (See Figure 6.5.) Generally speaking, stocks have a higher dividend yield when prices are low and stocks are unloved.

Quite obviously, you can try to time the market based on any or a combination of these indicators and ratios. And some investors don't consider these factors—but instead rely on signals sent by charts and price action of the market and individual stocks.

Technical Stock Market Signals

The Volatility Index or VIX is one measure of market sentiment that many people use to try to predict future market direction. Sometimes

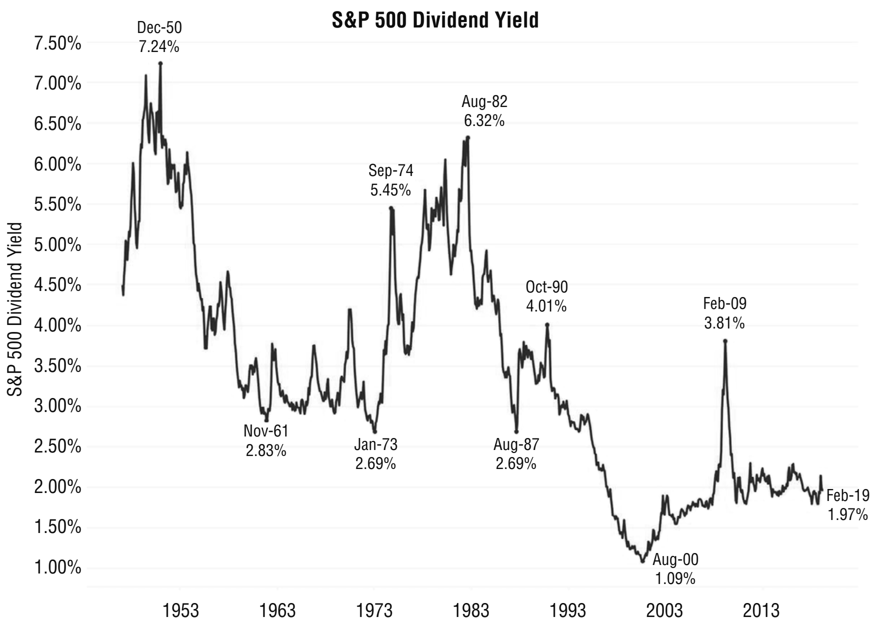

Figure 6.5 S&P Dividend Yield

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called the "fear index," it was created by the Chicago Board Options Exchange, using input from options on the S&P 500 Stock Index. Each individual stock can have a VIX as well, but the VIX Index is designed to statistically model the expected price volatility of stocks.

It's a complicated formula, but basically what you need to know is that when stock prices spike upward, the VIX index typically falls. And vice versa. When the VIX is higher than 30, it is generally seen as a period of increased uncertainty and risk, while when the VIX is below 20, expectations are that the market will remain calm and has upside potential.

Another popular index is CNBC's Fear & Greed Index, which tracks seven indicators of investor sentiment and has a range of 1 to 100. Followers believe that when market sentiment moves over 70, and into the greed range, it might be time to consider selling. And when the market is below 40, an indicator of fear, it could be a buying signal.

There's an entire world of trading based on signals sent by the market. Those who follow these signals are called *market technicians* and they use a variety of techniques to predict future stock market trends. *Technical analysis* involves charting systems, which primarily track prices and volumes, and their interactions. It's a respected art form for some investors, but it also requires patience and diligence as well as the willingness to follow the signals to buy and sell no matter what your mind or heart tell you.

If this approach intrigues you, there are plenty of books and newsletters on technical analysis. Be sure that you don't spend more on the tuition than you make in trading profits. There are numerous online charting websites that will draw not only price charts, but also *moving averages* of prices, and help you understand trendlines and all sorts of pricing formations from "double tops" to "flags." One of the easiest places to start, with plenty of free content, is BigCharts.com, a part of the Marketwatch website.

There are many websites devoted to market timing and technical techniques. One of the most interesting is www.Wealth365.com, where you can sign up to view free presentations of market trading techniques and attend their live quarterly online trading events.

But with all due respect to market technicians, I am still waiting to see the *Wall Street Journal* or *Barron's* profile a strict market technician who *consistently* beats the averages over a long period of time.

The Savage Truth on Market Behavior—and Yours!

Here's a basic Savage Truth: *The market is always right.*

If you're determined to trade the markets with a portion of your capital, you must always respect the power of the market. Most investors suffer big losses out of stubbornness, because they are unwilling to listen to what the market is telling them. They become convinced that eventually the market will see it their way!

The market may turn eventually, but that typically comes long after they have run out of money. Everybody is wrong in the markets at some time. The problem is compounded if you *stay* wrong in an attempt to prove you're right. There's an old stock trader's adage and a Savage Truth: *"The market can stay 'wrong' longer than you can stay long."*

Not only is the market always right, but it's always bigger than any individual or group. As long as a market is run fairly, with prompt dissemination of all relevant information, the market will be king.

Leverage Cuts Both Ways

Leverage is the art of getting a lot of movement out of a little pressure, or getting a lot of profit out of a small investment. When leverage is used in an investment sense, it implies the use of borrowed money to maximize returns on the amount invested.

That's called *margin.* When you purchase stocks on margin, putting down 50 percent in cash and borrowing the rest of the purchase price, you're using leverage.

For example, if you purchase 100 shares of a $20 stock, you'd ordinarily need to pay the $2,000 purchase price in cash. If you use margin, you could put up only $1,000 to control $2,000 worth of stock. Every one-point increase in the price becomes a 10 percent return on the $1,000 you have invested, a far better percentage return than you would get if you put up the entire purchase price. That same leverage works against you very powerfully on the downside.

Futures markets operate on the principles of leverage. A margin, or good faith deposit, of only 5 percent of the contract value is often all that's needed to control a sizeable amount of corn, soybeans, bonds, oil, gold, currencies, or interest rate contracts. Thus, a very

small move in price can either double your initial investment or wipe it out completely.

When leverage is carried to an extreme, it can produce fantastic, or disastrous, results. One good example is the collapse of the Long-Term Capital Management (LTCM) hedge fund in the fall of 1998. Its investment techniques were masterminded by two Nobel Prize–winning economists who miscalculated the risks of the extreme leverage they were using. At the peak, LTCM owned securities totaling more than $100 billion, although it had only $2.3 billion in capital.

Similarly, the mortgage crisis of 2008 was brought on by a different form of leverage, as well as outright fraud (though no high-ranking bankers were punished). Homes were sold to people who had small, or no, down payments—and no income to support the required mortgage payments.

The lenders didn't keep the mortgages; instead they sold them to unsuspecting investors—including banks around the world. Once again, a bubble based on leveraged bets almost brought down the global financial system. And once again, it resulted in a government bailout that was much larger this time around.

It seems you can't legislate against human nature. So the next section on the psychology of investing should serve as a warning for the future debacles that are certainly incubating somewhere around the world.

The Savage Truth on The Psychology of Investing

While our stock market returns are measured in gains and losses, there is an additional dimension of investing that impacts your results. It is the psychological component that makes all the difference as we make investing and trading decisions.

At TraderPsyches.com, Denise Shull researches the subject of "neuro-economics," a combination of twenty-first century psychoanalysis with her years of experience in the trading markets. (She is the inspiration for the psychologist trading advisor on the TV series *Billions*.) To vastly oversimplify some of her work, Shull postulates that human emotions travel faster to the brain's decision centers than rational thought. Thus, many investment decisions are made because

the brain is overwhelmed by an emotional reaction that outweighs rational decision making.

The best investors and traders have instinctive, or learned, behavior to overcome that physical difference in the neurons in our brains. They react differently than most people—and their trading results show it.

While you might not want to enter psychoanalysis to determine whether you have the makings of a good trader, you certainly should be aware that the more emotional a situation (that is, the more of your money at risk), the less likely you will act rationally. That's why you might want to enter a stop order to sell when the market declines to a certain level—so you won't be paralyzed by fear. Or why you might set up an automatic monthly investment program so you won't hesitate to follow your plan in a down market.

The Savage Truth on Bulls, Bears, and Bubbles

Once a generation, investors come to believe that "this time is different" and that the stock market, or at least a few sectors of the stock market, will continue to soar, defying both gravity and logic. Even naysayers give up their skepticism and join in because it is simply too painful to miss out on profits.

The Savage Truth is that *few are ever prepared for a bear market, because bear markets only start when everybody is feeling bullish and there is no one left to buy.*

The most difficult decisions you will make when investing involve not only the self-discipline to stick with your investment plan but the willingness to make adjustments when that plan is distorted by market action. It's tough to continue to buy stocks at the bottom, when shrinking prices have devalued your position. It's even more psychologically difficult to rebalance your assets by moving money out of stocks when a bull market and rising prices have over-allocated your stock market plan.

In recent years, we have lived through the longest bull market in history. It started at the scary lows of March 2009, when it seemed our financial system was on the verge of collapse after the mortgage crisis. Congress passed bailout bills and the Fed flooded the system with new liquidity by purchasing securities, including packages of mortgages, paying for them with newly created money.

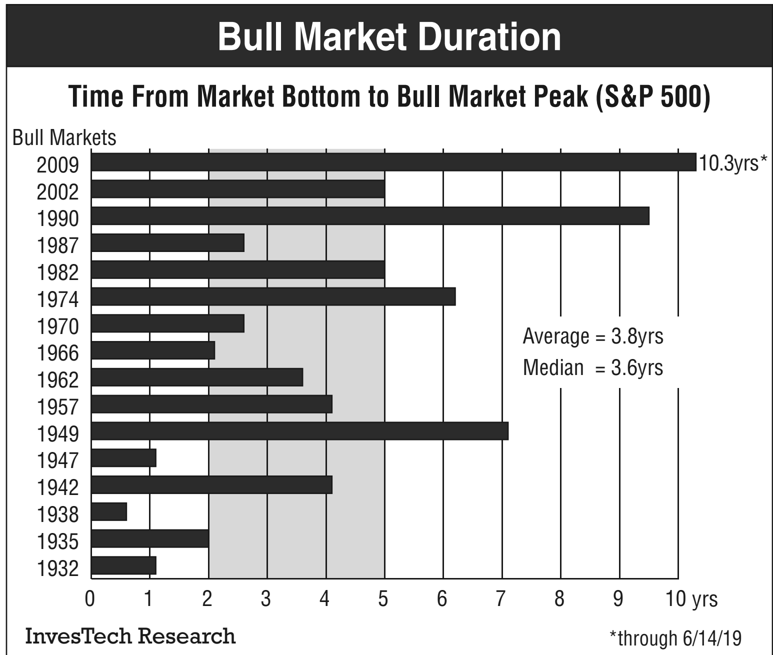

Figure 6.6 Bull Market Duration
Source: www.Investech.com. Reproduced with permission.

As seen in Figure 6.6, the bull market that started in March 2009 with the Dow Jones Industrial Average at 6443.27 the popular index surpassed 27,000 in 2019. This bull market has lasted more than 10 years, far surpassing the average bull market rise of 3.8 years in the past 100 years.

As you read this, the bull market may be over—or maybe not. One thing is sure and it's an old Savage (and Wall Street) Truth: *No one rings a bell at the top of a bull market.*

That's why, although you take a long-term view of investing, you need to make sure that growth in your stock portfolio over a long bull market does not overexpose you to risk of loss—especially as you near retirement. Adjusting your market exposure is not market timing; it is a prudent approach to risk management.

Bubbles Eventually Burst

Sometimes the market defies logic or all the historic rules of valuation. Historians call these periods *bubbles,* or *manias.* One well-known mania occurred in seventeenth-century Holland when prices

of tulip bulbs were pushed to incredible valuations. A contemporary history describes how one man traded "his silver drinking cup, his oxen, a carriage, and two gray horses" for one rare black Viceroy tulip bulb. History is rife with examples of financial hysteria pushed to extremes: from the South Seas Bubble of 1720, in which investors bought shares of a company formed to explore the riches of the New World, to the speculative investment pools of the U.S. stock market in 1929. Manias typically end when there is no one else left to buy.

Manias unleash the basic human emotion of greed, and the belief that you really can get a lot of something for nothing. Manias are different from scams in that there's no mastermind organizing the scheme. Instead, at the heart of every speculative mania there is a widely accepted, intellectually justified belief that the ordinary rules do not apply in this situation, a belief that "this time it's different." In every mania, there are many people who are completely ruled by emotion, and a few who claim to understand that they are in the midst of a whirlwind but plan to get out before it's too late. Very few do.

At the base of every bubble there is a naïve belief that some new fact or current reality will expand forever. Most recently we have seen the crypto-currency bubble, which burst in December 2018—when Bitcoin prices had soared from a few dollars to $29,783 in December, 2017—only to fall sharply back to $3,300, before rebounding to $11,600—all within 18 months.

Crypto-currencies (and the blockchain ledger behind them) will undoubtedly change the world of global banking and transactions in our lifetime. What got out of line was the price—not the facts. It was a market carried away by emotion. And, as always, those who bought at the top for fear of missing out suffered huge losses.

It's difficult to gain perspective when a market is going to extremes—and you have no idea how far the extremes will extend. Stepping back and taking the historic overview, it's easy to see that all markets reach extremes. Figure 6.7 gives you a long-term perspective on extremes, by comparing the total market value of all stocks to the annual gross domestic product (GDP). From this chart, it's clear that sometimes the stock market is wildly overvalued—and that other times, it's undervalued. And sometimes—as in the dot-com bubble of 2000, the stock market is "off the charts!"

Figure 6.7 Stock Market Capitalization as a Percentage of Nominal GDP
Source: BiancoResearch.com. Reproduced with permission.

There's a simple Savage Truth: *The right thing to do is usually the most difficult thing to do.*

If everybody is rushing into a "sure thing," then it's a good time to sell. But you need both perspective and discipline to take action. Those major turning points are few and far between—and easily identified only in hindsight.

Only liars catch tops and bottoms. For the rest of us, the task is to sort out long-term probabilities and stick with them, maintaining flexibility to adjust our commitment at the edges.

Bear Markets Are Inevitable

In spite of all the studies and reports showing that the stock market has been a fantastic investment over the long run, there are always bear markets. By definition, a *bear market* is a price decline of 20 percent or more, generally over at least two months. A smaller decline is sometimes called a *correction*—a brief dip in stock prices that lasts just days or weeks. No one really knows whether a correction will develop into a full-fledged bear market.

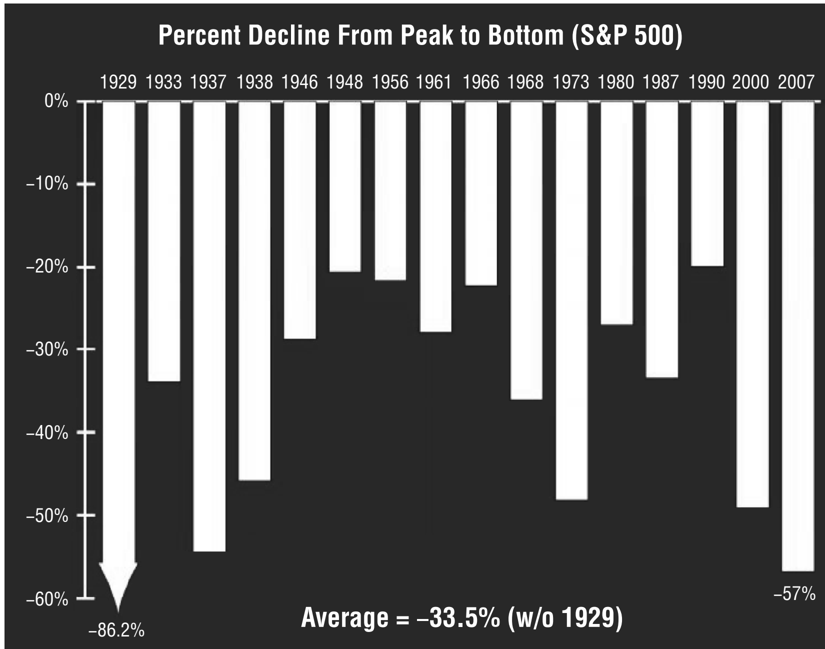

Figure 6.8 Cost of Bear Markets
Source: www.Investech.com. Reproduced with permission

The average bear market of the 100 years took 1.3 years from market peak to bottom and required an average of 4.5 years to fully recover.

There have been 10 bear markets since 1956, representing an average decline in the Dow Jones Industrial Average of about 33 percent. These bear markets lasted, on average, 14 months. But some lasted far longer and had far steeper declines from top to bottom (see Figure 6.8).

Perhaps the most memorable bear market in modern history started on January 11, 1973, and took the Dow Jones Industrial Average down a staggering 45.1 percent in 23 months. It took 9.8 years for the market to reach its previous highs, but during that time, inflation destroyed a significant portion of the dollar's value. In real terms, it took investors who held onto their Dow stocks nearly 20 years to break even.

The decade from 2000 to 2010 gave us two bear markets. The bear market that started in 2000 was the third-longest on record.

The bear market that started in 2007 was associated with the near-collapse of the global financial system, engendering more fear than even its longer predecessor.

Eventually—which is long after current investors lose their fear based on recent experience—there will be another significant market decline that inspires fear and challenges your well-planned, long-term investment strategy. It is better to contemplate your reaction in advance than to panic and be overcome with emotion. Of course, no one will know at the time whether the decline is merely a market correction or a full-fledged bear. In either case, as prices fall, your wealth will melt away.

You have basically three choices in a bear market: ride it out, sell down to the sleeping point (an old Wall Street sentiment), or attempt to hedge against losses.

If you're truly a long-term investor, it will be easier to ride out any size market decline if you are not expecting to use your stock market investments for short-term purposes. That means having a cushion of cash or available credit, as well as a secure income. In that case, you can afford to ignore the bear's growls.

Selling a portion of your assets under pressure is the most dangerous way to take on a bear market. In fact, this type of panic selling creates bear market bottoms. Determine in advance which is your trading money and which is your long-term investment fund. You might even place stop orders to sell at fixed prices below the market in your trading account, to eliminate emotional decisions.

Or you could choose to take out some "insurance" against bear market losses. For example, you could seek profits from a market decline by purchasing put options on the Dow Jones Industrial Average or on the S&P 500 Stock Index in order to offset losses in stocks or mutual funds you don't want to sell. (More on options in Chapter 7.)

You should also be aware of the safest choices inside your company retirement plan. Likely there is a stable value fund, which promises a low yield but guarantees against loss. A bond fund is definitely not a safe alternative to the stock funds in the plan. As you learned earlier in Chapter 4, bonds can lose money too.

It's scary to own stock market investments during a bear market. But if you have appropriately divided your assets, and have some "chicken money" on the sidelines, you will get through it. It's important to remember this Savage Truth: *Markets don't grow to the sky; then again, neither do they disappear forever into a black hole.*

A Final Thought: Take Stock

It's easy to be overwhelmed by the world of the stock market. There are many ways to analyze the market and choose stocks. No one has the perfect answer to creating wealth in the stock market. But, in spite of all the ups and downs, the stock market has a terrific record for creating wealth if you give it a sensible chance.

And in the next chapter, I'll show you just how easy it is to get started, and continue investing—even if you just have a few dollars to commit. It's the easiest way to make your money work for you—as hard as you work for *it*!

Instead of trying for perfection, accept the fact that you'll make mistakes, and recognize that those mistakes are measured in dollars and cents, just as your success in the stock market will be measured in tangible terms. If you can overcome the emotional reaction to loss, you improve your chances of creating gains.

And remember that the stock market is a reflection of America—its growth in the past and the opportunities for the future. No one has gone wrong—over the long run—in being bullish on America!

TERRY'S TO-DO LIST

1. Learn and understand the concept of stock market risk.
2. Determine your *real* time horizon.
3. Decide whether you want to be a market timer or a long-term investor.
4. Examine your current stock market investments to see how they match your goals.
5. Allocate your investment dollars to a plan that fits your own needs and personality.
6. Create—and stick to—a plan of regular investments.
7. Have reasonable expectations based on historic results over the same time frame.

CHAPTER 7

THE SAVAGE TRUTH ON INVESTMENT CHOICES

Getting Started Is Easy

The idea of investing in the stock market may seem overwhelming at first. There's so much to learn, so many different "opportunities" to invest—and so many people willing to give you advice. But it doesn't have to be complicated or time consuming to start investing. And you don't have to start with a lot of money. Here's how to get going.

Starting Small with Stocks

Let me say right from the start that you don't need a lot of money to get started investing in stocks and you don't have to sign up with a well-known brokerage firm. In fact, the latest technology has created the opportunity to take your "small change" from credit card purchases and amass those pennies into a stock purchase. So to keep you from being overwhelmed by the process of opening an investment account, here are three easy ways to start your investments—or to get a child or grandchild started on investing in stocks.

1. *The Acorns App.* Acorns is a financial services app that resides on your smartphone. But you can learn more about it at

www.Acorns.com. It starts with the simple premise that you should invest your small change—money you won't miss. So you enroll your credit cards and checking account, and all the purchases you make are rounded up to the next dollar. When you've amassed just $5, the money is rolled into one of the five low-cost fund portfolios designed to give you either conservative or more aggressive exposure to the stock market, including international stocks.

There is no minimum investment to start, and you can always add more money to your Acorns investment account. Or you can withdraw, although that's not the idea. You can even put your investment into an individual retirement account (IRA) through the "Acorns Later" feature. IRAs, of course, are subject to withdrawal rules and taxes.

More than 250,000 people have signed up for Acorns Later IRA accounts—and the entire Acorns idea has become so popular that they already have more than $1 billion invested—just a few short years from inception. The Acorns website offers articles on everything from smart vacations to creating a budget—all geared toward people who never want to become investing experts but are excited to see their money go to work for them. Many of their retail partners offer cash back rewards that go directly into your Acorns investment account.

Acorns is the easiest place to start investing. Simply download the Acorns app and securely link your checking and credit card accounts.

2. *The Stockpile app*. You can start investing with as little as $5, buying fractional shares of almost every listed stock and ETF. Learn all about it at www.Stockpile.com. Parents and grandparents can create gift cards, allowing recipients to choose their own stocks—companies whose products they use and enjoy. Kids and teens can create wish lists so you don't have to guess at birthday and holiday presents. They can actually trade the stocks they own.

   Yes, parental approval is required, but there is not much paperwork to open this account. The Stockpile account is linked directly to your bank account (or the parental custodian's bank account). But adult approval is required so your budding investor can't drain money destined for your mortgage

payment. You can set up automatic monthly transfers to fund your Stockpile account and can even buy stocks using a debit or credit card.

Stockpile is not for sophisticated traders. You just can't specify a purchase price, and must accept the price set when orders are executed (buy or sell) at the closing price of the day. Each transaction costs just 99 cents. And, yes, you can reinvest dividends.

This is the perfect holiday gift for teens. You can set up the gift card online—or if you plan early enough, have a plastic gift card mailed to the recipient. The app contains educational features and games designed to pique the interest of young people. And it's easy for grownups to pick stocks, too.

3. *The Robinhood App*. Robinhood boasts that you can invest in stocks, ETFs, and options for free. They've even expanded into crypto currencies (more on that in the next chapter) And they're expanding into cash management services, in competition with banks. Learn more at www.Robinhood.com.

   Robinhood accepts cash transfers into your account directly from your checking account. Cash purchases of stock literally cost nothing. And there are tools to help investors make stock decisions, or learn about options.

   Robinhood offers margin accounts in "tiers" that determine the minimum amount required to trade on margin and the account fee. With $2,000 in your account there is a monthly fee of $10. But you can upgrade to the gold tier, accessing $15,000 of margin credit for $75 per month. This is a direct appeal to more sophisticated day traders interested in multiple free transactions.

The fintech industry is constantly inventing new apps to make investing easy, automatic, and minimalistic. You can earn rewards for shopping, round up purchase prices, get cash-back in the form of investment credits—and the concepts are endless.

Anything that makes it easier to start investing is a plus, as long as you're not paying too much for the service. Your annual costs should be well under 1 percent per year to make it worth your while to invest. Companies that provide apps that give access to stock market investing are subject to SEC registration and the SIPC insurance rules. They are the low-cost, easy way to start investing in the stock market.

As your account grows, you can stick with these services or consider other ways to invest your money. You can start by opening a brokerage account or move on to mutual funds. In either case, you really can do it yourself at a discount broker or directly through a no-load mutual fund—and save yourself fees and costs along the way.

Here's an important Savage Truth: *You don't have to pay money to make money.*

As you'll see below, you now have options to invest in individual stocks or mutual funds at zero cost. If you don't like paying retail for clothing or appliances, and if you don't pay the sticker price on the car, and if you shop at Marshalls instead of Neiman-Marcus, then you definitely want to get the best deal when it comes to investing! Read on.

First Step: Opening Your Account

If you work for a company that offers a 401(k) retirement plan (or a nonprofit or government agency, which offer similar plans), your account will exist in your name inside the company plan. But if you don't have that opportunity at work, you'll want to open an account at a place that will do the buying and selling for you—a brokerage firm or mutual fund company. The financial services industry is spending millions on advertising to get your investment dollars. You need to know some basics before opening your account.

Wherever you open your investment account, it's important that you start out with the correct title or name on your account. It will determine tax consequences down the road, and how your account is handled after your death or if you become incapacitated. That's probably not on your mind when you're just starting out, but it's critical to get it right.

You could use your own name, and make it a personal investment account. Or you might want to set up the account in joint name with a spouse or relative. That means you each have an equal interest in the investments in the account. If it is set up in *joint tenancy with rights of survivorship* your co-owner will own the entire account if you die. So, it's worth thinking ahead!

You might also set up the account in the name of a revocable living trust you create to title your assets. (More on that in Chapter 16.) That trust account allows your named successor trustee to make investment and withdrawal decisions if you are incapacitated or die—but gives you full control over the account while you are alive and well. It pays taxes on your personal return.

Make Your Account an IRA

If you are not covered by a company retirement plan, (or if you want to save more for retirement), you might want to set up your investment account as your own individual retirement account (IRA) to hold your stock or mutual fund purchases. With an IRA account, you don't pay taxes on gains or dividends inside your IRA until you withdraw the money at retirement, when it will all be taxed as ordinary income.

The amount you contribute to that IRA will likely be a deduction on your tax return in the year of contribution. Remember: You'll have to leave the money growing in this traditional IRA at least until you're age 59½ or face penalties for early withdrawal in addition to ordinary income taxes on the money you take out. At your death, the IRA may be extended on a tax-free basis (see Chapter 8), so make sure you name a *beneficiary* when you open your account.

There is one exception to that IRA tax rule: If you qualify to open a Roth IRA—by having earned income of less than $122,000 in 2019 and $124,000 in 2020 on a single return, or $193,000 in 2019 and $196,000 in 2020 on a joint return (above those income levels eligibility phases out)—all of your money will grow tax free over the years. With a Roth IRA you don't get an up-front deduction on your taxes in the year of your contribution, unlike with a traditional IRA or retirement plan at work. But you're never required to take annual minimum distributions from a Roth IRA.

Different tax rules apply to stocks and funds purchased outside a retirement plan account. If you own stocks or mutual funds for longer than a year, and sell them for a gain, you get a special lower tax rate on your profits or a limited deduction if you sell them at a loss. But over the long run, you are likely better off with the discipline of opening your investment account as an IRA, if you qualify based on income.

For 2019 and 2020, you can open a traditional IRA and contribute up to $6,000 ($7,000 if age 50 or older) out of *earned income* (which does not include Social Security income, dividends, interest, rents, etc). You get a tax deduction for your contribution. However, if you are

covered by a retirement plan at work, this deduction starts to phase out as your income on a single return exceeds $64,000 ($103,000 on a joint return) and an additional $1,000 in each case for 2020.

You can contribute to a traditional tax-deductible IRA up to the year you reach age 70½, as long as you have earned income. But there is no age limit to contributing to a Roth IRA, as long as you have earned income. One other benefit: You have until the date your tax return is due (usually April 15) to make your contribution to an IRA for the previous year (see Chapter 8 for details).

Keep in mind that an IRA is truly an *individual* account, never a joint asset. Also, there is one exception to the "must have earned income" rule: A non-working spouse can contribute to his or her own IRA as long as there is enough spousal income on a joint return to qualify for both spouses to contribute.

This is pretty complicated stuff to write about early in a chapter on investing. But it's important that you start out on the right path. And naming your account appropriately is an important first step—especially considering the long-term tax implications. The next step is to decide *where* to open your account—based on costs, services, fees, technology—and your own need for personal attention.

Traditional Stock Brokers

Full-service brokerage firms are a strong force in the industry, but their original model of charging large commissions for providing research and executing transactions is certainly changing under pressure from competition and regulators. It's now widely acknowledged there is an inherent conflict of interest when a stockbroker (sometimes labeled a "representative" or "financial advisor") is compensated only when you either buy or sell, paying a commission. That creates an incentive to take actions not necessarily in your best interests. Also, stockbrokers were frequently compensated with extra commissions for selling *proprietary products*—securities owned by the firms they represent. In many cases, the commission on those products was not fully disclosed but buried in the purchase price. That is definitely NOT a fiduciary relationship as defined in Chapter 5.

The traditional regulations required only that a broker suggest investments that were "suitable"—not necessarily the lowest cost. Going forward the SEC has created a rule that the recommendations must be in your "best interests." But the newer best interests standard does not create a fiduciary relationship.

Even so, the brokerage firm revenue model is changing from the old commission-based approach. Now many traditional brokerage firms are now charging an annual management fee for their advice and services—a fee that may come on top of fees and expenses charged inside mutual funds.

As investors have grown more aware of alternatives, they realize that paying 1 percent (or more) a year for this kind of service is very impactful on long-term returns—unless a broker with outstanding advice is keeping them ahead of the market and available for frequent consultation in turbulent times. That's especially true if you're a very conservative investor, keeping a significant portion of your assets in money market funds or short-term bond funds.

Discount Brokers

If you know which stocks you want to buy, it makes sense to open an account at a discount brokerage firm such as TD Ameritrade or eTrade, or at the discount brokerage firms within Fidelity and Charles Schwab (as noted in the previous chapter). Other highly rated discount brokers include Merrill Edge and Ally Invest.

Discount brokers require very low minimums to invest and have minimal costs per transaction. In fact, competition among discount firms has driven minimums and commissions to zero in some cases, at least for a promotional period. And your account is fully insured by the SIPC—the Securities Investor Protection Corporation.

What you don't get with a discount brokerage firm is personalized hand-holding in moments when the markets are volatile and scary. Ask yourself just how much that may be worth over the long run.

All of these discount brokerage firms allow you to trade individual stocks, ETFs, options, and bonds. Some also offer futures and foreign exchange. If you're a frequent trader you might choose the firm based on the trading technology, tools, and platforms they offer, as well as costs and minimums.

Each discount brokerage firm has its own commission schedule. Some may favor frequent traders, and some may offer discounts to accounts that carry larger balances. (Firms make money despite commission discounts for directing "order flow" and by earning interest on cash balances.) Some have annual account fees, or inactivity fees, or even fees to transfer an account out of their firm. Frequently, discount brokers offer promotional deals, such as a certain number of free trades if you sign up during a specific time period. It's up to

you to check the fees and choose the firm that offers the best deal according to your needs.

Your Rights if Something Goes Wrong

Your brokerage account is guaranteed up to $500,000 by the Securities Investor Protection Corporation (SIPC). But it is not guaranteed against market losses—only against brokerage firm malfeasance, such as lost or stolen securities. Deal only with a firm that displays the SIPC logo.

If you have a dispute with any brokerage firm—over anything from unauthorized trading to inappropriate investments—you must take immediate action by notifying not only the broker, but the supervising manager of that office in writing or by e-mail. The sooner you limit the losses, or inappropriate trades, the better. That's an incentive to review your updated positions at least weekly in your money management software described in Chapter 2.

You'll find that when you opened the account you gave up your rights to file a lawsuit, and instead agreed to arbitration of any disputes. You do not need an attorney to participate in an arbitration proceeding, but be aware that the brokerage firm will be well represented. To learn more about the arbitration process go to http://www.FINRA.org/arbitration-and-mediation/arbitration-process.

Investing The Easy Way: Mutual Funds

How do you get started investing in a diversified portfolio of stocks? That's where mutual funds come in. A mutual fund is a portfolio of stocks—typically chosen by a fund manager according to the specific goals stated in a little booklet called a *prospectus.* It is the job of the portfolio manager to choose what he or she thinks will be the best-performing stocks (or bonds) in that category.

Each mutual fund has a specific investment plan. For example, it could track the performance of the Standard & Poor's 500 Stock Index, purchasing shares equally of all the companies included. Or it could concentrate only on small company stocks, or only tech stocks, or shares of global companies, for example. Some mutual funds chose a balanced approach, striving for conservative growth, plus a stream of income from bonds or dividend-paying stocks.

At Morningstar.com you can research individual mutual funds based on categories and past performance. You can see the closing prices of mutual fund shares every day, determined by the value of the shares in the fund. It's easy to be overwhelmed by the wide range of choices. And of course, past performance is no guarantee of future results. But Morningstar offers a series of tools in their premium membership to help you not only choose funds, but create a balanced portfolio of mutual funds.

Every day, the price of the mutual fund shares is set at the close of traditional stock market trading (4 p.m. Eastern time for the New York Stock Exchange, except on holidays), even though the stock market now trades in extended hours around the clock. At the close, the value of each share of the mutual fund depends on the price of all the securities it owns, divided by the number of shares.

Your purchase price is determined once a day, at the close—regardless of whether you are buying or selling. When more money is invested in the mutual fund by new investors (or as dividends are reinvested), the money is used to purchase more securities in the fund portfolio.

Most mutual fund companies will let you set up a regular, automatic investment through electronic deductions from your checking or savings account. If you set up these regular monthly contributions, your fixed dollar amount will buy a different number of shares (or fractional shares) in the fund.

That's a process called *dollar cost averaging*. When share prices are low, your contribution will buy more shares, giving you more profits when the markets rise. And it removes the temptations of trying to time the market with your purchases. In fact, if you're new to fund investing, you might want to put some of your investment into a money market fund, with instructions to transfer a regular dollar amount into a stock fund on a certain day each month. That way you'll never pick exactly the low point, but you won't put all your money in at the top, either.

Mutual funds are the easiest way for you to build a diversified portfolio of stocks with professional management. But if that's all you needed to know, there wouldn't be an entire industry devoted to managing and advertising a wide variety of mutual funds. You don't have to become an expert to make mutual fund choices, but you do need to understand some of the basic differences between all those funds, and the costs and risks involved.

Fund Fees and Costs

It matters very much where and how you choose and buy your mutual fund shares because that determines the up-front fees and commissions you pay, as well as the ongoing annual management fees that impact account performance—and perhaps even additional fees to sell your funds down the road.

A large, well-known mutual fund company may sell the same mutual fund directly through its website or toll-free telephone center with no up-front commission and low annual fees, yet also make the fund available through brokers or investment advisors with a more expensive cost structure.

Here's how mutual funds charge you for their services. Every mutual fund has an *annual management fee* that is taken right out of the fund assets, along with operating expenses. The fund's expenses include a *12-b-1 fee* (named for the section of the SEC rules that govern them), which covers marketing and distribution expenses. This portion of the total expense is generally between 0.25% and 0.75% of a fund's net assets. It may also cover fees paid to advisors who sell the fund. It can all add up on an annual basis. All of these costs are considered part of the expense ratio, which does not cover sales costs.

The other type of fee you might pay is a *commission*, or *load*, paid to the salesperson who guides you to this purchase. It can be as high as 5 percent, so it's definitely an important issue. You can buy mutual funds directly from fund management companies such as Vanguard, Fidelity, T. Rowe Price, American Century, and many others without paying any commission.

Some advisor-sold funds charge fees up front, while others charge a *back-end* commission, which you pay when you redeem shares later. If you hold the portfolio for years you'll be paying a larger fee to sell, given that your assets have probably grown over the years. And back-end load fees typically accompany higher annual management fees. Some back-end fees diminish over time, but if you only hold the fund for a short period, you may pay as much as 6 percent of your assets.

If you're working with a fiduciary, fee-only advisor (see Chapter 5), who recommends mutual funds, your advisor will make direct purchases, with no up-front commission or excess annual management fees. The fiduciary advisor is compensated for the advice by the annual fee you agree to pay. But any other "advisor" may choose the funds that compensate him or her most—at your expense.

Fees and commissions aren't the only cost considerations when buying mutual funds. In a typical managed mutual fund, the portfolio managers will make buy-and-sell decisions about the securities they own within the fund. That generates *transaction costs.* The buying power of a large fund means that commissions paid to brokers are minimal, but they can add up if the fund does a lot of trading. To figure out whether the managers are very active traders, you'll want to ask about the *portfolio turnover*—how frequently the investments inside the fund change. This is not necessarily a negative, because some aggressive funds trade frequently and make more money by doing so.

Another cost you bear is *capital gains* (or losses). You know you will be required to report a capital gain or loss when you sell your mutual fund shares unless they are held in a retirement account (where all your ultimate withdrawals will be taxed as ordinary income). But even if you don't sell your fund shares, you'll receive a notice of capital gains each year based on the gains (or losses) taken by the fund managers as they buy and sell. (If your fund is held inside a retirement account, you can ignore these notices.) Otherwise, you must add them to your taxable income or subtract them under the tax-loss rules.

Did your eyes just glaze over? Your first inclination is probably to choose a fund based on its performance. But I have put this cost section first because, no matter what the performance, these costs will come out of your net returns. So you might want to start your search by limiting it to low-cost choices that give value for the fees you do pay.

Index Funds

These days you can buy a variety of stock index funds from Vanguard or Fidelity with zero up-front commission, zero annual management fees, and zero minimum investment! You get exposure to the entire stock market and major sectors with these funds.

The Savage Truth: *You can easily invest at ZERO cost. Why pay more?*

The best kind of starter fund for most people is that basic index of America's largest stocks—the Standard & Poor's 500 (S&P 500) Stock Index. (It is against this index that most general stock market performance is measured.) An index fund doesn't employ a portfolio manager and research assistants, so it has lower costs.

Index funds are mutual funds that own the same shares, in the same percentages, as the most popular market averages. They don't buy and sell stocks in the fund based on a belief that some shares will outperform the index; their job is to *match* the index. Of course, if a new stock is added to the index itself, then there will be some adjustments. But, basically, when an investor opens an account and adds new money to the fund, it is distributed among all the stocks in the index by a computer program. That's why index funds are sometimes called *passive* funds, as compared to *actively managed* funds.

Although the popular indexes such as the S&P 500 or the Dow Jones Industrial Average (DJIA) or the Russell 2000 are seen as generalized measures of market direction, they are not all constructed in the same way. The S&P 500 stock index, for example, is not an equally weighted ownership of the 500 largest companies in the market. Instead, the index is weighted by market capitalization—stock price times the number of shares outstanding—so that the largest and most popular stocks account for a greater percentage of the index. The Dow Jones Industrial Average (DJIA) holds just 30 stocks, and each stock's weight or allocation in the index is based on its price alone.

Thus, when new money is invested in an S&P 500 index fund, a larger proportion goes to buy shares of companies that are already top-performing and may have the highest price-earnings ratios. It's a self-reinforcing cycle, pushing the hottest big company stocks even higher in a bull market.

Index funds are typically available in your 401(k) or 403(b) plan at work, or through major mutual fund companies such as Vanguard, Fidelity, American Century, and T. Rowe Price. (Each has a website, where you can open an account and deal directly with their non-commissioned representatives, or discuss your account on a toll-free number.) All are commission-free (no-load) and charge the lowest annual management fees—as described earlier—*if* you buy directly from the fund company.

Do Managed Funds Beat the Market?

As noted in the previous chapter, according to Standard & Poor's year-end 2018 scorecard, 65 percent of large-cap mutual funds failed to beat their benchmark S&P 500 Stock Index over the previous year.

More than 82 percent failed to beat it over the most recent 5-year period and 91.6 percent failed to beat the market over a 15-year period!

Through bear markets and bull markets, professional large company fund managers lagged the market performance. Similarly, in every category (mid-cap, small-cap, multi-cap, large cap growth), over the most recent 15-year period more than 90 percent of managed funds failed to beat their own benchmarks.

That tells you, the ordinary investor, you don't have to devote a lot of time to picking funds that *beat* the market. Instead, you can do just fine matching the overall performance of the market over the long run.

SPECIALLY MANAGED FUNDS

If you don't want to simply use the S&P 500 stock fund, or create a portfolio of index funds, the mutual fund companies have done some work for you, helping you to create a balanced and dynamic investment portfolio. They are frequently found in your company retirement plan, absolving the company of responsibility for your investment decisions. These funds do the decision making for you—and change the balance of investments within the fund as you age.

Target-Date Funds: If you just gave up on the idea of researching and choosing mutual funds, the fund management companies have created a product designed especially for you. They're called *target-date* funds and they're designed for people investing for retirement. You pick the date of your hoped-for retirement, and they'll adjust the investments inside the fund to become more conservative as you approach that date. It takes away your responsibility for making adjustments to your portfolio as you grow older.

These funds are offered by the major mutual fund companies such as Fidelity, Vanguard, T. Rowe Price, American Century, and others. Each has its own name and its own strategy. For example, Fidelity calls these target-date funds Fidelity Freedom Funds, while American Century calls this category its Livestrong funds. You can search for target-date fund reports and comparisons on www.Morningstar.com.

Be sure to read the fund information carefully, especially the explanation of their investment allocation process. You might think that you'd like to be all in "chicken money," safe investments, the

day you retire. These funds take into consideration the fact that you're likely to live 20 years or longer in retirement and that you'll need the growth provided by stocks. So make sure you understand exactly how conservative the portfolio will be when you reach retirement age.

And here's a word of warning about target-date funds. Many will have a high exposure to stocks, especially at the end of a record-setting bull market. If you retire just as a bear market starts, you won't have time on your side to recoup stock market losses. So just because the fund sets a "target date" doesn't mean you shouldn't set aside some of your retirement assets in more conservative choices (perhaps a stable value fund) as you near a retirement date that coincides with a historic period of stock market outperformance.

Fund of Funds: Here's another way to get help in diversifying your investment portfolio. Many fund management companies create a sort of "superfund" that invests in other funds they manage at no extra cost.

For example, the T. Rowe Price Spectrum Income Fund can invest in as many as nine different bond funds to gain exposure to various quality bonds as well as geographical diversification. The Spectrum Income Fund's holdings are designed to increase income but balance risk. Similarly, the T. Rowe Price Spectrum Growth Fund invests in other T. Rowe Price—managed stock funds, ranging from small to large cap, value to growth, and domestic to international. The fees are minimal, and if you open the account as an IRA, there is a $1,000 minimum investment.

Vanguard offers its Star Fund, which invests in 11 underlying Vanguard funds, aiming to keep a mix of stocks and bonds that is 60/40. This balanced fund will easily give you broad diversification at low cost—a sort of one-stop-shopping choice for mutual funds. It is the only Vanguard fund that has a minimum of only $1,000 to invest.

Financial Planning Funds: Mutual fund companies realize that there's a huge universe to choose from and that you can easily be overwhelmed. So they've created funds designed to do the decision making for you when it comes to balancing stocks, bonds, and cash.

Vanguard offers its *LifeStrategy* funds, which range from an income fund, a conservative growth fund, and a moderate growth fund, to a more aggressive growth fund. Each has a different proportion of stocks and bonds and is set up for a different time perspective. The fund maintains the balance of investments, so that you do not have to make decisions about rebalancing your investments. And, since it

is Vanguard, the all-in costs are less than 0.14 percent, with a minimum investment of $1,000 for an IRA.

Fidelity takes a slightly different approach. It offers seven *Asset Manager Funds*, each with a different asset allocation mix among stocks, bonds, and short-term instruments that range from a more conservative and lower-equity allocation mix to a more aggressive and higher-equity allocation mix. Each fund is named for its percentage exposure to stocks. For example, the Fidelity Asset Manager 20% maintains an equity allocation of around 20 percent, while the Fidelity Asset Manager 85% maintains an allocation to stocks of around 85 percent. Fees are low and there is no minimum investment requirement.

Exchange-Traded Funds (ETFs)

Exchange-traded funds are fixed baskets of securities (stocks, bonds, commodities) that are generally designed to track an index or hold stocks from a specific, narrow market sector. Some ETFs are "managed" so that the basket may be altered in composition. Like individual stocks, ETFs are traded on major exchanges (NYSE, Amex, or Nasdaq). They must be purchased through a broker (or discount brokerage firm), instead of being purchased directly from a mutual fund company.

Each ETF is "sponsored" by a company that manages the packages of securities inside the fund and handles the recordkeeping process. Sponsors include companies such as iShares (BlackRock), State Street Global Advisors, Vanguard, and Fidelity. But investors never deal with the sponsors; they simply buy and sell shares of the ETFs at any point during the trading day, with prices being set by bid and offer, as with all listed securities. That may be an advantage over traditional mutual funds, which are priced at the close of the trading day.

Depending on demand for the ETF, the ETF shares might be worth more than the securities in the basket, or they might trade at a discount to the underlying value of the securities in the basket. If prices get too far out of line with the actual value of the assets, there is an *arbitrage* so professional traders will move to narrow the differential.

ETF shares can be bought on margin and even sold short. If the basket of securities represents a major segment of the market, you have a convenient way to own that segment or, if you're hoping to

profit from falling prices, to sell it short. Because most ETFs are passively managed, fixed portfolios of stocks, expenses within the funds are very low. You will, however, have to pay a commission to buy and sell the shares through your broker.

ETFs allow a focused, yet diversified, exposure to various market segments in a cost-efficient format. They allow you to invest in targeted sectors of the market or in broad market indexes with one purchase. For example, you could purchase the equivalent of the S&P 500 Stock Index in the form of an ETF called the SPDR, popularly known as *Spiders*. It is traded on the NYSE under the symbol SPY. Several other ETFs also track the same index.

QQQ is the symbol for the best-known ETF that represents the Nasdaq 100 index of stocks, which is dominated by the tech sector. Another ETF with the symbol DIA, called *Diamonds*, replicates the DJIA. There are also ETFs for major market sectors, from health care to real estate to financial services to natural resources. And there are ETFs that hold the representative stocks from individual foreign countries.

There are many fixed-income (bond) ETFs, including corporate bonds and Treasuries, as well as ETFs that replicate foreign stock and bond indexes. These bond ETFs have quite a range, from short-term maturities to longer term, and represent different risk characteristics, depending on the bond ratings of the assets they hold. As a result, they will perform differently when interest rates rise or fall.

There are also ETFs that either hold physical commodities or track commodity indexes using futures and swaps. There are ETFs that track commodity subsectors, such as agriculture or energy or metals, and include several commodities in the underlying basket. And there are several broad-based commodity index ETFs, which differ based on their weighting of various commodities such as energy, gold, or agricultural products.

Other ETFs are designed to track the price of a specific commodity, and represent an actual share of ownership in that commodity. For example, the SPDR Gold Shares ETF (symbol: GLD) buys gold bars for every share issued. The bars are stored in vaults in London. So this ETF tracks the price for immediate delivery of gold, the *spot* price. Similarly, you can invest in ETFs that track natural gas, oil, or currencies.

There are even *leveraged* ETFs and *inverse* ETFs, which are daily trading vehicles that can be very volatile and expensive. The leveraged ETFs are designed to give you more return (or losses) for your small investment. And the inverse ETFs are designed to let you profit

from a move to the downside in an index or group of stocks or commodities. But, by design, the returns are amplified far more than you might expect.

For tax purposes, ETFs are treated just like other securities. You pay capital gains taxes on the sale of your ETF shares based on your profit or loss and on the length of your holding period, just as you would with any other security. Because these portfolios are fixed, there are rarely capital gains distributions to shareholders unless the manager has to sell a security inside the portfolio, as in the case of a merger. But when large shareholders of an ETF want to get out, they can take securities instead of cash, meaning there is less likelihood of securities being sold for a profit (or loss) inside the ETF.

(*Special note:* Not all ETFs are *tax-efficient*. Some do have a high turnover rate, which may generate taxes on distributions for ETFs held outside a qualified retirement account. Some ETFs that hold underlying physical commodities, such as precious metals, are taxed as *collectibles* rather than securities—at ordinary income tax rates, compared to the long-term capital gains on securities. These are best held inside an IRA.)

The low expense of ETFs makes them attractive to long-term investors. But if you're planning to invest a fixed amount every month, you'd probably want to avoid paying a commission—even a discounted commission—on each transaction and send your monthly check to a low-cost traditional mutual fund, if there is one that represents a similar portfolio as the ETF. On the other hand, traders like the liquidity of an ETF, enabling them to sell if their market perspective changes during the trading day.

The very best place to learn about ETFs, and to compare and contrast their content and performance, is under the "ETF" tab at www.Morningstar.com.

Socially Responsible Investing

In the past decade, the concept of investing based on ethical principles has grown dramatically. More than one out of every four dollars under professional management in the United States—$8 trillion or more, and an estimated $70 trillion globally—is invested according to strategies that incorporate environmental, social, and corporate governance (ESG) criteria, according to Morningstar.

Numerous academic studies have shown there is no additional risk when investing using ESG screens, nor any impact on returns. A recent Nuveen-TIAA white paper on ESG investing found:

> No statistical difference in returns compared to broad market benchmarks, suggesting the absence of any systematic performance penalty. Moreover, incorporating environmental, social and governance criteria in security selection did not entail additional risk.

The easiest way for American investors to participate in this trend is through ETFs that specialize in various forms of socially responsible investing. Those funds may include stocks, bonds, cause-specific securities, or a mixture. Additionally, there are traditional managed mutual funds that have adopted ESG criteria. Morningstar even has an investment tool to evaluate funds based on sustainability criteria.

The cost of investing using ESG principles is no more than a standard mutual fund or ETF. Vanguard, which has four ETFs concentrating on SRI (socially responsible investing) screening, also offers a Global ESG managed mutual fund, Global ESG Select Stock fund. These are the lowest-cost places to start your search for a fund that represents your concerns.

The Newday Impact Investing App There's a new and unique approach to SRI investing—aimed directly a millennials. This app allow individuals to customize their investing goals directed toward seven major sustainability impact portfolios: Ocean Health, Global Impact, Fresh Water, Animal Welfare, Gender Equality, Climate Action, and Stakeholder Capitalism.

Participants create access a risk-profiled account where you can start investing for as little as $5 a month to build an investment account, or a traditional or Roth IRA. But the Newday Investing app goes beyond just investments. The social side of Newday Investing supports the causes you choose, with 5 percent of the minimal account fees contributed to support organizations working to help that specific cause. The goal is to build a social community around those causes, not only investing but also advocating for a better world, using the power of investments.

Using the app, it's easy to open your account and link your bank account to set up regular contributions. The portfolios you choose are priced once daily, and there is complete liquidity to take your money out by moving it back to your bank account. This approach takes SRI investing to a new level—and makes it accessible to everyone. Learn more at NewdayImpact.com.

If you choose traditional mutual funds or ETFs and want to do your own research, the Morningstar Sustainability Rating tool lets investors evaluate funds based on sustainability criteria. Also, at the website of the Social Investment Forum, www.SocialInvest.org, you can compare the investment performance and criteria of 200 mutual funds that use ESG criteria.

Options

Options are both one of the most useful and one of the least understood aspects of the stock market. Though some see them as a low-priced way to speculate on future stock prices, they are actually better suited to ordinary investors as a way to increase portfolio income and protect your existing stock portfolio from losses.

An option on a stock gives you the right to buy (*call options)* or sell (*put options)* a specific number of shares in a company at a specific price for a specific period of time. You can buy options on a single stock or on a major market index, on specific market segment indexes, or on many ETFs.

Options offer a variety of expiration dates, including weekly, monthly, and LEAPS, which are long-dated options expiring up to two years into the future. Option traders can customize their strategy to target a specific date or event. Essentially, with an option you're buying time—hopefully enough time for the stock to move in the direction you choose.

If you believe a stock will rise, you can buy a *call* option instead of paying for the full 100 shares or paying the 50 percent margin required to buy 100 shares of stock. With a far smaller investment, you get some of the benefits of owning the stock, but only for a limited amount of time. If you guess right about the direction of the stock but your timing is off, you can lose all the money you spent on the option.

If you believe the stock will fall, instead of selling the stock short, you can buy a put option. This bearish strategy will profit if your forecast is correct and the stock declines. A put limits your market exposure if you're wrong and the stock doesn't fall. If instead you had sold the stock short (the perfectly legal strategy of selling stock you don't own in hopes of buying it back at a lower price), you would have unlimited upside risk.

Basically, options allow you to diversify your portfolio for a relatively small amount of money. The trade-off is that you own the

option for only a limited amount of time. When it comes to investing in options, timing is everything!

There's another use for options. As an investor, you can use them to protect your portfolio. You can sell (*write*) options on a stock you already own, and you can pocket the amount (the *premium*) you are paid. But by selling the option, you are granting the buyer of the option the right to purchase your stock at a specific price during a specific period of time. So you have to be ready to have your stock called away by the owner of the option during the period of time the option is outstanding.

For example, if you own a stock that is trading at 50, someone might pay you $5 for a six-month option. (Price is determined by the market.) If the stock rises, the option holder will call the stock away from you, paying you $50 a share. But since you collected the option premium, it is as if you sold the stock at $55. You'll have to decide in advance if that's enough profit for you.

If you change your mind and don't want to sell the stock at 55, then you can buy the option back. Again, the price of the option will be determined by the market, which weighs the time left until the expiration of the option against the likelihood that the stock will move higher. If the stock has moved up, and there is time left on the option when you buy it back, then you will likely suffer a loss on your option trade—but you will still own the now higher-priced stock.

And if you sold the call at $50 a share, but the stock falls instead of rising, you have some protection on the downside. Until the stock falls below 45 (offsetting the $5/share you collected in premium), you're not actually losing money on your position.

Selling options on stocks you own can increase your income in retirement and cushion the impact of a declining market. You can set up a regular program of call writing, and if the market stays at about the same level, you can substantially increase your return on investment by taking in option premiums.

The main drawbacks to this strategy are that until the option expires, you are obligated to deliver those shares. If the market declines, you are free to sell your underlying stock to cut your losses—but the obligation remains. If you sell the stock before closing the option position, the call will be *uncovered*, and you'll likely want to buy back that call. Otherwise, if there's a subsequent rally in the stock, you could be forced to buy back the stock at higher prices to deliver to the call buyer at any time until the expiration date.

For more information on options, go to the Chicago Board Options Exchange (Cboe) at www.Cboe.com, and click on "Education." You'll find resources from beginner to advanced, and might particularly be interested in the courses and seminars offered by the Cboe Options Institute.

Or check in at the Options Industry Council (OIC) website, www.OptionsEducation.org. OIC offers free online courses, podcasts, videos, and webinars for investors of all skill levels with topics ranging from options fundamentals to more advanced concepts of pricing and position management.

Whether you're a speculator, hoping to profit from a quick rise in the price of a stock, or a more conservative investor, hoping to add income to an existing portfolio, options offer strategies to both minimize risk and maximize profit. But always remember that an option is essentially just buying time, in which your strategy can work. In many cases, when you run out of time on an option, you also run out of money.

Real Estate Investment Trusts

This book won't go into direct real estate investing for the simple reason that every property is different and it's hard to give general rules for investors who simply want to diversify their portfolios. That is not to say that investing in real estate couldn't play an important role in your investment strategy.

But if you just want to give your investment portfolio some exposure to real estate, there is a certain category of stocks designed to do just that. They are *real estate investment trusts* (REITs), and they invest directly in real estate. Their shares are traded on the major exchanges, and when you buy shares, you own a piece of those real estate assets.

There are 165 publicly traded REITs listed on the NYSE and NASDAQ exchanges , with more than $1 trillion in market capitalization—the price of the shares multiplied by the number of shares the companies have outstanding. REITs are simply a form of holding company for real estate properties and services. Typically, equity REITs have concentrated ownership in one type of property: apartments, offices, shopping malls, hotels, or even storage units. Other REITs offer mortgages to existing properties. If you can't decide

which REIT to buy, there are many mutual funds that invest primarily in the shares of REITs.

The attraction for investors is twofold. First, REITs offer a chance to own a diversified piece of choice properties that could appreciate in value, especially if inflation returns. Second, these companies are required by law to pay out 90 percent of the rents they collect in the form of dividends to shareholders. So REIT shares offer a tempting regular dividend payment that is higher than most other equity investments.

A portion of that dividend may be ordinary income, capital gains, or even return of invested principal. That creates some beneficial tax opportunities as well as a stream of income. This payout of dividends is based on the *flow of funds from operations* (FFO), which is the traditional measure of REIT earnings.

REITs add balance to a portfolio. In times of inflation, REIT shares may become more valuable, reflecting the increase in value of underlying properties. And in a slowing or deflationary economy, the dividends—secured by rents—make REIT shares relatively more attractive than many other companies.

Of course, there are risks in REITs. In a deep recession, vacancies increase and tenants may be evicted or go bankrupt. Online shopping impacted REITs that specialize in shopping malls. Business travel slowdowns could cause problems for hotel REITs. But although income may decline, the REITs still own the properties. That's the attraction of REITs and the mutual funds that specialize in them.

At the National Association of REITs (NAREIT) website (www.REIT.com), you can get a list of all publicly traded REITs and a quick link to their websites. You can search by category. There's also a list of mutual funds that specialize in REITs. You can also research REIT funds at www.Morningstar.com.

Futures

What will your dollar be worth in the future? Or your house? That's basically a function of unknowable factors like inflation, the economy, global trade, and changing tastes. Futures markets exist as a forum to lock in future prices and deliveries of everything from raw commodities to interest rates to currency values, and more. They create certainty around future values of today's assets.

If you're an individual or a business, you might want to hedge against the risk of future price changes. For example, a homebuilder might want to lock in today's price for lumber or plywood or copper piping. A cereal manufacturer might want to get a firm grip on the price of corn after the harvest comes in next fall—and also get a guaranteed delivery of his supply of corn. And an exporter might want to make sure that the money she is paid in a foreign currency will be worth enough in dollars to cover her manufacturing costs, and make a profit.

Futures markets exist to allow producers and users of products to hedge against risk. In between, in these freely traded markets, speculators agree to accept the risk of becoming the "middleperson"—buying or selling on their belief that they can make a profit. The more buyers and sellers, the more liquidity, as each has a different outlook and viewpoint on future values. That trading liquidity sets prices far more efficiently than any two people might agree upon over the phone, and certainly far more efficiently than government price mandates.

Many of the products traded in these markets are tangible commodities such as oil, natural gas, corn, wheat, cattle, coffee, and hogs. But there is also risk in the future value of intangibles, such as interest rates, currencies, stock prices, and the relationships among these vital parts of the financial system. So there are futures contracts to hedge against financial risk as well as commodity risk.

These days most futures trading takes place electronically on a 24-hour basis. Unlike stocks, where a company issues shares, futures contracts are created when a buyer and seller agree on a price for future delivery of a standardized contract. Thus, it could be said that futures trading is a zero-sum situation: For every side of the contract that wins, there is an opposite side that posts a loss.

Of course, only a small percentage of contracts traded result in actual delivery of the physical commodity. Much trading volume is done by speculators who participate merely to make a profit if they are correct in forecasting the direction of prices. Most of these contracts are settled by exchanging money represented by the value of the contract when it expires—or by selling the contract to an end user before the expiration month.

Since futures are traded with a very small cash margin, there is a lot of leverage to the money invested. Leverage works both ways: You can easily double your money, but you can also lose all of your

initial investment, or even more. The major futures exchanges have websites with educational features that explain how futures work. Check out the Chicago Mercantile Exchange (CME) Group's site at www.CMEGroup.com. (Full disclosure: I am a public director of CME Group Inc.)

Although you may never be a speculator, you might want to use futures to hedge against the stocks and mutual funds in your retirement portfolio. If you believe that the market will decline but don't want to sell your stock funds, you could easily sell a futures contract that roughly represents the stocks in your portfolio or buy a put option on a stock futures contract.

If you're interested in commodity futures, you will have to do your homework and deal with a reputable brokerage firm. Many online brokerage firms have created special sections to teach and advise on futures trading strategies. The thinkorswim trading platform by TD Ameritrade is an especially robust platform with terrific tools and resources. The platform also features an education tab covering a range of topics and trading strategies so you can learn and grow as an investor. You can also practice with "paper money" before you put your own money at risk. Similarly, Schwab, TradeStation, Interactive Brokers, and eTrade are good places to both start your futures education and begin trading.

Or, as noted above, you may choose to add commodities exposure to your portfolio through an ETF, or an index fund that does not speculate but simply tracks an index of physical commodities. Or use a managed mutual fund, such as the Fidelity Commodity Strategy Fund, which has a very low expense ratio. Note that many commodity funds have annual costs of over 1 percent, reflecting, in part, trading fees that are paid to maintain their positions.

Another way for sophisticated investors to gain exposures to futures is through *managed futures accounts*. If you are considering a managed futures account, check out the track record of the programs at ManagedFuturesInvesting.com, using their performance database. Do not rely on promotional literature touting success stories.

Beware of offers to trade currencies or other commodities that are not tied to exchange contracts. If you're concerned about researching a lesser-known firm that manages money in futures or offers cash trading of currencies, check the company out at the website of the National Futures Association (NFA), www.NFA.futures.org. There you can research individual brokers, firms, and money managers that specialize in futures.

Hedging the Dollar with Foreign Currencies

We live in dollars, shop in dollars, invest using dollars, and plan our retirement in dollars. But what will the dollar be worth in a few years? If you buy only "made in America" goods, you're less exposed to the changing global value of the dollar. But because we are all dependent on imported oil, and might want to drive imported cars, or wear imported clothes, we are all better off when the world respects the dollar and it can buy more of anything made outside the United States.

But the dollar itself is a commodity dependent on others' perceptions of its future value. When the Federal Reserve announces it is creating more dollars to get the economy growing, those who hold substantial amounts of dollars suddenly realize that this printing process will cause their dollars to lose value. That's the simple definition of *inflation*.

Americans have always felt the world revolved around the dollar. But in recent years the countries that have collected the dollars we spent as we shopped globally are now starting to get worried about holding so many dollars. With more than $1 trillion U.S. dollars in its reserves, China is one of our largest creditors. Japan holds a similar amount of U.S. dollars in its reserves. They typically invest those dollars by purchasing U.S. Treasury bills, notes and bonds—helping us finance our massive budget deficits.

If a foreign central bank worries about the future value of the dollar—inflation—they may make a different investment decision. That's not likely in the case of China, since they hold so many dollars, they are somewhat restricted in the actions they can take, lest they cause a decline in the value of their own dollar holdings.

It's worth remembering that when the global financial markets were on the verge of collapse, there was a giant rush to the presumed safety of the U.S. dollar. Perhaps the lesson is that the world doesn't trust the dollar, but it trusts other currencies even less. The result is a dollar that is relatively stronger than other currencies, allowing U.S. consumers to afford more foreign-made products.

Although most of us will always make financial transactions in dollars, there is a good reason to watch the value of the U.S. dollar against foreign currencies. The value of the dollar not only impacts the cost of imported goods, but the price we pay to import capital.

That price is interest rates. If our global creditors demand higher interest rates as an offset to feared inflation, it will impact the entire U.S. economy, from mortgage loans to credit card rates.

As long as the world is willing to hold those dollars and reinvest them in U.S. Treasury bills or other government securities, at low rates based on confidence in the future value of the dollar, there's no problem. But if you have a global business, you need to hedge against the possibility of a falling dollar. Similarly, if you have an investment portfolio, you'll want to protect against that same risk.

To hedge your need for foreign currencies or simply to speculate on the value of the dollar (and indirectly on global interest rates), you can use futures and options contracts traded on the Chicago Mercantile Exchange.

Or you can actually trade cash currencies at Fidelity, which has an international currency trading program that gives you 24-hour access to trading dollars for 35 different currencies. Access is limited to investors with substantial assets.

There's another easy way to speculate on the future value of the dollar—or simply to get the currency you need for future trips to a foreign country, if you expect the value of your U.S. dollars to decline. At TIAA Bank (formerly Everbank) you can use their world currency program to buy certificates of deposit (CDs) that are denominated in a wide variety of foreign currencies. Or you can use their borderless currency account, found at www.Transferwise.com to open easily accessible accounts denominated in foreign currencies, and use their foreign currency Mastercard to access them.

Gold

The ultimate hedge against currency inflation is gold. It has kept its value throughout history against paper currencies that ultimately became worthless. While any government can create paper currency, no one has ever been able to create gold. Even medieval alchemists tried to no avail, and you remember the story of Rumpelstiltskin, who tried to spin straw into gold!

Gold is virtually indestructible, and in all of history, only 161,000 tons of gold have been mined, barely enough to fill two Olympic-size swimming pools. More than half of that was extracted in the past 50 years, and there have been few recent discoveries. That's part of what makes gold unique and so special. Many people believe that gold's place as a safe haven will be usurped by a new generation of

crypto-currencies, backed by the secure blockchain ledger of transactions. (See below.) That remains to be seen, as gold has a very long history of providing a store of wealth in uncertain times.

A Brief History of Gold

America has an interesting historic relationship with gold. A century ago, our country (along with England, France, and Germany) backed its paper currency with gold, meaning the paper money was interchangeable with gold at an official price. Then in 1933, during the depths of the Depression, the United States went off the gold standard. The government demanded that its citizens turn in all their gold bullion coins in exchange for paper currency. President Roosevelt's Executive Order in 1933 proclaimed a national emergency and called for the "requisition of all privately held gold in America," with a penalty of "up to 10 years in prison and/or up to a $10,000 fine." Some numismatic, *collector* coins were exempted, but gold bullion coins and bars were confiscated.

In 1946, after World War II, global powers created a fixed international exchange rate based on the ability of major central banks to exchange gold with the U.S. Treasury for a fixed price of $35 an ounce. It was called the *Bretton Woods Agreement*. The dollar, implicitly backed by the gold held in Fort Knox, became the world's medium of exchange.

This system of fixed exchange rates lasted until August 15, 1971, when President Nixon "closed the gold window" just as France, under Charles de Gaulle, decided that it would rather have bullion than the paper dollars that the United States was starting to print excessively. At the same time, Nixon imposed wage and price controls in a fruitless attempt to control inflation, then running at around 4 percent annually.

It wasn't until January 1, 1975, that Americans were again allowed to own gold bullion coins and bars. At the time, gold was trading in global markets at around $170 an ounce. Just five years later, in 1980, amid growing inflation fears, the price of gold rose to more than $800 an ounce. When the Fed, under Chairman Paul Volcker, regained control over inflation and inflation expectations, gold prices dropped back to below $300 an ounce, where it traded for years before the most recent rally.

Since August 1971, there has been no official link between the dollar and gold. Gold owned by the government was officially priced

at $38 an ounce in 1972, although no foreign central bank or individual could access that gold. In February 1973, the official price was raised to $42.22 an ounce, where it remains today. The U.S. Mint says there are currently 261.5 million ounces of gold in Fort Knox.

Why is it important to understand the historic role of gold in a world of paper currencies? It's because few governments have resisted the temptation to "print" their way out of economic problems. The lessons of Germany in the 1930s have been forgotten—except for many older Germans who would rightly choose austerity on the part of government instead of the secret tax of inflation, which destroys buying power. Always remember that a little bit of inflation (creation of too much money) can easily turn into a conflagration when everyone runs to exit the currency.

It is possible that if the world were to completely lose faith in the value of the U.S. dollar, our government could be forced once again make the dollar convertible into gold—at much higher prices!

How to Buy Gold

There are several ways to invest in gold, and each has its own advantages and drawbacks. If you decide to purchase gold, you might want to choose several of these alternatives:

- *Gold-Mining Stocks or Mutual Funds:* The advantage of buying shares of gold mining companies is that they pay dividends. That gives you a stream of income that you don't get when you buy bullion or coins. In addition, these gold-mining companies are leveraged, in the nicest sense of the word. Their mining costs are fixed; if the price of gold bullion rises, they make more profits without much additional cost. You don't have to become a gold stock expert, since there are many gold mutual funds listed at www.Morningstar.com.
- *Gold ETFs:* The NYSE-listed stocks SPDR Gold Trust (GLD) and Central Gold Trust (GTU) reflect daily price changes in gold. You are in effect buying a share of their bullion holdings. There are listed ETFs that purchase shares of gold-mining companies, such as the iShares MSCI Global Gold Miners ETF.
- *Gold Bullion Coins:* Many countries issue gold bullion coins, including the United States, which currently issues U.S. Gold Eagle coins containing one ounce of gold, and also smaller gold coins, as well as gold "Buffalo" coins. You can also purchase

Canadian Maple Leaf coins, Australian Kangaroos, and the Austrian Philharmonic gold bullion coin. All are priced based on gold bullion, with a slight premium for minting and distribution costs.

- *Numismatic (Collector) Coins:* Older gold coins may have collector's value and a more limited marketplace. Their value is based on rarity and the condition of the coin. Some investors remember that in 1933 most numismatic coins were exempted from confiscation, so they are willing to pay a premium over the gold value to hold these coins.

  Always make sure you are dealing with a reputable company, take possession of your coins, and store them in a safe place. Check the registry of American Numismatic Association dealers at their website, www.Money.org.
- *Gold Bars:* You can purchase gold bullion bars in various sizes. One ounce is standard, but there are smaller *wafers*, and bars as large as 450 ounces. The problem with larger gold bars is that they should be kept in custody to ascertain they have not been tampered with in any way. Thus, there are storage charges. And the storage provision opens the way for fraud. In the "gold rush" of the early 1980s, there were revelations of warehouses filled with bricks painted gold to look like gold bars!
- *Futures:* You also can trade futures contracts on gold, and options on futures contracts, but this is the riskiest way to participate in the market because so much leverage is used.

When you buy gold in one of the forms previously described, you are buying "insurance," so this should be done only with a portion of your total investment portfolio. Sadly, if gold were to soar, it would reflect a breakdown in this country's financial system—a situation that would be far more costly in other aspects of your life.

Crypto-Currencies and Blockchain

Even if you know nothing about the stock market, you've probably heard about crypto-currencies and blockchain technology. Both are likely to change not only the United States, but the global financial system, over time. You need to understand the basics, but beware of investing (speculating) at this early stage of their development.

Blockchain is a technology that provides an immutable *ledger* or record of transactions. Once a transaction is made, it is recorded forever. The records may be accessible to anyone—or restricted to those who participate in a certain company or industry. The important point is that blockchain technology takes away the need for third-party verification of transactions.

For example, if you buy a house, you'll pay for title insurance—a third-party record of the deed, a guarantee against any liens against the property. But if the transaction were registered on a blockchain, there would be no need for the middleman or the fees paid to them. Suddenly, you can see the applications of blockchain technology—from transferring money globally from bank to bank to transacting business deals to getting immediate access to your checking account deposit—if it were made through an instant, secure blockchain ledger.

So called crypto-currencies use the blockchain ledger to avoid the "middleman" of the banking system. You can exchange your dollars—or yen or euros or renminbi—for a crypto currency like Bitcoin, Ripple, or Ethereum, or any one of more than 1600 crypto-currencies currently available. Their current valuations exist in code on the blockchain, and you can gain access to your currency account with a "key"—a very complex password that cannot be recovered if lost.

An important aspect of cryto-currencies is their secrecy. That's been a great attraction for the global criminal element, as well as citizens trying to get their wealth out of countries that in some way restrict exporting their financial assets. Think China or Russia.

What can you do with your crypto-currency? The goal is to use them for transactions. Today more and more retailers from online merchant Overstock to Dish Network to car dealers and some apartment landlords have announced they will accept Bitcoin for purchases. Their risk—unlike with the dollar—is what the value of that crypto-currency will be in the days and months ahead—until they can spend it, or hold it for hoped-for appreciation.

But usage is growing. Intuit now offers small businesses a way to accept cryptocurrency payments through Intuit using a "PayByCoin" service as part of QuickBooks. The most exciting development in blockchain usage may be led by Facebook, which is leveraging its enormous reach to partner with existing financial companies to facilitate ordinary transactions using its own planned crypto-currency, Libra. This concept has attracted substantial attention from U.S. banking and securities regulators.

So what's a particular crypto-currency "worth"? That depends on the market demand for it, which in turn is dependent on the amount of crypto-currency available. Crypto-currency is created through a complicated (and expensive, and energy-intensive) computer process called mining. On any given day at any time there is a market price set for the best-known crypto currencies. And that price may vary widely over the course of time. For example, in the space of just 18 months Bitcoin went from a price of around $400 per dollar in January 2016 to $18,480 in December 2017, to falling to just over $3,300 in subsequent months, before rebounding to over $11,000. This is the very definition of volatility!

Crypto "tokens" are now being created that do not come from mining, but instead have some form of exchangeable backing. They are, in effect, bringing back asset-backed currencies, such are the gold standard of 100 years ago. The difference is that the currency is now exchangeable for a product. For example, one coin could equal a cup of Starbucks coffee or entrance to an amusement park. These are called *proof of stake*. Tokens are going to be very important in the future and may very well be bigger than crypto-currencies.

Volatility in pricing isn't the only major issue with crypto-currencies. The other concern is the security risk in the process of exchanging your dollars for the crypto. These crypto accounts are held in "wallets" at "exchanges" that are not the traditional form of stock or futures exchange we trust. Instead, these are private, unregulated companies that have frequently had security breaches, thefts, or simple disappearance of significant amounts of the crypto-currencies they store.

That security issue will certainly be minimized as the financial services industry moves to apply regulated standards to the exchange of crypto-currencies for our current conventional currencies. There is just too much interest in the opportunities created by the blockchain, and transactions based on it, for it to continue to exist in its current Wild West state.

Crypto-currencies are currently mostly a speculation, although there is little doubt that as institutions recognize the technology and enter the marketplace, there will be true economic uses—and valuations—for many of them. But until the cash markets are better established (and regulated), be very careful about how and where you change your "real money" for crypto-currencies.

To understand the complete market for crypto-currencies and the markets where you can buy them, go to www.CoinMarketCap.com. This site provides a view of all of the crypto-currencies and

their market cap. It will give you the latest prices and also contains the 24-hour trading volume that will provide an understanding of the velocity of trading of each currency.

Just Get Started!

The choices presented in this chapter range from the very basic—mutual funds and ETFs—to the more sophisticated ways to deal with the market and the economy, ranging from the use of options and futures to hedges to the dollar.

Each of these choices has its own costs and risks. Always ask, and always get specific answers, about these issues. Your trusted investment advisor can guide you to the balance that is appropriate for your personal situation.

Don't be overwhelmed by all the choices. You don't have to have a lot of money to get started. In almost every category listed above, I've shown you how to get started with $100—and with Acorns, as little as $5.

Now, let me overcome your second excuse—that you don't have extra money to invest or that you can't afford it. It's always difficult to save and invest for the future. But take a look at your paycheck, with all its deductions for income tax withholding and Social Security. You can't afford that, either! At least when you invest in a well-diversified mutual fund you have a better chance of seeing something of value for your future.

Don't wait until it's the "right time" in the market. There's never a right time. Just get started. With an ongoing program of regular investing, you might never get the lowest price, but you'll never pay the top price, either. Over the years, as you build up shares in your mutual fund, you'll find that your money is starting to work for you.

Yes, there may be temporary setbacks. But look again at the long-term stock market investment chart in Chapter 6. Think of all the people who gave up investing during the Depression, or during the sad seventies, or even after the 2008 global financial crisis. Look at what they missed out on in subsequent years. Remember, *no one ever got rich betting against America*. And that's The Savage Truth.

TERRY'S TO-DO LIST

1. Get started with a small amount of money using Acorns, Stockpile, or Robinhood.
2. Open an IRA and start with the S&P 500 stock index fund.
3. Use ETFs to get sector exposure.
4. Go to www.Cboe.com, click on "Education" and then on the free "Option Tutorials."
5. Start to hedge your dollar exposure by purchasing a gold coin or a few shares of a gold stock mutual fund.
6. Be aware of cryptos—and beware!

CHAPTER

THE SAVAGE TRUTH ON INVESTING FOR RETIREMENT

The Sooner the Better—But It's Never Too Late

Time is money. And nowhere is that Savage Truth more apparent than when it comes to investing for retirement. Even a small amount of money, invested regularly, can grow dramatically over the years. But retirement is so far on the horizon for most millennials and Gen X and Y, that other financial issues seem more pressing. How is it possible to both repay student loan debt and save for retirement?

Well, here's an optimistic thought: If you have a job, you're *already* saving for retirement. You're just not doing it in the optimal place. Social Security is taking a cut of your money from every paycheck. For sure, it won't be enough to retire in the style you envision. So this chapter will show you some easy alternatives to getting started in retirement savings with a small amount of money, at a low cost, in a diversified investment, and without any hassle.

Getting Started on Saving for Retirement

The Savage Truth: *The first step is always the hardest—getting started.*

There is never "extra" money to save for retirement. So don't bother looking for it. Instead, take a look at your paycheck. You'll

see a little box marked "FICA." That's Social Security—and it takes a nice hunk out of every paycheck. It's your first step toward retirement savings—and it's not a matter of choice.

Do you know what the initials *FICA* stand for? *FICA* is the acronym for *Federal Insurance Contributions Act*. You're making a *contribution*—but likely not to your own retirement. Instead, the money coming out of your paycheck this week will be on the way to your parents or grandparents on the first day of next month in *their* Social Security checks!

When Social Security first started, there were many more people working than there were retirees. And those retirees didn't live as long as they do today. As a result, Social Security is no longer the well-funded retirement plan for your future. Instead it has become a transfer payment—from those still working to those who have already retired.

The actuaries have made it clear: The Social Security trust funds are predicted to run out of money in 2034. Of course, it will continue to pay some benefits, because of FICA tax revenues coming into the program. But likely those benefits will be paid at a far lower level than promised. The alternative—"printing" the money—would cause a massive inflation, and devalue the spending power of those dollars. Instead, during your lifetime, Social Security will likely become a means-tested program—offering benefits only to those truly in need, despite the fact that all workers contributed to the plan.

The point here is not to debate the future of Social Security. Instead it is to give you an incentive to save on your own. You'll notice the word *contribution* in the FICA name. Mostly when that word is used it connotes a voluntary giving. But don't walk into the HR office at work and tell them you "can't afford to contribute to FICA this month." It's not optional!

Instead, you should take note of that money being taken out of your paycheck before you can see it or spend it. Then set up another deduction for your own retirement. If your employer has a *401(k)* or *403(b)* or *thrift savings plan*, take advantage of it. Don't tell yourself that you can't afford it. In reality, you can't afford *not* to set money aside for your own retirement.

If your employer matches all or even part of your contribution, that's free money—a riskless gain. Yet, amazingly, major corporations report that a significant percentage of employees fail to contribute enough to the plan to get the matching dollars. No excuses: Increase your contributions.

The Savage Truth is: *If you don't see it in your paycheck, you won't spend it.*

If your employer doesn't offer a retirement plan that will take automatic deductions from your paycheck, head to a low-cost investment firm like Vanguard, Fidelity, T. Rowe Price, Schwab, TD Ameritrade, or robos like Betterment, Personal Capital, or Wealthfront. There you can easily set up an *individual retirement account* (IRA) or a *Roth* IRA. (See Chapter 5.) Once you open the IRA account, they'll take automatic deductions from your checking account every month before you see the money and spend it!

Time Is on Your Side

Time leverages the power of money through compounding. The earlier you start making regular contributions to a retirement plan, the less you have to contribute along the way to build your assets. Consider the story of Tom and Mary.

(By the way, in my stories the woman is always the smart investor!)

Tom and Mary both start work at age 25. They're asked if they want to make pretax contributions to the company's 401(k) plan. Mary decides to contribute $200 a month. She does so for 40 years, until she retires at age 65. Over the years, she contributes a total of $96,000 ($200/month for 40 years). The money grows at an average annual rate of 9 percent, sheltered from taxes inside the plan.

At retirement, Mary's account is worth **$850,000**.

Tom, on the other hand, feels he is way too young to start thinking about retirement at age 25. But at age 45, he notices that his hoped-for retirement is now on the horizon and he realizes he needs to catch up. Tom decides to contribute $400 a month (twice what Mary is putting in), which he does for 20 years. When he retires at age 65, he has contributed a total of $96,000 (400/month for 20 years)—the same amount as Mary—and his account also grows at an annual rate of 9 percent inside the plan.

But at retirement, Tom's account is worth only **$257,000**—*far* less than Mary's.

The big difference is due to the time the money had to grow within the plan. The fact is that if Mary had stopped contributing when Tom started, she'd still have more than *twice* as much as Tom at retirement.

If Tom really wanted to catch up to Mary by starting his retirement plan at age 45, he would have had to contribute $1,321 per month in order to have the same total at retirement.

If Tom and Mary happen to be married to each other, Tom's a lucky guy. Here's another thought: Even if you are married, each individual should be setting aside money in his or her separate retirement plan.

The bottom line: The younger you are when you start saving and investing for retirement, the less you have to save along the way. It's a lesson we must pass on to every young worker. But don't be depressed if you've fallen behind. There's another Savage Truth that applies to you: *Better late than never.*

Better Late than Never

Don't be paralyzed by fear of taking the first step. There are several ways to leverage the growth of your retirement dollars even if you're late in getting started. There's an old saying that even a small percentage of *something* is better than 100 percent of *nothing*. If you're a late starter, there are three basic alternatives: save more, take more risk to earn a higher return, or delay taking withdrawals as long as possible.

First, look at the effects of saving more. Consider the earlier example (in Chapter 1) of the person who contributes $38.46 a week for 31 years to amass $364,000 in his or her retirement account. You could start at age 40 and have that much by age 71, when you'd be required to start making withdrawals.

Would you rather have $1 million in your retirement account? Of course you would. So let's do some rounding and figure that you'd have to save about three times that amount, or $120 a week, or about $500 a month, to reach your goal. (That's assuming a long-term average investment return of about 10 percent, the historic average return of the stock market with dividends reinvested.) Ask yourself if it would be worth it to you to earn that much more every month, perhaps in a part-time job, or to spend that much less every month.

In fact, that additional amount could be partly made up by your employer's matching contribution to your retirement plan. That's what you miss when you fail to see the big picture. A match of 50 cents on the dollar is like buying a stock that goes up 50 percent overnight.

Now consider what happens to Tom and Mary if the company retirement plan matches their investment for the typical 50 cents on the dollar. Mary's account would be worth $1,275,000 at age 65, and even late-starter Tom would come out with a much better result.

After 20 years of contributing $400 a month with a match of 50 cents on the dollar, his account would be worth $386,000 when he reached age 65.

Certainly, it's better to start early. But even a late-starting program of regular retirement investing, using every opportunity to leverage your investment dollars while taking only acceptable risk, will bring you far closer to a secure future. And if you're still worried about stock market risks, reread Chapter 6, and I'm sure you'll conclude that the greater risk is in *not* investing for the long run.

Your Time Horizon—and the Market

Here's a sad Savage Truth that many people learned the hard way over the past decade: *Your investment discipline should match your time horizon.* Since the turn of the century, we've lived through two major bear markets. The decline of 2008–2009 was especially scary. It created a whiplash effect for many retirement accounts. Reflecting those powerful emotions—fear and greed—many bought recklessly at the top, or sold emotionally at the bottom. Of course, that only becomes obvious in hindsight.

The lesson to be learned is that retirement savings is a long-term process. If you continue to contribute to your account every month, you'll never pick the top or be fortunate enough to buy at the bottom. But you will accumulate more shares and they will give your account a powerful boost when the market rises, as it eventually will. Even if you're just a few years from retirement, you'll need some form of growth in your investments for the extended period in which you'll live during retirement.

If you have a long-term goal in your retirement savings, you don't want to be making short-term investment decisions. Unfortunately, with today's technology you can check your balances every night. And most retirement plans let you make immediate changes to your portfolio with a click of your mouse. That can lead to big mistakes because of impulsive decision making.

Taxing Decisions

Taxes are another issue to consider when you start your program of retirement savings. Traditional programs such as 401(k) plans and most individual retirement accounts give you an immediate tax deduction for the money you save. And the money you invest grows

tax-deferred. That means you'll pay ordinary income taxes when you withdraw the money at retirement.

It was always simply assumed that you'd be in a lower tax bracket at retirement, as you start withdrawing. Now, however, given America's huge debt and the propensity to increase tax rates, that might not be such a wise assumption. Current tax rates are historically low but they might not always remain at these levels. So you might want to hedge your bet on future taxes by contributing to both pretax and after-tax savings plans.

The best way to accumulate after-tax savings is a Roth IRA (described below) in which you pay taxes now (or upon conversion from a traditional IRA), and can withdraw all the money, including the growth, on a tax-free basis. The details will be discussed later, but the concept of tax planning is growing ever more important.

Don't let those considerations deter you from your main objective: setting aside money today and making it grow for your future. The best place to start is your employer-sponsored retirement plan.

Your 401(k) is the Easy Way

Your 401(k) or 403(b) or thrift savings plan is the easiest way to set aside money for retirement. These plans, offered by corporations, nonprofits, and government agencies, have replaced the traditional pension plans, which promise a lifetime monthly check at retirement. I speak before many corporate employee groups and am often surprised by the percentage of employees who don't contribute (opting out from payroll deductions) or don't contribute enough to get the full employer match. That's like leaving money on the floor.

Ever since these *defined contributions plans* replaced the traditional pension *defined benefits plans,* you've been made responsible for your own retirement lifestyle. It will depend on how much you contribute and how wisely you invest. Originally, employers were mostly prohibited from—or felt they could be liable for—offering investment advice that went beyond simple education. So employees were left on their own to make important decisions.

That has changed dramatically. Most employers now automatically default new hires into the company plan. And instead of defaulting them into a conservative money market fund, which won't bring desired growth, employee contributions may be automatically placed into *safe harbor* investments—funds that balance the need for safety and the opportunity to grow your retirement money.

These funds do not guarantee returns, but over the long run they are likely to provide better results. Still, the choice is yours, and since it's your money, you should understand the alternatives. Here are a few simple ways to make investing in your employer plan easier and more profitable in the long run.

Target-Date Funds

Target-date funds, as explained in Chapter 7, are managed mutual funds that are invested to reflect a growing conservative stance as you approach your hoped-for retirement date. They typically come in a series—about five years apart—allowing you to choose the target-date fund closest to your planned retirement. These are often the *default* option in 401(k) plans for employees who do not choose among the other funds offered.

It's important to understand that target-date funds always maintain a portion of their assets in stocks, even as the target date approaches. This reflects the understanding that you will need some growth of your assets offered by stocks during your years of retirement. Many investors who were close to retirement were shocked by losses in these funds during the market crash in 2008–2009. And when the next bear market comes around—and it will—those closest to retirement will be in a very unfortunate situation. If they don't have other cash on the sidelines, they might be forced to withdraw money for retirement living at a most inopportune time.

So if you're using target-date funds in your 401(k) plan, then you might also want to set aside a money market fund component that will cushion both your balances and your emotions if the market declines just before you're ready to retire.

Choosing Among Plan Investments

If you really want to be involved in choosing among your 401(k) plan alternatives, your company is likely to give you plenty of choices.

Typically, a 401(k) plan should allow you to choose an index fund that represents the large-capitalization domestic stocks, such as an S&P 500 Stock Index fund. There should also be a fund that is growth oriented, one that is balanced between growth and income, and one that concentrates on stocks of smaller companies. Most companies also offer one or more international mutual funds.

A well-run plan also gives employees a chance to invest in bonds, or it may include a *guaranteed income contract* (GIC) fund that is

invested in insurance company promissory notes or bank CDs. Or you could find a *stable value fund* that is designed for income with little price volatility. There should also be a money market–type choice for those nearing retirement, although many employers worry that their younger employees will invest too conservatively in this type of fund. Under the ERISA rules, a 401(k) plan must be run professionally, with an appropriate choice of low-cost investments.

The best 401(k) plans offer some form of guidance and advice for diversifying the investments inside your plan. When 401(k) plans first started nearly 40 years ago, companies that sponsored the plans were wary of providing any kind of investment advice, fearing the responsibility for bad choices would fall on them.

That has changed in recent years. The best corporate 401(k) plans are now making investment advice through independent, outside advisors, including robo-advisors, to provide investment guidance to employees. Financial Engines led the way as an independent advice provider, and your company may provide its services as part of their program design. Frequently the mutual fund management companies offered in your plan, such as Vanguard and Fidelity, also provide individualized investment advice.

You can access investment advice for your 401(k) directly through www.FinancialEngines.com. Wealthfront and Betterment (described in Chapter 5) offer retirement plan diversification advice as part of their services. And a fiduciary, fee-only financial planner will certainly give advice about which funds within the plan you should choose, depending on your age and stage in life.

Fixing Your 401(k)

The problem with many 401(k) and 403(b) plans is that the funds inside are very costly. Studies have shown that the most expensive plans cost nearly 1.75 percent annually in fees, and the average plan charges just under 1 percent in annual fees, as a result of the underlying expenses. To find out your company's fees, you can go to the company plan documents, which by law must be made available to you yearly. But few people bother, since what can you really do about plans with excessive fees if you find them? Plenty, is the answer.

Start by going to www.BrightScope.com, and searching for your company's name. The numerical "score" they give you plan depends on more than 200 variables, and the vast majority of 401(k) plans are rated. The site not only gives you the "score"—but also helps you

realize how much more money your account would have earned if it had a higher score (primarily through lower costs and fees). Or go to www.FeeX.com. There you can get a free analysis of your retirement account costs by linking securely to your personal retirement plan account.

If you think your plan fees are excessive, a group of employees needs to speak up. Send them a screen shot of your company's BrightScope rating. Often, in smaller companies, the owners don't realize their responsibility to provide a fiduciary plan that offers good choices and controls cost. But now there have been plenty of lawsuits against major companies that demonstrate the significant liability of having a costly retirement plan.

Roll Over—Don't Withdraw

What happens if you leave your job or retire? When switching jobs, it's very tempting to simply take a check and use the accumulated money to pay off current bills. Don't yield to that temptation.

If you withdraw money from your 401(k) account before age 59½, you'll pay ordinary income taxes on all your withdrawals, plus an additional 10 percent federal tax penalty. You may also owe state income taxes. (There is an exception to this penalty for people over age 55, who retire, or age 50 for certain public safety employees.)

When you add it up, half of your early withdrawal could be lost in taxes. It's a huge mistake because you not only pay taxes and the penalty now, but you also lose all the future tax-deferred growth on the money you take out.

When you leave your job, some companies will allow you to leave your funds within the company plan, although you may make no more contributions and will receive no more matching dollars. That's fine if your plan gives you access to low-cost, well-performing funds that are exclusive to that company's plan.

But you may prefer to make your own, different investment choices under your own control. In that case, you should roll over the plan assets directly into a *rollover IRA* at a bank, mutual fund, or brokerage firm, or into your new employer's plan. Doing a rollover gives you the opportunity to choose a new *custodian* that offers a wide variety of low-cost investment options. And it helps organize your financial life, so you don't have a variety of retirement plans to manage.

The critical point is that you *do not touch the money or cash a check* from your existing plan. Instead, notify your new custodian and they will handle the direct transfer process to avoid taxes and penalties.

If you're retiring, there are additional reasons to do a rollover to an IRA. First, the investment choices in your employer's plan are likely designed for the accumulation period of younger workers, and may not be suitable or broad enough for a retiree. Second, it is easier to name a beneficiary (or joint beneficiaries) for an IRA or to divide your rollover into several IRA accounts with different beneficiaries. And third, it will be easier to calculate your eventual required minimum distributions (RMDs) if your assets are consolidated in just a few firms.

But here's an important word of warning: If your company retirement plan includes highly appreciated company stock, do *not* roll that stock into an IRA. You may be able to take advantage of a special tax provision for net unrealized appreciation (NUA) on this stock, a tax benefit that could turn your stock appreciation into capital gains, instead of the ordinary income tax treatment generally accorded to IRA withdrawals. Consult your tax professional.

Name a Beneficiary

Be sure you *name a beneficiary* for the money that is growing in your retirement plan. And be sure to update that designation as your life situation changes. The money in your retirement plan passes directly to the named beneficiary, outside the court process of probate. As you'll see in Chapter 13, depending on this designation, your beneficiary will have the option to stretch out payments from an inherited retirement plan over his or her lifetime, allowing the money to continue to grow. And, if your spouse is your beneficiary, you might also want to name contingent beneficiaries, such as your adult children, in case you die together in an accident, or within a short time of each other.

Borrowing from Your 401(k) Is Costly

As noted in Chapter 3 on debt, borrowing from your 401(k) plan is allowable, within limits, but more costly than you may realize. Sure, you're borrowing from yourself—and at a cost that may be lower than charging expenses on a credit card. But you're also borrowing *opportunity* from yourself. You lose not only the investment earnings

for the period you borrowed the money, but also all the future growth on the money you didn't earn while your cash was out of the plan. And you'll be repaying that loan with after-tax dollars. So while that pool of money may be tempting, or your only choice in tough economic times, you need to be aware of the true cost.

There are some other drawbacks to borrowing from your 401(k) plan. Loans must be repaid within five years (unless the money is used to buy a house), and repayments are made from paycheck deductions. If you lose your job, your loan must be repaid before the tax return filing due date for that tax year, including any extensions. Otherwise, it is considered a withdrawal, subject to taxes and penalties. So instead of considering your 401(k) plan a first resort in a cash shortage, it should actually be your last resort for borrowing.

There are limits to how much you can borrow from your plan. You can borrow $10,000 or 50 percent of your vested account balance, whichever is greater, but not more than $50,000. You should begin repaying the loan through payroll deductions (if your employer allows it) or through a repayment schedule that includes "substantially equal payments that include principal and interest and that are paid at least quarterly," according to IRS guidelines. So don't think you can just walk away and forget about this loan.

Most employers allow actual withdrawals from a 401(k) plan in cases of real hardship, such as medical expenses or to prevent eviction from your house. Ordinary income taxes and penalties still apply, and these withdrawals mean future growth on this money is lost forever.

The realization of how costly it is to borrow or withdraw from your 401(k) should lead you to another important awareness.

Your 401(k) Can't Be Your *Only* Savings Plan

Having extra cash set aside for a rainy day seems like a waste of money, until you need it. If your only recourse is to borrow from your retirement plan, you'll probably sell out at just the wrong time, especially if your plan assets are invested in stock market funds.

And if you lose your job while a loan is outstanding, it will almost immediately become a taxable withdrawal. Even if you think your job is secure, you need a savings cushion because secure jobs are lost only when economic times are worst. And when economic times are bad, the stock market is likely to be down. You could face the double

whammy of being forced to liquidate your retirement plan assets when prices are lowest.

If you're going to mentally segregate your retirement plan assets for retirement, you must have other liquid assets for the emergencies that are bound to come between now and then. Otherwise, you're fooling yourself about your true level of financial security.

People have always asked me whether they should repay consumer debt or contribute to a 401(k) plan. I have one standard answer, which is guaranteed to displease: *Do both.* That may come under the heading "easier said than done" as even in good times many people are literally a paycheck away from financial disaster. So let me point out once again the importance of savings. It's an old Savage Truth that we can all spend as much as we earn. The secret is to have the money automatically set aside before you see it and spend it.

The Savage Truth on IRAs

They're called *individual retirement accounts* for a reason. It's up to you—the *individual*—to open the account, keep contributing, make smart investment decisions, and plan for eventual withdrawals. No employer, no spouse, no one but your own conscience will motivate you to contribute. However, you will be the one to benefit from your decisions.

Even if you have a retirement plan at work, and some additional savings outside a retirement plan for emergencies, you might want to stash some extra money away in an IRA. And, as you'll see below, you have choices to make that money grow tax-free, assuming you are willing to forego the current tax deduction for your contribution.

And, even if you don't work outside your home, the government has recognized your right to individual savings, based on your spouse's work record by allowing a *spousal IRA* contribution. As long as you file a joint return, and show earned income in excess of the contributions to both IRAs, a non-working spouse can have an IRA of his or her own.

Depending on your salary, it is possible that you can contribute more to a company retirement plan than to an IRA. And if your employer matches all or part of your contribution, the 401(k) is the place to start. But in recent years rising contribution limits for IRAs have made them an excellent choice for those not covered by a company plan.

Now, as part of a federal overhaul of retirement plan opportunities, there will likely be new opportunities created for small businesses to provide pre-tax savings for employees. But no matter what the opportunity, it does you no good unless you take advantage of it!

Traditional IRA versus Roth

There are two types of individual retirement accounts. A traditional IRA contribution can typically be deducted on that year's tax return (with some exceptions, below). The money in a traditional IRA grows tax-deferred, but when it is withdrawn all the money is taxable. A Roth IRA contribution is made with after-tax dollars. You don't get a deduction on your current taxes, but all the growth in future years is withdrawn tax free.

The distinctions between the two are explained below, along with contribution rules. But first, consider this question: Do you need the current tax deduction for your contribution, or would you rather have the tax-free withdrawals later in life? Speaking generally, I would always advise choosing the Roth IRA, especially if you have many years to make your account grow. Of course, not everyone qualifies for a Roth (see below) based on income. But if you do qualify, it's a great place to start your retirement savings.

One caveat: I'm always asked whether the government will make good on its promise of tax-free withdrawals down the road. It's a question I can't answer. Looking back, we see that Social Security was originally meant to be free from income taxes. That changed in 1984. But if you're investing in a Roth during a time of relatively low tax rates, it seems reasonable to give up the current deduction in favor of the promise.

Of course, your actual decision to Roth or not will likely depend on the rules for Roth and traditional IRA contributions. Here's what you need to know.

Traditional IRA Rules

The money in a traditional IRA grows tax-deferred, but when it is withdrawn all the money is taxable at your then-current tax rate. If you withdraw money before age 59½, there is also a 10 percent federal tax penalty. After that age, you can withdraw any amount at any time, paying ordinary income taxes on the withdrawals. With a traditional IRA, there are rules that require you to start a systematic, lifetime

program of withdrawals in the year after you reach age 70½—*required minimum distributions* (RMDs) based on your life expectancy.

Almost anyone can contribute to a traditional IRA, providing you have earned income and are under age 70½. But whether your contribution to a traditional IRA is deductible or not depends on certain criteria, such as whether you (or your spouse) are covered by an employer-sponsored plan.

If you are not covered by another plan, then the entire allowable annual contribution is deductible. If one of you is covered, then there are annual income limits, beyond which the deduction is not allowed. Since these limits change each year, you can find them at TerrySavage.com, or search online.

Roth IRA Rules

A Roth IRA gives you no tax deduction in the year in which the contribution is made. But the contributions and all the investment gains in the account can be withdrawn tax-free in the future. But there are income limits for contributing to a Roth IRA, and those limits change annually. To give you an idea, in 2020, the income limit for contributing the maximum to a Roth IRA is $124,000 for a single filer, and $196,000 for married filers, filing jointly.

Unlike with a traditional IRA, you can continue to contribute to a Roth IRA after age 70½—as long as you have earned income and meet the income limitation requirements for that year.

There is no requirement that you ever must withdraw money from a Roth, so it can keep growing tax-free, to be distributed to your heirs upon your death if you do not need the money in retirement—and then, handled correctly, they can keep the money growing tax-free over their lifetimes, as well. However, unlike you, your heirs are subject to RMDs on the inherited Roth IRAs, but these RMDs will generally be tax-free.

Your withdrawal from a Roth IRA is considered a *tax-free distribution* if you have had at least one Roth account for at least five years and you are age 59½. If you do not follow those rules, then the portion of the withdrawal that comes from *investment earnings* may be subject to ordinary income taxes and the 10 percent early withdrawal penalty.

Whichever type of IRA you select, the most important thing is to get started early.

Contributing to an IRA

You would think the government would encourage the maximum amount of savings, but instead there are limitations on how much you can contribute to your IRA each year, and on the income levels at which an IRA contribution is allowed. Since these numbers change dramatically every year, you should search online for the current limitations on contributions. You'll find a link at TerrySavage.com.

There are a couple of key factors to keep in mind. Any allowable IRA contributions require that you have "earned income" in that year. Only nonworking spouses, filing a joint return showing earned income, can make IRA contributions without having their own personal income. (The actual money you deposit into an IRA can come from savings or interest earnings, but you must report income above the level of your contribution.) And if you are age 50 or older, you can make a larger allowable "catch-up" contribution each year.

As I mentioned earlier, there is never any extra money to set aside. So the best way is to set up an automatic deduction from your checking account each month, timed to coincide with the arrival of your paycheck. Take a look at that FICA deduction, remembering you have no choice about that money disappearing from your paycheck. Your goal should be to match it. But even a few hundred dollars a month will set you on the path to retirement.

And if you're looking for a last-minute tax deduction when you're preparing your tax return, remember the actual contribution may be made up until the date that year's return is due, in April of the following year.

Investing Your IRA

You'll be faced with a wide array of choices for investing your IRA. Mutual fund companies, banks, insurance companies, and other providers all will be competing for your business. In Chapter 7, you learned about the importance of long-term growth in a retirement account and the products that provide it.

One of the most important considerations before you open your IRA is the question of costs and fees. You'll want to know whether there are annual maintenance fees for your IRA, or an overall management fee. Those are easy to avoid, but should be an important consideration.

If you make a mistake, you're not stuck, unless you've chosen an account with early withdrawal penalties. Simply contact a new

custodian and they will handle a rollover. Or you can open a new account for this year's contribution, and also for future contributions. It's a lot easier than you think.

Although there are annual maximums for contributions to an IRA, you can get started these days for a very small amount. In fact, companies including TD Ameritrade, eTrade, Schwab, Fidelity, and Merrill Edge all offer various promotions that include no minimum investment to open an IRA at their firms. There is always a catch—and typically it's a good one. Most require you to agree to an automatic monthly contribution of at least $100 to your IRA account. Many banks and credit unions also have no-minimum IRAs. So there goes your first excuse for not opening an account: Yes, you do have enough money to get started!

IRA Early Withdrawals

There are some opportunities to take money out of your IRA without penalty. For instance, you can withdraw up to $10,000 from your IRA, penalty free, for the purchase of your first home. (You still have to pay income taxes on the withdrawal.) Your spouse must meet this requirement, as well. But the withdrawal can also be penalty-free if you are helping an immediate family member if they qualify as a first-time home-buyer.

Or you can withdraw any amount to pay for higher-education expenses for your immediate family members. You can take money out penalty-free to pay medical insurance premiums, if you've been unemployed for longer than 12 consecutive weeks, and if the withdrawal is made the year unemployment compensation is received or the subsequent year.

You can withdraw from your IRA penalty-free to pay for unreimbursed medical expenses that exceed 10 percent of your adjusted gross income. And there is no penalty for withdrawals if you become fully disabled, or for your estate if you die before age 59½.

If you retire at age 55 or older, you can take penalty-free withdrawals from your workplace retirement plan, although you still pay income taxes. Certain public safety employees can get penalty-free access if they retire at age 50 or older. If you retire at a younger age, you can take substantially equal distributions from your workplace retirement plan or IRA over your lifetime without incurring a penalty.

All of these early withdrawals are exceptions to the rule that you want to keep your retirement savings growing as long as possible. While the early withdrawal penalties stop at age 59½, your retirement

plan should keep working. No one says you must, or should, take money out as soon as the penalty period expires. But eventually the government will require you to take money out so it can collect taxes! That will be discussed in Chapter 13.

Just as with your 401(k) plan, taking money out of your IRA before retirement is truly something to be avoided. It may look like a tempting pool of cash in an emergency, but what emergency could be greater than contemplating your later years as a bag lady or a street person?

Conversion to a Roth IRA

If you fear rising tax rates in the future, you might want to convert your traditional IRA or IRA rollover account to a Roth IRA, where the money will then grow tax-free. For many years, there were income restrictions on converting a traditional IRA to a Roth IRA. Those were eliminated in 2010, and now you have a choice of converting your traditional IRA, or rollover IRA, into a Roth, regardless of income level.

There's one big caveat. You must pay the federal and state income taxes at the time of conversion. That means, if you're in the 32 percent marginal tax bracket, and convert a $100,000 traditional IRA to a Roth, you'd owe $32,000 in taxes for the year in which you do the conversion. In fact, adding the converted amount to your current income could actually push you into a higher bracket. It's important to consult with your tax advisor before doing the conversion. And helpfully, you do have the option to do a partial conversion of your IRA, to make the taxes more affordable.

There's an even more important consideration. Those taxes should be paid with money held *outside* your traditional IRA. Otherwise, you'll pay taxes (and a 10 percent early withdrawal penalty if under age 59½), on the money you withdraw to pay the conversion tax. After all, the whole idea of a conversion is to keep the maximum amount of money growing tax-free for the longest time.

Money in converted Roth accounts must be held for five years and account holders must be at least 59½ before money can be withdrawn tax-free—except in cases of death or becoming disabled. This five-year period is calculated from the first day of the tax year for which you make your initial contribution to your first Roth account. That initial contribution can be a regular annual contribution, or it can be a conversion contribution. For Roth conversions, each conversion must be held for the five years (i.e., each conversion starts a new five-year period).

Converting a traditional IRA to a Roth is sometimes known as a *backdoor Roth*—an opportunity to make your money grow tax-free from this point on. But just because you now have a Roth IRA does not mean you can make additional contributions, unless you meet the annual income limits.

Conversion is now an irrevocable decision. (In the past, you had an opportunity to reconsider and recharacterize the decision to convert.) So the time to do a conversion is when you know you'll be in a lower tax bracket that year and at a point when you think the IRA is near its lowest values, perhaps because of a bear market. Just think how terrible you'd feel if you converted near the peak of a bull market, paid the taxes, and then watched the account diminish in value because of a market decline.

Roth IRA conversions make sense if you have the extra money, and if you find yourself in a low-earnings year. But you need to consider the impact of paying taxes now instead of later. This involves not only your tax rate forecast, but whether you will have time to let the money grow tax-deferred to make up for the early tax payment—or don't plan to use the money in your Roth and want to leave it to your heirs.

A Roth IRA left to a spouse as beneficiary is treated as his or her own Roth IRA, and there are no distribution rules. But a Roth IRA left to other heirs will result in minimum required distributions, but those distributions will be withdrawn tax-free, providing the account was open for five years. Think carefully about naming a beneficiary for your Roth, because a very young beneficiary can stretch out that tax-free growth over a long lifetime, with minimal withdrawals. Your estate planning attorney or CFP can explain the possibilities and tax benefits.

Don't forget that converting to a Roth IRA will increase your income in the year of the conversion. Beyond taxes, that could impact other income-sensitive situations, such as eligibility for student financial aid or for other federal benefits, including the premium you pay for Medicare Part B. Discuss this with your tax professional.

As noted earlier, there's no guarantee that the government will keep its promise of tax-free withdrawals from Roth IRAs. Then again, there's no guarantee that income tax rates will stay at their current levels. You have to weigh the alternatives at the time you make your decision.

Roth IRA or 401(k)? Do Both

One of the most attractive features of a Roth IRA is that it allows you to open an account, as long as you qualify based on income, even

if you are covered by an employer plan, such as a 401(k) or 403(b) plan. Given a choice, invest in both.

But some employers have now added the Roth 401(k) option to their retirement plans, allowing you to contribute all or a portion of your retirement dollars into a Roth version of the traditional 401(k) plan. There are contributions limits ($19,000 in 2019). And workers age 50 and older can add an extra $6,000 per year in "catch-up" contributions, bringing their total to $25,000. If the company matches your contribution, that amount is not included in the limits.

Of course, you don't get a tax deduction for the Roth 401(k) contribution, but if you can live without the deduction it would be good to grow some of your money on a tax-free basis in a Roth, as well as your employer's tax-deductible plan. I never heard anyone complain about retiring with too much money! And hedging your bets on the taxation of withdrawals is a smart move.

The Savage Truth on Small Business Retirement Plans

There are other types of retirement plans available for small business owners to create for themselves and their employees. These plans don't have to be costly or create a mountain of paperwork. But they can provide an incentive for good employees to stick with the company even through periods of pay cuts.

Among these are the *SIMPLE* plan—Savings Incentive Match Plan for Employees of Small Employers. It's easy to set up a plan, working with an insurance company or mutual fund provider. Allowable contributions are significantly higher than an IRA, and workers can contribute up to $13,500 in 2020, plus a $3,000 catch-up contribution for those age 50 or older for a total of $16,500.

Designed for small businesses, the employer must make a contribution every year it maintains the plan. The company can contribute either 2 percent of a worker's compensation or a dollar-for-dollar matching contribution, not to exceed 3 percent of pay. The employer must make a contribution even if an employee chooses not to, and all employees must receive the same type of contribution.

All of the money, including matching contributions, belongs to the employee. Withdrawals taken before age 59½ incur the standard 10 percent early withdrawal penalty, plus income taxes. But withdrawals made during the first two years face a 25 percent tax penalty.

A *Solo 40l(k) plan* is the most enticing option for sole proprietors. Since you have only yourself to cover, and part-time employees are not required to be covered, this is a great opportunity to make a significant contribution to a retirement plan. For 2020, you can contribute up to $57,000 to your Solo 401(k), of which a portion can be allocated as a Roth contribution. You have your choice of custodians to set up and maintain the plan, and a wide choice of investment opportunities.

A *SEP-IRA* is a plan available to individuals, or small business owners with fewer than 10 employees. The employer makes the tax-deductible contribution each year, ranging from zero to 25 percent of compensation, but each employee must receive the same percentage contribution.

Contributions are optional each year, and no contribution is required. All contributions are made by the employer, but each employee maintains his or her own SEP-IRA account and investments. This is a lower-cost and more flexible program than a 40l(k), and it has the same annual contribution limits.

Retirement Plan Protection

Just in case, you should be aware of how assets in your retirement plans are protected in the event of bankruptcy or lawsuit. Assets in 401(k) and certain other company plans fall under the ERISA protections of federal law. That makes them generally immune from attachment by creditors. Just ask O.J. Simpson, who is living off pension distributions from his retirement plan, which was structured just for this purpose.

But individual retirement account assets are protected only by state laws, which may vary and change. That means there is a slightly lower degree of protection for those assets in many states. New Hampshire and New Mexico have no laws protecting IRA assets, while Texas, Arizona, and Washington have strong protection from creditors for IRAs.

It's something to check out before you roll over assets from a company plan to your IRA, if you think you might be exposed to litigation.

TERRY'S TO-DO LIST

1. Sign up for the company retirement savings plan or open an IRA today.
2. Try to contribute at least as much to the company plan as your Social Security (FICA) deduction from your paycheck. At least, contribute up to the maximum the company will match.
3. Choose carefully among the investment options in the company plan. Make sure your retirement plan money is working in growth investments.
4. Don't borrow from your retirement plan. If you have already borrowed, make repayment a priority.
5. If eligible, open a Roth IRA in addition to the company retirement plan.
6. Make sure you have named a beneficiary for your company retirement plan and IRAs.
7. When changing jobs, do a direct IRA rollover. Avoid withdrawals that create taxes and penalties.
8. Seek trusted help on IRA rules from the experts at www.IRAHelp.com.

CHAPTER 9

THE SAVAGE TRUTH ON ANNUITIES

Risks and Rewards

Annuities were originally designed to offer income for life—no matter how long you live! Now, many annuity products offer the tempting attraction of tax-deferred growth of your money, even before you may decide to withdraw that income. At that point, you'll have choices to either take out some of the value as needed, or create lifetime income over your life, or a joint life with your spouse. Lifetime income is the unique benefit proposition that only annuities offer—guaranteed payments, regardless of how long you live.

It's a deal that sounds too good to be true. And in many cases, it is. That's why it's so important for you to understand the various types of annuities, the costs and restrictions, and the hidden traps that can cost you plenty if you don't make the right choices.

These days, as a generation of retiring Americans must make decisions about rolling over 401(k) plans that grew their assets in a historic bull market, there are salespeople dangling promises of both growth and income through annuity products. Since annuities can only be offered by insurance companies, these salespeople—and their "free lunches"—are not required to be fiduciaries with your best interests at heart. Instead, you may be financing *their* retirement through the commissions you pay!

Remember, when buying an annuity, it's not the possibilities or illustrations in the sales pitches that matter. The only things that really count are the contractual guarantees.

Yet chosen correctly, annuities can provide an important component of retirement security for your financial plan. Please don't be confused by the acronyms or initials that describe these annuity opportunities. Just follow along with these simple explanations of the benefits, costs, and pitfalls of each. Then you will be empowered to make the best decisions. (And if you are still a bit confused, I will give you annuity resources you can trust.)

So let's get those annuity terms defined right at the start. There are basically two different types of annuities.

Guaranteed income annuities let you start your income now, or at a later date of your choice. Here's how these various forms of guaranteed income annuities are named:

- If you start income immediately, the product is known as a ***SPIA***—*single premium immediate annuity*.
- If you choose to start later, the product is called a ***DIA***—*deferred income annuity*.
- If it is purchased inside a retirement plan, it is a ***QLAC***—*qualified longevity annuity contract*.
- Or, if attached to a deferred annuity like a FIA or VA (see below) it is called an *income rider*.

Deferred annuities are insurance contracts that offer the opportunity for tax-deferred growth—until you decide at some future time to take the money out, either in a withdrawal of a portion of the account value, or by creating a lifetime stream of income. They come in several varieties:

- ***MYGA***—*multi-year guarantee annuity*—This is the insurance industry's version of a CD, though without the federal guarantees. It guarantees you a fixed rate will be paid for a period of years, typically from 1-10 years. The income earned is tax-deferred, so if you don't withdraw income (taxed at ordinary rates), but simply renew a maturing MYGA, your money will continue to grow tax-deferred inside the contract. Or you can convert it to a SPIA, if you want a lifetime stream of income.
- ***FIA***—*fixed index annuity*—This is an annuity that grows the money you deposit at a rate linked to a stock index option created by the insurance company. It typically features a guarantee of

downside protection against loss—*if* you agree to certain withdrawal conditions. More on FIAs later in this chapter.

- *VA—variable annuity*—With this annuity contract you get to choose between mutual fund-like "sub-accounts" that will grow your money based on the investment returns. Many have hefty management fees on the sub-accounts, as well as insurance contract fees.

So that's the jargon of annuities. As you might expect, the details can be more complex and will be explained later in this chapter. But first, here's an overview of why annuities have become so appealing.

The one thing all annuities have in common is that they are products offered by life insurance companies. Life insurance companies have a special tax deal, authorized by Congress, that other financial companies simply can't match: Money invested in their contracts can grow tax-deferred, thus building up a huge pool of cash. That applies to life insurance policies—but also to annuity contracts.

Of course, you will eventually withdraw money from your annuity, and depending on the contract (and unless it comes as a death benefit from an annuity), the government will tax the income portion of the withdrawals—or the entire amount if the annuity was owned by your traditional IRA or 401(k)—at ordinary income tax rates in effect at the time.

Immediate Annuities

If you're looking for income for life, your choice is likely to be a SPIA—single premium immediate annuity. You give the insurance company a lump sum of money, and it promises to pay you a fixed monthly amount for as long as you live, or you and your spouse live, or for a fixed period of years—as little as five years to as long as 20 or 30 years.

You can use either after-tax money or IRA money to purchase an immediate annuity. The guarantees are the same, but the taxability of the income is different.

The size of that monthly check is based on the amount of money you put into the annuity contract and your life expectancy (or the combined life expectancies of you and your spouse), as calculated by the insurance company. If you add your spouse to the contract, or choose other guarantees, it will reduce your monthly payment substantially. Interest rates play a secondary role in defining the amount of your monthly check.

With an immediate lifetime annuity you can never outlive your cash flow. Even if you beat the actuarial statistics and live past 100, the insurance company must keep paying you a check. On the other hand, if you die shortly after starting the annuity payout, the insurance company gets to keep the balance of your investment—unless you have made provisions for survivors. So it makes sense to start a life-only immediate annuity only if you believe your health will let you live at least as long as the insurance company is betting you will, and if you don't care about leaving the balance of your money to your heirs.

If you do want to purchase an immediate annuity and still make sure your heirs receive the balance of your account after you die, you can structure the lifetime guarantees to make sure that the annuity company doesn't keep a penny. You can choose a contract that offers *life with installment refund* or *life with cash refund* at death. Or you can structure the guaranteed payments for life with a minimum period of payments, such as *life with 20- or 25-year certain*.

If you're in your seventies, a 25- or 30-year term-certain payout should give you a stream of income that will cover your life expectancy. If you die before the end of that term certain, your spouse or other heir will continue to receive the same monthly check. If you outlive the term-certain annuity, the checks will stop at the end of the chosen term, so choose the length of that term wisely.

Immediate Annuities and Taxes

The taxation of the money that comes out of an immediate annuity depends on the status of the money that went into it. For example, if you rolled your retirement account into an immediate annuity that pays out a guaranteed monthly check for life, then all of the money coming out of the annuity would be taxable as ordinary income because neither the money going into the contract nor the earnings had been previously taxed.

If, however, you invest a lump sum of after-tax cash into an immediate annuity, then part of your monthly check will be considered a tax-free return of your own capital, and part will be considered a taxable payment of interest earned on the cash inside your annuity. The contract will specify the percentage of your monthly check that is taxable and the portion that is tax-free. If your heir receives the monthly check after your death, the same proportion will be taxed at his or her marginal tax rate, but always work closely with a tax professional on these matters.

Immediate Annuity Risks

When considering an immediate annuity, most people focus on the gamble that they might die "too soon," leaving the insurance company with a windfall of cash from the balance of the investment. But, that risk can be mitigated by features of the contract that extend payments to survivors.

The real risk is accepting a SPIA that doesn't give you a large enough check. SPIAs are commodities; they are just a guaranteed check. So as long as you're dealing with a highly rated insurance company, the only difference is price. It pays to shop around, just as you would for a deal on a car or a plane ticket. Most people aren't aware they can compare the monthly check amounts promised by different insurance companies. Even though all insurance companies use the same mortality tables, they may use different investment assumptions or other calculations to determine the amount of the monthly check they promise to you.

To find out what amount you could get for life, go to www.SPIA.direct or www.ImmediateAnnuities.com, two sites where you can compare the monthly payment promises you could receive from various top-rated insurance companies. Simply input the amount of money you want to invest, your age, your gender, and your state of residence. You'll see quotes on a monthly check from major insurers. All fees and costs are included in these numbers, so you can simply compare monthly payments.

This can also be a useful strategy if your company retirement fund offers an option of a fixed, immediate annuity. You're not locked into what the company plan offers, although they typically offer the best monthly payment deal. But if they don't offer the same contractual lifetime guarantees as other SPIAs (term-certain, or cash refund), you can always roll over a lump-sum payout from your company plan into another insurance company's immediate annuity that offers a higher monthly check or better features. It might pay to do the comparison.

Deferred Income Annuity (DIA)

What if your real concern is not immediate income now—but income to carry you through your later stages of retirement, when you may have spent much of your other savings? In that case, you could choose a *deferred income annuity* or DIA, often called a *longevity annuity*.

Running out of income in your later years is every retiree's nightmare. What if you live too long and run out of money? The nightmare is not the living longer part, but the impoverishment. And since few people earn lifetime pensions these days, Social Security may be the only income you can count on to last as long as you do.

That's true—unless you buy a deferred income annuity. It provides a stream of income that starts paying out at a later age, perhaps at age 75, or 80, or even at 85. If you make that commitment now, in your sixties, the insurance company has a lot of time to make the money grow and can offer a surprisingly large monthly check in your old age.

You might also be concerned about the impact of inflation on those delayed payments. There are two ways to deal with that problem. Most of these deferred income annuities allow you to buy a 3 percent cost-of-living rider (COLA). You can choose the percentage at the time of application. That protection will lower your eventual monthly payout.

Another great concern might be about what happens to your money if you die before collecting those future payments, or collect only a small amount of money by the time you die. You can purchase a *life with cash refund* deferred annuity. If, when you die, the insurer hasn't paid out all your initial premium, the balance will go to your heirs. Of course, you pay for this protection as well, in the form of a lower initial payout.

And finally, if you're part of a couple and worried that a surviving spouse will outlive your retirement savings, you can set up a joint income stream over two lives, although the payout obviously will be lower because it is guaranteeing payments over two lives. Note that if a woman is purchasing a DIA, payouts for women are less on the same investment, because women are projected to live longer than men.

With a deferred income annuity, you're buying peace of mind about your longevity. The time to purchase this type of annuity is when you're just starting retirement so the insurance company has longer to make your money grow, thus providing a larger check later on in life.

DIA Inside Your IRA—A QLAC

A deferred income annuity doesn't necessarily have to be purchased with your after-tax savings. When it is purchased inside your IRA, it

is a QLAC—*a qualified longevity annuity contract.* If most of your retirement savings is (or will be) inside an IRA rollover account, you might decide to purchase the longevity inside that account. It may only be purchased inside a rollover or traditional IRA, not a Roth. Recently, many company 401(k) plans have started to include a QLAC option among their investment choices.

Remember, your IRA is going to require minimum distributions after age 70½, and those distributions will be based on the government's tables of life expectancy. They are designed to empty your IRA by the time you reach the predicted actuarial age of death. But if you purchase a QLAC in your IRA, the amount invested—up to 25 percent of your retirement plan assets, or a maximum of $130,000 (in 2019)—is not included for calculating RMD distributions. Since your RMDs will be lower, your taxes will be lower.

A real advantage in purchasing a QLAC inside an IRA is the potential to provide income if you live longer than your required minimum distributions last, or if your investments don't provide enough retirement money in your later years. The QLAC will start sending you a check in your later retirement years, perhaps at age 75, 80 or 85. And, if you need to adjust your plans, most QLACs allow you to change the income start date one time after the policy is issued.

Again, this type of annuity is basically buying peace of mind for your later years. The QLAC is a deferred income annuity (DIA) inside an IRA account. No one is out aggressively selling these products because there is basically no sales incentive and only very low, built-in commissions to be earned. But you can purchase them directly from www.QLAC.direct—another of the low-cost annuity access points created by Stan Haithcock, whose main website www.StanTheAnnuityMan.com is a most valuable resource to the money-smart consumer of annuity products.

Consider the Risks

A final warning: Just remember that you'll be paying for this promise of lifetime payments—or guaranteed continuing payments for your survivors. You can never break out of an immediate annuity deal, or renegotiate. Once you sign up for an immediate annuity, you're stuck with that regular monthly check for life. Even if interest rates rise, your life circumstances change, or the insurance company has some bad publicity, you must stick with your ongoing plan. That's why it's

so important to consider all aspects of the deal before you sign up for the plan—especially the insurance company's safety rating.

Even more significantly, that fixed monthly payment might look good today, but could seem small if inflation returns. As a general principle, it is extremely unwise to tie up more than a portion of your money in this type of fixed payment. Consider a SPIA as a part of your personal pension, albeit without a cost-of-living increase that many pensions (and Social Security) offer. That monthly SPIA check is a part of your personal income floor. It is reassuring to know you will have that income over your lifetime, but inflation will certainly cut into its buying power.

Variable Annuities

As noted in the opening of this chapter, variable annuities are insurance contracts designed not for immediate income, but to give you a place to let your money grow tax-deferred. The company may guarantee you a fixed interest rate that will be credited to your investment deposit for a period of years (a MYGA). They may offer growth of your money, tied to an equity index option (an FIA). Or you may be given a choice of investment accounts that work much like mutual funds (a VA). Either way, the money grows inside your annuity account and is not taxed until you withdraw it.

Tax deferral is a powerful attraction. But there are so many variations on these variable annuities that you need to understand all the wrinkles and costs before you invest.

Still, if you've made the maximum contribution to your employer's 401(k) or 403(b) retirement plan, and perhaps contributed to an IRA, you should consider tax-deferred annuities. You'll pay fees for the privilege of tax deferral with variable annuities, and you'll lose the benefit of lower capital gains taxes made outside a tax-deferred plan. But in return you'll get some attractive benefits and guarantees with some tax-deferred annuities.

Variable Annuities and Taxes

Tax deferral is not tax avoidance. So right up front you should be aware of the tax considerations upon withdrawal from variable annuities. Just as with immediate annuities, only perhaps down the road, you'll deal with the tax consequences of growth inside a variable annuity.

You pay for the tax-deferred growth by giving up any capital gains tax preference you might have earned on an equity investment account held in your own name. When tax laws give a substantial capital gains tax preference to assets held for over one year, you are giving that up since withdrawals that come from interest earned or investment gains inside your annuity are taxed as ordinary income.

If you take money in one or more withdrawals, you'll pay ordinary income taxes on the gains. That's assuming that there *is* a gain. The first withdrawals are always considered ordinary income, and ultimately you can withdraw your original investment tax-free. If you annuitize and take a check a month for life, a portion is taxed as ordinary income and a portion is not taxed because it is considered a return of principal.

Surrender Charges and Liquidity Risk

There are two more considerations with variable annuities that might make you think twice before buying. The first is *surrender charges*. Although these charges can be as high as 20 percent and last as long as 15 years, they generally start at 8 percent and decline over the years. No-load VAs (purchased through Vanguard, Fidelity, Nationwide, etc.) have no surrender charge periods, but MYGAs, FIAs, and most broker-sold VAs do carry surrender charges.

Surrender charges are levied if you cash out early to offset the marketing expenses and sales commissions that are paid to the insurance agents. Typically, the sales agent is paid an immediate commission by the insurance company of approximately 2 to 7 percent of your annuity investment, even though all of your money is invested in your account. If you leave early, the company recoups the commission it paid out through the surrender charge. Most companies allow a withdrawal of 10 percent of your initial investment in a FIA or VA every year, free from surrender charges. That may not be the case with a MYGA. It depends on the specific product and carrier.

There are other hardship considerations such as waivers if the money is needed for a nursing home or terminal illness. These make the annuity more liquid, but you'll have to read the fine print.

Surrender charges aren't the only fees and expenses charged to your account, but until they expire at the end of a set period, they are the most burdensome. Other fees could be the cost of income riders or simply the management fees on the investment subaccounts.

The second concern is the federal rule that says withdrawals of earnings from tax-deferred annuities before age 59½ face a 10 percent federal tax penalty. (There are certain penalty exceptions for annuity withdrawals under age 59½, if the payments are taken in equal payments over your life expectancy, under Rules 72T and 72Q.) For these situations, always consult with a tax professional familiar with your tax specifics.

So tax-deferred annuities are usually best for people who don't need their principal for a number of years, and certainly not until they are older than 60. Basically, if you're considering a tax-deferred annuity, you'll want to be sure you have no immediate need for the money you're investing.

MYGA Annuities

A *multi-year guaranteed annuity* (MYGA) pays you a promised interest rate for a specified period of time. It's like the insurance company version of a CD. The rate is guaranteed for maturities of one year or several years, or as long as 10 years. At the end of the promised rate period, you can renew the contract, based on prevailing interest rates. Or you could transfer it to another MYGA via an IRS-approved 1035 transfer (a non-taxable event). You could also choose to convert or transfer to a SPIA for lifetime income. The growth in value of the account depends on the rate at which interest is paid. There are no additional fees, since the costs are built into the rate you are being paid.

One strategy for using MYGAs is to ladder, or stagger, maturities of each annuity contract. That way, if rates rise you will be able to renew or transfer your MYGA at the current higher rate as each matures. Conversely, if interest rates fall, you will still have some higher-yielding contracts as each matures and must be renewed at a lower rate. You can lock in rates for one or two years, or as long as 10 years. Creating staggered fixed-rate contracts and renewing each as it matures is all done within your annuity contract—deferring taxes on the interest until you withdraw in the future.

Also, beware of *market value adjustment* (MVA). This deceptively simple statement masks the fact that the insurance company reserves the right to adjust the cash value of your account to reflect changing market conditions, such as higher rates. If rates rise during the time of your fixed-rate annuity investment, you'll likely want out of your deal early. You may even be willing to pay surrender charges, if they

are low. But the insurance company reserves the right to subtract some cash from your investment to offset its losses when it sells some of its matching investments to give you your cash. That can really impact the sum you can withdraw.

If you don't like the new rate offered when your MYGA matures, don't simply take the money into your own checking account. That will trigger taxes, and possibly penalties. Treat it much as you would an *IRA rollover*—except that for insurance contracts it's called a *1035 exchange*. This provision of the tax law allows you to move directly into another insurance contact, in a non-IRA account, even with a different carrier, and preserve your tax-deferred status on existing gains.

A final note of warning: Many agents will try to steer you away from a MYGA because the commissions are so much larger on variable and fixed index annuities. You can buy a MYGA directly from www.MYGA.direct or see a live feed of the best rates for your state at www.StanTheAnnuityMan.com.

Variable Annuities

A *variable annuity* allows you to choose among a variety of mutual fund subaccounts or separate accounts. The growth of your money depends on the choice of funds and the performance of the stock market. A variable annuity typically offers many choices of funds, often named and managed by and in the same style as well-known mutual funds.

Depending on the terms of the variable annuity contract, the investor may make unlimited switches among fund subaccounts or may be limited in the number and timing of changes. Because these moves are made inside the annuity contract, there is no capital gains tax, or loss benefit, when you switch between funds. The growth in value of a variable annuity depends on the performance of the fund separate accounts chosen for investment.

But variable annuities also carry hefty costs that may add up to as much as 3 percent a year—making a big impact on those tax-deferred investment returns. In addition to early-withdrawal penalties and surrender charges similar to those that impact fixed-rate tax-deferred annuities, variable annuities have other costs that aren't always easy to measure.

Many tax-deferred variable annuities charge costly annual fees. First there is the management fee, paid to the advisor of the mutual

fund subaccount, which could rise to more than 1 percent unless you are using an annuity with a low-cost fund manager, such as Vanguard, Fidelity, or Nationwide. Then there is the mortality charge for the small bit of insurance that promises your account can be worth no less than your original investment at the time of your death, or not less than some stepped-up value that reflects your investment gains each year. That insurance benefit is supposed to offset the risk of investing in the variable subaccounts.

It's reassuring for your heirs to know they'll never inherit less than your original investment, but if you were planning to withdraw cash to pay for retirement expenses, that insurance provision won't help you while you're alive. If you lose money in your investments, you'll have a smaller pool of cash to draw on during your lifetime.

The average mortality charge and insurance fees total around 3 percent per year for the life of the policy for most VAs sold by agents and advisors. That may not seem like much in a year when your funds register double-digit gains, but the costs will really stand out in a year when the market declines. Even over the long run, those high costs are a drag on investment returns.

As noted earlier, variable annuities convert capital gains to ordinary income, the reverse of most investment goals. All of the gains in your investment accounts are taxed on withdrawal as ordinary income instead of at the much lower capital gains tax rates. If you cash out your annuity at a loss, the amount of the loss (not including surrender charges) may be deductible against ordinary income if the loss exceeds 2 percent of your adjusted gross income. Check with your accountant.

Fixed Index Annuities

Looking for upside gains in the stock market with no downside risk? That's the sales pitch often given for a *fixed index annuity*—and in recent years this product has attracted vast sums of money. The pitch is especially potent when made to retirees, looking to roll over their 401(k) accounts to get both growth and safety with this huge lump sum as they retire. These annuities seem to offer a high interest rate, and a chance to profit from gains in the stock market, without risk of loss.

Only later do investors realize that those products mask so many costs, restrictions, and limitations that they might have done

far better simply investing part of their rollover in low-cost mutual funds, balancing their stock market exposure by using CDs or more conservative investments inside their rollover account. Lured by the pitch of "no losses," they pay huge, mostly hidden, fees—and give up much of the stock market upside.

Or they might have purchased a MYGA—the multi-year guarantee annuity that works much like a CD. In the end, both products can be structured to give a lifetime of income, based on tax-deferred growth. But either an IRA rollover to a diversified, low-cost investment portfolio or the purchase of staggered MYGAs wouldn't put commissions in the pockets of sales agents.

Fixed index annuities are sold by insurance agents, who are paid their commissions out of the sales fees and limitations built into the contracts. Remember, there is no free lunch when you are invited to a retirement income luncheon or dinner seminar! You need to look carefully at how these products are structured. These limitations make it possible for the insurers to offer large commissions to the agents who sell them. But basically, they are designed to restrict your returns.

For example, each insurance company uses known indexes or creates its own "index" on which stock market returns are based, using call options. Some only offer the point gains of a major index like the S&P 500. But they don't include the dividend yield, which over the long run contributes roughly 40 percent of stock market return. There are many ways to restrict the returns to only a portion of the market's gains. Gains are locked in with most FIAs on the contract anniversary date—and the carrier can change the rules on how these potential gains are calculated at their discretion on the contract anniversary date.

Other fixed index annuities provide for a *cap*, an upper limit on what you can earn. Even in a bull-market year, your return may be capped at 6 percent. That cap offsets the protection the insurance company offers in guaranteeing a floor—the promise that you won't earn a negative rate of interest even if the market falls.

Fixed index annuities can also offer an attractive interest rate that will be credited to your account, even if there is a decline in their stock market index. This is called an *income rider*. But that interest is credited to your guaranteed withdrawal account—the phantom account that cannot be withdrawn except through lifetime payments. So it doesn't really offset any losses in your investment account. It is a separate calculation from the index option side of the ledger.

And finally, there is the surrender period. Typically these products lock the investor in for at least 10 years. That means the interest rate promise can decline along with the stock market, impacting those hoped-for returns based on either their index or interest rate crediting. And the investor is stuck!

On a strictly investment basis, the promises of fixed index annuities will likely fall far short of the discussed benefits, which you might assume. FIAs historically produce CD-type returns, so that is what you should expect. Despite the hype of the fixed index, these products are designed by the insurers to generally produce only CD returns. But one thing these products offer is an ability to generate future income by attaching an income rider to the contract—if you are patient.

Guaranteed Income Benefits/Income Riders

Annuities with *guaranteed income benefits* or *income riders* are an attachment to a contract, designed to create an income stream at a date you choose in the future. Despite promises of potential upside on the investment portion of any annuity contract, the ultimate and predictable lifetime stream of income provided by this rider comes not from the investment account, but from a phantom account that typically grows by a specific promised interest rate during the deferral time period.

It's called the *protected withdrawal value*, or the *guaranteed income base*. Sadly, no matter how large this phantom income account grows, you can't access the money unless you "turn on the income stream."

Turning on the income stream means you agree to a set amount to be paid monthly, semi-annually, or annually for the rest of your life—even if the income base account is diminished to zero. But, you can't withdraw income in any other way than by taking this lifetime deal. Of course, you could withdraw your entire investment account and pay ordinary income taxes on the gains. But that will decimate your returns on this investment.

Income riders can be attached to most deferred VA or FIA annuities. Once you've purchased the rider (the cost of which is taken out of the investment side of your annuity account), you're pretty well locked in. As the phantom income account grows, you won't want to walk away from the lifetime stream of income it will generate. And surprisingly, the way these policies are designed, *the income account will always be worth more to you than the cash surrender value of your investment account.*

I know that's a surprise, but it is part of the way these policies are created. And despite an enticingly high interest rate promised on the income account, when it comes time to withdraw from it, you can only get the stream of income they calculate. Once you start taking the stream of income, that high interest is no longer being paid.

You can't withdraw the total balance of the income account or even take a portion of it. You can only take the promised stream. And it can only come from that protected value phantom account. And the way that stream is calculated, based on your age and life expectancy, the odds are you won't get to collect all that pot of money before you die!

So, in the end, what's the real rate of return you are getting on your annuity investment? We won't know for sure, until you die. Then we can calculate the return on investment. But insurance companies are not giving away those high-interest crediting rates, or the free bonus money. The insurers are charging fees and getting paid for their promises either along the way or when you withdraw—even though you might not see these things in the sales presentation. And those sales presentations are not currently regulated very well by the states, in my opinion.

Annuity Income at Death

What happens to your stream of income when you die? That all depends on how you structured your annuity when you decided to take the money out. And it's an important decision that cannot be reversed once made. Many annuity riders allow for *spousal protection* (at an additional cost), which will preserve this *income benefit* for your spouse as well, so that both of you would receive lifetime income.

You can also purchase a *death benefit rider* in addition to the *income benefit rider* (at an additional cost), which guarantees your heirs will receive the promised compounding on the initial investment at your death—unless the cash value goes to zero as a result of your withdrawals. When purchasing a death benefit rider, it is important to know how your death benefit is affected by withdrawals, and at what rate, if any, it can grow.

When you buy one of these annuities, you should give careful thought to the costs of both the income and death benefit riders. The cost will be roughly 1 percent for the guaranteed withdrawal benefit, and half a percent for the death benefit rider, all taken out of the cash value of your investment account. Those seem a reasonable price to pay for the guarantees, but some annuities charge even more, so you must ask.

When to Take the Money Out

These annuities have another challenge. You must decide *when* to start making withdrawals. (Remember, your income rider account stops compounding at the promised rate when you start making withdrawals.) And some of these income riders stop growing at the promised minimum rate of return after the 10th year, while others promise minimum growth for as long as you live.

So you want to take withdrawals early enough to get the maximum value withdrawn before you die. Adding a death benefit rider can help you deal with that challenge, potentially giving you the best of both worlds: income for as long as you live, plus providing a legacy for your beneficiaries.

But either way, you are subject to the decision of the insurance company as to how much you can take on a monthly or annual basis over your lifetime. That amount is determined based on your age—and life expectancy—when you start withdrawals.

So, is there a "sweet spot" at which you can maximize your income withdrawals? Only if you know in advance exactly when you will die! And can you win the bet against the insurer's mortality tables? Only by outliving them by a substantial margin. It's sort of like a Clint Eastwood movie: "Do you feel lucky?"

After years of watching the annuity market—and after making some long-term annuity investments of my own along the way—I am convinced of a few things about these trendy products:

Yes, they give you tax-deferral—outside of your retirement account. Yes, they may offer interest crediting at attractive rates (well, maybe not so attractive after fees are subtracted). And yes, they can promise a lifetime of income, giving you a very good feeling when a deposit drops into your checking account once or twice a year, or monthly.

But no, they won't help you beat the stock market, because the insurance company will always restrict the upside—compared to what you could have made in a traditional index fund. And no, they don't really protect against the stock market downside; they just give you an alternative portfolio growing at a guaranteed rate—but which you can only access through lifetime withdrawals. Your investment account may have losses, but your income account can only be accessed on their terms.

So enjoy your free lunch and the stories of downside protected growth of your retirement money. But here's a word of advice in any annuity presentation. Write down what you think you are hearing,

what you think the agent is promising—and how you understand what the agent said. Sign it and date it. Then ask the agent to sign it, as well. If the agent walks away, you know you saved yourself some money and some heartache. And that's the Savage Truth.

A Few Final Warnings

In most states, but not all, assets held inside an annuity (similar to assets held in retirement accounts) are protected from creditors—in bankruptcy or as a result of legal judgments. Check with an attorney about the legal status of annuities in your state to see whether this might be a reason for funding a tax-deferred annuity.

Some planners use annuities to protect assets from seizure by Medicaid when the owner enters a nursing home. Those strategies use an annuity to convert cash to a stream of current income that may be used for the care of a spouse remaining outside the nursing home. There is no guarantee that this strategy will remove the asset from the patient's estate if your state's Medicaid program challenges the purchase.

Before using any of these strategies be sure to check with a qualified attorney, *in your state,* about changing laws, before you assume that an annuity will protect your assets in all eventualities. You can be sure that, in any case, a fraudulent transfer of assets into an annuity to avoid seizure will be challenged in court.

There's one final estate planning issue to consider before you purchase a variable annuity to defer taxes on your investments: Unless you plan to take the money out in your lifetime and pay taxes on the gains at ordinary income tax rates, you may be doing your estate a disservice. Heirs to a tax-deferred annuity pay ordinary income taxes on all of the gains, so they don't get the step-up valuation benefit of investments held outside an insurance contract. Review an annuity contract with your estate planning attorney so you don't make an expensive mistake.

***The Last Word of Warning*:** All annuities are insurance contracts, no matter what they say about participation in equity markets. As such, the insurers are not covered by either FDIC, which insures banks or CUNA, which insures credit unions, or SIPC which insures brokerage accounts. Insurance companies are only ultimately backed by guaranty funds set up by each state in which they do business. And those funds may be only theoretical, calling for contributions by other insurers to make good on their limited promises if an insurance company defaults. To find out more about the guarantee fund in your state of residence, go to www.NOLHGA.com and click on your state.

GETTING STARTED

1. Decline all invitations to a "free lunch" or dinner that promises to explain stock market growth without the risk.
2. Understand the difference between promises of lifetime income starting now, and promises of future income based in some way on stock market growth.
3. Read the fine print about surrender charges and liquidity limitations.
4. Look for limitations on fixed indexes, including caps, percentages, measurement points, and potential changes in the index itself.
5. Consider inflation risk when accepting a fixed lifetime payment promise. At only 3 percent inflation, your check will lose half its buying power in 25 years.
6. Consider insurance company safety ratings.
7. Check insurance company ratings at A.M. Best (www.ambest.com)

CHAPTER 10

THE SAVAGE TRUTH ON LIFE, HEALTH, AND DISABILITY INSURANCE

Don't Wait until It's Too Late

What's your life worth? Can you measure in terms of dollars and cents what the impact would be on your family and loved ones if you suddenly lost your life? Yes, you are priceless to those who love you. But if there would be financial consequences to those loved ones, you must consider life insurance.

And then think of the financial burden if you were disabled, or were diagnosed with a life-threatening disease or condition. No one wants to think about that—especially in monetary terms. But the bills will keep coming, adding even more stress to your situation.

Health insurance is suddenly a worry that is on a par with the impact of death or disability. There is so much change happening every day—and many of those proposals don't make sense from an insurance context, but seem to be manipulated by political whims.

It's understandable that you don't want to think about these terrible possibilities. But insurance can protect the people you care about, and for whom you have a responsibility to provide. And a cash payment if you are unable to work or face a medical challenge would certainly be welcomed. The most effective health insurance policy can protect your other financial assets.

So here's a brief look at insurance basics. If you skip this chapter and these products, you're tempting fate. And that's the Savage Truth.

Life Insurance: Against The Odds

Insurance on your life is a bet you won't be around to collect! For that reason alone, it's tempting to postpone thinking about it. Life insurance is also an intimidating topic, perhaps because for many years insurance salespeople convinced us that the subject was so complicated we needed their help to buy a policy. These days it's easy and relatively inexpensive to buy simple insurance policies via the Internet. Websites like www.AccuQuote.com, www.SelectQuote.com, and www.TermQuote.com will give you instant access to price comparison and easy access to help with the applications for many types of life insurance.

The Savage Truth is that the basics of life insurance are actually pretty simple and logical. Yes, there are more complex policies that include savings and investment features. And yes, there are important discussions over how the policy should be owned, and who should be the beneficiary, and how to deal with estate tax issues. But don't get buried in the details (pun intended). The very first step is to determine whether you need coverage, how much coverage you require, and for how long you'll need it. Let's start there.

Do You Need Life Insurance?

The first decision is whether you need life insurance at all. Life insurance is merely a way of leaving money behind to take care of those you love—or to pay estate taxes to the federal government. If there's no one in your life who relies on you financially (children, spouse, aging parents), you may not need life insurance. Typically, your health insurance plan at work will have a small life insurance component to pay for funeral costs. Any creditors will file claims against your estate to be repaid from your assets, and unpaid balances will be written off.

If you're single and unencumbered, you might be better off buying *critical illness insurance*, which pays you a lump sum upon diagnosis of serious illness. You can use that cash to cover daily living needs

(see the section on specialty insurance policies later in this chapter). Or *disability insurance* could provide salary continuation. If you fear being seriously disabled, *long-term care insurance* might be a better solution than life insurance for those who have no obvious beneficiary for life insurance.

Some singles prefer to buy life insurance even though they have no immediate heirs because they figure they're more insurable at reasonable rates when they're young. That presumes that there will be a future need for insurance to meet loved ones' financial needs. Even worse, some parents buy life insurance on young children, wasting their premium dollars on unnecessary mortality charges when they could be saving for college in a tax-deferred 529 college savings plan.

There's no amount of life insurance that can replace the loss of a young child. Seriously, what would you do with the proceeds?

However, you definitely *should* have life insurance if you have children who will need to be educated or a mortgage that needs to be paid so your family can continue to live in the home, or people who are dependent on your income or services. That group includes mothers who are not primary breadwinners but handle the tough job of raising children and running a household. Your services are priceless and would be very expensive to duplicate in your absence.

That's the basis for determining how much life insurance you need. Just ask yourself how much it would cost, and how long that cost would last, to replace the value of your income and services to those who are dependent upon you. That will give you a more realistic idea of the magnitude of the financial hole your absence would leave.

Please don't stop reading because you have term life insurance as part of your benefits package at work. First, if you really need life insurance to protect those you love, the small amount of life insurance you receive at work certainly won't do the job. Typically it is just one, or maybe two, times your annual salary. But even more important, if you lose your job, that insurance policy will go away. You can't continue your life insurance as you can your health insurance. And you might not get the same benefit with your next job—or you might have a pre-existing condition that makes a new policy expensive, or prohibitive.

The time to start thinking about owning your own life insurance policy is now. Once you've calculated the amount of coverage that would be required, you can examine the alternatives to find the type of policy that best suits your needs and your budget.

First Decide How Much

Many people look at the cost of life insurance to determine how much they can afford. That's a backward approach. Your first consideration should be how much insurance coverage you *need*, based on the ages of your dependents, your desired lifestyle for your family, and your spouse's ability to make up for your lost income. If you need insurance only for a specific purpose, such as paying off a mortgage, it will be easier to estimate the amount of coverage to purchase. It's far more subjective to evaluate how much cash—wisely invested, of course—it will take to protect and educate a young family in your absence.

Some experts advise leaving an amount equal to six times your annual gross salary, or 10 times your net income. Since life insurance will pass income tax-free to your beneficiaries, this may be an adequate amount. Then again, it might not be enough, depending on special circumstances. The experts won't be around to help your family if you're underinsured!

The "how much" question is very personal. Life insurance can't replace *you*—a father, a mother, wife, or husband. But it can, if you structure it correctly, replace the economic value that will be lost to your family when you die. So ask yourself the question: If you were to receive a check for the total death benefit of your life insurance right now, would it be enough so that you wouldn't have to work for the rest of your life? That should put the amount in perspective!

One big mistake that many people make when it comes to buying life insurance is assuming that the need for insurance will go away on a certain date: when the children finish college or when the mortgage is paid off. So they purchase less expensive level-term insurance, which will stay in effect for only 20 or 30 years.

There is one need for life insurance that may last beyond the need to house or educate your family. As your wealth grows—including the value of your home, investments, and retirement account—you may need life insurance proceeds to help defray the cost of estate taxes. As you'll see in Chapter 16 on estate planning, the need for life insurance to pay for estate taxes has diminished. Only the very wealthy need worry about this issue—unless the law changes in the future. If you purchase a policy that has a fixed term and fixed annual payments, you might find yourself unable to qualify for more insurance just at the time you need it to cover estate tax issues. But term life is certainly the way to get started.

THE SAVAGE TRUTH ON TERM LIFE INSURANCE

If you're looking for the most insurance at the least cost, simple term life insurance is certainly the place to start. Term life insurance covers the cost of insuring against your death for one year at a time. You pay only to cover that cost—no additional amount goes into savings or investment within the policy. The annual premium you pay is based on the likelihood that you'll die that year. Since that possibility of death increases a bit every year as you age, the cost of this type of term life insurance rises every year.

Insurance companies long ago recognized that people want to be able to plan ahead for their annual insurance costs, so they invented 10-, 20-, and 30-year *level-term* policies. Some large insurers issue 35- and 40-year level-term policies. That is, the insurance company establishes a flat premium that remains the same for every year of the specified term length, no matter what happens to your health. But these level-term policies still do not build up any cash value.

As long as you pay the premium every year, your insurance policy stays in force. If you miss paying the premium, your insurance will expire after a short grace period of about one month. There is no cash value to these term insurance policies. That is, there is no money to borrow out of the policy. And your death benefit will never grow to be more than the face amount you originally purchased.

When the term expires, you have no more life insurance. Or else they may offer a renewal policy at ridiculously expensive rates. So if you purchase 30-year level term at age 25, when you're worried about covering college costs for your young children in the event of your untimely death, you might find that at age 55 you have no insurance to protect your spouse—even though your children are grown and out the door. And at age 55, your health might make insurance very expensive, or possibly unavailable.

It's important to think long term about the amount of the insurance you need and the length of time you will need this coverage.

Many term policies guarantee you the right to convert your term plan into a permanent policy without evidence of insurability—that is, without having to prove you're still healthy. The conversion privilege in the policy will always have an expiration date. Some policies provide this right for as little as five years after purchase, while others allow it as long as to age 75. And others allow conversion only into

less-than-competitive cash value policies. So if you want your coverage to last until you die (which is really the only way life insurance works best), consider permanent cash value insurance now.

Of course, when you're young, you may not be thinking about the need for longer-term, affordable coverage. But family and health situations can change, and you don't want to find yourself uninsurable just when your family might need the benefits most. So, when purchasing term, make sure you have the right to convert for as long as possible. Of course, premiums on the new conversion policy will be substantially higher the longer you wait to convert, since the price to convert is based on the issue age at the time of the conversion.

Term Insurance Prices Are Competitive

Term insurance is the least expensive type of life insurance you can buy. The annual cost is based on your age, current health, gender, and the amount of coverage you purchase. With the advent of comparison shopping on the Internet, prices have become more competitive—and lower. In fact, today's prices for the most popular term life policies (20-year term) insurance are 65 percent lower than they were in 1994.

For example, in 2019, a 40-year-old male in the best preferred, nonsmoker category could buy $500,000 of coverage for less than $350 a year. Even if you don't qualify for the very best rating, the next best class would still be under $440 a year. Women pay lower rates, so a 40-year-old woman could buy a half-million dollars in coverage for under $300 in preferred plus, and under $370 a year in the preferred health category.

Premiums are also relatively inexpensive even if you're in your sixties. The same 20-year level-term policy for a 60-year-old man would cost around $2,400 annually if he is in the top (preferred) health category, or under $2,800 in a health category that is one step down. A 60-year-old woman pays under $1,700 per year in preferred-plus, or under $2,000 if her health isn't in the top rating.

When it comes to buying life insurance, your health is a critical component of the pricing. Preferred rates can easily be 30 percent lower than standard rates. So if you haven't ever smoked and maintain a healthy weight, you're about to get your reward. Smokers actually pay over four times the price of healthy non-smokers for a typical 20-year term life policy! Of course, not all health conditions

are under our control, and the need for insurance may be greater for those who have less-than-perfect health. The price of your coverage will reflect that—and insurance companies are very sophisticated about pricing risk.

Premiums on level terms will not change during the level term period. But, of course, they can and do change all the time before you buy one. And you never know when your health may change, making it much more difficult or impossible to buy a policy. So locking in 20 or 30 years of level premiums when your age is young, your health is good, and prices are historically cheap is a good idea.

To find the least expensive term policy, consult one of the term insurance quotation services on the Internet, like AccuQuote.com. These websites are perfect for making price comparisons, but you'll also want to speak with their experienced representatives by calling their toll-free numbers. Their advisors will guide you through the application process, and any physical exams that might be required if you apply for a large amount of insurance.

Here's a subtle point. There are a number of insurance companies that will now issue reasonable amounts of coverage without the need for an exam. AccuQuote knows which companies will do this, and whether it makes sense to apply with one of these insurance companies.

Here's a word of warning about "group term" insurance, which is frequently offered by association or trade groups. It is almost always more expensive than an individual policy—if you are healthy. Those who can't qualify for an individual plan are attracted by group term offerings. But their health challenges mean these policies must charge more, not less, for the same coverage. Check it out yourself online, if you are offered one of those tempting "group, no medical exam required" life insurance policies.

Check Insurance Company Ratings

Just as individuals have different risk profiles, so do insurance companies. Some have stronger financial reserves than others. Before purchasing a policy, check the insurance company's rating from an independent agency. It's easy to search for an insurer's rating at www.AMBest.com, www.Moodys.com, or www.Insure.com. You'll find financial stability ratings, which are most important, and at Insure.com you can also find customer satisfaction ratings.

Since you hope you won't be using the benefits of your life insurance for a long time, it's only smart business to purchase your policy from a company with assured financial staying power.

The Savage Truth on Cash Value Life Insurance

While term insurance is the least expensive, and designed to cover your insurance needs for the next 20 or 30 years, there are some instances in which it makes sense to buy more permanent life insurance. That type of insurance is variously called *whole life* or *cash value life* insurance. It is not easily purchased by making online price comparisons because of its complexities. Some variations of whole life include *universal life* and *variable universal life*.

Each has its own strengths and potential pitfalls, which is why these policies are sold, not purchased. You'll probably be dealing with a registered insurance agent for this type of insurance. But you definitely need to understand the basics so you can ask the right questions.

Since it's more expensive and more complex, you might be wondering why you should ever consider cash value life insurance. First, you might believe that you will outlive term insurance, but still want to leave insurance proceeds to your loved ones or to a charity. You may want a policy that will provide them with cash, especially if you have spent most of your money by the time you die.

Or you might use a permanent whole life policy to provide liquidity for estate taxes, with the policy owned by an irrevocable trust outside your estate (see Chapter 16).

And finally, these policies do build some cash value, unlike term insurance. So, they can be a source of "forced savings" should you need to withdraw some of that value in the future. However, you are paying for mortality charges, so there are other, better ways to save if you don't need the insurance coverage.

How Cash Value Works

The advantage of *whole life*, assuming it is issued by a major quality insurance company, is that it has guaranteed premiums for life along with guaranteed cash values that are almost always enhanced by non-guaranteed dividends. Whole life is designed to *endow*, which means the guaranteed cash value will equal the contractual death

benefit, usually at age 100 or 121, (although some contracts provide for endowment at other ages).

Many people who have paid for whole life and universal life policies for many years are finding that even if they are current on all their payments, the policies will "end," or "endow," at age 95 or 98 or 100. Most recently issued policies typically mature at age 121, reflecting new actuarial life expectancy tables that account for increasing longevity.

As more people reach their endowment or maturity age, they are confronted with two problems. First, there might not be much cash value in the policy if it was used to subsidize premiums. The death benefit was far more valuable than the cash that could be distributed. Even worse, the cash value if fully distributed while you're still alive might be subject to taxes on a portion of the distribution. A tax hit comes just at the wrong time for people who were expecting to let their heirs get the death benefit tax-free.

The good news is that many insurance companies now allow policy owners who reach the age of maturity, say 100 or 121, to leave their policy in a state of limbo where there are no premiums due, and the death benefit is simply paid when they die. This avoids the income taxation problem. And it's a nice reward for living that long!

Most policies allow the owner to borrow out a portion of the cash value at very low rates of interest. If you die with a policy loan outstanding, the amount of the death benefit is typically reduced by the amount of the loan plus any accrued interest.

Other policies allow cash withdrawals, but the amount withdrawn reduces the death benefit. And in cases of variable policies, described later, if too much money is withdrawn, the policy value could be destroyed. That would be a shame because you paid huge fees along the way to keep this policy growing.

Of course, the multiple benefits and tax breaks that life insurance can provide also come with a few minor drawbacks. First, the government realized that wealthy people might dump huge amounts of cash into these policies to grow tax-free, and then borrow it out again, so it set ratios of the amount of insurance coverage versus the cash invested inside the policy to qualify it as a legitimate life insurance deal instead of a modified endowment contract. And, of course, there is the annual cost of the life insurance that goes along with this tax-free buildup. If you need the life insurance anyway, this is a fine place to invest your money, but be aware of the insurance charges, fees, and commissions that you're paying along the way.

Three Basic Choices in Permanent Life Insurance

Let's make this simple. You have three basic types of permanent life insurance, each with its own way of building cash value:

1. *Traditional whole life.* You give the insurance company extra money in premiums every year, above the actual cost of death benefits (the mortality charge). The insurance company promises that the premium will always stay the same and that it will always give you a fixed amount of life insurance. A mutual insurance company credits dividends from its investments to your policy, building up cash value along the way. A stock-owned insurance company pays interest on your cash buildup. You can borrow against this cash value, but if you die before the loan is repaid, the insurance payout is reduced by the amount of the loan.
2. *Universal life.* This policy is similar to whole life, but the extra money you pay in premiums goes into a tax-deferred account. You can decide how much extra money you want to pay in premiums. If you pay enough in the early years, and if your cash account keeps earning the projected interest rate, at some point in the future there will be enough cash in the account to pay future premiums. If the cash account grows at a lower rate than projected, you could lower the death benefit instead of paying more premiums. Universal life gives the policyholder flexibility over premium payments, death benefits, and how long the coverage will last.
3. *Variable universal life.* This policy is similar to universal life, but you have options about how your cash is invested. Instead of accepting the interest rate provided by the insurer, you'll have a choice of stock or bond mutual funds to make your money grow inside the account. If the market moves higher, your account will grow in value, perhaps enough so you never have to pay in another premium dollar. However, if the value of your investments inside the policy declines, you could have to add more cash to pay the premiums to keep your insurance in force. If you don't have the cash, you can lower the death benefit. And these variable policies typically have the highest fees, because there are management fees for the investment subaccounts, as well as surrender charges that can last as long as 10 to 20 years.

Those are the basics of the three kinds of permanent life insurance being sold today. With the variable policies, the risk is that if the market moves against you, your ability to keep the policy going might not be so permanent, after all.

The alternative—term insurance—may look attractive when you're young, and the premiums are relatively low. You might assume you will have accumulated significant financial assets in 30 years, so you won't need the insurance payout to provide for a surviving spouse or adult children. But if your circumstances change, you could find yourself seeking a new policy at just the wrong time.

Finally, there's the unquantifiable peace of mind that having permanent insurance brings. If you're superstitious, you might even wonder if you're tempting fate to let your term coverage expire at the relatively young age of 60 or 65. Buying life insurance is a long-term project—you hope.

Since you don't know when you will die, the safest bet is some sort of guaranteed level premium permanent policy—one that cannot be cancelled, and that cannot raise your premium to squeeze you out as you get older. That way, you're more likely to die with your policy in force—paying out to your beneficiaries.

Illustrations Are Not Promises

When you are considering purchasing a permanent or cash value life insurance policy, the agent will give you some illustrations. These are long lists of numbers that will make your eyes glaze over. Basically, they are projections of how long you will have to keep paying premiums to keep your insurance in force.

In the past, many insurance buyers mistakenly figured these illustrations were guarantees of future premiums. When interest rates declined over the past decade, the actual investment earnings inside these policies lagged far behind the projections. Suddenly, people who were led to believe they would have to pay into the policies for only 10 years to create enough cash value to keep them going in their old age were now being told they'd have to keep paying huge premiums for 20 years or more. Their only alternative to paying more premiums is to lower the death benefit substantially. It has been a shock for people who believed they would have fully paid-up policies at this late stage in life.

There are two ways to avoid this kind of shock. First, when you consider purchasing a universal life policy, ask the agent to project what

the premiums would be if the interest earnings dropped to the minimum guaranteed level (typically about 4.5 percent annually, or even lower) and if the mortality charges were to rise to the maximum allowable level. Some universal life policies offer a *no-lapse guarantee* that so long as the customer continues to pay a specified target premium, the coverage will remain in force to a specific age—regardless of whether there is money in the investment account inside the policy.

Alternatively, simply pay attention to the GUARANTEED columns on any illustration provided to you. If you aren't seeing those columns, you need to ask your agent to show them to you. Those are the only columns that show fully guaranteed elements of any policy.

The second way to avoid being surprised by your investment account inside the policy falling short of its intended goals is to ask your agent for a policy checkup every year. Request a *current illustration* or *in-force ledger*—a projection of current cash values that shows how much more money you'll have to invest at the current rates to keep the policy in force until the desired age.

You don't want to be surprised to find out later in life, when you can least afford it, that you need to pay increased (and sometimes exorbitant) premiums to keep your insurance in force, because either interest credit rates or market returns were lower than your agent initially projected.

The Hidden Costs

If you think a variable universal life policy is a winning deal because you're an astute investor, take a second look. Yes, this is a way to make your premium dollars grow tax-deferred fast enough to cover future insurance costs, or even to increase your death benefit, but that opportunity does not come without substantial costs.

It's difficult to sort out all the fees inside these policies, but you can be sure your insurance agent and the insurance company are making a small fortune off your premium dollars. First there's a *premium expense load* of as much as 8 percent that is deducted from every premium payment. Ask yourself if you would pay an 8 percent load on a mutual fund!

The agent actually receives far more than that as a commission from the insurance company in the first year or two, as much as 100 percent of the first year's premium when you take into account other benefits to the agent, such as vacation trips or clerical assistance provided by the insurance company.

Next there's the actual cost of life insurance, which is buried inside the premium you pay. It varies by age and by the actual amount of death benefit the insurance company has at risk, compared to the cash value of your account. There are also administrative fees, state premium taxes, and even a fund management fee for the mutual funds inside your variable account. If you cancel your policy in the first 10 to 15 years, you'll have to pay a substantial surrender charge unless you have a low-load policy.

You can find lower-cost variable universal life policies, which are offered through fee-only financial planners. At the AmeritasDirect .com website, you can take a peek at what these lower-cost plans might cost, without the typical huge up-front fees that most insurance premiums use to cover sales commissions. But while those policies tend to build cash value dramatically over the early years because of the lower initial fees, they lose their edge in later years. That's likely because fewer people cancel these policies, having been smart enough to buy them in the first place. But early terminations build cash value for surviving policyholders, so there are less funds to pass on to the remaining holders in these "low-load" policies.

With all policies, these ongoing fees must be broken out separately in the prospectus for a variable universal life policy, but few people read the details. They are also often detailed pretty well on your annual statement, but that comes only after you buy your policy, which can sometimes be too late if the policy is a bad deal. That's unfortunate because these costs all affect the ability of your cash to grow inside your policy. It's like trying to run a race with wings on one foot (the tax-free growth) and a lead weight on the other (the fees and charges). Unless you're planning to keep the policy for a very long time, you'll actually be a loser for the first 10 or 15 years of this policy. And remember, if you don't have enough cash in your investment account inside the policy—because of high fees or poor performance—your coverage will lapse.

According to the LIMRA/SOA 2019 life insurance persistency study, 9.3 percent of whole life insurance policyholders will lapse their policies in the first year, 7.1 percent will lapse in the second year and another 5.3 percent will lapse in the third year. That means the insurance company—and its agents—make a lot of money on insurance policies that they will never be required to pay out or for which they will not be required to hold reserves.

The good news here is that if you're one of the folks that holds on to your policy, and you die with it in force, the rates of return at

death are actually quite high. Those rates of return are subsidized by all the lapses by those policy owners that lose the faith along the way.

The way to figure out the real impact of the charges is to look at the surrender value of the policy as illustrated in a few years, not the cash buildup. If you're not sure about the real cost of these charges, or if you're wondering whether it makes sense to exchange for a new policy that promises lower internal costs, here's how to get an independent appraisal.

If you'd like a professional evaluation of your policy, go to www.EvaluateLifeInsurance.org, a division of the Consumer Federation of America, where noted consumer insurance advocate James Hunt provides individual policy evaluations and comparisons at a very reasonable charge of $135 for the first policy, and $90 for additional comparisons. You can get this independent review and advice either before you purchase a policy, or for an existing policy.

When to Switch

There is no fixed rule about when it pays to replace a life insurance policy. For term policies, it's actually pretty simple as there are no surrender charges, so it's easy to compare premiums and the duration of the level terms to compare. But whole life "permanent" policies have a lot more moving parts to consider, as well as making sure you don't create a taxable event when you switch to a new policy.

It's important to know that insurance agents receive most of their compensation out of the first year's premium on a new policy, so they have an incentive to ask customers to switch. The best companies demand to know whether an older policy is being surrendered, and they may limit agents' commissions on such replacements. When you complete an application for a new policy, you can expect to be specifically asked whether it is replacing an existing policy. The replacement question is part of every life insurance application, by law.

It's critical to compare the *surrender values* on the new policy versus the old one. As you'll easily see, the surrender charges may cause the value to be zero in the early years, reflecting the big commissions and other up-front costs that are paid to the agent. So you need a very compelling reason to move the existing cash value from an older policy into a new one. Use the service mentioned earlier at EvaluateLifeInsurance.org if you're not sure that the switch deal is a good one.

If you do decide on a replacement policy, never simply cash in an old policy, take the cash, and buy a new policy. That could trigger taxes on the gains in the investments inside the policy. Instead, you'll want to examine a *1035 exchange*—named for the section of the tax law that authorizes this tax-free exchange into a new insurance or annuity policy.

"Buy Term and Invest the Difference" Works Only if You *Do* It

Even with these explanations of life insurance policies that build cash value, you may decide that, for your needs, term insurance is cheap and easy to purchase. If that's all you can afford—and you need life insurance—then purchase a term policy immediately. Leaving your insurance needs uncovered is like tempting fate.

In fact, even some people who could afford to pay more in premiums have decided to go with the cheaper term insurance and invest the difference. That strategy has become a mantra among those who advocate term insurance, but it's a strategy that works only if you *do* invest the difference every month, preferably in a tax-sheltered account such as an IRA. You'll avoid the commissions and fees associated with many life insurance policies that build cash value, although with an IRA you won't be able to withdraw your premiums tax-free or borrow your cash value tax-free. And you'll still have the concern over how to pay the rising costs of term insurance when your flat-rate guarantee expires.

The way to compare the benefits of "buying term, and investing the difference" is to get the *internal rate of return* (IRR) calculation for your cash value policy versus what you might reasonably expect to earn (with or without risk) in an investment account. The IRR on the insurance policy might be negative for the first few years, reflecting those up-front charges. But over the longer run of perhaps 20 years, you might get a higher return on the policy than on your investments. Your agent should be able to illustrate the promised IRR of any policy you purchase.

And remember, when you do this analysis on the IRR of a life insurance policy's cash value, you need to subtract the cost of what you would have paid for the term insurance. Determining the IRR on the death benefit is relatively easy, as most insurance companies will provide it in their illustrations either automatically, or certainly if you ask for it. The only hard part of that calculation is picking the year you know you're going to die!

Those are the trade-offs for the higher-cost universal and variable universal life policies. The insurance industry will continue to try to structure both types to make sure you can afford coverage.

I leave you with this persuasive argument for permanent life from a very successful insurance agent, Byron Udell, president of AccuQuote.com:

> Term insurance works fine for temporary life insurance needs. Today's term products are available with guaranteed level premiums for as long as 30, or even 40, years. They are very inexpensive, assuming you are in good health. But remember, they are inexpensive for a reason. Odds are, you'll outlive the policy and collect nothing. The only way to win the game of life insurance using a term policy is to die before your time!
>
> Permanent plans can be structured—and guaranteed—to last forever, so that they are still around when you die. If you die with your policy in force, you will have won the game. Since everyone dies, and since no one is better off dying *without* life insurance, it would seem that people would be lining up to buy some sort of permanent insurance policy to make sure that they have the coverage in force when they die—whether that's tomorrow or in 50 years.

Owner, Insured, and Beneficiary

Before you make a final purchase decision, give some careful thought to the who's-who of your life insurance policy. Figuring out the *insured* is simple; that's the person whose life is covered by the policy. But there are several choices for the *owner* of the policy, and the wrong decision can make a big impact on the eventual payout. It's also important to consider the *beneficiary*—the person who will eventually receive the proceeds when the insured dies. Remember to update or change the beneficiary when your life circumstances change. (That's a subtle reminder that you don't want your "ex" collecting the payout!)

POLICY OWNER

If you own the policy on your own life, at death it becomes part of your estate—although the actual proceeds of the policy pass income tax-free to the designated beneficiary. Even if your children or a charity are the beneficiary and receive the full death benefit, the total amount of that benefit is included in your estate for federal

estate tax purposes. When you combine the death benefit with all your other assets, including your home and retirement plan, the federal government could take a huge tax bite, depending on estate tax rates in force that year.

In recent years, the size of an estate that is subject to taxation has increased dramatically to $11.4 million (and even more if you're married and set things up right) as you'll see in Chapter 16. But many states have far lower estate tax exemptions. An attorney who practices in your state of residence can give you the specifics of when estate taxes might apply to you. And, of course, the federal estate tax exemption is subject to the political whims of Congress in the future.

You may choose to make your adult children the owners of the policy on your life and gift them enough money each year to pay the premiums. Or, you may want to set up an irrevocable life insurance trust to own the policy on your life. That gets the death benefit out of your estate. Have the trust purchase a new policy rather than transfer an existing one, because for the first three years after a transfer an existing policy's death benefit is still considered part of your estate. When the life insurance is owned by an irrevocable trust, the trustees can then lend the proceeds to your estate for tax purposes and distribute the rest to your heirs according to your instructions. The trust must meet several legal requirements, so use a competent estate planning attorney.

POLICY BENEFICIARY

Your estate planning attorney can also help you decide the appropriate beneficiary. Each situation will be different, and life insurance can be a very valuable tool to allow you to equalize your estate between your children without leaving them equal shares of each particular asset.

Consider this situation: You have a daughter who works in your business and you envision her taking over the business, but your son works in another field and has no interest in the business. You can leave the business to your daughter and leave your son the proceeds of life insurance policy in an amount you believe is equal to the value of the business. That way, you're being fair without needlessly complicating the lives of your children later.

It's also important to correctly name the beneficiary of your life insurance policy. In some cases, it may be best to name a revocable (not irrevocable) trust as beneficiary to safeguard the policy proceeds in case of a subsequent remarriage.

Unfortunately, many young parents make the mistake of naming minor children as beneficiaries of the parents' life insurance policies. Since a minor will not have the authority to handle the money, the state will then name a trustee to act as fiduciary to invest and dole out the funds. You can avoid these problems by setting up a revocable trust (naming a trustee and successor trustees) to be the beneficiary of your life insurance policy, with instructions for how the money is to be used on behalf of your children.

And here's a special note for spouses who might become beneficiaries of a life insurance policy as part of a divorce settlement. The *owner* of the policy always has the right to change the beneficiary—or simply stop paying the premiums. If you want to make sure the coverage stays in force, insist that you become the owner. Request either a fully paid policy or enough cash as part of the settlement to cover the future premiums you will need to pay as owner. That way, you are in control and the policy will stay in force.

If you can't get that done, another option for divorce situations where the court requires your spouse to maintain life insurance is to become listed an *irrevocable beneficiary*. This prevents your spouse from changing the beneficiary designation on the policy without your knowledge. It also requires that you be provided with notice if the premiums are not paid and the policy is in danger of lapsing. Neither of these protections are there if you are simply listed as an ordinary beneficiary on a life insurance policy.

Life Insurance—Combo Policies for Long-Term Care (LTC)

In recent years, a new category of life insurance has emerged—one that allows the policy owner to access his or her death benefit for long-term care (LTC) expenses. I'll explain the specifics at length in Chapter 15 on long-term care insurance, but include it here because for this reason alone it might be worthwhile reviewing your current policies. Many that have been written in recent years allow access to cash values to cover the costs of custodial care. Or you might purposely choose to purchase a policy that not only offers tax-free cash withdrawals, but actually leverages the cash you invest in your policy to provide significant payments for either qualified home care or assisted living or nursing-home care.

Typically, these policies provide you with 2 percent of your death benefit per month, essentially as an advance on your death benefit, reducing your death benefit dollar for dollar. And because they are

essentially giving you access to money that they figure they'd be paying you soon anyway (since average long-term care need is 3.5 years before death), it doesn't add much to the price of the same policy without this benefit.

Specialty Life Insurance: It Costs Less to Insure Two Lives

Second-to-die life insurance policies, sometimes called *survivorship policies,* cover two lives but pay off only on the death of the second insured. They're particularly useful in estate planning situations, where cash will be needed to pay federal estate taxes or state inheritance taxes at the death of the second spouse. That's because unlimited assets can be left to a spouse without being subject to estate taxes, but when the second spouse dies the remaining estate could face a heavy tax burden.

Since survivorship policies insure two lives, but pay off only on the death of one, they can cut premiums by 50 percent or more.

First-to-die life insurance could theoretically save premium dollars for a young couple who can't afford to insure both lives but want to make sure there is cash to help a surviving parent care for children. With today's low term rates, this isn't a particularly appealing solution, as both spouses should have individual policies.

But first-to-die policies could make sense for business partners, who might use this type of policy to make sure there is cash available for the surviving partner to buy out the interest of the deceased partner. But in practice, these policies are costly, and unless coverage is needed for many years, two separate policies are likely to be a better solution. Very few companies are offering first-to-die policies today, and because there is little competition, they are almost always priced too high in comparison to individual policies.

Accelerate Death Benefits without Dying

In the past 20 years, insurance companies recognized the need to allow people who have terminal illnesses or other special needs to access the cash death benefit before they die. This is different from a policy loan in that in most cases no interest is charged on the amount withdrawn. And since it is an advance payment on a death benefit, it is still considered to be income tax-free.

The accelerated death benefit was an insurance industry response to a growing business of *viatical settlements*—cash advances

on life insurance policies, offered at a discount by investors to terminally ill people, given impetus by the initial wave of AIDS cases. (Interestingly, many of those investors were burned in the late 1990s when they gave cash advances to AIDS patients who were presumably terminal but who then recovered as a result of new medicines.)

What subsequently developed was a huge market for what is now referred to as *life settlements*, with incentive payments given to individuals who own life insurance policies, even though the death benefits are no longer needed. Investors then purchase the policies, typically providing policy owners with more money than they would otherwise receive if they were to surrender the policy for its cash surrender value. In some cases (generally when you're older, and not in the best health), even term policies can be sold in this market. The investors are hoping to get a substantial return on their investment when the insured dies.

Life insurance laws prevent a person from buying a new policy on the life of an individual upon which they have no insurable interest. This is for public policy reasons, specifically to keep people from speculating on the life or death of strangers and possibly creating incentive for murder. Yet, courts have interpreted the life insurance contract as a property right that can be sold to anyone—even a stranger—after it is already in force. While this doesn't seem to make sense, an entire industry has developed around it.

During the 2008 recession, many of these deals collapsed due to lack of funding. Just remember, to put it simply, if you participate in this kind of deal, you are giving a stranger a strong incentive to see you die sooner rather than later!

There are now numerous providers of life settlements, and if you do decide to participate, it's still considered the Wild West in that there are no standardized pricing paradigms and the offers received may vary from company to company.

Life Insurance—A Final Thought

If all this talk about death and dying makes you queasy, you're not alone. A smart man once told me: "Life insurance is a bet against my own life." There's a better way to think of it. The odds of death are *one out of one!* We all, eventually, will die. When you do the math, if you're smart enough to die with your policy in force, there are few financial instruments that can compete with a life insurance policy. And one way to cheat death in a small way is to make sure that those who depend on you are well taken care of in your absence.

The Savage Truth on Health and Disability Insurance

Life insurance is important to protect your family if you are not around to take care of them financially. But health insurance to keep you and your loved ones protected is an equally important topic. And if you become disabled, you'll understand the true value of good health, as it allows you to maintain your lifestyle. And as you age, you'll suddenly realize the importance of long-term care insurance, which is discussed in a separate chapter, Chapter 15. But let's start with an insurance issue that is of most immediate import to the millions of Americans who do not receive health insurance from their employer.

The Health Insurance Crisis

Health insurance has become a nightmare for American families, raising the potential of financial devastation and lack of both preventive and urgent care for people who desperately need it. Whatever your politics, I think we can agree that this situation must rise above our divisive society to provide some form of insurance coverage—and excellent health care—for our citizens. This is such a fast-changing topic that it's difficult to give current advice in a book. But here are a few basic facts you should have in your arsenal as you search for coverage.

According to the most recent census bureau statistics, in 2017, private health insurance coverage continued to be more prevalent than government coverage, at 67.2 percent and 37.7 percent, respectively. Of the subtypes of health insurance coverage, employer-based insurance was the most common, covering 56.0 percent of the population for some or all of the calendar year, followed by Medicaid (19.3 percent), Medicare (17.2 percent), direct-purchase coverage (16.0 percent), and military coverage (4.8 percent).

Of course, the Affordable Care Act (Obamacare) continued to make headlines, despite efforts to eliminate it. The fines for lack of participation were eliminated, along with the advertising that encouraged people to sign up. Even worse, the government-mandated subsidies lagged the cost of care, forcing insurers to increase premiums. In fact, unless an individual or family qualifies for a subsidy, the basic "affordable care" coverage is unaffordable for too many. But there are some alternatives.

Finding Health Insurance

Private Health Insurance. It's worth checking out the private health insurance that is available in your state from major insurers. The most significant determinants of price, beyond your current health, are the deductible and the percentage of cost-sharing you must pay. Those comparisons are best done online by an independent provider such as eHealthInsurance.com. They represent most insurers doing business in your state and have no incentive to point you in any direction but the one that benefits you the most. Their telephone representatives are experienced and can help you find the coverage you can afford, with the providers of your choice. And, while you're at it, consider a policy that comes with a tax-deductible health savings account (HSA) that can build up a pool of pre-tax dollars to pay for uncovered medical expenses.

Health Savings Accounts. As noted in the previous paragraph, HSAs are a way to leverage your health care costs with tax benefits. Health savings accounts are essentially tax-advantaged medical savings accounts that you own. You contribute money (within an annual limit) to an HSA on a tax-deductible basis, much as you would to a traditional individual retirement account.

While the money is inside the HSA, it can be invested through major financial services companies, including Vanguard, Fidelity, and most major banks. All the growth of your account will eventually come out tax-free when you withdraw money to pay your medical expenses. Those expenses can include dental, vision, and hearing.

To open an HSA, you must purchase a qualifying high-deductible health plan, or HDHP. (These plans have historically been labeled "high deductible," but given today's health insurance environment, they may not be much higher than most affordable plans.) These HDHP plans feature relatively low monthly premiums in exchange for coverage that only kicks in after you pay your deductible.

The 2019 minimum annual deductible is $1,350 for self-only HDHP coverage and $2,700 for family HDHP coverage. You can compare and purchase these plans at sites like www.eHealthInsurance.com.

You can contribute up to $3,500 to an HSA if you have single coverage or up to $7,000 for family coverage in 2019. If you're 55 or older anytime in 2019, you can contribute an extra $1,000 to your HSA. And like an IRA, you can contribute to your HSA account during any calendar year, through April 15 of the following calendar year.

If you are in the position of paying for your own or your family's health insurance, you should definitely check out the combo of HSA and a qualifying HDHP policy. When you pay your own medical expenses you are likely to have greater freedom of choice among providers. Plus, you're paying with tax-deductible dollars.

COBRA Extension of Company Coverage. If you're laid off from your job, you may be offered an extension of your current coverage for 18 months. Federal law that requires employers of 20 or more employees who offer health-care benefits to offer the option of continuing this coverage for those who would otherwise lose their benefits due to termination of employment. That law applies even if you quit your job. But COBRA essentially requires that you pay both the employer and employee portion of the premiums, resulting in a very expensive monthly payment. It is, however, the only kind of policy that will guarantee 18 months coverage, including existing conditions.

Employees that work for companies with fewer than 20 employees may be eligible for state health insurance continuation policies that typically last 12 months. Check your state's laws.

Short-Term Health Insurance. These policies offer coverage for as long as one year (365 days to be specific), and may be renewed up to 36 months. They require limited medical underwriting and are not required to cover pre-existing medical conditions (as ACA plans must do). They do not cover maternity expenses, and most do not cover prescription drugs. They typically have a lifetime payout maximum. Short-term plans are typically far less expensive than ACA plans, especially if you do not qualify for a subsidy, but they do carry a deductible.

One drawback is that you must re-qualify for coverage after the one-year policy expires. So a medical issue that occurs during the year could make you ineligible for coverage the next year. Or some expenses related to that condition might not be covered if the policy is renewed. And the premium could be higher. Obviously, it's not an ideal solution, but it is better than being uninsured.

You can do online comparison shopping at www.eHealthInsurance.com, www.HealthPocket.com, and www.AgileHealthInsurance.com.

Small Employer Special Enrollment Period. A little known provision of the Affordable Care Act mandates a special enrollment period during which all small businesses (from 2 to 50 employees) must be offered a plan that is comparable to those offered to major companies doing business in that state. Obviously, the insurers aren't

running out to publicize this offering since they make more profits from large groups.

But the plans that major insurers such as Blue Cross/Blue Shield, United Healthcare, and Humana make available to big companies are also available to small businesses during the SEP period, which runs from November 15 through December 15 for a January 1 effective date. During this period, employers that would otherwise not meet contribution or participation requirements for group plans can enroll in the best group health plans available in their state.

These group health plans may offer multiple choices such as HMO, PPO, and Health Savings Accounts. They offer the widest access to hospitals and physicians—unlike many ACA plans which have recently limited access to physicians and teaching hospitals. If these plans are good enough for the state's largest corporate employers, you can be sure they will offer you the best coverage. And because these plans are mandated offerings by the ACA, there is no disqualification or higher premium for employees with pre-existing conditions.

Even more attractive to a small business running on a tight budget: The company is not required to make a contribution to cover the cost of participating employees. And even if only one employee chooses to participate, out of the two or more salaried employees, the plan can go into effect. Thus, if the owner is covered by Medicare, for example, but one or more additional employees find this plan more attractive than the ACA offerings, the plan will cover them.

Only one salaried full employee needs to participate to take advantage of this offering—even if other employees choose an ACA plan that provides more limited coverage but lower premiums because of a subsidy. If the plan is structured correctly, employees can pay premiums through a payroll deduction on a pre-tax basis, thus lowering the true cost even more.

This is such an incredibly good deal—and potentially so costly to insurers—that few insurance companies are advertising it, and with low commissions few brokers have an incentive to sell them. They require documentation that an employee has been on the payroll for an entire year to qualify. And there is a very short window near year-end to establish this type of plan.

If you work for a small business that does not offer health insurance because of the costs, this is a perfect solution. Bring it to the attention of the owner. The one resource I've found that has a

national reach and experience is www.VestaBenefitsGroup.com. But avoid the year-end rush and get help in documenting your situation early in the year.

Critical Illness Insurance Provides Cash

We all understand the importance of life insurance to leave cash for support of those we leave behind. But these days, you have a greater chance of surviving a critical illness, which can deplete all your savings. If you are single and childless, it may be more important to have cash during your illness than to leave an estate for your heirs. Unreimbursed medical expenses are a leading cause of bankruptcy, even when an individual has health insurance. And many cutting-edge treatments are not covered by health insurance plans.

That's where a relatively new concept—*critical illness insurance*—steps in. It's a policy that pays a lump sum in cash if you survive 30 days from the date of diagnosis of the most life-threatening medical conditions.

Imagine buying an insurance policy that would pay off if you were diagnosed with cancer, stroke, heart attack, paralysis, renal failure, multiple sclerosis, Alzheimer's, blindness, deafness, or organ transplantation. It sounds like a litany of your worst health-care nightmares.

Like life insurance, critical illness insurance is purchased in lump-sum amounts from $25,000 to $2 million face value for the policy. But unlike life insurance, you don't have to wait until you die to receive a payout. You'll receive a check a month after your diagnosis. You can use the cash to pay uncovered medical bills, maintain your lifestyle, make mortgage payments, or cover college tuition. The entire payout is tax-free, as long as you (not your employer) paid the policy premiums.

We tend to think more about illness as we age, but this policy is available only to those ages 20 through 64. Critical illness policies appeal to singles who don't need much life insurance but worry about having enough assets to see them through a serious illness. Two-income families who need both paychecks to make monthly mortgage payments might also consider this new type of coverage.

The critical illness policy is *not* a substitute for adequate healthcare insurance. And because the proceeds are likely to be used during the patient's lifetime, it is not a substitute for life insurance. It may, however, be considered a substitute for, or work in tandem with, disability insurance—with some differences.

A traditional disability policy would cover a much broader array of situations that keep you from performing your usual occupation, but it would pay benefits only on a monthly basis. And if you have a critical illness, you might not survive long enough to collect much in the way of disability benefits. Also, people without a regular income (including nonworking spouses) can't get disability coverage.

Not everyone qualifies for critical illness insurance—certainly not at a reasonable price. If your family has a history of heart disease, stroke, or breast cancer, then you may be denied coverage or charged a steep premium. As usual, smokers also pay a lot more for a policy.

Critical illness coverage is offered by many major insurers, so you can compare prices and features. Most exclude skin cancer, and some common procedures such as balloon angioplasty. Some offer a *return of premium* feature if you die without using your policy.

The price you'll pay for this critical illness insurance depends on your age, medical condition, and the amount of coverage you buy. Some employers offer these benefits as part of a workplace healthcare plan. This insurance is expensive, but that's the price some people are willing to pay for peace of mind.

For more information, a cost calculator, as well as links to carriers and brokers, go to www.CriticalIllnessInsuranceInfo.org.

Disease-Specific Insurance

I'm often asked whether it makes sense to buy a policy that gives you money when you are diagnosed for a specific disease. After all, good health insurance should cover most of the costs. Or will it? Some disease-specific policies are considered *indemnity* policies. That is, they pay you cash as outlined in the policy specifics and you can use the money in any way you want. It may be used for uncovered medical expenses. Or to pay living expenses if you can't work. Or lodging expenses if you have to travel for treatment.

The most popular form of disease-specific insurance is cancer insurance. It is offered by a number of major insurance companies, including AFLAC, CIGNA, MetLife, and United Healthcare. Mutual of Omaha offers a combined critical illness and cancer policy. They will check your medical records to make sure you haven't previously been treated for any form of cancer.

One can envision that with DNA testing becoming more commonplace, it will be more difficult to acquire this type of insurance. So if you have a feeling that cancer might be a problem in the future, you might look into this type of policy now.

Disability Insurance Covers a Real Risk

One of the greatest risks to your financial security is the possibility that an illness or injury will keep you from earning current income and from contributing to your retirement plan. The Disability Insurance Resource Center says disability from either injury or illness is a far greater threat than most people realize.

As an example, for a 32-year-old, a serious disability (three months or longer) is 6½ times more likely than death. Only 3 percent of mortgage foreclosures are caused by death, while 48 percent are caused by disability. The average disability lasts two to four years, but some people are disabled for life. So it makes sense to insure your ability to earn an income.

Disability insurance may be offered as part of a group benefit provided by your employer or purchased independently. Disability insurance costs less when purchased through a company benefits plan, and premiums are usually paid with pretax dollars. But if you ever have to receive a monthly disability check from a company plan, you'll owe income taxes on the payments. Some companies allow payroll deductions on an after-tax basis, so future benefits would be tax-free.

If you purchase a disability policy on your own, you can expect to pay more, and you won't receive any tax deduction for the premiums, but any future payouts will be tax-free. And keep in mind that if you leave your company, your group disability insurance may not be portable.

Don't make the mistake of assuming that company-paid sick leave will last long enough to cover all your income needs in case of a disability. Workers' compensation payments cover only injuries or illnesses that are proved to be work-related. Social Security does provide some disability income, but only after an arduous claims process that results in benefits only for the severely disabled. None of these programs comes close to replacing your previous income.

The most important consideration in purchasing a disability policy is the definition of what constitutes a disability. Some policies pay benefits if you are unable to perform the duties of your customary occupation; others pay only if you cannot work—or are not working—at *any* gainful occupation. And a policy may cover only the difference between what you can earn after your disability and what you were earning before the illness or injury, up to the limits of the policy.

You also want to make sure your individual disability policy is guaranteed renewable, which means they cannot cancel unless you fail to pay, and that premiums can only be increased if the entire class of insureds in the state is impacted equally.

Of course, you'll have to take a physical exam before the policy is originally issued. As well, your driving record, earnings history and tax returns, and medical history from the MIB (medical information bureau) will be examined. They will also contact your health care provider for a full set of medical records. Most underwriters are very picky about covering mental or drug-related disabilities.

Obviously, key pricing considerations relate to your age and health, as well as your occupation. But there are other variables:

- *The amount of monthly benefits.* This amount is typically limited to 60 percent of your current pretax income.
- *The waiting period.* This is the lag time before payments start, usually a minimum of 90 days. (You should have enough savings to cover that gap period.)
- *Term of benefits.* It's most common to purchase coverage to the age when Social Security will provide ongoing income. You can save money by purchasing coverage for a shorter period in order to lower the cost, but once disabled, you might need coverage for longer than you ever dreamed.
- *Future increase option.* Many policies allow you to purchase additional benefits without evidence of insurability.
- *Cost of living adjustment option.* For an additional cost, you can get a small annual increase in benefits to keep up with inflation when you are disabled.
- *Residual benefit.* With this option you can collect a monthly benefit if you have a loss of income when disabled, but working and earning less as a result of your disability.
- *Women pay more than men.* It's an actuarial fact that women tend to utilize the benefits at a greater rate than men.

As a general rule, the best disability insurance policy for a professional worker (not one in an industrial occupation) and in good health, should cost roughly 3 percent of your annual pre-tax income, or net income for self-employed people.

Very few insurance companies still underwrite individual disability insurance, Among the best known are Guardian, MassMutual, Standard, Ohio National, Ameritas, Northwestern Mutual, and Principal. To learn more about the costs, and use tools to calculate your needs, as well as to get quotes from individual companies, go to the website of a leading disability insurance sales organization: www.DI-Resource-Center.com.

TERRY'S TO-DO LIST

1. Figure out how much life insurance money, if any, you need to really provide for your family or loved ones.
2. Check the prices for level-term insurance to meet basic insurance needs.
3. Consider permanent life for longer-term insurance needs.
4. Buy policies only from top-rated companies.
5. Take a close look at existing policies. Ask for an in-force ledger to determine current values.
6. If considering a change, contact EvaluateLifeInsurance .org for a policy comparison.
7. Make sure you have named the correct beneficiary for each policy.
8. Consider opening a health savings account combined with an affordable high-deductible health insurance policy.
9. Review the need for critical illness insurance and/or disability insurance.

CHAPTER 11

THE SAVAGE TRUTH ON PROTECTING YOUR ASSETS

Your Home, Your Auto, Your Wealth

You've worked so hard to build up financial assets—whether your home, your car, your furniture and other possessions, or even the money you hope to use for retirement. Doesn't it make sense to protect those assets from disaster, especially when insurance is available at a reasonable and competitive price?

But thinking about insurance requires thinking about loss—something we'd all prefer to avoid. The most basic Savage Truth when it comes to insurance is that *not* having insurance is like tempting fate. You can come up with a million excuses, starting with not having enough time, not having enough money, and not understanding the policies. But in the end, if you stare at the ruined pieces of your hard work after a loss, you'll wonder why on earth you didn't read this chapter and take action.

The Savage Truth on Homeowners Insurance

As a result of the housing and mortgage crisis of recent years, we've all come to have a new appreciation of the meaning of "home, sweet home." If you're fortunate enough to have your home intact, it's

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time to reconsider how much homeowners insurance is enough and what coverage you need.

A basic consultation with your insurance agent will give you a checklist of the specific coverage and amounts you need. But here's a look at some of the issues you hope you'll never face. My greatest wish for you is that the premiums you pay for homeowners insurance are all "wasted"—that you never need to call upon your insurance because of a fire, a flood, or theft, or because your neighbor injures herself on your property. In that sense, your premiums are never wasted because they pay for your peace of mind.

For most people, the family home is the largest and most important investment you will ever make. And unlike investments in the stock market, you can protect yourself completely against the risk of loss. From that perspective, why would you consider not having complete coverage?

Here are the key ingredients you must consider.

Understand Your Policy Coverage and Limits

Reading through an insurance policy has about as much appeal as going to the dentist. You know it's important, but you don't want to devote a lot of time to the project. A homeowners policy is filled with the word *peril*. A list of those perils (potential losses) sounds like the biblical plagues: fire, lightning, windstorm, smoke, hail, explosion, and riots or civil disorders. There's also coverage for damage caused by vehicles or aircraft (those events make news headlines), and for vandalism or glass breakage. And what about damage caused by a water heater exploding, or frozen pipes, or electrical surges that impact appliances?

That's just damage to the structure. What about your personal property? And what *isn't* covered in the standard policy—floods, earthquakes, wars, and perhaps sewer backups? That's why you need a competent agent to make sure you are appropriately covered.

HOW MUCH?

You'll want to cover the structure of your home for its current market value. (The insurance company won't allow you to cover it for much more, and they will know comparable values for homes in your area.) But don't be surprised if your coverage is less than what you perceive

to be the total value of your home, since the land underneath your home is not likely to be destroyed in any covered event. (Earthquake coverage is purchased separately.)

If you have a mortgage on your property, the lender will require you to list the mortgage company as an "additional insured," and to insure at least 80 percent of the value of your home, or 100 percent of the amount of your mortgage. If you insure for less than 80 percent of the replacement cost, many companies will place a limit on what they'll pay out, or prorate the coverage based on the percentage by which you are underinsured.

The personal property in your home, including furnishings, clothing, and books and records, will be included as an additional amount—typically a percentage of the total coverage for the structure. See the following if you have valuable items that should be covered separately.

REPLACEMENT COST VERSUS ACTUAL CASH VALUE

This is a critical element of your property insurance. If there's a fire in your living room and you need to replace your couch and other furniture, you want to be sure you have replacement cost coverage. That is, you don't want to receive a check only for the actual cash value of your 10-year-old furniture. It is worth paying more to make sure you have enough coverage to refurnish at today's prices.

If you're smart, every few years you'll make a video or digital photo record of your home interior, pointing out furnishings, carpeting, wall coverings or other decorative items that are unusual and would be expensive to replace. Give a copy or disc of this digital record to your insurance agent for her files. If needed, this could save time and annoyance in getting your home rebuilt.

SEPARATELY SCHEDULED ITEMS

Some items, such as jewelry, artwork, silverware, antiques, coin collections, or furs, would not be covered adequately under the personal property section of your policy, which might allow only $2,500 for "all jewelry." To make sure you have replacement coverage for these items, you will need to *schedule* them and pay an extra premium based on their value. For that purpose, you will need an independent appraisal of their current value. Make sure your agent keeps records of those appraisals so they are not destroyed in a disaster.

DEDUCTIBLE

The *deductible* is the amount you must pay, before the insurance coverage starts. Deductibles can range from as little as $100 to $2,500 or more. Ask for price quotations for a $500 deductible and compare to a much higher level. Raising the deductible can save a substantial amount on annual premiums, but this is wise only if you have the cash and are willing to cover lesser charges, such as the theft of an item from your car, which is normally covered by homeowners insurance.

LIABILITY INSURANCE

If a member of your household is accused of accidentally causing injury or damages to another person or property, this section of the policy pays for a legal defense, and will cover a settlement or judgment up to the limits of your policy. Ask about those legal limits; you might want to pay additional premium to increase them.

GUEST MEDICAL INSURANCE

Your house-guest slips and falls in your shower. Those injuries may be covered by their own insurance, or they may be paid by your homeowners policy without getting into a lawsuit. The guest medical section of your homeowners insurance policy means you will not be digging into your pocket to pay these expenses.

WHAT'S *NOT* COVERED?

Flood and earthquake insurance are purchased separately from your standard homeowners policy. And it's important to know exactly what this means. If groundwater or a sewer backs up into your basement, destroying carpeting and appliances, this damage is not likely to be covered by your standard homeowners policy, but it would be covered if you purchase additional, optional coverage for that possibility. Flooding is only covered by flood insurance, which must be purchased from the National Flood Insurance program (NFIP), if it arises out of general flooding conditions in the area. Rates for flood insurance are set based on the federal flood hazard map, which you can find at www.FloodSmart.gov.

Earthquake coverage is expensive and difficult to get these days. If you live in an area prone to earthquakes, then you may find it prohibitively expensive and with a very high deductible.

Ask your agent about how outbuildings such as garages or sheds are covered under your policy. Similarly, you may find that landscaping

is not covered. So if wind damages your tree, you'll have to pay for removal. But if the tree hits your roof, or your neighbor's roof, your policy will pay for the damages, and may pay for removal, as well.

ADDITIONAL LIVING EXPENSES

This section of your policy will reimburse you for living expenses if your home is uninhabitable after a fire or other disaster. Make sure you check for this coverage.

Beyond the Basics

The more things you have, the more insurance you need. It's a simple formula. But it's not always a direct ratio. The Savage Truth is *if you have wealth, you become a target for legal actions.* But if you have very little in the way of possessions, a small loss becomes even more devastating. So here are some policy ideas you should consider beyond your standard auto and homeowners coverage.

UMBRELLA LIABILITY

If you fear that the limits of your homeowners liability coverage are not large enough, you can purchase additional liability in the form of an *umbrella* policy, typically for an additional million dollars or more. It is a good idea to coordinate with the coverage of your underlying homeowners or auto policy, and it will likely cost less if you do so. Ask about the liability limits of your policy per incident, and how this coverage is determined. This coverage is usually relatively inexpensive.

RENTERS INSURANCE

If you live in a rental unit, your landlord probably has insurance to replace the walls and permanent fixtures in your unit. But you are responsible for replacing all your personal property, including clothing, electronics, furniture, and decorations—anything that you own. A fire or smoke damage could destroy you financially if you do not purchase renters insurance. And renters policies also include liability insurance, guest medical protection, and reimbursed living expenses.

CONDO INSURANCE

Your insurance agent should check the condominium association policy to make sure your condo insurance coordinates with the building's coverage. Typically, you are responsible for the interior

of your unit, including wall and floor coverings, and decoration beyond the initial surfaces of the building. That could add up to a huge bill if there were a fire in an adjoining unit.

A condo policy also offers liability, guest medical, and reimbursed living expenses. Do not count on the building's insurance or that of a neighbor to make you whole, even if a disaster is their fault. You need your own insurance policy.

SAVING MONEY

There are ways to save money on your insurance needs. One of the easiest is to combine all your insurance needs with one company, including auto, homeowners, and umbrella. That should earn you a discount.

You should ask if there are discounts for fire and burglary alarms, for smoke detectors, or for other safety measures around your home. And seniors may also qualify for insurance discounts.

Insurance is a competitive market today, so you want to shop around for the best price. But in case you actually need to *use* your coverage, you'll want to be dealing with a reliable, well-established company and with an agent you know personally.

THE SAVAGE TRUTH ON AUTO INSURANCE

Every state in the United States has a law against driving without automobile insurance, including a minimum amount of liability insurance. But almost everyone has heard of people being involved in accidents with uninsured drivers. That's why it's especially important that you have full auto insurance coverage.

Even though uninsured drivers are penalized in every state with fines, loss of driver's license, and even jail time, you may find that it is your insurance you must reply upon if there is an accident. If you drive without insurance and are at fault in an accident, you could lose everything you have. That's the Savage Truth. And it should be an incentive to find at least minimal coverage.

That said, coverage requirements vary state by state. Auto insurance policies are very competitive, and price is not the only issue. While the easiest thing to compare about auto insurance is prices—readily available on the Internet through many websites—the premiums are only one part of your policy decision.

If you're concerned enough to read this chapter, you want not only the best coverage for the price, but also an insurance company that will handle the consequences of an accident promptly and efficiently. That's really the extra that you expect your premium dollars to buy, beyond the protection of the insurance policy.

Here are the basics you need to understand.

No-Fault Insurance

The coverage you need depends on your state of residence. About a dozen states have no-fault insurance, where there is no legal recourse to the other driver's insurance to sue for pain and suffering. Your own policy picks up all medical costs regardless of who caused the accident. This portion of your policy is called *PIP* (personal injury protection). As for repairs to your physical damage to your car, you look first to your own collision coverage.

Most states follow the standard *tort* system of law, where the courts may determine who is at fault and whose insurance picks up the tab. You want an insurance company that will pay you promptly and repair your car, using its legal talent to recoup those costs from the other driver's insurance.

Coverage

Bodily Injury Coverage: This feature provides protection if the driver, policyholder, or family member causes bodily harm to someone else. You may find your policy has two limits, such as $100,000 per person, up to $300,000 per accident. (You'll find it written this way: $100,000/$300,000.) If you feel you could potentially be a tempting target for a lawsuit, you'll want to purchase higher limits or an umbrella policy.

Property Damage Liability: This feature covers damages to others' property if you, or someone you allow to drive your car, is in an accident. Make sure you have adequate coverage under this provision in case you hit an expensive car.

Collision Coverage: This is the portion that covers repair to your car (minus the deductible) regardless of who was at fault in the accident. (If you were not at fault, the insurance company will try to collect this amount from the other driver's insurance company.)

Personal Injury Protection or Medical Payments Coverage: This covers medical costs if either the passengers or driver of the

policyholder's vehicle are injured, and may also cover lost wages, cost of replacing services, and funeral costs.

Uninsured/Underinsured Motorist: If the other driver does not have insurance, or enough insurance, this portion of your policy will pay the costs, and should also pay if you are hit as a pedestrian. In effect, you're paying the other driver's premium.

Comprehensive Insurance: By this point, you probably think you already have comprehensive coverage. But this portion of the policy pays for damage as a result of theft, falling trees, vandalism, or fire and flood. It may also pay for a rental car if yours is stolen.

Rental Car Insurance: This is a good time to ask your agent if your policy also covers collision damages and loss of use (to the car rental agency) if you are in an accident in a rented car. If you have this complete coverage (or if you have it through the credit card you use to rent a car), then you could save a significant amount when you rent a car.

Pricing and Money-Saving Tips

The cost of your auto insurance is based on your driving record, your location, and the kind of car you drive (something to think about before you buy), and can even be based on your credit score. It can also be impacted by a number of other factors that are within your control if you plan appropriately.

You can save money on your insurance premiums by raising the deductible (the amount you are willing to pay). You probably won't make small claims, anyway, out of fear that your claims history will result in higher premiums the following year. So if you are willing to pay the first $250, or $500, or even $1,000 out of pocket, you can save a lot of money on your premiums.

Ask your agent for discounts for safe driving records, for longevity with the same company, for low mileage, or good credit. All can cut your premiums. Bundle your auto insurance with your homeowners insurance to get discounts on both. And you can save a few dollars by paying your premiums either annually, or semiannually, instead of monthly. But don't skimp on basic coverage such as medical payments coverage or bodily injury liability. That may turn out to be penny-wise and pound-foolish.

Many companies are able to tap into your car's "black box" to gain information about the amount you drive and how you drive

to determine the risk of insuring you. You likely will have to give authorization for them to access this information. If you're willing to part with this information, you could save money on your insurance premiums. Insurers are becoming more sophisticated about pricing risk as more information becomes available.

It's a sad but true fact that if you have an accident claim or even a speeding ticket, your premium is likely to rise the next time your policy is renewed. That could be the case even if you were not determined to be at fault in the accident. Many people decide not to report small claims, either because they are under the deductible amount or because they fear rising premiums in the future.

Here's a note of warning: If you decide not to tell your insurer about a minor accident, it may cause problems later. If you get sued by the other driver, your auto policy provider might not cover you because of the time lapse. And if you have not reported the accident to the police, it will be harder to substantiate your claim of not being at fault if the other driver decides to sue.

Double-Check Your Coverage

You've heard all the advertisements about auto insurance features, but don't take your coverage for granted. Does the insurer promise—in print—to forgive the first accident? If your car is totaled within the first few months, will the insurer give you a brand-new one? Can you get cash to replace a car, or will the insurer demand it provide a replacement? If your laptop is stolen out of your car, is it covered by your auto insurance, or more likely by your homeowners or renters policy?

These are all questions to ask your agent before you jump online to purchase a standard policy. Your experience might not be standard, and you don't want to find out about missing links when it's too late.

The Savage Truth on Asset Protection

Although you can buy insurance to protect your assets from loss as a result of all sorts of perils, there are other losses you should keep in mind when thinking about asset protection. For most people, it

will never be necessary to contemplate the loss that could come as a result of lawsuits or bankruptcy. But each state has its own laws about asset protection; if you might be exposed, then you should consult a lawyer about how to handle this eventuality.

Some exposures can be limited merely by the way you hold title to the asset. For instance, owning an asset as *tenants in the entirety* affords more protection than *tenants with the right of survivorship*.

In some states, employer retirement plans such as a 401(k) or 403(b) are afforded more protection than an individual retirement account (IRA). That's something to consider before rolling out of your employer's plan.

In case of divorce, some states limit access to retirement plan assets, while others accept qualified domestic relations orders (QDRO), dividing those assets. And in community-property states, each spouse may have an interest in a total property division, including accumulated retirement benefits. The judge may reserve jurisdiction to award each spouse a proportionate share when benefits are eventually paid.

There is no protection for assets given away in contemplation of bankruptcy. If the asset was given away within one year (longer in some states) and if there was not appropriate compensation, or the transfer was made to hinder creditors, the bankruptcy discharge may be denied. However, filing for bankruptcy may protect assets by delaying foreclosure.

As you'll see in Chapter 14, it is becoming more difficult to protect assets from Medicaid, though for years families have given away assets so impoverished seniors could get nursing home care provided by the state. Now *lookback* periods have lengthened, and you don't want to be in a state-funded nursing home, anyway.

There's an amazing array of trusts that have been designed to protect assets, both on-shore and off, from creditors and lawsuits. And there's an equally astounding number of scams that prey upon fearful doctors and other professionals.

In all these instances, it's important to get competent legal help—and a second, independent opinion. Even the largest Swiss banks have recently given up lists of Americans participating in tax-avoidance deals that were structured by well-known accounting firms. Your best asset protection is likely to be traditional forms of insurance and a good lawyer—and an honest lifestyle.

GETTING STARTED

INSURANCE NEEDS CHECKLIST

Homeowners Coverage:

- ❑ Estimated Replacement Value of Home or Condo: $
- ❑ Estimated Replacement Value of Contents: $
- ❑ List of Items to Be Covered Separately (e.g., Jewelry, Silver, Art)

Auto Insurance Coverage:

- ❑ Liability Limits ____
- ❑ Collision Coverage ____________________________________
- ❑ Personal Injury ____
- ❑ Uninsured Motorist ____________________________________
- ❑ Comprehensive ____
- ❑ Rental Car Coverage ___________________________________

Use this checklist to compare. It does you no good to save money on insurance if you don't get complete coverage.

CHAPTER 12

THE SAVAGE TRUTH ON PAYING FOR COLLEGE

A Burden and a Blessing

Going to college has always been part of the American Dream. For a nation of immigrants, a college education meant that children would always do better than their parents. Now college costs have become the American nightmare as more than $1.5 trillion in student loans burden an entire generation—and their parents.

The problem of student loans has not only become a headline number—and a political issue—but an economic crisis that is impacting our economy. Debt-burdened graduates (and dropouts) are delaying getting married, forming families, and buying first homes. That should not come as a surprise, when a significant portion of every paycheck swallowed up with debt repayment.

The parents who cosigned much of this debt burden are finding their own retirement plans impacted by student loan debt. Americans over age 60 owe more than $86 billion in student loans, according to a *Wall Street Journal* study. In one recent year, the federal government garnished Social Security benefits, tax refunds, or other federal payments of more than 40,000 people age 65 or older!

It's a sad Savage Truth that you cannot escape repaying student loans. They are almost impossible to discharge in bankruptcy, requiring stringent proof of "undue hardship." Once you sign for a student loan you will owe it—and all of the interest that accrues while you

are repaying, or deferring repayments, through some of the plans described in this chapter.

I can't stress enough how important it is to calculate not only the impact of the amount borrowed, but the totality of the interest burden, over the presumed 20-year repayment period. Adding insult to this "injury," the government pays only half as much to borrow to finance its deficits as the rates it charges on student loans!

In previous editions of this book, I focused on how to get a student loan at the start of this chapter, and then moved on to repayment advice. But now, I am going to reverse the order and focus first on the challenging topic of dealing with student loan debt. Perhaps that will serve as a warning to future borrowers, and an incentive for parents to participate in 529 college savings plans at an early age, to accumulate at least a portion of future college expenses. Every dollar you save is a dollar less that you'll have to borrow.

There's a great debate building about whether a college education is an inherent right, and thus should be publicly funded, much like our elementary and secondary school systems. There's another debate about who is responsible for the current student loan debt problem. Some lay the blame on Congress, which promised that by having the federal government take over the management of most student loans, the country would save money. Perhaps it is the colleges, which accept the payments but have little responsibility for the outcomes of the education they provide. Yet others blame the thoughtless way in which students (and parents) take on the debt, without much concern for repayment.

There's plenty of blame to go around. It would be an insult to those who worked two jobs and have already paid down their debt to simply forgive outstanding balances. Yet, the longer the problem exists, and the more the interest grows, the greater burden on individuals and our economy. I will leave it to others to deal with this issue in a macro way. My point is merely to illustrate the ultimate cost of student loans.

Student loan debt is an issue I started writing about many years ago. It's not a question of whether college is "worth it." A real education will always be well-rewarded in our Information Age. A recent study by Georgetown University says that a college graduate is likely to earn at least $1 million more than a non-graduate over a lifetime of work. And some college majors will yield a lifetime advantage of more than $3 million.

The wage differences between educated and lesser-educated Americans will grow even wider, as the world is willing to pay for

knowledge and creativity. So, yes, your education will repay you many times over, but only if you graduate into opportunity that is not overwhelmed with the demands of debt repayment.

Perhaps the most accurate response to that question is that college will certainly be worth the time and money—*if* you choose wisely not only the school you attend and your major course of studies, but the way you pay for that education.

This chapter is designed for you if you're a parent or student facing the college challenge, or a graduate trying to deal with repaying student loans. An entire college generation and their parents have been snookered by easy credit and empty dreams. A significant portion of that debt was encouraged by unscrupulous trade schools, which never provided the promised education, and left students with impossible debt burdens. Others simply had no idea about the cost of repayment when they signed up for the loans.

Whatever the reason, too many people have taken on huge and unprecedented amounts of debt, which is difficult to repay and practically cannot be defaulted, no matter what the hardship. It's important to look before you leap into student loan debt.

The real financial "trick" is to figure out how to finance a college education—and how to repay that debt—to produce the best and most productive results from your education dollars.

The Savage Truth on Student Loan Repayment

The time to analyze how much you can afford to take out in loans is *before* you choose a college, and while you have time to save, adjust, and analyze the costs and benefits. We will come to the section on choosing loans and finding scholarships later. For now, let's work backwards.

You've just graduated—congratulations! And suddenly you realize you'll have to deal with your debt. The lenders give you six months from graduation to start some kind of repayment plan, or other option for delaying those payments. You may be tempted to hide from this challenge. Don't do that!

Savage Truth: *You can't hide from your student loans; they will eventually find you.*

Waiting is not only expensive, but could impact your credit for years if you miss repayment deadlines. You may be tempted to hide under the covers of the educational system. It's true that most

federal student loans will remain in deferment while you are at least a half-time student.

In fact, I once met a man in his forties who was still attending school part-time to avoid confronting his student loans. He hadn't gotten far in his career because he couldn't hold a good full-time job. Don't let the fear of repayment sink your future before you get started.

Finding Your Loans

The first step in dealing with loans after graduation is finding them! All of your federal student loans can be found at the government website, www.StudentLoans.gov. That stands for the National Student Loan Data System. It requires a secure log-in, using your Federal Student Aid (FSA) ID. (This user name/password combination replaced the four-digit PIN that was used in the past to create your FAFSA form, so if you haven't logged in for a few years, you may have to create a new FSA ID. You can create or update an FSA ID at FSAID.ed.gov.)

The StudentLoans.gov site will have a record of all your federal loans. That includes Federal Stafford Loans, Federal Grad PLUS Loans, Federal Perkins Loans and Federal Consolidation Loans. (You'll learn more about those loans later in this chapter.) Make sure the database has your current address, so they can send you information about repayment requirements. But the only loans shown in this database are the ones for which you are responsible. Federal Parent PLUS loans and private loans do not show up in this database. The "aid summary" lists all your loans by type, the disbursement date, and the total amount outstanding.

Just finding your student loans is not enough. You need to find your *loan servicer*—the company that will be processing your payments. This can be complicated because your loan may be sold to a different processing company. At the bottom of the NSLDS summary of your loans, you'll see a box marked: "Servicer/Lender/Guaranty Agency/ED Servicer Information." There you can find your current loan servicer.

What about private loans, not listed in the database. The easiest way to find them is to get your credit report (see Chapter 3). All of the private loans you have taken out will be listed there, along with the loan servicer. (Your parents' PLUS loans will show up on their credit reports.) Be sure to contact your servicer to make sure they know how to reach you.

Now you're ready for the challenge of setting up payments on those loans. First, let me suggest that there are so many details, as well as advertisements for services around student loan repayment, that you might easily be led astray, making unnecessary payments or taking actions that can limit future opportunities to adjust your loan repayments.

The most basic source for information on this topic is the government website: www.studentaid.ed.gov. There you can get the latest information and rates, and extensive explanations and answers to all your federal student loan questions.

Setting Up a Repayment Plan

Let's start by assuming you have a job and are ready to make at least some payments on your loans. Here's the most basic Savage Truth about repaying student loans:

The Savage Truth: When it comes to student loan repayments, the sooner the better.

There are two *basic repayment plans* for federal student loans: the standard 10-year plan, and a "stretch plan" that allows you to stretch out payments for as long as 25 years. Of course, the longer-term option will result in lower monthly payments. But it will also result in a dramatic increase in the total you repay, because of the interest that is charged. The smart move is to choose the repayment plan with the highest monthly payment you can afford.

To compare the specific cost of your loan repayment, go to www.FinAid.org and use their calculators. (In fact, since we are starting this chapter with the burden of loans, you certainly want to use these calculators *before* you decide to take on the loans.)

Your best move is to sign up for an automatic monthly transfer for your payments from your checking or money market deposit account. If you sign up for automatic payments, most lenders will give you a 0.25 percentage point reduction in the loan interest rate.

A *graduated repayment* plan is designed for those who expect their earnings to rise over the next 10 years. You can start with a lower payment and then every two years the payment will increase, reflecting your expected increase in earnings.

The government has also created a series of *income-driven repayment plans*, which are available for federal student loans. Your monthly payment is capped and recalculated each year based on your income (plus a spouse's income if married) and the size of your family.

Most borrowers will have a monthly payment under income-based repayment that is less than 10 percent of gross income. If you have made payments under one of these plans for 25 years and have not fully repaid your loan, the balance will be canceled. To learn more go to www.IBRInfo.org.

There is also a relatively new Public Service Loan Forgiveness Program that will forgive the remaining balance of federal student loans after 10 years of full-time public service employment. This program has attracted a lot of attention for obvious reasons, including the fact that the ultimate forgiveness is tax-free. But the details are so complex that many borrowers who are working in public service jobs never actually qualify for the forgiveness.

The rules to qualify seem simple:

- Your loans must be federal direct loans.
- Your employer must be a government organization at any level, a 501(c)(3) not-for-profit organization or some other type of not-for-profit organization that provides a public service.
- By the end, you need to have made 120 qualifying, on-time payments in an income-driven repayment plan or the standard repayment plan.

You can be making those payments through income-based repayment plans or the pay-as-you-earn plan, among others. Still, more than a decade after the program started, the Department of Education admitted it had forgiven only 206 loans, out of the more than 41,000 people who applied. You can find the detailed rules for public service loan forgiveness at www.StudentAid.ed.gov, but don't count on this being the easy way out.

There are other income-sensitive and income-contingent repayment options offered for federal loans under the U.S. Department of Education. In fact, you almost need a graduate degree to understand and compare all the alternatives! For more information on these programs, as well as current interest rates and calculators, go to www.StudentAid.ed.gov.

Federal student loans can be *deferred*—temporarily postponing payments. During a deferment, interest does not accrue on most subsidized student loans. But interest will accrue on unsubsidized loans, such as unsubsidized Federal Stafford loans and Federal PLUS loans.

Forbearance is a sort of last-resort option if you do not have a job, or are on medical or maternity leave. Instead of simply defaulting

on your federal student loans (and starting a chain of consequences that destroys your credit), you can ask for forbearance. While in forbearance, your loans continue to accrue interest, which gets added to your loan balance. You can extend the forbearance period after one year but you are only creating a mountain of interest added to your debt.

Private student loans also offer forbearances, but they are usually limited to a year in total duration, unlike the three-year limit for federal student loans.

It's particularly important to be aware of all these options before you are enticed to consolidate your federal student loans in search of a lower interest rate. If you consolidate with a private lender, you may lose many of these benefits that could get you through a rough patch in your career down the road.

Student Loan Consolidation

Repaying student loans might be a lot simpler if you had only one monthly bill to pay, especially if your loans are with different servicers. That's the thought behind student loan consolidation. It can allow you to extend your repayment term to as long as 30 years, lowering your monthly payment. And you can consolidate federal student loans into a Federal Direct Consolidation loan, with no fees. But, by now you realize that extending the time period really increases the debt burden because of interest costs.

There are other drawbacks to consolidation. The outstanding interest becomes part of the principal of the new loan, thus raising the balance on which interest is charged. Consolidation may disqualify you from other benefits, requiring you to start over on a public service loan forgiveness program. Also, consolidation will prevent you from targeting the loan with the highest interest rate for quicker repayment.

Since you don't have to consolidate all your loans, choose carefully regarding those with special benefits. Once your loans are combined into a Direct Consolidation loan, they are considered paid off and no longer exist.

Student Loan Refinancing

The latest trend in dealing with student loans is to refinance them at a lower interest rate. Many private companies have sprung up to

provide this service, assuming that you have a good income and good credit. A refinanced student loan loses all privileges for adjusting payments in case of future financial woes. But saving several percent in interest is certainly an attraction.

Most private lenders like Sallie Mae, Wells Fargo, and Discover, to name some of the largest private lenders, have little incentive to refinance your student loans to a lower rate. After all, they know that ultimately you can't default. But recently, alternative refinancing sources have grown quickly, Companies including SoFi.com, CollegeAve.com, and Earnest.com (the latter is owned by Navient) each specialize in refinancing both federal and private student loans.

The Savage Truth on Getting Money for College

Now that you've had a closer look at the potential lifetime impact of student loans, it's time to take a closer look at what college costs—and how to pay for it.

There are only a few ways to find the money for college. It can come from parental savings or borrowings; it can come from various types of student loans; or it can come as "free money" in the form of scholarships and grants. Plus, of course, some of the costs can be covered by the student's own summer job savings.

Still, paying for college is not easy for most families. Over the past 10 years, the average price for tuition and fees at four-year private colleges and universities has jumped to more than $40,000. And that's just the average. Many prestigious private schools charge $75,000 a year when factoring in tuition, room and board, books, and fees,

College costs have far outstripped inflation, and increased eight times as fast as wages since 1989. Clearly, the education has not become that much better or more valuable over the years. The colleges and universities are run as a business. Many of these schools have huge endowments, relatively little of which is spent on underwriting student expenses. They also have rising costs for upkeep of their facilities. And yet schools continue to compete to offer more of everything.

Unfortunately, the students and their families bear the brunt of this lopsided business model. Meanwhile, the federal government subsidizes the situation by offering student loans to partially cover the gap between what families can afford and the rising cost of college. Unfortunately, the schools do not suffer any losses when the

education they provide does not lead to employment that can generate income to repay those loans.

It's up to parents to set realistic expectations about what they can afford for each of their children, and about the true costs of debt. This is a process that should start as a child enters high school, not when it comes time to apply for college. That gives the entire family the opportunity to make sensible decisions.

Here are a few basic Savage Truths about paying for college:

- Parents should borrow no more for all their children's education than their annual income. But if retirement is less than 10 years away, they should only borrow half as much as their income.
- Definitely do not take money out of your retirement savings. (Very few college grads will support their parents in their old age, and you don't want to be that burdensome elder.)
- Consider the alternatives. There are other ways to help, including having your student attend a nearby college and live at home for a couple of years. An in-state public college costs a quarter to a third the cost of a private college.
- Students need to understand the ultimate burden of loan repayment *before* signing for a loan. This chapter lists websites that help you calculate the total costs over 10 or 20 years of loan repayments—with interest. Being realistic about *total* costs will impact your choice of schools.
- Recognize that some more expensive schools may offer larger financial aid packages—if they really want your child as a student. So, it's not wrong to apply to a prestige school. Just be sure you also apply to a financial-aid safety school. This is a college you can afford to attend even if you get no financial aid. This may mean attending a local, community college—for at least the first two years.
- There is some free money, but not as much as you hope. Yes, scholarships are worth checking out at the websites described later, but they typically make a relatively small contribution to overall college costs.

I make these points first not to burst your bubble, but as a reality check. Your high school guidance counselor can be more specific about the financial aid that may be available to your family. But

always keep in mind that while the borrowing number may sound huge, the repayment amount will be far greater when you add in the costs of interest.

One of the worst moments in a parent's life is telling your child that even though he or she was accepted at that dream school, they can't afford to pay for it. Planning in advance is essential to turn college dreams into reality.

FAFSA First

The road to most financial aid, loans, and grants starts with the Free Application for Federal Student Aid or FAFSA. This is the basis for almost every financial aid decision based on need. The information you file on the FAFSA form is used to determine the *expected family contribution* (EFC), no matter which school you attend. Then each school will create an aid package based on the EFC.

The process of filling out the FAFSA form is more intrusive than even your IRS tax return. It asks not only about income of the parent and student, but also about the totality of their financial assets. Thus, although the FAFSA form is first filled out in the student's senior year of high school (and again in every year for which aid is requested), there are important steps to take in the student's junior year—a year in advance of filling out FAFSA—to potentially make the family eligible for the most financial aid.

You can access the FAFSA forms at FAFSA.ed.gov, or you can download the MyStudentAid app to your smart phone. The form can only be filled out on or after October 1st of the student's senior year. But you can start creating your account and gathering basic information in advance.

Start by setting up your account and creating a password. This process will create your FSA ID. Parents and children must create separate passwords, helpful for parents who want to keep income information private and out of view of either the student or a divorced spouse. You'll need Social Security numbers, birth dates, driver's license numbers, plus the previous year's tax returns and W-2 forms to fill out the forms completely. That tax information can be automatically filled out by a direct link to the IRS called the IRS Data Retrieval Tool. (It's all the same government!) Be sure to save the information every time you use the website or app.

The earlier you file, the sooner you get your *student aid report* (SAR), the form that lets you know how much aid you might be

eligible to receive, as well as your EFC. This report helps schools put together a total financial aid package for you.

You might also be asked to complete the CSS Profile, required by some schools. And individual institutions may have their own financial aid forms. Consult with your high school guidance officer to see which forms will be required by the schools you are considering.

Filing FAFSA is free. If you devote a bit of time and planning to the process, instead of rushing to get the information in January, you'll be ahead of the game. Many state colleges and universities have earlier deadlines for awarding aid, so make sure you meet their deadlines. A dozen states give out their grants on a first-come, first-served basis until the money runs out. And if you are applying to a state school as a "safety," list that school first on your list of schools that will receive information about your need for financial aid.

Many families simply give up on the process, figuring they earn too much to qualify for aid. But even if you aren't going to apply for student loans, there are other programs, including school-sponsored scholarships, that might require FAFSA information. It's best to slog through the process even if you doubt you'll get anything other than federal student loans.

Subtle changes can have a big impact on eligibility for need-based financial aid. For example, increasing the number of children in college at the same time can lead to much more financial aid.

Children of divorced (or separated) parents may have an especially difficult time gathering the information required for FAFSA. Only one parent's information is required on the FAFSA. This is the parent with whom the student has lived the most during the 12 months ending on the FAFSA filing date. If this parent has remarried, the step-parent must provide his or her financial information, even if the step-parent has no financial responsibility for the student! This is a delicate situation, but the information must be provided if you hope for financial aid. (The CSS Profile form requires information from both parents and also the step-parents.)

Even worse, the FAFSA must be filed again every year in which you apply for financial aid.

The EFC

A strict federal formula isused to review all your information to decide your EFC—the amount of the family's income and assets that

must be put toward college costs for that year. The number they calculate your family should pay may be shockingly high. Below are some ways to make sure you benefit from opportunities to structure your family finances before filing FAFSA.

Each school you listed on the FAFSA will receive this information about your EFC. That shouldn't stop you from applying to some expensive schools if you meet their admission standards. Prestigious private schools recognize that students need more aid, and if they want you to attend they will create a financial aid package to narrow the gap between EFC and the cost of attendance. In fact, any remaining gap might be narrower than the aid package offered by your state school.

Lowering your EFC

The following information is designed to get you the maximum financial aid package for which you might qualify. It is *not* cheating the system or finding a "side door." You take all appropriate deductions on your annual tax return. And you might as well do the same in preparing to file the FAFSA. And, remember, it's not just income that determines aid; the evaluation of the family's assets plays an important role in the formula.

For purposes of the FAFSA, the EFC calculation excludes the value of the family's primary residence (or family farm), as well as any small business (less than 100 employees) owned and controlled by the family. IRAs 401(k)s, pensions, annuities, and other retirement plans are not included in the calculation. And the cash value of life insurance is also excluded. As well, personal assets such as jewelry and furnishings are not included.

But other assets, such as bank accounts, brokerage accounts, second homes, cars, and investment real estate are part of the calculations. Money in 529 college savings plans, prepaid tuition plans, and Coverdell education savings accounts owned by a parent must be reported as a parent asset on the FAFSA, even if the beneficiary is a sibling.

There is an *asset protection allowance* that protects some assets from being counted for middle-income families, but it has decreased significantly in recent years.

Now, here's the tricky part. Assets held in the student's name, including custodial or Uniform Gifts to Minors Act/Uniform Transfer to Minors Act (UGMA/UTMA) accounts, weigh far more heavily against you in the aid formula. They are assessed at 20 percent, versus 5.64 percent for parental assets.

Savage Truth: If you're planning to apply for financial aid for college, never put assets in an UGMA or UTMA account.

Not only do those assets count heavily against you in the aid formula, but at the age of majority (21 in most states, but 18 in some) those assets become the property of the child. You may have been thinking Princeton; she may be thinking Porsche!

Similarly, if a child earns more than $6,660, the excess will heavily impact the financial aid formula. Additional income is assessed at a rate of 50 percent. The way the amount is calculated, including some student assets, an extra dollar of income above that limit could cost 70 cents in financial aid.

You'll notice that 529 accounts are considered part of financial assets in the aid formula. But what if the grandparents open a 529 account for your children? As you'll see below, 529 accounts are not only a great way to save tax-free for college expenses, but an interesting estate tax strategy. Annual gifts to a 529 plan will exclude money from a potentially taxable estate. These accounts, if held in the grandparents' name for the benefit of the child, are excluded from the family EFC calculations.

But—and this is the big but—for grandparent-owned 529 plans, the year in which they are distributed to pay for college, the money is considered income to the child. (Distributions from a parent-owned plan, are ignored.) And you've just seen what a major impact that can have on financial aid.

The best way to deal with this situation is to save the money in a grandparent-owned 529 for the last two years of college, and then use it to pay the bills. Presumably, the family will not file FAFSA (unless the child is going to grad school) the following years.

However, don't think the grandparents' 529 account can be tapped to repay student loans after graduation. That is not allowed under the current rules of tax-free withdrawals for education, although there is some indication that rule might be changed.

These are the basic rules of preparing—a year in advance—for filing FAFSA to get the lowest possible number for your EFC. Details can change. Most college counselors don't have the time to advise you on these issues, so I highly recommend the latest annual edition of the Princeton Review book called *Paying for College*, by Kalman Chany. It will answer almost every question you might have about the issues in this chapter.

When the FAFSA is completed, the analysis and EFC number will be sent to every school you listed. Then it's time for the college financial aid office to create its offer.

The Financial Aid Package

The acceptance letter arrives. The next day or so, the financial aid package offer arrives. Euphoria can quickly turn to despair. There's likely to be a gap—and it might make college unaffordable. Colleges call that *unmet need*. They acknowledge that gap, and hope you—the parent—will take on some loans to make up the difference.

But first take a close look at the aid package. It will consist of three parts.

- Student Loans. These are federal loans taken out by the student, regardless of credit qualifications. If you are offered *subsidized* loans, no interest accrues while you are in college, and no repayment is required until you graduate or leave school.
- Grants and Scholarships. This is free money—and does not have to be repaid. It is distributed by the financial aid office. (You may also qualify for other, private scholarships, as you'll see below.)
- Work–Study Programs. These programs provide part-time jobs to help defray either tuition or living expenses. For example, you could be a dorm monitor or server in a dining hall and qualify for free board, or food.

One of the most important things you need to know about this aid package offer is that it is only for the first year of college. Most aid packages are renewed, although some schools do set performance standards. The mix of aid types may change in subsequent years, with less grants and scholarships and more loans. You will still have to fill out the FAFSA for every academic year.

The money you receive will be disbursed by the school at least twice during the academic years. This requires careful budgeting so that you don't spend an entire semester's living allowance in the first two months. About half of college students run out of money in the middle of the year. You will receive entrance counseling about this issue.

Financial Aid Packages: Asking for More

There is a temptation to protest, to plea for more money. That rarely happens unless you can demonstrate a change in your family's circumstances since the FAFSA was filed. Certainly, the death of one parent, and resulting loss of income, would be reason for change.

Otherwise, there are few circumstances in which a school will increase its initial offer. If you want to know specifically how that

might happen, please read *How To Appeal for More College Financial Aid*, by student loan guru Mark Kantrowitz. It explains the appeals process and gives you actionable tips for adjusting your individual situation to possibly qualify for more aid.

The Savage Truth on Student Loans

The federal student loan program is called the William D. Ford Federal Direct Loan (Direct Loan) Program. Under this program, the U.S. Department of Education is your lender, and the money is disbursed (paid out) at least twice yearly.

Loans made under this program are subject to annual limits—and aggregate limits over the course of your education. The amount you can borrow depends on your year in college (freshman, sophomore, etc.), and the amount of subsidized loans (where interest does not accrue) is limited to a portion of the total.

Current loan limitations, for example, for a dependent, first-year undergrad are $5,500, of which no more than $3,500 can be in subsidized loans. That limit rises by $1,000 in the second year. Third- and fourth-year undergrads can borrow $7,500 per year, with no more than $5,500 in subsidized loans.

Given the annual loan limitations, it is unlikely that this could be your *only* source of aid to pay for college. But federal student loans are typically the base of the aid package. And over four years, your debt can mount up.

There are two types of Direct Loans available directly to students:

- Direct subsidized loans are made to undergraduates, based on need (as determined by FAFSA). No interest accrues while the student is in school at least half-time. These loans are also known as Stafford loans or Direct Stafford loans.
- Direct unsubsidized loans are available to both undergrad and graduate students, regardless of financial need. Interest begins accruing immediately after the loan is disbursed but can be deferred until six months after the student graduates or drops below half-time enrollment. These are also known as Stafford loans.

The interest rates on new loans change each award year, which runs from July 1 to the following June 30. Each loan has a fixed interest rate for the life of the loan.

Despite the fact that these loans are given out by the government, they carry rates substantially above government borrowing rates. For example, undergraduate student loan rates were hovering around 5 percent, at a time when the government could borrow by selling 10-year Treasury bonds yielding only about 2.3 percent. Since risk is limited because borrowers cannot default on a federal student loan, it's difficult to justify those comparatively high student loan interest rates.

Understanding Parent PLUS Loans

While it's expected that parents will have amassed some savings for college costs, the government also offers loans directly to parents, at rates that are even higher than student loan rates. For example, when student loan rates were 5.05 percent, the rate on Parent PLUS loans was 7.6 percent. Needless to say, they are not a bargain. But since you can no longer deduct interest on a home equity loan if the proceeds are used to pay for college, this may be the best opportunity to fill the needs gap.

You must have filed the FAFSA before applying for a Parent PLUS loan. And they do require a credit check. These loans are not subsidized, which means interest starts accruing from the time the loan is disbursed through the college or university. Most schools require you to apply for a Direct PLUS Loan online at StudentLoans.gov. You'll be required to sign a promissory note, agreeing to the terms of the loan.

Grad students can also qualify for a separate version called Grad PLUS loans.

Private Student Loans

If you don't have enough money to fill the gap between the financial aid package offered by your school and the actual cost of attendance, many families turn to private student loans. These loans are made by private lenders and their terms are not standardized. To get the best deal you'll have to compare multiple options for repayment length, repayment type, and interest rates.

Some offer better repayment terms, allowing you to increase payments as your income rises or pay interest-only while you are in school. Others have either fixed or variable rates. Most require a co-signer. It's a complex series of choices for a burden that will be with you for many years.

Some of the major private lenders include Sallie Mae, Discover, and College Ave. Also ask your local bank or banks that specialize in offering student loan deals, like Citizens Bank. Or you can search at comparison sites like Credible. LendingTree sponsors the www.SimpleTuition.com website. Your first stop should be www.PrivateStudentLoan.guru, where you can find a comprehensive listing of lenders, not just those who have paid to be on a comparison site.

Student lending is a big business. It's relatively easy to find the money and relatively hard to pay it back. Once again, even though these private student loans are not issued by the government, there is an extremely slim chance that you can deal with them through bankruptcy if you don't earn enough to repay them on schedule.

The Savage Truth on Finding Free Money

The best money you can use for college is money that doesn't have to be repaid. But the time to start planning to access that money is when the student is a sophomore in high school. That's when you still have time to build the credentials to qualify for many scholarships.

Of course, athletic scholarships are the real hope of many families. NCAA Divisions I and II schools provide more than $2.9 billion in athletics scholarships annually to more than 150,000 student-athletes. Division III schools do not offer athletics scholarships. And thanks to Title IX, which prohibits sex discrimination in educational programs or activities at schools and colleges that receive federal funds, there is money available for women as well as men. Dream on.

Another source of free money is federal Pell grants, a program for truly needy college students. Given out in amounts that range up to slightly over $6,000 a year, this money does not have to be repaid. Getting a Pell Grant requires filing the FAFSA every year.

Private scholarships cover significant part of college costs each year. An estimated $46 billion in grants and scholarship money is awarded each year by the nation's colleges and universities, as well as through federal grant programs. An additional $6 billion is awarded by private scholarship providers, such as foundations, corporations, philanthropists, and associations. But it's likely that a large amount of potential scholarship money is unused each year, simply because people do not know where to search or apply, or because they wait too long to apply.

It's natural to start by searching for free money in the form of merit scholarships and grants. But you don't have to pay fees or attend costly seminars to get access to all the information available on these subjects. Still, every year desperate families fall for sales pitches promising access to financial aid. It's all online—and free.

There are several free websites that allow you to search among thousands of scholarships based on your interests, accomplishments, family history, and dozens of other surprising qualifiers. At either Fastweb.com or Scholarships.com you fill out a profile to determine a potential match among many thousands of scholarships available. There is an excellent scholarship search service at CollegeBoard.com.

It's important to fill out all the details in the profile, because things like the parents' place of employment, membership in religious or fraternal organizations, and community groups all may offer small grants. And those can add up.

The sites are free because they are underwritten by companies that want access to market goods and services to high school and college students. Don't procrastinate because many scholarship and grant applications have early deadlines. Typically, scholarship money is handed out on a first-come, first-served basis each year. Some have deadlines in the fall. Others are available to children in younger grades.

If you start browsing these scholarship matching sites when your child enters high school, you'll notice that many require a couple of years of community service, or an essay on some special topic. There's no reason your child can't write that essay in his or her sophomore year, getting practice. Your child might win an award that can be used later for college. Just check out the details of each offering.

Best Ways to Save for College

Wouldn't it be nice to avoid all the issues around qualifying for financial aid and repaying student loans? The best way to do that is to have generous grandparents, or embark early on a lifetime savings program to accumulate the money for future college costs.

That's a difficult task in an economy where wages lag and other expenses rise. But if you can create an automatic deduction for college savings, the process is much easier than deciding whether you can afford to save.

At the start of this section, let me give you an important reminder:

Savage Truth: Avoid saving for college in the child's name.

As noted earlier, there are two good reasons to avoid using custodial accounts or UGMA and/or UTMA accounts.

First, when the child reaches the age of majority (which is age 18 in many states), the money belongs to him or her. The second reason is equally hazardous. Money titled in a child's name, even in a custodial account, weighs much more heavily against the family in the FAFSA financial aid calculation, as explained above.

So if you already have money in this type of account, spend it wisely for the child's benefit (perhaps a new computer) well before you file the financial aid application. Or you can invest it in a custodial 529 college savings plan account, which is reported as a parent asset on the FAFSA instead of as a student asset. (More on 529 plans below.)

That said, here are a few of the best ways to save and invest for college—and advice on how much you should be saving to make a real dent in future college costs.

The Best Education Deal: 529 College Savings Plans

By far, the most efficient and effective way to save for college is through a *529 college savings plan*, named for the Internal Revenue Code section that created these programs. Very simply, they are a way to save for college that allows all the gains on money invested to be withdrawn free of taxes to pay for college expenses, including tuition, room and board, books, and fees. (In recent years, the law was amended so that money can also be withdrawn for elementary and secondary tuition.)

The initial law was written so that each state could set up its own plan, with various financial advisors providing money management for funds invested within the state's plan. Some states even offer a break on state taxes for residents who make contributions to the state plan.

That said, you can invest in *any* state's plan and use the money for *any* college in *any* state. And the money in the plan can be allocated to any family member for college expenses, so if one child doesn't attend college or receives a scholarship, another can use the account.

And be sure to tell the grandparents and family friends about this great way to recognize birthdays and holidays. Give them a deposit coupon, or ask them to make a check payable to your 529 plan. Or go to www.GiftofCollege.com to learn about gift certificates that you can purchase at major retailers. The money on the cards can be deposited to a 529 plan. Clothing and toys are outgrown and worn out in a short time. But a tax-free college savings plan will create its own long-term rewards.

When it comes time to withdraw distributions from a 529 plan owned by parents, the money receives favorable treatment in the college financial aid formula. A tax-free distribution from a 529 plan to pay this year's college expenses will not be part of the *base-year income* that reduces a subsequent year's financial aid eligibility.

Most plans allow you to start with a very small amount of money; in some cases as little as $25 will open an account. You can then set up an automatic program to make regular additional contributions directly from your checking or savings account or through a payroll deduction plan offered at many companies. As well, relatives and friends can add contributions to this college account at any time.

These plans are an excellent estate planning tool for grandparents. Without going to the expense of setting up a separate trust, grandparents can contribute large sums (up to five years of the annual allowable gift tax exclusion at one time). So, if the annual gift tax exclusion is $15,000, then Grandma can give $75,000 to little Susie's 529 plan, and Grandpa could give an additional $75,000. And they could do this for each grandchild. It is quite a transfer of wealth—and an opportunity for all this money to grow tax-free for education. It is a great way for grandparents to leave a legacy for their grandchildren—even if they can't afford the maximum contribution.

Of course, there's always the possibility that the grandparents might need this money in their old age. They can get it back. They simply have to pay taxes on all the gains and a 10 tax percent penalty to take the money back. (It's good insurance that the grandkids will be appropriately loving!)

Best of all, as noted above, when grandparents make this gift to a grandparent-owned 529 plan, the asset is not included in the FAFSA disclosure of the parents. But later payouts will be treated as income to the student, so should be deferred until the last year of school when no more FAFSAs must be filed. Or perhaps you'll accumulate enough money in the 529 plan that you won't even worry about financial aid.

Most states give you a choice of investments within the plan, but these are not trading accounts. Changes between investment options are restricted to twice a year. Or the plan will offer age-based options with the manager typically moving the assets to more conservative choices as the child gets closer to college age.

To find out more about the 529 plan offered by your state, go to www.SavingforCollege.com, where you can find plan details, and compare ratings, which are based on performance and management fees and costs. Every quarater they post their star ratings of the best-performing plans, considering costs and investment options. Or check the 529 plan ratings at www.Morningstar.com.

Or you can go directly to a low-cost provider such as Vanguard, TIAA, or Fidelity to sign up for one of the plans they manage. Remember, you can invest in any state's plan and use the money for any college in any state for any relative.

One other note: Most states have two variations of their 529 plan—one sold directly through the state's plan website and the other sold through financial advisors. The latter plans may have higher internal costs or initial fees to compensate the advisor for time spent explaining the investment. They also have higher annual expense ratios than the direct-sold plans.

You can easily avoid those costs by opening your 529 plan on your own. The 529 college savings plans are the easiest and best way to save for college, whether you're starting with a small amount of money or a large contribution.

State Prepaid Tuition Programs

I have always been cautious about these prepaid tuition plans because they are basically an unsecured promise from a state government. Depending on your state of residence—and its fiscal situation—you might want to be a bit skeptical.

Prepaid tuition plans are actually another form of 529 college savings plan. Offered by about a dozen states, you are paying for college tomorrow at today's prices. Since tuition has historically risen at a faster pace than consumer prices, these plans have become very attractive.

Prepaid tuition plans do not carry the investment risk of the 529 investment plans described earlier. But they do have some limitations. First, the money must be used for a public or private college in the state where you invest. Some states will allow a refund of what

you paid in, but without interest, if your child does not use the plan, or a transfer to pay tuition at another school. But there is no guarantee that the guaranteed one-semester purchase at your state school will be enough to pay tuition at an out-of-state college.

Second, as noted above, these programs are underwritten by the state, and you are dependent on the state to pay off. In these days of troubled state finances, it is possible that the state might renege on part or all of its promise, or that the schools in your state might not be the best choice for your child because of funding cutbacks.

The cost of these plans depends on your child's age when you purchase these tuition credits. Many states add on additional fees, called *tuition differential* fees, to hedge their bets, so the cost of these plans might not be such a bargain. In effect, you are paying a premium on top of today's tuition. Go to www.SavingforCollege.com to check out their analysis and rating of your state's prepaid tuition plan.

Don't Overlook These College Savings Techniques

If you have young children, start saving as much as you can right now so your money will have time to grow and work for you. But even if you're starting late, tax credits and state savings plans can help build a college fund for your children. Grandparents can easily contribute to these savings plans. And programs such as www.UPromise.com can leverage your everyday spending to add to college savings.

Along those same lines, the U-Nest app is an intuitive and easy-to-use mobile app that establishes and manages a tax-free 529 college fund for your child by securely linking to your bank account to automatically transfer money each month into your child's plan. But there is a $3 monthly fee. Instead you could be using the "Enroll Now" tab at SavingforCollege.com without paying a fee.

The College Savings Bank (www.CollegeSavingsBank.com) is one of several federally insured financial institutions offering variable-rate certificates of deposit (CDs). At the College Savings Bank, they are called CollegeSure CDs. These are FDIC-insured bank certificates of deposit, with the variable rate indexed to college costs and designed to meet the future cost of college. They can be purchased inside a 529 plan offered at the bank website, so they offer the same tax-free growth for education opportunities as your state's plan.

Each of these CDs can also be purchased inside an IRA or a Coverdell Education Savings Account (ESA). Signing up is easy at www.CollegeSavingsBank.com.

Coverdell ESAs are another way to save for educational expenses; however, they are limited in the amount you can contribute to a maximum of $2,000 per year. There are income limits for those who want to contribute. Contributions end when the beneficiary reaches age 18. And, the money must be used by the time the beneficiary reaches age 30. Coverdell savings can be used for a wider range of K-12 education-related expenses than a 529 plan. A Coverdell ESA can be rolled over into a 529 plan.

Although I no longer recommend Series EE or Series I savings bonds as an investment because of the change to fixed rates, they do offer an interesting feature for college savings. Many parents purchased EE bonds for just this purpose and should be aware that they do still carry a special benefit. For middle-income families, savings bonds purchased after 1989 *owned by the parents* and cashed in the same year the money is used for college tuition and fees (but not room and board) are completely free from federal taxes.

This benefit is not great enough for me to recommend current purchase of EE bonds, with their low fixed rates. However, if you are a parent holding bonds purchased since 1989 when this provision was enacted, you might want to take advantage of the tax break if you qualify. For more information, including current income level restrictions, go to www.TreasuryDirect.gov.

The tax-free interest benefit of education savings bonds has an income phaseout. If you expect to have income above this threshold, you might want to roll over the savings bonds into a 529 plan before your income exceeds the threshold. 529 plans do not have income phaseouts.

Tax Deductions for Tuition and Interest

A portion of the interest you pay on your federal and private student loans may also be deductible. The student loan interest deduction is an "above the line" deduction that you can claim without itemizing. It's taken in the adjusted gross income (AGI) section of Form 1040. This means that you can take it in addition to itemizing other deductions, or you can take it if you choose to use the standard deduction rather than itemize.

You can deduct interest on student loans paid by you, or by your spouse if you file a joint return. You can't claim the student loan interest deduction if you are married, but file a separate return. And you can't claim this deduction if you can be claimed as a dependent on anyone else's tax return.

Your lender will send you Form 1098-E, showing the amount of interest you paid for the year. The maximum deduction for student loan interest is $2,500 in 2019. And this deduction is also limited by your income.

The *lifetime learning tax credit* (LLTC) is for qualified tuition and related expenses paid for eligible students enrolled in an eligible educational institution. This credit can help pay for undergraduate, graduate and professional degree courses—including courses to acquire or improve job skills—as well as continuing education courses. There is no limit on the number of years you can claim the credit. It is worth up to $2,000 per tax return.

The *American opportunity tax credit* (AOTC) is a credit for qualified education expenses paid for an eligible student for the first four years of higher education. You can get a maximum annual credit of $2,500 per year eligible student for up to four years. If the credit brings the amount of tax you owe to zero, you can have 40 percent of any remaining amount of the credit (up to $1,000) refunded to you.

Consult your tax advisor, because you cannot take two of these credits in any one year, and there are other limitations on their use. Generally, though, the AOTC is better than the LLTC, if you are eligible, since it provides a greater financial benefit and the income phaseout is higher.

A Savage Truth Reminder: Time Is Money

You signed on to your student loans because you believed your education would have continuing value and increase your earning power over your lifetime. And despite recessions and job challenges, you will have a better future with an education. Still, the sooner you can pay off your student loans, the better. As rates dropped, many student loans that once looked attractive failed to adjust interest rates downward. As a result, your student loans may become relatively expensive and not look like such a bargain.

None of the repayment plans prohibits additional payments. So if you do have a job and get a bonus or a raise, consider adding to your payments to pay down the loan faster and with less interest expense.

In the end, college will be worth it only if you make good use of your time *and* the money you borrow.

GETTING STARTED

FOR PARENTS OF YOUNG CHILDREN:

Go to www.SavingforCollege.com and check out your state's 529 college savings plan. Then open an account even with a small amount of money and ask relatives and grandparents to add to it. Read the in-depth articles for details on every aspect of saving for college, taking out loans, and loan repayment.

FOR PARENTS OF HIGH SCHOOLERS:

Go to www.FAFSA.ed.gov to learn about federal financial aid and start the online application process. Do this before the student's senior year so you can rearrange your finances to qualify for the most aid possible.

FOR RECENT GRADS:

Go to the National Student Loan Data System at StudentAid.ed.gov to find the loan amounts, lender(s), and repayment status for all of your federal loans. Then get started on a repayment plan within six months of graduation.

BEST RESOURCES:

- SavingforCollege.com
- StudentAid.ed.gov
- FinAid.org

TERRY'S TO-DO LIST

1. Don't be intimidated by the high cost of college.
2. Start saving as early as possible, using 529 college savings plans.
3. Avoid putting money in custodial accounts if you're going to apply for financial aid.
4. Study the aid process early so you can adjust family income to qualify for the most aid.
5. Check Scholarships.com or Fastweb.com for "free money," but start in your junior year or earlier.
6. Use student loans knowledgeably and repay them on schedule.

CHAPTER 13

THE SAVAGE TRUTH ON GETTING TO—AND THROUGH—RETIREMENT

Time to Withdraw

The time to start thinking about retirement planning is well *before* retirement, when you have time on your side and the flexibility to adjust your investments, your lifestyle, and your expectations to meet the reality of living longer. Every day for the next 20 years, 10,000 Americans a day will turn 65. As the 76 million members of the baby boom generation face this new stage of life, they have created a new definition of retirement—one that is likely to include the need for continuing employment, even on a part-time or entrepreneurial basis. It's the start of a trend that will be passed on to younger generations.

Today's retirees will live much longer than their parents and grandparents, who could sensibly retire at age 65 and expect to live for only a few years. Now, at least one member of a 65-year-old couple can expect to live for another 23 years, to age 88. And there is a 30 percent chance that one of them will reach at least age 92, according to Social Security. At their website, www.SSA.gov or www.SocialSecurity.gov, you can access their life expectancy calculator.

The reality of longer lives has a huge impact on retirement planning. On the plus side, it gives us more years to work and save up for retirement. And with new hips, knees, and heart valves, not to mention other medical advances, many seniors are capable of and

challenged by the idea of continuing to work. Thirty years on a golf course or at the beach could get very boring.

On the minus side, that longevity not only stretches out your need for income, but also exposes you to the potential ravages of inflation or stock market volatility. If you retired at age 65, and had only a four-year life expectancy (as was the case in the 1950s), then you'd divide your money into four parts, and probably spend a bit more than a quarter of your savings in the first year—just in case! But as life expectancy increases, more uncertainty is created.

As noted earlier, time is on your side if you start early. Even though you're still raising a family, paying off student loans, or saving for college for your children, it's never too early to consider the issues you will face in retirement. And smart retirement planning doesn't end with the official date of retirement. In fact, that's when you'll face an entirely new set of challenges.

In the next chapter, I'll explain why it doesn't make sense to count on Social Security for your retirement security. The numbers don't add up. And there must be changes in order for Millennials and Gen X and Y to see any real benefits from this historic program. But, since you can't opt out, it's important to try to match the money taken out of your paycheck for Social Security with a significant amount of private savings. Yes, I'm repeating myself with this admonition, but I think it can't be said enough times.

In my earlier book, *The New Savage Number: How Much Money Do You* Really *Need to Retire?*, I started the conversation about this question. No matter what your age, you likely have this same question on your mind: How much will be enough? And, once you get to retirement, there is another overwhelming question. How do I manage that money so it lasts my lifetime, with maybe a little left over to give to my children? This chapter explains how to find rational answers to those questions.

The Savage Truth: How Much Money Will I Need?

This is the most important question and the easiest one to answer. It's not a matter of guesswork or hopeful assumptions. Instead, the answer to that question requires a calculation that takes many variables into account. Most financial firms offer online calculators for retirement planning. My favorite is one that will calculate the

answer to that "how much" question in seconds if you're willing to input some current information and make some assumptions.

Go to www.ChooseToSave.org, the website of the national nonprofit Employee Benefit Research Institute (EBRI). When you get there, search under "calculators" for one that says "Ballpark Estimate." That will take you to their interactive calculator, and all you have to do is fill in the blanks.

Some are easy. You'll be asked to fill in your age, salary, current savings, and planned retirement age. Then, you'll need a little more thinking. They're going to ask how much of your current income you'll need to replace in retirement. You may not need 100 percent of your income, because you won't have commuting expenses, dry cleaning charges, or other workplace needs. However, you *will* likely have higher medical expenses, and you do want money to travel or pursue your hobbies. Start with a replacement figure of at least 80 percent of your current salary.

Then the calculator gets a little tougher, which is why you can try it with several sets of numbers. You'll be asked to make assumptions about your wage growth, about inflation, and about investment returns. But the most important question is a simple one: How long do you expect to live?

I can give you a little help with that estimate. Just go to www.LivingTo100.com, and take their online quiz. You'll be asked about your parents' and siblings' longevity and about your eating and exercise habits. You'll even be asked if you floss your teeth daily! (It seems gum infections can go to your heart and contribute to your mortality.) When you've filled in the blanks, one click will give you the computer's estimate of your life expectancy. This is far more personal than abstract Social Security statistics.

Your predicted lifetime "expiration date" is likely to be shocking—either way. (When the computer reported I'd likely live to 104, I decided to go back and be more honest about my exercise and eating habits!) Still, you might be surprised to find that you'll live well into your nineties. And that can have a huge impact on your retirement planning.

The current life expectancy for an American is 78.6 years—59 percent longer than in 1900, when the average life expectancy was 49 years. Males born today have a life expectancy of 76 years; women are likely to live to 81. Those are just averages, however, and there is a 30 percent chance of living past 92. Plus, don't we all want to be above average?

Is this good news, or bad? That depends on your planning. So go back to the "Ballpark Estimate" and fill in this number—your life expectancy. Now, after filling in a few more blanks, you're ready to click and calculate. The program will instantly tell you how much more you should be saving to reach your retirement income goals. Or how much your lifestyle will be reduced in retirement if you don't adjust your savings. That's how to find your number.

This number—the Savage Number—is a wake-up call, no matter what your age. Of course, if you're younger, you have more time to make adjustments. And if you're older, you might postpone full retirement, planning to work part-time or become a consultant, or taking up another income-producing lifestyle based on a hobby or talent. If you can continue to work and delay retirement withdrawals until they are required, you gain a significant edge in making your savings last.

Clearly, it's important not to view retirement as a cliff off which you will drop at a certain age. You've climbed the mountain to save for retirement. Now the challenge is to stay near the top of that mountain range for the rest of your life. Whether you can do that will depend not only on your investments and withdrawal strategy, but also on your choice of retirement lifestyle.

This chapter is about the tools, techniques, and sophisticated advice that will help you achieve your goals. The first, most important step is to face up to the reality of your current situation. Use the "Getting Started" box at the end of the chapter.

Your Retirement Balance Sheet

Now that you know how much more money you may need to contribute to maintain your desired standard of living in retirement, the second step is to take a closer look at your dreams and hopes for a retirement lifestyle. It's entirely possible that you can afford the retirement you want, but it could take some adjustments. Since time is on your side, you'll have to make those changes as early as possible. But you'll also have to examine your personal balance sheet.

A personal balance sheet is just an assessment of what you *own* and what you *owe,* as you saw in Chapter 3. As you approach retirement it's time once again to confront your assets and liabilities, perhaps from a slightly different perspective. Although the popular view

of retirement is as a time to draw down your assets, you might benefit from simply rearranging your assets. And when listing your material holdings, don't forget to include intangibles such as your knowledge, experience, skills, and good health. They may come in handy if you need to rearrange your financial situation.

Retirement is a time to reassess the usefulness of your assets, and you might find that some assets are a cash drain. This analysis could result in the sale of the family residence, if you can get a reasonable price. The purchase of a smaller residence or condo at a bargain price could free up cash for investment or spending, and eliminate mortgage payments.

A change in location could positively affect your cash flow if you move to a state with no state income tax. But be aware that some states tax pension or retirement plan income, while others do not. There is an excellent state tax calculator at www.RetirementLiving.com. And don't forget that a change in state residency will require a review of your estate plan.

You might be able to turn a liability into an income-producing asset. For example, consider turning your mortgage-free home into your pension through a reverse mortgage. As you'll see later in this chapter, a reverse mortgage gives you a tax-free withdrawal of either a lump sum of cash or a monthly check that will keep coming as long as you live there. That can turn your home from a cash drain into a source of cash flow—if you plan to stay in your home.

On the other hand, if you're thinking of selling your home and buying a less expensive property in another state, you're not alone. Demographics are at work here. Many Millennials and members of Gen X and Y are hesitant to take on the burden of your larger home—especially faced with rising property taxes and the ongoing need to repay student loans. Get a realistic estimate of your home's value before making your retirement budget. And remember, if you've owned your residence for many years, you could have substantial gains. At this writing, you can exclude $250,000 in gains on a single return, and $500,000 in gains on the sale of a residence if you're filing a joint return.

Study the liability side of your balance sheet carefully. Credit card debt is particularly burdensome when you're paying double-digit finance charges and earning far less on your savings. Seniors have been among the fastest-growing groups filing for bankruptcy, since it is tougher as a senior to increase your income to make a dent in the interest expense that keeps piling up.

The other great burden is—believe it or not—student loans. Many parents who took out PLUS loans, or cosigned private loans for their children are facing the impossible task of repaying student loans in retirement. And the government has started attaching tax refunds, and even taking a portion of Social Security benefits from seniors who default on student loans.

The goal is to enter your retirement years free from as much debt as possible. For retirement planning, you want a lopsided balance sheet—all assets and very little debt.

Streams of Retirement Income

The greatest fear in retirement is running out of money—either from a massive hit to your assets because of a health-care crisis, like needing long-term care, or from a stock market reversal that impacts your ability to make your assets last as long as you do.

Peace of mind about your retirement is not a matter of guesswork, or even about achieving a certain dollar amount of assets. This is where a trusted financial planner can help you reorganize and structure your assets to create a reliable stream of income and protect your lifestyle against most calamities.

You may use a variety of strategies, beyond just collecting Social Security. (When to collect Social Security is, in itself, a complicated decision, explained in Chapter 14.) Perhaps you'll purchase an annuity with a portion of your retirement funds, starting a payout now, or later in life (see Chapter 9). But fearing the impact of inflation, you'll also need growth in your investments, which requires taking a certain amount of risk.

A reverse mortgage (see below) can add to your tax-free income, if you plan to remain in your home. And a long-term care insurance policy (see Chapter 15) can bring peace of mind about the too-likely catastrophic costs that could devastate your plan.

All of these strategies must be considered in creating a stream of retirement income.

Cash Flows Differently in Retirement

First, you and your planner will need a realistic look at your projected retirement cash flow. Start with your expected monthly spending

needs in your hoped-for retirement scenario. While some expenses will drop in retirement, others will consume a bigger part of your budget. As noted earlier, you may no longer pay the expenses of commuting to work, dry cleaning, and a business wardrobe suitable for the office.

However, you probably want to spend more money traveling or dining out. And you're certain to have higher medical expenses and copayments than you did when health insurance was provided by your employer. Medicare premiums keep rising, and are even more expensive if you have additional income. You'll need a Medicare supplement and Part D prescription drug insurance unless you have retiree health coverage to take care of those costs, or opt for a Medicare Advantage plan (see more in Chapter 14).

Even if you think you'll be ready to cut back on spending in retirement, don't forget about the new costs that will arise around health care. The current annual Fidelity survey estimates that a 65-year-old couple retiring today would need $280,000 to cover health-care costs, including out-of-pocket drug expenses and Medicare premiums. And remember the lessons of the Rule of 72: Even at a low 3 percent annual inflation rate, your buying power will be cut in half in less than 25 years.

How Much Can I Withdraw?

For a long time, financial planning for retirement withdrawals revolved around the 4 percent rule. This was a simple rule of thumb that suggested retirees could withdraw 4 percent from a balanced portfolio each year, and that for a period of at least 33 years they would not run out of money—despite the ups and downs of the stock market and the potential for inflation.

Further refinements to the rule involved increasing withdrawals at 2 percent per year (the Fed's target inflation rate) or adjusting withdrawal based on actual inflation rates. Historically, the stock market has outperformed inflation over the long run (see Chapter 6), so this type of projection seemed reasonable.

But what if a period of inflation arrives early in your retirement, causing you to withdraw extra money? Or, more significantly, what if a bear market arrives shortly after you retire, decimating your investment portfolio? How can you make a reliable plan for those possibilities, which might happen in your real life as opposed to the average historical scenario?

Take Your Money to Monte Carlo!

No, I haven't suddenly lost my mind, but I did want to catch your attention. And I'll explain about Monte Carlo in just a moment.

First, though, you need to get your mind around the concept that if you're going to make your money last your lifetime, you will probably have to dig into your principal at some point in your retirement, unless you have a large enough fortune that you can live off the income. That doesn't apply to most people reading this book!

But if you have saved and invested enough to hope that your money will last as long as your life—with perhaps a bit left over for your heirs—then it's important to come up with a plan for withdrawals of both principal and income.

When planning for your retirement withdrawals, here's an important Savage Truth: *Beware of averages!*

Although we often talk of investment returns in terms of average returns, in the case of retirement withdrawal, averages can be dangerous, as you can see from Figure 13.1, which shows a man who drowned crossing a river with an "average depth" of three feet.

It's dangerous to use historic averages in your retirement withdrawal scenario, because averages mask a wide array of extremes. You don't want to be withdrawing too much when the market is

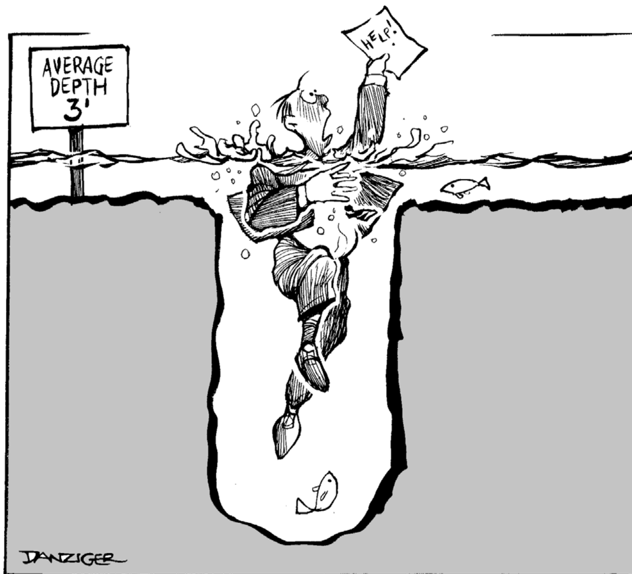

Figure 13.1 Man Drowning Crossing River
Source: © Jeff Danziger (www.danzigercartoons.com).

down, or you won't have enough assets left to recover your balance when the market rebounds.

There's a much better way to calculate the probabilities that an investment and withdrawal strategy will be successful. It's a process called *Monte Carlo modeling*—and it has nothing whatever to do with gambling. In fact, the term refers to the science of *probabilities* and was a code name developed at the time the first nuclear bomb was created. Monte Carlo lives on in the modern world as the technique for modeling probabilities when a variety of factors interact.

In the case of retirement planning, a sophisticated computer can quickly do the Monte Carlo math for millions of historical interactions of a wide range of stock and bond indexes. The program will give you a range of probabilities of outcomes, depending on the strategy you choose for both investing and withdrawing.

After running thousands of simulated interactions, the program will produce a range of probable outcomes and suggested strategies designed for your retirement planning. Each will have a different investment mix of stock categories and bonds, and perhaps even the promise of some income from a fixed annuity or other withdrawal schedules. And each scenario will have a different probability for success—defined as making your money last as long as you do.

If you are comfortable with an 80 percent probability that you won't run out of money before the end of your lifetime, then you can use that asset allocation and withdrawal strategy. Of course, you could get 100 percent assurance that your money would last your lifetime by using an immediate annuity, but then you wouldn't have the growth potential that a stock portfolio gives. It's all in the balancing act between growth and safety and in the withdrawal rate that the program advises.

Most mutual fund management companies, investment advisors, and financial planners now use Monte Carlo modeling tools for retirement planning. Not all will produce the same results because they use different time periods for historical market returns, and because they may run a different number of simulations. We'll never know—until the far-distant future—which produced the best investment advice. But we do know that this type of modeling will produce a far better outcome than merely guessing or using averages to predict future returns and guide future retirement plan withdrawals.

Streams of Retirement Income

Most of us would like to have a stream of retirement income that will provide for our everyday lifestyle, *without* drawing down our principal. Then we could leave the balance for our children, grandchildren, or favorite charities. Unfortunately, that's unlikely to be the case for most people. They'll need to spend the principal over their remaining lifetime, in an intelligent plan provided by Monte Carlo modeling.

But you can minimize that use of principal if you can add to your income, either from your portfolio or from other sources. So let's examine how you might enhance a stream of income for your retirement lifestyle, beyond the challenging idea of just continuing to work as long as possible.

Required Minimum Distributions (RMDs)

You've been saving for your retirement in a tax-deferred account such as a 401(k) or 403(b) or thrift savings plan, or a traditional IRA. You took a tax deduction for your contributions every year, and the money has been growing. Now the government wants its share!

There's no use arguing that you don't want to take money out of your retirement account, because—at least currently—you have enough money to live on. When you reach age 70½, the government forces you to start taking money out. And not just a little money. They have statistics about how long you're likely to live, and they set up a schedule of *required minimum distributions* in an effort to empty—and tax—your retirement savings before your death.

Speaking of taxes, all the money is taxed as ordinary income, at your then-current marginal tax bracket. If you had held these assets outside of a retirement account, and had big gains, you might have benefited from a lower capital gains tax rate.

Remember, you can always take more than the minimum required in any year, without penalty if you're over the age of 59½. You're required to pay income taxes on all withdrawals.

The amount you must withdraw each year is a standard calculation, based on the IRS Uniform Lifetime Table. It is calculated based on your age and the amount of money in total in *all* your retirement accounts (except Roth accounts) at the end of the previous year. (There is a separate calculation for those with a spouse at least 10 years younger, which likely will result in a lower required annual withdrawal.)

Any one of your retirement plan custodians will calculate the required amount for you, but you must give a year-end total of *all* your traditional IRA accounts for the calculation. Additionally, many financial sites have online calculators to help you do the computation yourself.

My suggestion is to keep your year-end statements from all retirement accounts in a separate file and make a list of the year-end balances. Though you may not want to take the RMD until the last minute in the following year, it will make calculating the amount easier if you have the previous year's balance.

You can take the withdrawal from any one of your IRAs—or from several IRA accounts—as long as you meet the required minimum. If you also have a 401(k), you must calculate and withdraw separately from that account. Each will send you a tax form, noting the withdrawal, at the end of the year.

Special note: You must start taking these withdrawals in the year you reach age 70½, or you can delay until April 1 of the year *after* you reach age 70½. But in order to avoid a double withdrawal in one year, which may boost your income and impact other federal benefits and your tax bracket, you might want to take your first distribution in the actual year you reach age 70½.

Plan ahead for your RMD each year. As noted above, you don't have to take it out until year-end of the following year. But you should have some liquidity in your accounts, so that you aren't forced to sell stocks in a year-end crunch. And be sure to ask your custodian to withhold income taxes so you don't get a tax penalty. Keep careful records if you have multiple accounts, so you can confirm both year-end balances, amounts withdrawn from each account, and taxes withheld just in case you are questioned by the IRS.

One other note: If you decide to transfer (roll over) your IRA to a different custodian after you reach age 70½, the current custodian will require you to take this year's RMD from the account before making a transfer. If you've already taken an RMD for the year, perhaps from another account, you could be forced to withdraw more than you planned or to wait until the following year.

Annuities

If you wanted to make sure you had a check a month for life, beyond what Social Security promises, you could purchase an immediate annuity. (Annuities are described more fully in Chapter 9.) These

insurance company contracts start paying a fixed monthly check that is guaranteed by the insurer to last as long as you live—or can continue over the life of your spouse. Of course, an annuity that covers two lives will pay a smaller monthly amount.

To find out how much income you could receive if you decided to purchase one of these annuities, go to www.ImmediateAnnuities.com or www.SPIA.direct. Fill in the amount you have to invest, your age, gender, state of residence, and whether the annuity is for your lifetime or to cover two lives. You'll get an immediate quote from several major insurers offering annuity coverage.

But wait: Before you invest, you should understand the drawbacks of a fixed immediate annuity.

- First, you've decided on a fixed monthly check that will last your lifetime. But as already noted, inflation will cut into your buying power over time. That monthly check looks adequate now, but will it cover your living expenses in the future?
- Second, when you (or you and your spouse) die, any remaining balance in the annuity belongs to the insurance company. There is nothing left for your heirs even if you die just a short time after purchasing the annuity (unless you've structured it to pay out to a beneficiary or for a term certain period of years). (This is described in Chapter 9).

If you're worried about income in your later years, when some other assets may have dwindled, please re-read the explanation of deferred income annuities in Chapter 9. These products offer a larger payout if you start collecting income later in life.

Annuities do offer the security of a monthly check that you cannot outlive. And so, many people will want to place a portion of their retirement funds in this type of product. But it certainly isn't where you would want to place *all* of your money, for the reasons just listed.

A Reverse Mortgage

A *reverse mortgage* turns your home into your pension, giving you either a lump-sum payout from the equity in your home or a fixed monthly check that will keep paying you as long as you live in the home. Reverse mortgages have gotten a bad name in recent years, as seniors were induced to take out a lump sum and then scammed out of the proceeds by fraudulent home repair companies, and others. But I know firsthand how beneficial a reverse mortgage

can be to a senior, who wants to remain in his or her home, and has enough assets to continue the upkeep, insurance and taxes.

I helped my own father take out a reverse mortgage on his condo when he was in his early 80s. It provided the extra tax-free cash this proud man needed to remain independently in his own home. (And his long-term care policy—see Chapter 15—contributed to that independence in his later years.) My dad worried as he saw the outstanding balance build up, including interest. But I convinced him that the longer he lived, the better this deal worked.

Over the years, the outstanding balance on the reverse mortgage grew to more than what the condo was worth! Dad died at age 96 after only a few days in the hospital, having long outlived the estimated life span upon which the RM was based. We left the keys to the condo to the lender. (And don't worry, the lender was insured for that possibility.)

A reverse mortgage is available to homeowners age 62 or older who have either paid off their mortgage or have a small remaining balance. The amount you can receive is determined by your age, the value of your home, and current interest rates. Basically, the older you are when you take out the reverse mortgage, the more money you can receive, either in a lump-sum or a monthly payout. And all the money you withdraw is tax-free, since it is the return of your own capital.

You don't need a credit check to qualify, and you retain title to your home. You won't have any mortgage payments, although you will be responsible for homeowners insurance, property taxes, and upkeep on your home. But you'll now have a monthly check to pay for those expenses, or a pool of money in the bank to cover emergencies.

Basically, you are just borrowing from yourself, although you will be paying interest on that loan. But the interest is added to the amount of equity taken out of the home. When you sell the home, or die, the amount you have borrowed out of your home's equity must be repaid from the sale proceeds.

Most important, you—or your heirs—can never owe more than the home is worth. And you can never be forced out of your home because you've run out of equity. Eventually, when the home is sold, because you move or die, any proceeds (minus the withdrawals and interest and fees) are returned to you or your heirs. If the value of the home has dropped below the total amount taken out through the reverse mortgage, you or your estate are not liable to make up the difference.

The standard HECM (home equity conversion mortgage) is what is most commonly offered. Since these mortgages are insured by the Federal Housing Administration (FHA), they must follow the same basic rules, although there could be some differences in cost. By the way, the insurance protects the lender in case you outlive your projected life expectancy and withdraw more than the home is eventually worth at your death.

In addition to the FHA HECM, there is a growing market for proprietary reverse mortgages that can meet the needs of older homeowners whose properties are ineligible for FHA financing—such as units in non-FHA-approved condominiums or some planned unit developments (PUDs)—or whose home values exceed the HECM lending limit.

There are no credit score requirements for the FHA-insured HECM reverse mortgage. HECM lenders will, however, conduct a financial assessment of every prospective reverse mortgage client during the application process to ensure the borrower has the financial means to continue paying property taxes, homeowners insurance, homeowners association dues, and other property charges.

If a lender determines that the borrower may not be able to keep up with property taxes and hazard insurance payments, they will be authorized to set aside a certain amount of funds from the loan to pay future charges.

The amount you can borrow on a reverse mortgage depends on the appraised value of your home. But no matter how valuable your home, the FHA has determined that the maximum amount of equity that will be considered for a reverse mortgage, currently $726,525. (That limit is likely to increase in future years.)

The interest (which is taken out of your home equity) is typically calculated at a variable rate, which is tied to a popular index such as Libor or Treasury notes or the newly created secured overnight financing rate (SOFR). The interest may be adjusted monthly.

There are also up-front fees to consider. First, there is an *up-front mortgage insurance premium.* This is a flat 2 percent premium based on the amount the maximum lending limit of $726,525 or your home's appraised value, whichever is less. This insurance guarantees that the lender cannot come after other assets if you die or leave the home owing more than it is worth. It also guarantees that the promised loan disbursements will continue over your lifetime and cannot be frozen by the lender at any point in the future.

There is also an ongoing *monthly insurance premium* of 0.5 percent, of the outstanding loan balance, which is accrued annually. But it's not a fee you have to pay out of pocket, since it is part of the loan balance if you choose to repay the loan at some point in the future.

This insurance protects the lenders so they don't lose money. Think about it this way: If the bank promises to pay you $2,000 a month for life through a reverse mortgage, and if you live to be 100 instead of the expected 85, the bank will lose out on the deal. The FHA insurance covers that possibility.

There is also an *origination fee*. A lender cannot charge more than $2,500 or 2 percent of the first $200,000 of the home's value plus 1 percent of the amount over $200,000. HECM origination fees are capped at $6,000. The one place lenders do compete is in origination fees on these loans. Many lenders today advertise that they will waive the entire origination fee. (They know they will make money on the loan interest over the years—as long as you don't live too long!)

If you're interested in knowing how large a lump sum—or what guaranteed monthly check—you could get through a reverse mortgage, go to www.ReverseMortgage.org, and use the online calculator. This site also has a search function to find reverse mortgage lenders in your area.

Income from Your Investment Portfolio

You could also structure your investment portfolio to receive income without selling stocks or digging into the principal. Here are a few strategies you might employ. The most obvious is switching from an aggressive stock mutual fund to an equity-income fund. That will give you stock market growth, but also an income component. You can take the dividends quarterly, or you can withdraw them as part of your RMDs if the fund is in a retirement account.

Bond Ladder

For example, you could create a *bond ladder* by purchasing high-quality bonds that mature in a staggered fashion over a number of years. If interest rates move higher, then as the bonds mature you will be able to invest in higher-yielding securities. And depending on the payment dates on the bonds you own, you'll receive a regular stream of income deposited directly into your bank account.

Just be careful to invest in high-quality bonds. Treasuries are particularly appropriate for this strategy, and it's easy to do this through TreasuryDirect.gov (see Chapter 4). But you might want to use corporate or high-quality, tax-free municipal bonds as well. If you think interest rates are trending higher, keep your maturities short—perhaps spread out over only five years.

Just remember the lessons of Chapter 4 on bond pricing. When interest rates rise, bond prices fall. So if you need to sell your bonds, no matter what quality, in a period of rising rates, you could take a loss of principal. Finally, remember that bond pricing is typically opaque, and prices may jump significantly if you are purchasing only a small quantity.

A bond ladder is a good strategy only if you have a substantial amount of money to invest, or if you use TreasuryDirect.gov to purchase Treasuries and automatically roll them over as they mature.

Writing Covered Calls

Here's an interesting strategy that will require you to have a sophisticated broker to support your efforts. If you have a portfolio of high-quality stocks, you could write *covered call options* to get a stream of income without selling your stocks. The premium you collect increases your portfolio yield. Of course, the stock could be called away from you at the *strike price* of the option. But that simply means you have cash to buy more stock. And, of course, you collected the amount of the option premium. Equally likely, the stock will remain around the same level, or fall. Then when the option expires you have both the stock and the premium you collected.

That's a brief explanation of a strategy to increase portfolio income. To learn more, speak with a broker who has expertise in options, or go to www.Cboe.com and click on "Options Institute" where you can find simple explanations and courses to explain various option strategies.

The Bottom Line on Retirement Planning

I know financial planning for retirement sounds complicated, but there is plenty of competent help available. Your first job is to know how much is enough—and to save even more! The second

challenge is to stick with your investment plan, once you know you've established reasonable goals. Then you'll face the challenge that comes with the realization that you are no longer contributing and must start withdrawing.

That's when you need sophisticated, professional advice about how to balance your investments and withdrawals so that you have the best chance of making it to the finish line with some money left over. Find your fiduciary advisor by reading Chapter 5.

No one will take care of you in your old age if you don't make plans to take care of yourself. The government can't afford to keep you in the style you dream about. And your children will be busy facing the burdens of taxation, repaying student loans, college for their children, and saving for their own retirement. By facing the issue as early as possible, you can have retirement security.

Now, assuming you've been successful in your financial planning, I have one more slight problem for you to consider. What happens if you have "extra money" at your death—a balance in your IRA or stocks that you haven't been forced to liquidate for everyday expenses? That will be considered in Chapter 16 on estate planning.

But you should be aware that at your death, your IRA or other retirement plan will be rolled over into an *inherited IRA*. If you advise your heirs to seek help understanding their options and any required distributions (different rules for spouses and others), they may be able to keep a large portion of those assets growing for their own future retirement. Taking the balances out of your IRAs immediately after your death triggers immediate taxes and loses this opportunity.

If you are the beneficiary of an inherited IRA, remember to immediately name your own new beneficiary, in case you die with money left in the account. That beneficiary can then continue withdrawing on your remaining schedule.

If you have questions on any aspect of IRA rules, especially around estate planning and withdrawals, consult your IRA custodian, or turn to the expert: Ed Slott whose website www.IRAHelp.com is the source of all answers to IRA issues. He has trained a national cadre of elite IRA experts, whose planning advice you can seek.

If you take your retirement savings seriously, you could have amassed a huge pool of money by the time you—or your heirs—confront these issues. But the real challenge, of course, is making sure your retirement money lasts as long as you do.

Only one disaster could completely disrupt your plans and I show you how to insure against that in Chapter 15 about long-term care insurance.

TERRY'S TO-DO LIST

1. Get some perspective on your expected longevity by using the calculator at www.Livingto100.com.
2. Go to www.ChoosetoSave.org and use the "Ballpark Estimate" tool to figure out how much more you should be saving now to maintain your lifestyle in retirement.
3. Talk with a financial planner or mutual fund company about doing a Monte Carlo modeling scenario as you approach retirement age.
4. Go to www.ReverseMortgage.org to see how much money you could withdraw from your home, tax-free, either as a lump sum or a monthly check.

CHAPTER 14

THE SAVAGE TRUTH ON SOCIAL SECURITY, MEDICARE, AND AGING ALONE

Getting It Right Is Essential

The Savage Truth on Social Security

Some of the most important financial decisions you will make in your life revolve around Social Security and Medicare. Deciding when to claim your well-earned Social Security benefits, how to maximize your Medicare Part B benefits (Part A is automatic), and how to make sure you qualify for the most comprehensive supplement, are all among the choices you must make. Then you'll also sign up for Medicare Part D, the prescription drug benefit, even if you currently don't take any prescription meds. And making it very challenging for some baby boomers, most of this is done online without much advice.

If you're divorced, remarried, a widow or widower, or the retiring spouse with a still-working spouse, the complexity of your situation expands. If you're still covered by health insurance from your company, the way that plan interacts with Medicare will depend on the number of employees in the plan. You may also have to decide whether it's important to keep your existing relationships with hospitals or physicians, or save money by signing up for Medicare Advantage, with its lower costs but limited networks for care.

If these two paragraphs haven't overwhelmed you, let me say that the choices you make today could impact your retirement by literally hundreds of thousands of dollars. And they could also impact the health care you receive.

So don't rely solely on getting help from the Social Security website, www.SSA.gov, where you will likely sign up, or from the hard-working employees who answer the toll-free phone number (800-772-1213), when you make your decisions. This chapter will introduce you to some of those challenges, but I also highly recommend reading the bestseller and authoritative guide to Social Security, called *Get What's Yours,* by Laurence J. Kotlikoff.

It's important to be guided by the facts, not your fears about the future of Social Security. So let me state clearly at the start of this chapter:

> *The Savage Truth: The most costly mistake is taking Social Security benefits before your full retirement age.*

Unless you are faced with a life-limiting health situation or are in desperate financial straits, you must wait as long as possible to claim your benefits. Failing to do so is like giving away a roughly 8 percent increase in benefits every year (the best sure-thing return you can get)—and it limits the base income on which future inflation adjustments will be made. As the authors of the aforementioned *Get What's Yours* explain so clearly, if a 62-year-old waits until age 70 to collect, the monthly check will be 76 percent higher than the amount received at age 62!

The age at which you are eligible to collect your full retirement benefit, called your FRA, has been gradually climbing. When the full-benefit age reaches 67, (which will impact those born in 1960 and later), benefits taken at age 62 will be reduced to 70 percent of the full benefit and benefits first taken at age 65 will be reduced to 86.7 percent of the full benefit.

Even worse, if you take benefits early and then find you need to work to make ends meet, your benefits will be reduced by $1 for every $2 earned (over $1,470 per month, or $17,640 per year in 2019) until the year you reach full retirement age, at which point your benefits are reduced by $1 for every $3 of earnings above that year's earnings limit. This is called the *earnings test.* After you reach your FRA, this penalty no longer applies. But it's another incentive to wait until your FRA to start taking benefits.

Astonishingly, more than a third of today's Social Security beneficiaries claimed their benefits at age 62. That implies a massive reduction in lifetime income. While some claims may have been forced by need or health issues, a good portion might have seen it as a chance to retire early with ongoing income. Over their remaining retirement lifetime, that choice will prove a costly mistake.

And if you did the calculations on the website www.Livingto100.com, recommended in Chapter 13, you'll know that your longevity projection is likely to increase over your retirement years. Don't make a bad bet against yourself by collecting your Social Security early.

Many people rush to claim their benefits, fearing that Social Security will run out of money before it's their turn. Remember, the massive generation of boomers has always had a great impact on public policy. They won't go quietly if benefits are further taxed, or cut. The ultimate alternative is for the government to print the money to create the promised benefits. But right now, the sensible approach is to make your decisions based on the current rules.

Social Security in Perspective

Whether you're working as an employee or self-employed, you're contributing to Social Security. Just look at your paycheck deduction for FICA. That stands for Federal Insurance Contributions Act. In 2019, each employee pays Social Security taxes at a 6.2 percent rate (matched by the employer) up to $132,900 in earnings. (Self-employed individuals pay tax at a 12.4 percent rate up to the limit.) If you earn the maximum as an employee, it means you will be paying $8,239.80 in FICA in 2019.

On top of that, you'll pay the Medicare tax, of 1.45 percent, which applies to all earned wages. Higher income earners (over $200,000 on a single return or $250,000 married, filing jointly) earners pay an additional 0.9 percent. And it isn't enough to keep the programs solvent!

When the Social Security program was started in 1935, there were far more workers than potential retirees. Today there are fewer than three workers per retiree, a ratio that has been dropping for the past decade as the boomer generation retires.

It's not the fault of today's seniors that they are living longer than projected at the start of the program in 1935, nor that the baby boomers were the largest generation to participate in this program. Even with significant reform of Social Security in 1983 to increase payroll taxes and extend the date at which benefits may be collected, (as well as taxing the benefits of wealthier seniors), the trustees of Social Security acknowledge the trust fund will be depleted by 2035. At that point, incoming revenue will be enough to pay only 79 cents for every dollar of projected benefits. But there will likely be tax changes to keep the program solvent before that date.

The government acknowledges the significant reliance of today's elderly population on Social Security benefits. In fact, that's why it has been so politically difficult to make adjustments. According to Social Security, its payments provide the majority of income to most elderly Americans. For about half of seniors, Social Security provides at least 50 percent of their income, and for about one in five seniors, it provides at least 90 percent of income.

There are now more than 62 million people, or about one in every six U.S. residents, collecting Social Security benefits. About 20 percent of them either collect disability from the Social Security program or are young survivors of deceased workers.

In 2019, the maximum Social Security benefit, if taken at full retirement age, is $2,861. That amount will be adjusted upward for inflation over the years by a COLA (cost of living adjustment). But once you sign up for Medicare Part B, the premium (impacted by your current earnings) will be deducted from your monthly benefit check. The net amount does not provide a windfall for today's seniors, who have paid into the program for decades.

Clearly, there will be some adjustments made to Social Security in the years ahead, likely before millennials come close to collecting the promised benefits. There is simply no way that today's young workers will receive the benefits that their parents and grandparents have taken for granted. So, as mentioned previously in this book, be sure to contribute as much to your own retirement plan as is being taken out of your paycheck for FICA.

The overall message to Millennials and Gen X and Y is a simple Savage Truth: *Don't count on Social Security for significant retirement income.*

Reforming Social Security and gaining control over Medicare expenses will be hotly debated issues in coming years. You're entitled to your own opinion. But a reality check says that in the future you will receive less in benefits—and the benefits you do receive will cost you more. Plan on it.

Your Social Security Benefits

Don't wait until you're approaching retirement to check your earnings record with Social Security. The place to start is the Social Security website—www.SSA.gov. There you can securely create your own account in My Social Security. You'll need your nine-digit Social Security number. This personal account has a history of your taxed

earnings, and it's worth checking to make sure your earnings history is correct.

That's because your Social Security is calculated based on those earnings, You must have 40 quarters of earnings in covered employment, and have earned at least $1,320 a quarter (in 2019) to be eligible for Social Security. (The actual calculation of your benefits is a complicated formula using the highest 35 years of earnings.) Those quarters don't have to be consecutive, but it's important that the report be accurate.

On the home page of the Social Security website, you'll see a link to a calculator "Estimate My Benefits." Whether you are approaching Social Security and want to see the difference waiting will make, or just doing financial planning or your future, this tool will be a real eye-opener. You can access your benefits calculation securely, much as you would an online credit report. If you're younger than 60, recognize that these calculations are based on today's formula, which is likely to change in future years.

When it comes time to collect Social Security benefits you can do it online, on their toll-free telephone (800-772-1213), or by going in to your local Social Security office. If you're waiting until FRA, apply a few months before and be sure to specify *in writing* under the remarks section of your application that you want benefits to start with the first month your benefit is *unreduced*. Ask for a copy of your application with a stamped date on it to ensure against mistakes.

When you qualify for Social Security and decide when to take benefits, you potentially impact the lives of many people: your current spouse, your ex-spouse, your young children, and any disabled children. All could potentially qualify for benefits based on your work record. But their eligibility and amount of benefits depend on some complicated rules.

In particular, spouses and ex-spouses can claim benefits on your work record if they meet the requirements. The maximum possible spouse's benefit is one-half of the other spouse's full retirement benefit—even if this person had no covered earnings at all. Before 2016, there was a game some played, taking spousal benefits at a younger age, and waiting until age 70 to claim your own, higher benefits. That technique is no longer available.

You can't collect your spousal benefit unless your spouse has already started collecting his or her benefits. And you can't collect a spousal benefit until you reach age 62. Plus, you must have been married for at least one year. If you have your own retirement benefit,

you'll have to claim it at the same time as you take your spousal benefit. They will pay you the larger of the two.

Divorced spouses may be able to claim on their ex-spouse's record. If you were married to your spouse for at least 10 years, have been divorced for at least two years (and are not remarried), and if your ex-spouse has started claiming on his or her own record, you are eligible to claim on your spouse's record. (Take that important fact into account when contemplating divorce!) The amount is reduced if you collect before your FRA. And, if you take that ex-spouse benefit at age 62, then your own earned benefit will be reduced as well (if you happen to have earned a larger benefit).

If you are a widow(er) or divorced widow(er), you can collect survivor benefits as early as age 60—but based on a very complicated calculation, that depends on your age and the age at which the deceased spouse took his or her benefits. It is complicated, and you'll want to have the calculations done before you make any decision, because it's possible that your own benefit could eventually be larger.

You have by now noticed that multiple people can collect on one earnings record. That's the way the law works. Minor children and those with disabilities are also entitled to benefits, which won't be discussed here.

One more thing: taxes. Depending on your income from other sources, your Social Security benefits may be taxable. You'll be taxed on up to 50 percent of your benefits if your income is between $25,000 and $34,000 for an individual or between $32,000 and $44,000 for a married couple filing jointly. You'll be taxed on 85 percent of your benefits if your income is above those levels.

The government has broken its original promise about tax-free Social Security benefits in two ways. First, since 1983, they collect taxes on up to 85 percent of your benefits above a certain income level. And, second, they include interest from municipal bonds in that income—interest that is promised to be tax-free. Additionally, more than a dozen states have their own version of taxation of Social Security income.

As you can see, *when* to collect Social Security, and *on whose record*, can create some complicated and potentially costly decisions. And, let me repeat, you can't always get the most accurate or beneficial answers from Social Security itself.

I highly recommend Laurence Kotlikoff's website, www.MaximizeMySocialSecurity.com. For households the cost is $40—a

small price to pay for calculations that could increase your benefits many times over.

The Savage Truth on Medicare

If you think Social Security is complicated, wait until you have to make decisions about Medicare! And, while Social Security is pretty much a one-time decision about when to take benefits, your Medicare choices must be reviewed every year, even though your health care situation doesn't change! An annual review allows you to change either your Medicare supplement or your Part D drug coverage each year and potentially save a lot of money. But, wait, I'm getting ahead of myself.

It would be impossible to give you all the quirks and details about Medicare in one chapter. My goal here is to give you an overview of the way Medicare works. At the end of this chapter you'll be directed to some resources for advice and counsel, which I hope you'll access well before you reach age 65, so you can both save money and avoid penalties.

First, here are some explanations about the various parts of Medicare.

How Medicare Works

There are two basic parts to traditional Medicare—Part A and Part B. You'll also have a choice, described later in this chapter, to instead enroll in a Medicare Advantage program (sometimes called Part C), which bundles all these coverages, but may restrict your access to certain physicians and hospitals and medicines. And you'll certainly need Part D—the prescription drug plan, unless you are covered by a retiree plan or use Medicare Advantage.

One of the most beneficial aspects of traditional Medicare (as opposed to Medicare Advantage) is that you pretty much have your choice of physicians and hospitals—as long as they accept Medicare payments. And most physicians will continue to accept Medicare insurance—as long as the government reimbursement remains adequate. This freedom of choice makes Medicare coverage—along with an additional supplement or Medigap insurance—competitive with the best health insurance plans of private companies.

As you begin your exploration of Medicare, you'll be confronted with a confusing alphabet soup of its parts, which will quickly become familiar as you work through the Medicare system. But it's important to understand all the parts of the program before you begin making your choices.

MEDICARE PART A

Part A is the program that covers hospitalization costs, most inpatient costs, a limited number of days in a skilled nursing facility (after admission to a hospital for at least three days), and hospice. It's more accurate to say Part A covers part of those costs, because there are unlimited deductibles and co-payments required for these services, which can really mount up. That's why you should also have a Medicare supplement policy, described later in this chapter.

You become eligible for Part A at age 65, and should sign up in the three months before your birthday to ensure this coverage begins in your birth month. You're not required to sign up for Part A unless you have started taking your Social Security benefits or you didn't earn enough to qualify for free Part A, in which case you must pay for Part A starting at age 65 or face a substantial penalty if you decide to sign up later.

Note: If you have not earned free Part A by completing 40 covered quarters of work (which qualifies you for Social Security), you can pay for Part A, but it is very expensive insurance. Seniors who do not qualify for free Part A might consider alternative state-provided Medicaid benefits or coverage on the Affordable Care Act exchanges, assuming that is still available by the time you read this book.

You have a seven-month window around your 65th birthday to sign up for Medicare Part A, but signing up in the three months before your birthday ensures coverage will start in your birth month. Otherwise, benefits could be delayed as long as three months.

Since Part A is free (for most people), you should sign up when you become eligible—even if you are still working and have health coverage from your employer or union. The only drawback to signing up for Part A while still working is that if you have a health savings account (HSA), you can no longer contribute to it once you sign up for Medicare Part A.

There are several catches in Part A that beneficiaries might not be aware of in the midst of a crisis. For example, hospitals are reimbursed differently if a patient is considered under observation as

opposed to being fully admitted. A visit to the emergency room for a suspected heart attack is likely to result in observation status. That could leave you with charges not covered by Part A, as well as impacting eligibility for covered skilled nursing (which requires three days admitted to a hospital). Be sure to check on the status of admission or observation after the immediate crisis has passed.

Also, while Part A is known as the hospitalization portion of your coverage, it does not cover a private room (unless medically necessary), or private duty nursing, or even a television in the room. And, it will not cover the 20 percent copayment fees from physicians that are considered hospitalists. Again, these should all be covered under a supplement policy, discussed later in this chapter.

By the way, while there is excellent information on the Medicare .gov website, you actually enroll in Medicare online through the SocialSecurity.gov website or at one of the regional Social Security offices.

MEDICARE PART B

Medicare Part B covers most doctors' services, outpatient care, medical supplies, and preventive services. Again, it doesn't cover the full cost of all these services; there is typically a co-payment required, which is why—and I know I'm becoming repetitive—you must have a supplement or Medigap policy.

In the "olden days" when enrollment in Medicare A and B was automatic at age 65, you weren't faced with choices about when to take Medicare Part B. But these days, although you are eligible for Part B at age 65, many people—at least a third of those over 65—are still working, and covered by employer health insurance.

Since there is a monthly premium for Medicare Part B, it may make sense to stick with your employer coverage—as long as you don't put yourself in a situation where you would pay a penalty for late enrollment. There is no late enrollment penalty for Part B as long as someone has coverage through a group plan related to current employment of the person, or his/her spouse. The problem is that with a company of fewer than 20 people, Medicare becomes the primary payer. Part A and Part B enrollment are essential; otherwise, it's as though there is no payer.

If you delay taking Part B until you retire or lose your job, you'll move into Medicare Part B without penalty during a special enrollment period. But depending on the timing, you could find yourself with a gap in coverage. That's the tricky part.

There are four different enrollment periods related to Medicare Part B.

The *Initial Enrollment Period (IEP)* is a seven-month period around your 65th birthday. You can enroll in the three months prior, and then Part B will start in the month of your birthday. If you wait until your birth month to enroll, coverage will start the following month. And if you wait until after your birthday, coverage could be delayed for as long as three months.

The *Special Enrollment Period (SEP)* is an eight-month period to sign up for Part A and/or Part B. It starts the month after employment ends, or the month after the group health insurance plan based on your current employment ends. There is generally no penalty for signing up in the SEP if you have lost your employer's coverage. If you miss the SEP, you must wait until the next General Enrollment Period, and sign up within 12 months of leaving your job, or face penalties.

The *Medicare General Enrollment Period (GEP)* is from January 1 to March 31 each year, with coverage starting July 1. That's why you should plan ahead, because there could be a delay in receiving Part B benefits, depending on when you enroll.

The *Medicare Open Enrollment Period (OEP)* does not specifically relate to Medicare Part B, but should be mentioned here. During that period, which runs from October 15 through December 7 of each year, you can change decisions about other parts of Medicare, allowing you to change your Part D drug plan for the next year or to move into a Medicare Advantage program. (You can also move back to original Medicare from an Advantage plan during this period, but heed the warnings below.)

It's important to know what is—and isn't—covered under Medicare Part B. For example, there is no coverage for dental, vision, and hearing services (all of which may be covered under a Medicare Advantage plan). But there is coverage for many preventive services, such as an annual mammogram, bone density, prostate cancer screenings—all among a long list you can find at www.Medicare.gov. Additionally, Part B covers flu, pneumococcal, and hepatitis shots.

Here's a tip: If you want to find out if a particular service is covered *before* you take a test or make an appointment, go to https://www.Medicare.gov/coverage and you can search for each test.

Medicare Part B charges a monthly premium ($135.50 in 2019). However, higher earners pay a surcharge in the form of a higher monthly premium, ranging from $54.10 to $325 per month per

person in 2019, depending on their earnings from two years previous to the current year. Higher earners (over $500,000) pay an even greater surcharge, bringing the monthly premium for top earners up to $460.60 in 2019.)

There is also an annual deductible, which changes each year. In most cases, the monthly premiums are deducted from your Social Security benefit. But if you have enrolled in Part B and are not yet taking your Social Security, you will be billed monthly and likely pay with an automatic deduction from your checking account.

The conclusions you should draw from this section are the facts that Medicare Part B is both costly and tricky—and that it leaves a lot of potentially expensive gaps in coverage. That's why you must sign up for a Medicare supplement policy.

MEDICARE SUPPLEMENT (MEDIGAP)

Now you're entering in the world of complicated choices. Medicare supplement polices are sold through private insurance companies. The coverages are standardized, no matter which company offers them. They are named alphabetically, from A through N, though several (E, H, I, and J) are no longer sold. Every company must offer the most basic plan, A. You can see exactly what each type of policy covers at www.Medicare.gov, under the "Supplemental Insurance" tab.

This is a case where it does not pay to pinch pennies, because you're risking dollars. In addition to the basic, but limited, coverages that all supplements must offer, Plan F offers full coverage for Part A and Part B deductibles and coverage for Part B "excess charges," as well as paying for Part B preventive care coinsurance, and the coinsurance for authorized, limited days of skilled nursing.

Plan F is by far the most comprehensive supplement and, like all the others, is offered by numerous insurers who compete not on coverage (since all must offer the same), but on price and service. Price depends on your age at purchase, so buying earlier gives you a lower price, although it may rise because of inflation. But beware of policies that are *attained-age-rated*, which means the premium is planned to increase as you get older.

The most important advice I can give you is: *Be sure to purchase your supplement policy at the same time as you enroll in Part B—or within six months after.*

If you purchase your supplement within 6 months of enrolling in Medicare Part B, *you cannot be denied because of current or previous health conditions.*

It's easy to find and compare Medicare supplement policies. In fact, you'll see many advertisements for them, especially around the year-end open enrollment period, where people can change their coverage. But the best place to search is at www.eHealthInsurance.com or www.BoomerBenefits.com, where helpful representatives guide you through the process, and help you sign up for your supplement. There is no additional charge or commission for this service.

A word of warning: Choose your supplement carefully, If you later decide to move to a different supplement, you can be subject to medical underwriting and may not qualify for the most comprehensive plan. Also, as described below, the same underwriting requirement applies if you are moving back to traditional Medicare from Medicare Advantage. So choose your Medicare supplement policy carefully, because you likely won't be any healthier down the road if you need to make a change.

MEDICARE PART D

As they say in the infomercials, "Wait, there's more!" Just when you thought you had nailed your Medicare coverage, you realize that none of the above coverages included prescription drugs. And that could potentially be a very expensive and very long-term cost in your retirement. That's why, in 2008, Medicare created Part D drug coverage.

Part D is not required but you are highly advised to sign up for it immediately upon taking Part B, even if you are not currently taking any prescription meds. If you fail to sign up at the earliest opportunity, but ultimately sign up when you find you do need meds, there is a costly monthly penalty on the premium you pay—unless you had creditable drug coverage from an employer plan. If you're a high-wage earner, you'll also pay an extra surcharge on your monthly Part D premiums.

Since Medicare is prohibited—strangely, and thanks to the pharmaceutical lobby—from negotiating drug prices, the cost of your prescriptions under this program can still be expensive. And your meds can change in price every year, or may move into a different tier with higher co-pays, or may not be offered at all in a subsequent year, depending on the insurer. Or you may have different prescriptions added during the year.

For that reason, you must make your Part D choice not only at the initial signup, but you also must review your Part D plan every year during open enrollment between October 15 and December 7.

There is one simple way to search for the Part D drug program with the least costs for you, based on the drugs you are prescribed, of even if you currently take no medicines. The greatest tool on the Medicare.gov website is their "Part D Plan Finder." Just input that name in their search box.

The Plan Finder will do the work for you, comparing not only premiums and annual deductibles, but formularies (lists of drugs offered by each plan to make sure yours is included) and availability of generic drugs. If you want to work with your neighborhood pharmacy or nearby superstore instead of mail order, the search will take that into consideration.

All you need to do is put all your medicine bottles in a line in front of your computer screen, so you can input the correct names and dosages. Then with a click, you'll be able to see the plans that are likely to cost you least out of pocket. You can enroll directly through the website, or call the plan to do it over the phone.

As a side note, the dreaded "donut hole" is gone! It was an expensive period in which your drug insurance simply disappeared, leaving you to pay out of pocket—until you reached the level of catastrophic coverage, where your policy again picked up the cost. The donut hole was eliminated starting in 2020 for branded drugs, and 2021 for generics.

A final reminder: *Your meds and your drug plan's coverage and prices will change every year. Don't forget to do a new search every year during open enrollment.*

MEDICARE ADVANTAGE

By now, you've realized two things: Medicare isn't free and it doesn't cover everything. And one more thing has become clear: Medicare is complicated! If you're searching for a simpler form of Medicare coverage that is potentially less expensive because it doesn't require a supplement or Part D drug plan, you might consider Medicare Advantage (sometimes called Medicare Part C). For one monthly premium, all your care is coordinated and you don't have to worry about billing. Plus, the cost is likely to be much lower than the combination of premiums you pay with Parts B and D.

It's a brilliantly simple concept, designed by private insurance companies who figure they can control their costs and become more efficient at delivering services to their members. In fact, roughly 30 percent of today's Medicare beneficiaries opt for Medicare Advantage.

There's just one thing wrong: *You are limited to using the plan's choice of hospitals, physicians, testing services, and likely generic drugs.*

Are you willing to make that tradeoff? It might not seem so important unless you want to reconfirm a diagnosis or treatment with a second opinion. You can't go outside your plan's list. Perhaps a hospital in another part of the country is doing special surgeries that could be a benefit. Sorry, it's outside the plan group. You have a long-time relationship with your physician, but if he is not included in the group, you'll have to change.

That's not the only consideration with a Medicare Advantage plan. Many look attractive with very low monthly premiums, some even zero! But the catch is they charge co-pays for services like X-rays and lab services and dialysis, that can cost you a fortune when you get sick. So if you're choosing an Advantage plan, be sure to look at the list of co-payments that might be required.

And one more consideration: While you can always switch to Medicare Advantage during open enrollment, it's not so easy to switch back. Yes, it's allowed to go back to Part B. But it may not be possible to get that best supplement policy if you've developed a medical condition in the interim.

A FINAL CONSIDERATION

This chapter could not possibly cover all your Medicare questions and the quirks in the law. I have a few suggestions for you if your situation is complicated by a spouse who is still working, or adult children (under 26) who are still on your company plan when you become Medicare-eligible, or myriad other considerations. Making a mistake could be costly, not only immediately but also in the long run.

There is a terrific, consumer-friendly online program at www.i65.com that will walk you through this maze of choices. The $65 cost is well worth it when you consider the cost of mistakes. And for an extra fee, you can get a personalized consultation with this group of experts on making your best decisions for Medicare benefits.

And if you want to slog through this on your own, consider reading the latest edition of Philip Moeler's *Get What's Yours for Medicare*, available on Amazon.

The dates, costs, and details of both Medicare and Social Security change annually. Be sure to check online at www.Medicare.gov to make sure you have the latest rules and information.

The Savage Truth on Aging Alone

It's a sad Savage Truth that many people will grow old alone, especially women, who statistically outlive men. According to the latest research, more than 12 million Americans over age 65 live alone. And 69 percent of them are women. Some have adult children, but there are no reliable statistics on how many have no family members, or have family members who do not live nearby.

Solitude certainly has its own rewards. But when it comes to finding someone to handle your financial affairs as you age, or whom you trust with a health-care power of attorney, you'll be faced with some tough choices. The problem is that as we age, so do our friends!

There are elder law specialists who will become your fiduciary. You can find them at www.NAELA.org, the National Association of Elder Law attorneys. The time to start thinking about this issue is when you create your revocable living trust (RLT). You'll need to name a successor trustee if you cannot act.

The person you name as successor, who will have to handle distribution of your estate according the directions you leave in your RLT, may not be the same person who gets your health care power of attorney. These are, after all, quite different tasks.

Do you have a trusted younger friend who would be present when difficult medical decisions are made? That should be someone who lives nearby, is intelligent and is willing to take on what could become a time-consuming burden. Remember, to give a copy of your health-care power of attorney to your physician, so there are no arguments when you are incapacitated.

Your successor trustee could be a younger relative who lives in another state. That person may or may not be a beneficiary of your estate. But he or she will have to handle some paperwork at the time of your death. Perhaps you should name your estate planning attorney as co-trustee. The trustee will be paid for services out of your estate. If you don't have someone you trust to handle these duties, contact the Association of Independent Trustees at www.TrusteeAlliance.com, to locate a professional, bonded trustee to handle this task.

In the old days, when everyone just made a simple will, your attorney would jump at the chance to handle these legal tasks. After all, a will must go through probate, the legal process of changing title to your assets. And that process generates fees. But a revocable living trust avoids probate, although not the challenges of finding heirs,

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helping with IRA rollovers, and distributing assets. It can still be time-consuming, so there should be a provision to pay the trustee a moderate amount for these services.

These are all things we don't want to consider—until it's too late. So here's another reminder to download my "Personal Financial Organizer" form and fill it out. Let your successor trustee know where to find it, and its information about accessing your financial accounts and advisors. This is especially important if you are living alone and may not be able to communicate this important information in a crisis.

I believe that planning is the best insurance against sudden disaster.

TERRY'S TO-DO LIST

1. Check your Social Security record at www.SSA.gov, and create your personal account in "My Social Security."
2. Never take benefits early—before your full retirement age—if you can possibly avoid it.
3. Prepare for the optimal time to collect Social Security benefits. Use the software at www.MaximizeMySocialSecurity.com.
4. Plan in advance for Medicare Part B so you don't miss the enrollment dates and can qualify for the most comprehensive supplement.
5. Make sure your financial affairs are well organized and documented to make things easier for your successor trustee and your heirs.

CHAPTER 15

THE SAVAGE TRUTH ON LONG-TERM CARE INSURANCE

Insure Your Retirement Lifestyle

Long-term care insurance (LTCI) is an essential part of your financial plan at any age. And in the past few years, new types of policies have created more realistically priced, guaranteed benefits to guard against impoverishment from the need for help doing basic activities of daily living and/or having a severe cognitive impairment.

In recent years, long-term care insurance has deservedly received some bad publicity. Decades ago, when many policies were purchased, insurers made significant mistakes in calculating premiums, underestimating not only the rising cost of care, but the fact that people would continue their coverage (unlike life insurance policies, which are often surrendered early). A long period of persistently low interest rates added to the problem.

The result was a dramatic—sometimes more than 80 percent—increase in annual premiums on older long-term care insurance policies. Policyholders were shocked, but most of these policies are still more reasonably priced than if they were starting out to purchase similar coverage today. Still, the increases have been devastating to many seniors who can ill afford higher premiums.

Given the choices offered, I always suggest maintaining some form of reduced coverage if the new premiums are unaffordable. Either

shortening the care period, or in some cases removing the inflation protection and freezing the benefits to where they are currently, are some solutions. Also, those dramatic price increases should moderate in the future. But, just as with auto and homeowners insurance, there will likely be more annual increases ahead.

Instead of letting that possibility scare you away from long-term care insurance, this could be the time to turn to a newer type of policy, which removes the threat of rising premiums, while guaranteeing coverage for care. It's called a *hybrid asset-based* or *combo* policy, in which you make a one-time deposit (or a series of premium payments) into a life insurance policy. That policy offers a long-term care insurance rider, which means you leverage your money to pay for long-term care, for one or two lives. And if the care isn't needed, your beneficiaries get a guaranteed death benefit, less any claims paid out.

This hybrid LTCI coverage has been growing in popularity. Of the 350,000 Americans who purchased LTCI in 2018, 84 percent purchased the hybrid/combo product. The specifics of these combo policies, along with costs and benefits, are discussed later in this chapter.

But first, it's important to have an overall view of why it's so important to insure against this huge—and very likely—cost to your retirement, and even more to your family's well-being.

Timing is Everything

This chapter on long-term care insurance is definitely not just for people on the verge of retirement although it is almost never too late to purchase LTCI if you're in good health. But given the structure of these new combined LTCI and life insurance policies, the "sweet spot" for purchase could be as early as age 50. And some people in their thirties have enough extra cash or sufficient income to put into one of these combo policies, perhaps over a period of years.

No matter what your age, the cost of care could have a direct impact on your own financial future—because you might be responsible for your parents' care. The time to start thinking about it is *now.*

Will you care for your parents—and your in-laws—in their old age? Will you invite them into your home, to use the bedroom your college kid just vacated, and will you provide them with help dressing

and bathing? Or let's reverse the situation: Who will care for *you* in your old age? Will your children invite you to live with them and help you shower and take you to your doctors' appointments?

Think about it, because one way or another we're all going to be faced with this problem. If you're all alone, the situation might be even more dire. We don't like to think about needing help, and we haven't had much of an example of what a burden—financial, physical, and emotional—it is to have the responsibility for caring for an older loved one.

The boomer generation is living longer, healthier lives. But sooner or later, time will catch up. It's estimated that seven out of ten people over age 65 today will need some long-term care, and one of five will need more than five years of care.

And that kind of care is costly, whether given in the home, or in assisted living, or in a nursing home. The cost of that care is not covered by Medicare (except for a limited number of days in a skilled nursing facility after a hospitalization), or by your Medicare supplement insurance. You, or your family, will have to spend a lot of money to provide that care, and those costs are rising faster than inflation. For example, according to the latest annual cost of care survey by Genworth Financial:

- The average private-room nursing home now costs $100,375 per year.
- Assisted-living facilities now cost nearly $48,000 a year, more if you have a cognitive problem.
- Home health aides cost nearly $21 an hour. If you needed care nine hours per day, five days per week while your family caregiver is working, it would cost $49,140 per year.

But those numbers may not reflect the *true* cost of care. They don't take into account the fact that some people will require 24 hours of care, and the numbers above for home health care reflect only one nine-hour shift. There's also the income lost by family members who provide unpaid care.

Think about how those costs would add up over several years of care. Today there are 1.8 million Americans residing in skilled nursing facilities, and 12 percent have been there for five years or more! Of course, some of them are younger, victims of accidents or debilitating disease.

Even Superman (Christopher Reeve) needed long-term care! Reeve was only 43 when he was paralyzed in a horse-jumping accident. Reeve lived for another nine years after the accident, surrounded by

an array of expensive medical equipment and nursing talent. He did much to publicize the need for research into spinal cord injuries, and his experience serves as a warning to all of us about the need for this type of insurance.

Having *long-term care insurance* does more than just pay for your care. It keeps you from spending all your savings, so your spouse or family does not become impoverished. And it gives you the choice of where you want to receive that assistance—at home, in an assisted-living facility, or in a private nursing home. It even pays for adult day care, a boon to working caregivers as well as non-working caregivers who are desperately in need of a break.

If you have spent down almost all of your assets and can't pay for your care, the state Medicaid program will take over. You will likely be placed in a state-funded nursing home. Given the financial constraints on most state governments these days, and with due respect to those who work there, this is not the place you would choose to reside, or would want your mother or father to spend their last days.

When it comes to planning for your future, long-term care insurance gives you peace of mind. Some call it "nursing home *avoidance* insurance" because it will give you *choice* of having care at home. Or you could consider it "retirement planning insurance" because you can live the retirement lifestyle you've planned without worrying about extended health care expenses or caregiving being a burden on your spouse or family.

Long-term care insurance is a multigenerational product. It buys peace of mind for the person who is insured, and an equal portion of relief to family members who would otherwise be left with the financial burden of paying for care. Put simply, having a long-term care insurance policy can allow those who care for you and about you to put financial considerations aside.

IN CASE YOU'RE WONDERING

I've given the subject of long-term care insurance a special chapter of its own, because I sense that one of the largest looming social problems for our country will be the huge cost of caring for an aging population. I've long been an advocate of LTCI because I've seen firsthand how costs pile up, and how desperately

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you want your loved ones (who cared for you as a child) to have the best care possible in their last years.

I paid for my grandmother's long-term care in the best private nursing home we could find. (Just visit a state-funded Medicaid nursing home as an alternative, and you'll see what I mean.) Her need for care came at the same time I was paying my son's college tuition. I have never seen money fly out of a checking account so fast.

I then purchased policies for my mother, my father, and myself. Yes, it was costly, but I remembered the old Savage Truth: *The lessons that cost the most teach the most.* Insurance seemed like a bargain compared to paying for years of care. My mother passed away without meeting the 90-day deductible to trigger her insurance. Thank goodness she didn't suffer long and didn't need extended care.

My father lived to a ripe old age and didn't want to access his long-term care policy. He lived at home, and I had to work to convince him to have needed help a few hours a day. That minimal cost ultimately satisfied the 90-day policy deductible. The timing worked out well. After the deductible period was satisfied, he almost immediately needed full-time care, which was fully covered by his policy. And he lived at home until a few days before his death at age 96.

My own policies give me peace of mind that my family will not be burdened by the cost of care I might need. Instead, I hope that money will go to my grandchildren's education.

Yes, I know that not all of my readers can afford to be fully insured for long-term care. But in most states, even a small amount of insurance can get you into a private facility, where you may be able to remain if you use up your insurance benefits and require state aid. So please, read on.

Understanding Long-Term Care Insurance

The time to purchase a policy is when you're healthy and can qualify for the least expensive policy. All LTCI policies require some level of medical underwriting to determine that you are eligible and to set

the price of your coverage. Given the benefits provided by the newer combo life and LTCI policies, you might start considering LTCI insurance at age 50 or earlier, when prices will be lower. And you're not too old to buy a policy at age 70, if you're still in good health and can afford the premiums. The amount of coverage you can get for your money will be more expensive as you grow older, so don't procrastinate.

When it comes time to actually use your coverage, it's not simply a matter of calling the insurance company and telling them you need a caregiver. A physician must certify your inability to do *two or more of the six basic activities of daily living* on your own, such as eating, bathing, dressing, toileting, transferring (walking), and continence—or the need for care because of a severe cognitive impairment (e.g., Alzheimer's)—any of which requires substantial supervision. The physician must also certify that you are expected to need that much care for at least 90 days.

It's all stuff you don't want to think about because it's hard to imagine you might require a caregiver to assist you in doing those tasks. But when the time comes to access your policy benefits—either at home, or in assisted living, or in a nursing home—you'll be glad you can pay for the best care available.

The most recent statistics show that the 10 top long-term care insurers have paid out $10.3 billion to more than 303,000 individual claimants, according to the American Association for Long-Term Care Insurance (www.AALTCI.org). That number will grow dramatically in future years as the nation's 10 million current LTCI policyholders grow older and increasingly need care.

In fact, the industry reports that the largest ongoing claim in 2018 has paid out $2,636,417 over more than 15 years. The association says LTCI insurers reported multiple claims that have exceeded $2 million!

Here's one more Savage Truth: *Long-term care insurance is especially important for women.*

It's a fact: Women live longer than men. So you're likely to wind up on your own. If there was a man in your life at one point, he is likely to have used up the family's financial resources, as well as your energy in providing care and assistance. That longest ongoing claim at $2.6 million is for a woman. I ask all women to please at least consider whether they can afford some kind of coverage—and their daughters and sons to think about contributing to the cost of their insurance.

And if you are a woman who expects to be alone in her later years, there's an added benefit that comes with an LTCI policy. Most policies provide a geriatric care manager who not only will

help with the payout, but also assist you in finding appropriate care providers or settings. This is especially important if you're a senior on your own. Find more information on this topic at www.AgingLifeCare.org, the website of the professional geriatric care managers.

Now, with those basics covered, let's take a look at what you should consider when purchasing a long-term care insurance policy.

Traditional Policy Coverage

Despite the risk of rising premiums, many people still choose the traditional long-term care policies because they don't have a lump sum to purchase a hybrid policy. These same basic definitions listed below also apply to the LTCI riders that are attached to the newer hybrid policies, so it's important to understand these key aspects of coverage.

Long-term care insurance policies typically cover nonskilled, skilled, and custodial care, as well as adult day care, either in your home or in an assisted-living facility or nursing home. All policies vary slightly in their coverage, so you will need an insurance agent who is familiar with these products to guide you through the purchase (more on that later in this chapter). But you should know the basics, which follow.

ELIMINATION PERIOD

Just as you have a deductible on your car insurance, there will also be a deductible—called a *waiting* or *elimination* period—before your LTCI coverage kicks in. Typically, this is a 90- or 100-day period. But with full-time or nursing home care costing more than $8,500 a month these days, you might be relieved when the policy kicks in after about three months. In some major metropolitan areas, the monthly costs of care will be even higher.

DAILY OR MONTHLY BENEFIT

Choosing a specific daily or monthly benefit is the most common way to define the amount of coverage to purchase. You'll want to have at least $200 a day ($6,000 a month) for your initial benefit. But if that makes the policy too expensive, it's better to have a smaller amount of coverage to assist with the cost of care than none at all. Remember, you will still have some income and assets of your own to contribute to your care.

LENGTH OF BENEFIT

Your policy could offer benefits for a period from two years to as long as you need care—sometimes called *lifetime* benefits, which is especially expensive. (Only two major carriers offer lifetime benefits now, National Guardian Life and OneAmerica.) These days the most popular benefit period is three to five years. But you are not restricted to using up your benefits in the specific time period. Any day or month you don't use the entire daily or monthly maximum, the difference stays in your benefit pool and makes it last longer. Or, if you need some care for a few months (after the elimination period) and then can go without care for a while before another period of needed care, the *pool of benefits* will last even longer. The exception to this is if you have a policy that pays out the entire daily or monthly benefit in cash, regardless of how much care you need. (More about that later.)

The average time someone needs long-term care is about three years—although Alzheimer's and stroke victims could require assistance for a decade or more. The Society of Actuaries further points out that women who need care longer than a year need an average of 4.7 years and men, 3.8 years. When choosing a plan that fits your budget, it is better to buy a larger daily or monthly benefit with a shorter benefit period instead of the reverse. Why? The higher the daily or monthly benefit it, the less you will have to strain to make up the difference between the cost of care and what your insurance policy pays.

INFLATION PROTECTION

The potential impact of inflation on care costs is a real concern when purchasing long-term care insurance. After all, you hope to use this coverage in the far-distant future, if at all. So you'll want to purchase some form of inflation protection when you buy the policy. The best policies will offer at least 3 percent *compound* inflation protection.

OPTIONAL RIDERS

Your agent may mention some optional riders to the standard, traditional LTCI policy. Most policies waive the premium when you start using the benefits. If it is an option, buy it. It doesn't cost much and you don't want to keep paying premium while you are receiving benefits. Some offer an option to waive the premium on a couple when only one person starts using the benefits. Other policies offer a *return of premium* feature, which promises that if you die without using the

coverage, the premiums you paid will be returned to your heirs. You can even pay extra to have all your premium returned to your family when you die, whether or not you needed care. This coverage is costly, and you might be better off using the money to increase your basic coverage.

There is also an interesting *shared-care* rider available on most policies. It allows couples to utilize each other's benefit pool, or access a third pool of benefits. This rider requires that each spouse purchase the same benefits. When one spouse dies, the remaining total lifetime benefit (if any) from the deceased spouse's policy will be added to the remaining spouse's total lifetime benefit. The premium for this rider will vary based on the age of the applicants and by carrier.

WHAT SHOULD IT COST?

Obviously, the annual premium on this type of policy will vary depending on the choices you make—working with your knowledgeable LTCI specialist. Your age and health make a difference, as well as your state of residence (care costs are higher in some states). But even more impactful are your choices about level of benefits, length of coverage, inflation protection, and the other factors described above. And as we have all learned, the current premium at time of purchase may be adjusted upward in future years.

That said, here's an example of what a traditional (annual premiums) policy might cost at this writing for a 60-year-old woman, in good health, residing in Illinois. She decides to purchase a policy that offers five years of coverage, with a 90-day elimination period, at a current daily benefit of $210/ day ($6,300/month).

The policy includes a 3 percent compound inflation protection that guarantees her a maximum benefit of $509/day at age 80. By the time she reaches age 80, she would have a total "pool of benefits" of $930,238, if she hasn't used any benefits. If she starts needing care shortly after purchase, there is a guaranteed pool of benefits amounting to $383,250.

There are two ways to pay for this policy. She can make an annual premium payment for the rest of her life until the premium is waived when she starts receiving benefits. Alternatively, she can pay the premium monthly bank draft, quarterly or semiannually, but annual is usually the least expensive. This is called lifetime pay. Please note that the premium is *not* guaranteed to remain the same. In fact, she knows going in that the premium is likely to rise in future years.

If she decides on an annual payment, the current cost will be $4500 per year. Or, some companies allow her to pay off the premium in a specific number of years. For example, if she chooses a 10-year payment schedule, the initial annual premium is $12,618. That premium could rise during the next nine years of payments, but can never go up once she has paid her premium for 10 years.

That is a whopping cost for most 50-year-old women to pay, on either schedule. There are some ways to mitigate those costs. If she owns her own business, an age-based amount of her premium may be paid pre-tax, somewhat reducing the impact. Those who have health savings accounts (HSAs) at work can use those dollars toward the same age-based LTCI premiums. Later on, if a person has significant unreimbursed medical expenses (exceeding 10 percent of adjusted gross income) the premiums for this insurance can be considered part of those potentially deductible costs.

And, long-term care insurance offers significant savings if there are spouses or partners involved. But the costs for this insurance at first look are astounding. They are only dwarfed by the potential costs of the care itself.

At this point, many clients go back to the drawing board. Perhaps the benefit period could be reduced. For example, dropping from a five-year benefit period to a three-year benefit period in the above example would save $1,000 a year on premium. However, the benefit pool would drop about $375,000. So is it worth saving $30,000 over a 30-year period to give up $375,000 in benefits? Only you can decide.

That's why it's so important to work with a knowledgeable agent (see references at the end of this chapter) who specializes in long-term care insurance, and who can get quotes from a variety of insurance companies.

And before you think there is absolutely no way you can afford any long-term care insurance coverage, consider the hybrid or combo policies that are becoming far more attractive in the coverage and cost protection they offer.

Combo Life/LTCI Policy Coverage

This is a popular alternative way to purchase long-term care insurance today. As noted earlier, in recent years the sale of hybrid policies has far outnumbered traditional LTCI. Combo or hybrid policies remove uncertainties about rising premiums, and they give guarantees that if the money is not spent on care, your beneficiaries get a

death benefit. You can even borrow some money out of your policy (reducing money available for care or the death benefit). It's easy to understand, and easy to price. And remember, the price you're paying is the price of peace of mind.

Here's how these policies work. You deposit a lump sum of money into the policy. You can do that all at once, or in a series of guaranteed payments lasting up to 20 years. Obviously, the longer you stretch out the payments, the more you ultimately pay.

You are purchasing a guaranteed whole life or universal life insurance policy, with a long-term care rider. The entire death benefit can be accessed as monthly LTCI benefits. The policy accumulates a monthly benefit for long-term care. Any unused benefits pass to your beneficiaries in the form of a life insurance death benefit. If a person uses the entire death benefit for care, some carriers will still provide a residual death benefit of 5 to 20 percent.

If you're worried about the need for longer coverage (if Alzheimer's is a concern in your family), you can purchase an optional lifetime benefit rider, offered only by the One-America Asset Care or Annuity Care policy. Annuity Care is based on a deferred annuity and can be accessed with fewer health questions. Both types offer another unusual benefit: if you want to cover the first few years of care out of your own substantial assets, but guard against the need for extended care, they offer a 33-month or a 50-month period of flat payouts, then the policy kicks into unlimited benefits. This means there is typically no inflation coverage on the 33 or 50 months, but the remaining benefits grow from day one based on the inflation factor you choose for the rest of your life. Asset Care or Annuity Care also offers the opportunity to cash in your policy with a full return of premium, unless money has already been withdrawn for care.

Pricing a Combo Policy

A combo policy has a one-time premium (or it can be structured over as long as 20 years). So the up-front price has something of a sticker shock for many. Just remember, that you are getting a guaranteed amount of LTCI coverage, and also a death benefit.

I've asked my trusted experts at MAGA Long Term Care Planning (www.MAGALTC.com or 800-533-6242), my long-time LTCI experts to create typical scenarios for purchasing a hybrid/combo policy.

The first example is for a couple, both ages 65, using the OneAmerica Asset Care product with a lump sum single payment of $250,000. Here's the coverage that would buy.

They get a long-term care benefit of $6,888 per month, per person, until they have exhausted the amount of the death benefit. At that point, they have a continuation of benefits rider, which extends their long-term care benefits at an even higher level of payout, reflecting the inflation protection. With this policy, there is a 30-day elimination period for home health care, and a 60-day elimination period for care in a facility. The care benefits include a 3 percent compound inflation adjustment.

There are no premium increases to worry about because they are covered by the single $250,000 deposit. But what if they never need care? In a traditional policy, all those premiums are down the drain if you die instantly of a heart attack or in a car crash! That's why the combination of life insurance, purchased with that same initial premium, makes this combo policy so attractive.

If one spouse dies, the survivor would not likely want to activate the death benefit, because now the survivor has an increased potential need to use the long-term care benefit. But, assuming no care benefit was used, and no cash withdrawn, at the death of the second spouse, the beneficiaries would receive $229,628.

Now if the purchaser were a single buyer who never used the care portion of this policy, then the death benefit would provide significant cash for the beneficiary. Here's another example:

A male, age 50, deposits $100,000 into the Lincoln MoneyGuard II combo product. His initial LTCI benefit is $6,296 per month, or a total of $488,662 per year in coverage for all types of long-term care costs (home, assisted living, adult day care, nursing home and hospice). The coverage will continue for a minimum of six years. And there is a 3 percent compound inflation increase in the benefits which will provide over $1 million in total benefits in 30 years.

Or you can structure it another way—paying a fixed and guaranteed premium over 10 years. In that case, you would have to pay $12,819 a year or $128,190 over 10 years to get roughly the same benefits. That makes it more affordable from a cash flow point of view.

But what if he dies two years after purchasing this policy, never using the long-term care coverage? His named beneficiary will receive a death benefit of $151,092.

The point of hybrid or combo life/LTCI policies is that you get peace of mind, whether you need the care or not. Either you make a one-time premium payment or a guaranteed annual payment for up to 20 years. In either case, your premium can never rise. And your coverage can never be diminished unless you borrow money out (which is never recommended).

Now, don't think the insurance companies are giving these benefits away. They've done the calculations. They have the use of your money over the years, until they need to pay out for care, or for a death benefit. But insurance is all about peace of mind. And in this case, when you think about it, (which you won't until you really need it), the price makes sense.

Living Without Long-Term Care Insurance

Despite the fact that the cost of long-term custodial care for an aging population threatens to overwhelm state and federal budgets, not much has been done to prepare for this eventuality. In fact, you could say that our state governments have offered such generous benefits that many people mistakenly figure it's not worthwhile to pay for long-term care insurance. They expect the state will pay, and that they will be able to transfer assets to others in their family in order to qualify for state Medicaid benefits.

Obviously, they haven't been inside a state-funded nursing facility in recent years. Is that really where you want to spend your final years, instead of receiving care in the familiar surroundings of your own home for as long as possible?

Many people mistakenly assume that Medicare will cover their nursing home needs, but it pays only for a limited number of days after a hospitalization of at least three days. Medicare supplement policies cover only the co-payments for those limited days of care covered by Medicare. Instead, it is the jointly funded state and federal Medicaid program that covers care for indigent seniors. And it's a program that is already being swamped by conflicting needs in state budgets.

You must spend down most of your assets and apply almost all of your income before Medicaid will pick up the nursing home bills. You can't simply transfer assets to your children or a trust in order to qualify for Medicaid. Strict rules govern transfer of assets by the

individual or spouse within five years of entering a nursing home. That's called the *lookback* period, and states are giving a much closer look at assets before picking up the tab. Not to mention the fact that a Medicaid nursing home might not be your long-term care location of choice.

Although the definition of Medicaid eligibility can change every year and varies from state to state, there are certain constants: A home of any value is exempted for singles (who are expected to return to the home) and for married couples. But Medicaid can attempt to recapture the cost of care after your death, preempting your plans to leave your home to your heirs. And if you receive a pension or Social Security, that income will be applied to the cost of your care.

Medicaid typically also exempts a prepaid funeral plan, cemetery plot, and certain personal items. Above those amounts, a married couple will be allowed a limited amount in resources to care for the spouse who remains outside the nursing home (the *community spouse*). Each state also has a monthly spousal asset exemption for the spouse who remains in the community.

But the bottom line is that states are going to get tougher about going after your assets if they have to pay for your care. There is no substitute for being able to pay. And the best way to ensure that you can pay for the care you want is through a long-term care insurance policy.

If you would like to find out about your state's rules for Medicaid nursing home eligibility, there is a wonderful interactive map, where you can click on your state and find the current specifics. You can find it at https://www.SeniorPlanning.org/long-term-care-medicaid-eligibility.

A Present for Your Parents

More and more adults are buying long-term care insurance policies for their parents. They buy the policies not only to preserve their inheritance, but to guard against spending their own retirement funds to take care of their parents. Seniors who have built up enough assets to cover their own long-term care needs may not require such a policy. But if paying for the care of one parent would leave the survivor penniless, adult children might want to make sure that both are adequately insured.

When looking into the subject of long-term care, those still in their fifties suddenly realize that the annual premiums are far more

attractive for them than for their parents. Since one in four applicants for long-term care insurance is turned down, it's better to buy a policy while you are younger and in good health.

But how do you bring up the discussion with your parents, since it's not an eventuality that either of you wants to consider? Perhaps you and your siblings can join together to present a "certificate" for an appointment with an insurance agent as a Mother's Day or Father's Day present. Of course, the appointment is free, but you could announce that you're getting together to pay all—or half—of each year's premium.

Surprisingly, this gift can go both ways. I've heard that some wealthy parents are using their $15,000 annual gift exclusion to pay premiums on LTCI policies for their adult children!

You might be surprised that this starts a discussion with your parents about their plans for aging—something they hesitated to discuss with you. But no parent wants to be a burden on their adult children. We'll talk more about that in the next chapter on estate planning. And please don't skip that chapter because you think you're too young to worry. I'm superstitious, and I believe that planning is the best insurance against sudden disaster.

GETTING STARTED

It can't hurt to ask for a price quotation on LTCI insurance for yourself or your parents. So pick up the phone and ask. Here are the names and contact information for trusted experts:

Long-Term Care Insurance Agencies/Brokers

www.MAGALTC.com	800-533-6242	Brian Gordon
www.GotLTCi.com	800-582-8425	Phyllis Shelton

CHAPTER 16

THE SAVAGE TRUTH ON ESTATE PLANNING

It Pays to Plan While You Can

It's the one subject people absolutely hate to talk about or think about. It's the one subject guaranteed to cause an argument or stop a conversation: *What would happen if you suddenly died tomorrow?* (See, you really wanted to skip this chapter!)

But like all other distasteful tasks, once you've made an estate plan—a simple will or living trust—you'll feel a whole lot better when it's done. You'll have the satisfaction of knowing that your loved ones will be taken care of and that the government will not be in charge of your assets. And the Savage Truth is that the entire process is easier and less expensive than you think.

This subject is not about saving on estate taxes. The most recent changes to the estate tax law, part of the Tax Cut and Jobs Act of December 2017, lifted the burden of federal estate taxes so they will be paid only by wealthy individuals whose estates exceeded $11.4 million or couples with wealth of more than $22.8 million (in 2019). I'm guessing that pretty well exceeds the concerns of most of my readers.

But that law is scheduled to expire on January 1, 2026, and the exemptions will revert to the previous $5.49 million, plus an inflation adjustment. Or Congress might decide to pass a law in the interim, which could impact the level at which federal estate taxes apply. At

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the current levels, the federal taxes currently do not impact a significant number of estates. An estimated 2,000 estates, or 0.1 percent of people who die, are expected to owe estate tax for 2019.

Individual states may also have estate taxes with lower exemption levels. At this writing, six states have an inheritance tax and 12 states and Washington, D.C. have an estate tax. These taxes can take a significant bite out of your ability to pass on your assets to your beneficiaries. And estate taxes are due and payable nine months after the date of death!

Even though you are not likely to pay estate taxes, you should have some clarity on what's involved. The federal estate tax is a flat 40 percent on amounts above the exemption level. State taxes can be as high as 20 percent of the state's exemption level (likely far lower than the federal exemption) and state taxes are typically graduated, increasing quickly once your estate is subject to them.

Estate taxes look backward at the gifts you've made over your lifetime, as well as the value of your estate at death. So if you gave your children the gift of a down payment on a house or distributed some of your wealth in advance of death, those distributions are considered when valuing your estate for taxation.

There is one important exception: You may gift $15,000 per year to any number of people without impacting your eventual potential estate taxation. A married couple could each give $15,000 per year, or a total of $30,000, to each of their children—or to anyone else.

There is another significant exception to the combined federal estate and gift tax: Spouses can transfer an unlimited amount of wealth to each other (assuming each is a U.S. citizen) without incurring any tax. That looks like a handy planning device, until you realize that Uncle Sam could get an even bigger cut of your estate when the surviving spouse dies. (See the section on financial planning for spouses, below in this chapter.)

These exemptions should be enough for most of my readers to avoid estate taxes. But, when you total the value of your house, retirement plan, and the face value of life insurance if you are the owner, you can see that the estate tax has the potential to impact your planning, especially if lower exemption limits return.

The point of this chapter is not about escaping estate taxes. It's designed to introduce you to the basics of planning to pass on your assets without creating a family feud, without being subject to lengthy and unnecessary court proceedings, and without having your heirs

subject to the income taxes that might be required on payouts from your retirement accounts.

Surely, those incentives are enough to send you to an attorney who specializes in estate planning in your state of residence. And having a qualified attorney is important. Estate planning is not a do-it-yourself project with forms found on the Internet. By the time a mistake is discovered, you won't be around to correct it.

Why *Everyone* Needs an Estate Plan

Consider this: You're a young couple with no children and have put all your assets in joint name. On the way home from a party, there's a terrible accident. You die at the scene of the crash; your spouse dies a week later in the hospital. No will. You died first, so your assets pass to your spouse. When your spouse dies, everything goes to your mother-in-law!

If you die without any plan—*intestate*—state law will determine who gets your assets, who will raise your children, and even whether your pet will be given to a friend or an animal shelter. The time to plan is now.

An estate plan is not only for those who have a sizeable estate. Your estate is everything you own. It includes your house or condo, mutual funds, savings accounts, 401(k) plan and IRAs, life insurance, clothes, and car—as well as your debts. It even includes digital assets, such as your airline miles. It may not seem like much to you, but even your personal property might have some sentimental value to your family and friends.

Even if you have a very small estate, it makes sense to have a simple plan to distribute those assets at death. Think of the aggravation you'll spare your parents, children, and friends by organizing your financial affairs. And if you suddenly notice that your estate has grown into a sizeable amount over the years, think of the money you could redirect from the federal government to your heirs or charity just by planning.

Whether you're single or married, just starting out or in your retirement years, a parent or childless, you need to make a plan in case you die suddenly or are incapacitated and unable to make decisions for yourself. As you'll see, the plan can be a simple and inexpensive document that has a great deal of power to carry out your wishes.

Finally, accept this bit of superstition that passes for a Savage Truth: *If you don't have an estate plan, you're tempting fate.*

Joint Tenancy Is Not a Solution

Many couples title all their assets in joint name and make each other the beneficiary of their retirement plans at work. They figure this simple solution will save on the costs of making an official estate plan. But joint tenancy not only doesn't solve all your estate problems; it can create problems you never contemplated.

The most common form of titling property in the names of co-owners is *joint tenancy with right of survivorship*. It's simple to purchase real estate in this manner, or even to retitle a bank account with the name of a relative or friend. At the death of one of the owners, the entire property automatically passes to the co-owner, usually upon presentation of a certified death certificate to the bank or title company. There is no lengthy court procedure to transfer title or ownership in the account or property.

Although this may seem like a simple solution to distributing property, there are some drawbacks to joint tenancy with right of survivorship. When you enter into such an arrangement, you are exposing your portion of the property to the other person's creditors. If one owner is sued, the property held in joint name may be tied up in a court proceeding. For example, a parent who jointly titles property with an adult child could find that property involved in the child's subsequent divorce proceeding.

Similarly, joint tenancy restricts the right of one owner to sell the property. And if either party should become mentally incapacitated, a court proceeding might be required, with the court stepping into the role of the joint owner who cannot make decisions. If you hold property jointly, each should give a financial power of attorney to the other—perhaps limited to that property—in order to avoid a court conservatorship.

Placing an asset such as a home or savings account in joint tenancy after it has been owned by one person can also create a gift for gift tax purposes. Aging parents sometimes decide to add an adult child's name to a bank account for purposes of convenience, authorizing withdrawals on either signature. But adding a joint owner could impact the combined estate and gift tax when the money is withdrawn—if the amount exceeds the annual allowable gift. That shouldn't be a problem under the total current exclusion amount of $11.4 million per person.

Adding a child on stock or a brokerage account means the child assumes that parent's basis instead of getting the stock at death with a stepped-up basis. The step-up creates a new cost basis—the value as of the date of death—for capital gains tax purposes. Transferring (or selling) highly appreciated stock shortly before death creates an unnecessary capital gains tax liability.

Finally, placing property in joint tenancy ownership supersedes instructions that may be left in a will or revocable living trust (RLT). You may want a portion of your property to pass to your children, but if you've titled your home or investment account in joint tenancy with your spouse, that property will not become part of your estate covered by your will. It will pass directly to your spouse. And if your spouse remarries, he or she may leave the property to his or her new spouse, completely disinheriting your children.

A Will Won't Prevent Probate

You've probably read this far and decided that it's worthwhile to make a simple will. But a will won't solve all the problems just described. Yes, a will can clearly direct how you want your property distributed at death, but before title to your property (your house or investment accounts, for example) can be changed to the name of your beneficiary, your will must pass through *probate*. That's the court procedure required to change title to your assets. A will guarantees that assets in your estate that are titled in your name go through the probate process.

Probate is simply the process of *retitling your assets* into the name of the person you designated as your beneficiary. But before that can be allowed, your assets must be made public to give your creditors a chance to file claims. The probate process makes your will an easy target for heirs who want to contest your will, causing additional delays and costs to your estate.

Probate has nothing to do with estate taxes, but it does take a long time—as much as a year or more, during which time your heirs may be restricted from transferring the property. Probate also costs money—fees for the lawyer handling the probate process.

When your will is filed with the probate court, it becomes a public document, exposing all your probate assets and the terms of your will to the public record. If you own property in more than one state, perhaps a vacation home, your will must go through probate in that state as well.

All property titled in your name must pass through probate, except for jointly held assets, assets titled payable-on-death and retirement accounts or life insurance policies where you have named a beneficiary other than your estate. If you have named a minor beneficiary, the child must have a court-appointed guardian to receive the funds, which are then tied up in probate court until the minor becomes 18 years old.

Of course, property held in joint name with right of survivorship passes directly to the survivor, exposing it all to his or her creditors and taking future direction of these assets entirely out of your control.

There is a much better way than either a simple will or joint survivorship to plan for your hard-earned assets. A *revocable living trust* gives you control over distributions not only at death, but even beyond death. It protects your wishes while you are alive but incapable of making decisions on your own, and it can be the basis for protecting money that would otherwise have gone to the government.

The Savage Truth on Revocable Living Trusts

The cornerstone of your estate plan should be a *revocable living trust.* The name is intimidating, but a revocable living trust is such a simple and flexible document that in the long run it actually eliminates a lot of legal work and costs. After all, assets in a revocable living trust completely avoid probate and probate legal fees!

But that's not all a revocable living trust does. It places your trust and your assets where they belong—in your hands, or the hands of someone you *trust*—not in the hands of the courts or the lawyers.

A revocable living trust is a trust you create and control while you are living. But it goes on, carrying out your instructions at your death or if you become temporarily or permanently incapacitated.

It is revocable because you may cancel it, change its terms, change the assets within it, or change its ultimate beneficiaries very easily at any time and for any reason. You may create the trust in your name (the Mary L. Smith Revocable Living Trust, Mary L. Smith, trustee) or in joint name (the Smith Family Revocable Living Trust, John and Mary Smith, co-trustees).

Because you are the trustee (or perhaps joint trustee with your spouse), you make all the decisions regarding your property or

investments while you are alive. You also issue instructions that must be carried out by the person who is named successor trustee when you die or become incapacitated.

Once you've created a revocable living trust, if you ever become incapacitated by a stroke or coma, for example, your relatives won't have to turn to a court for permission and supervision to make decisions about your property. Your successor trustee, whom you name, can act immediately on your behalf. You should also make a health-care power of attorney and living will, which gives your instructions about end-of-life decisions (see the section on planning for health and wealth later in this chapter).

At your death, your successor trustee steps in immediately to follow your instructions regarding distribution of your assets. Your estate does not have to go through probate—the process of changing title from the name of the deceased—because you transferred title to your property to the trust during your lifetime. You avoid the fees, costs, and delays associated with probate because your successor trustee can act immediately according to your instructions.

A Revocable Living Trust Is Worthless If Assets Are Not Retitled

Once you create a revocable living trust, it's your responsibility to transfer title to all your assets into the name of the trust. The process is called *funding* the trust. For bank, mutual fund, or investment accounts, that's usually a simple matter of notifying the financial institution to change the name. If you hold stock certificates in your own name, you'll want to send them back to the brokerage firm to be transferred into your trust. The financial institution might ask for a trust certification or a copy of the first and last pages of the trust document to verify its existence and your authority to act as trustee. You will not be required to disclose any trust provisions relating to your personal estate plan.

If you own title to real property—a house, vacation home, rental real estate—you'll have to make a special effort to have the property retitled. Your attorney can help with the procedure and may charge a small fee for each piece of property that is retitled. The title must be reregistered with the proper authorities, and you must notify the mortgage company that title has been changed. You should also ask your insurance company to add the trust's name as the insured.

You can simply assign all of your personal property—clothing, furniture, silverware, and china—to the name of your trust by preparing an inventory. If you have valuable artwork or collectibles, it is best to assign them specifically to the trust, using documentation your lawyer will provide.

If you really want your personal assets to be distributed according to your wishes, you must designate specifically in your revocable living trust. Simply placing a sticker on your artwork, or repeating regularly that your daughter gets the silverware, will not force your heirs to respect your wishes.

Some assets, such as retirement plans, cannot be retitled, but you might choose to name your living trust as the beneficiary in appropriate circumstances.

An RLT Has No Current Tax Impact

The revocable living trust will use your Social Security number, and it does not have to file its own tax return because you are the grantor of the trust. There is no tax consequence when you transfer assets into the trust. That is, if you purchased 100 shares of a stock at $2 a share, and it is trading at a much higher price when you transfer it into the name of your revocable living trust, there is no tax due, nor is there any change in your cost basis for the stock.

If you transfer your personal residence into a revocable living trust, you will still have the same cost basis. (And you will be able to exclude $250,000, or $500,000 on a joint return, of gains on the sale of the house.) In some states, the homestead exemption that protects the home from claims of creditors may be lost when title is held by a trust, so check with your attorney. If you own commercial property, the lender might have the right to accelerate the note when title is changed, something you should clarify in advance.

Any income from dividends or gains on the sale of property held by the trust will be reported on your personal or joint tax return, and you'll pay taxes at your personal or joint income tax rate. In other words, the revocable living trust is completely tax transparent while you're alive. And, by itself, the revocable living trust has no tax consequence at your death, either. Only when you combine your revocable living trust with more planning and additional trusts that may be funded at your death can you make an impact on your federal estate taxes.

You Can Easily Change Your Mind

You've heard about people adding codicils to their will to redirect their assets. It's an expensive and time-consuming process. But with a revocable living trust you can always change your directives with minimal cost and legal hassle. Selling an asset is as simple as calling your broker. Deciding to leave money to a charity or to change most provisions to a trust is a simple matter of adding an amendment to your document. But this must be done with the help of your attorney, not by simply writing a note on your trust document.

You'll Still Need a Pour-Over Will

When you establish your revocable living trust, you might keep some assets outside your trust. For example, your everyday checking account or your car will probably remain in your own name. You'll need a simple *pour-over will* that directs your representative to place these into your revocable living trust, where you've left instructions regarding their disposition. Since the assets outside your living trust will be minimal, probate won't cost much—or reveal anything about your bequests.

Although your living trust will give instructions about how your assets will be managed for the benefit of your minor children, a guardian must be named in a will. If you have young children, the pour-over will should accomplish that.

Singles, Single Parents, Domestic Partners, and Second Marriages

Singles and single parents often wonder whether it makes sense to have an estate plan. Perhaps more than anyone, they could benefit from a revocable living trust. If you're alone, this type of estate planning causes you to confront the issue of who would act in your best interests if you were unable to make decisions.

Although single parents generally rely on a surviving parent to care for children, there may be reasons to segregate the parenting responsibility from access to financial assets. A revocable living trust allows you to designate a successor trustee who is bound by your wishes and instructions in financial matters.

In the case of a second marriage, where spouses want to keep premarital assets separate, pursuant to a prenuptial agreement, a

revocable living trust can serve as the vehicle for managing individual assets. In situations where adults live together but are not married, a revocable living trust naming a partner as successor trustee may help ensure that the wishes of the deceased are carried out according to instructions.

A RLT Does Not Protect Against Creditors

A revocable living trust has many benefits, but there are some things it will not do. A revocable living trust does not protect assets from creditors or give special protection in a bankruptcy. Since you are still in control of the assets, they are still vulnerable. Only when you create an *irrevocable* trust, from which you cannot withdraw or control funds, can you move your assets out of harm's way. Even then, property cannot be conveyed in this manner in anticipation of a lawsuit or bankruptcy.

However, if a trust is created at your death for the benefit of your spouse or your children, the assets in that trust could be protected from the creditors of your children, or from your child's spouse in the event of a divorce. Most states protect the assets in your revocable living trust from claims of unsecured creditors upon your death.

Power of Attorney and Living Will

Even if you've created a revocable living trust and other documents to transfer your wealth and preserve your estate from taxes, you haven't finished planning until you execute some documents telling your loved ones and physicians how you want a health-care crisis to be handled and who has the power to make the decisions if you cannot.

We've all seen headlines about people languishing in a coma, or conflicted relatives debating in court about the care measures that should be taken for a patient. All of that would be resolved if the patient had created a *durable power of attorney for health care* and a *living will*. Even if you don't have a revocable living trust or a traditional will, these two documents are a must.

A *living will* is a written, legal expression of your desire to refuse medical treatment and life-sustaining procedures if you are in a terminal condition. Expressing your wishes relieves your closest relatives from the emotional trauma of making this decision or from debating among themselves about the best course of treatment.

Make sure your physician has a copy of this document in your medical records, and give a copy to the individual you've chosen to be responsible for this decision.

The companion piece to a living will is a *health-care power of attorney* or *health-care proxy*. This document names a legal representative to make medical decisions on your behalf if you are unable to do so yourself. The person holding this power would be able to make decisions on your behalf about additional surgery or procedures.

Naming someone very close to you to act as your legal health-care representative places a tremendous burden on the designee. Think carefully about your choice. You'll want someone who is forceful in stepping into the medical process, cool under pressure, and smart enough to make careful choices.

The requirements for these documents vary from state to state, so if you're a snowbird who spends several months in a warm climate, you might need appropriate documents for each location.

Finally, if you are willing to donate your organs after your death, you should sign the back of your driver's license and tell a relative or close friend of your decision. This is also a statement that can be included in your health-care power of attorney.

The Savage Truth on Estate Planning and Life Insurance

The one thing everyone seems to know about life insurance is that it is tax-free to the beneficiary. That's just part of the truth. In fact, life insurance benefits do pass *income-tax-free* to the beneficiary. But if the deceased is the *owner* of the policy, the total amount of the life insurance is still part of his or her estate for estate tax purposes and could result in estate taxes being owed.

If you want to keep life insurance proceeds out of your estate, you have two choices. You can make someone else—your child or partner—the owner of the policy. You could give that person up to $15,000 a year to pay the premiums.

Or you could create an *irrevocable life insurance trust* to be the owner of the policy. You'll name a trustee who will be responsible for disbursing the proceeds after your death, either to pay for estate taxes or as you have directed. Each year you can make a gift to this trust, suggesting that the trustee might want to use the money to pay the life insurance premium.

In either of these scenarios, the proceeds of the insurance policy are kept out of your taxable estate. And having liquid assets might preclude the scenario of your heirs being forced to sell the family home or business if there isn't enough cash to pay estate taxes. That's unlikely now, with the current high exemption from estate taxes, but it could come in handy if the exemption limits are reduced.

It's important to have the irrevocable life insurance trust purchase a newly issued policy on your life. If you transfer an existing policy into the trust and then die within three years of the transfer, the proceeds would still be included in your estate.

Spouses and Estates

The estate tax law allows married couples to leave an unlimited amount of assets to a spouse. That sounds like a simple way to plan, but it creates a problem down the road. The first to die will avoid estate taxes, but when the second spouse passes on, those combined assets might be subject to the estate tax, especially if the $11.4 million exemption is lowered in future years.

That's why estate planning attorneys for wealthy families typically create a trust designed to hold at least as much as the estate tax exemption. It may be referred to as a *bypass trust,* as it is designed to take advantage of the exemption from estate taxes. The rest of the money could pass directly to the spouse or other named beneficiaries.

Unfortunately, many estate plans create another trust to hold the assets designed to pass to the spouse, especially if the surviving spouse is a woman. This trust, sometimes called a *marital trust* or *QTIP* (qualified terminable interest property), is not an estate planning necessity. It simply reflects the desire of one spouse to retain control over the assets after death.

Many women who do not participate in estate planning sessions and ask questions find out too late that the money left to them is actually to be *administered* by trustees at a bank or law firm. A woman in this situation must ask for permission to withdraw cash, to change investment advisors, or to change the designation of what happens to the money after her death. It's a trust that demonstrates a lack of trust in the spouse who is the beneficiary.

To be sure, a wealthy woman could equally use this type of trust to restrict the use of assets by a spouse after her death. These trusts are often used in second marriages, where a wealthy spouse wants

the surviving spouse to have use of the assets, but also wants to be sure that they ultimately go to his or her children at the death of the second spouse.

It's a legitimate technique, but let this serve as a warning that you should raise questions when an estate planning attorney starts talking legalese. Ask him or her to simply draw a chart of where the money goes—and who has control.

Grandchildren Are Not Little Tax Shelters

Once you realize how much tax might come out of your estate before it reaches your children, you might be tempted to pass them by. If you have enough money, or if your adult children are well off, you might be tempted to skip a generation and leave your assets to your grandchildren. Not so fast: The government stopped that ploy in the 1986 tax law by revamping the punitive *generation-skipping tax*. The generation-skipping tax exemption is the same as the estate tax exemption—$11.4 million per individual in 2019.

I'm sure you're thinking that you wish you had an extra $11.4 million to hand off to your grandchildren! Well, you don't need an estate planning attorney and expensive trust to leave money to your grandchildren, especially if you want it to go to their college funds. Read Chapter 10 and learn about *529 college savings plans*, which allow you to give up to five years of the allowable $15,000 annual gift to each of your grandchildren and watch it grow completely tax-free if the money is used to pay for college expenses. A married couple can give double that amount to each grandchild in a 529 account.

And in case you change your mind about that gift, either because you need the cash or because of the child's behavior, you can take the money back, paying ordinary income taxes and a 10 percent penalty on the gains. Additionally, you can pay college tuition directly to the school in an amount that exceeds the annual exemption, without any impact on the ultimate estate tax.

Be Careful Not to Gift Away Your Independence

While reducing estate taxes is an admirable goal, it must be pursued carefully. The life expectancy of the general population increases every year as new drugs and healthier lifestyles push back the barriers of age. So while it may be tempting to help an adult child with

a gift of cash, and it may seem financially rational to remove assets from your estate, you never want to be in a position of requesting assistance from your children if you live longer than you expected or need additional assets to maintain your lifestyle.

As noted earlier in this book, you should remember that the cost of health care will rise in your retirement years. Fidelity estimated that a 65-year-old couple, retiring in 2019, would need to spend $285,000 in health-care and medical expenses throughout their retirement. This is in addition to expected Medicare coverage, but including the premiums for Medicare Part B, supplements, and uncovered expenses including vision and dental.

These days many older parents are also bearing the burden of co-signing for student loans. If a parent dies while a PLUS loan (see Chapter 12) is outstanding, the balance of the loan is forgiven. But while you're alive, and in retirement, those loans can become a burden—especially if your adult child cannot get, or loses, a job.

Consider the long-term consequences carefully before making gifts to your adult children, even in case of real need. You know what they say when you get on a plane: Put on your mask first, before helping others.

The Savage Truth on Charitable Giving

It Pays to Give

Despite the most recent tax law that increased the standard deduction and made itemizing contributions less appealing to millions of taxpayers, Americans continue to be the most generous people on the earth, giving over $400 billion annually to registered charities and educational institutions and countless more in non-deductible gifts to friends, relatives, and even strangers through GoFundMe accounts.

Cynics say that much of this giving is motivated by tax considerations, but even when changes in the tax laws make it less attractive, the gifts continue. Still, it pays to take advantage of the tax laws that allow you to deduct charitable contributions from ordinary income up to certain limits (50 percent of adjusted gross income).

Make your contributions by check, but be aware that for each contribution over $250 you must have a written receipt or text acknowledgment from the charity in addition to your check.

If your total deduction for all noncash contributions exceeds $500, you must complete IRS Form 8283, along with your tax return. And if any donated item is valued at more than $5,000, you must have a qualified appraisal unless it's a publicly traded security. There are special rules that apply to contributions of cars, boats, and other items (such as art, jewelry, collections) with a claimed value of more than $5,000.

If you are 70½ or older, you can donate up to $100,000 annually to charity directly from your IRA. You won't get a tax deduction for the contribution, but the benefit is that you won't have to include the withdrawn amount from your IRA as taxable income.

After a long bull market, many people have stocks or mutual funds held outside their retirement accounts. That creates another charitable opportunity that is also a tax benefit. If you make a gift of shares of appreciated stock, the valuation of the gift is as of the date of the gift—avoiding capital gains taxes.

As a reminder, you can't deduct a donation made directly to needy individuals who ask for assistance. You only get a deduction for contributions to registered 501(c)3 charities. Similarly, you don't get a deduction for your donation of services or the value of the time you contribute to charitable organizations. But you do get a very small deduction for miles driven on behalf of a charity.

And be sure to check out the record of the charity to which you give. Many are named to fight a particular illness or need, but keep a large percentage of the contributions for overhead. Go to www.CharityNavigator.com before making your gift to make sure it goes to a truly worthy cause.

Create Your Own "Foundation"

It really doesn't take a lot of money to become a philanthropist. Wealthy people create their own foundations to make gift distributions and maximize the benefit of tax laws on giving. You can easily do the same thing. But you don't have to pay legal fees to use these strategies.

Many financial services firms, including Fidelity Investments, Charles Schwab, and Vanguard, have created the *charitable gift funds* or *donor-advised funds*, which allow you to make a one-time, or annual, contribution to your own personal "foundation." That foundation is an account you set up in a charitable gift fund where the money is invested in a variety of mutual funds at your direction.

You, as donor, receive an immediate tax deduction on the current year's tax return for the entire contribution. But the money is invested to grow over the years as it is distributed gradually according to your instructions. Distributions can be made at your direction, only to registered charities. While the money remains in the investment pool it may grow in value, but those subsequent gains are not taxed. If you are seeking a large deduction, perhaps to offset a high-income year, a charitable gift fund gives you immediate tax benefit, continued growth of the assets, and a chance to do a lot of good.

This is an important opportunity for those just planning their retirement. In your highest-earning years, you might want to make a very-large one-time contribution to a donor-advised fund, taking the accompanying tax deduction when your income is highest, and the tax benefit the greatest. Then during retirement, when your lower income might not make the charitable deductions so valuable, you can have the money distributed to your chosen charities.

The Savage Truth on Planning for Health and Wealth

When the subject of estate planning comes up, most people think about money. And if they don't have a lot of money, they figure they don't need a lot of planning. Think again. There may come a time when you would be better served by a good plan than a huge fortune.

Few people are willing to consider the possibility that they'll be disabled by an accident or a medical incident such as a stroke, or that they'll be one of the multitude of new cases of diagnosed Alzheimer's disease every year. Without a revocable living trust, which automatically designates a successor trustee to handle your decisions, your family will have to go to court to gain that power.

No matter what your age, you owe it to your family and friends to be well organized and well prepared. Again, my inherent superstition plays a role in this advice. Could it really be a Savage Truth that fortune favors the well prepared?

An Organized Life Is an Unrecognized Virtue

If something were to happen to you tomorrow, would your family or friends be able to sort out your affairs, or is your financial life a mess?

At the very least you should make a list of all the important names, account numbers, and telephone numbers related to your financial affairs. Or set up a filing system for your important account statements, stock certificates, and legal documents. Be sure to include a copy of your will (or instructions on where it may be found), title to your home and car, and a key to your safe-deposit box. Don't put your will in a safe-deposit box because it may not be accessible there.

Whether you've made a list or compiled all the documentation, tell a trusted relative or friend where to find this information. Being organized but secretive is no solution. If you're managing your finances with Quicken or Mint, all your data may be available with a click of a computer key, but did you remember to give your password to someone who could access the information?

If you go to www.TerrySavage.com look on the home page for the link to my "Personal Financial Organizer" form. You can print out as many copies as you like and give them to friends and family. Or fill out the form online and then print it out. Not only will this information be available in case of emergency, but the form will act as a checklist for organizing your financial life.

This Parental Talk Is Tougher than "the Birds and the Bees"

Parents don't owe their adult children a lot—certainly not money or an inheritance. One of the basic concepts of estate planning, though, is the desire to distribute material things after death. Still, many aging parents want nothing more than to avoid becoming a burden on their adult children. This desire to remain independent can create conflicts and anxiety in both generations.

There is much debate over how much to tell your heirs about your plans for their inheritance, but there is no doubt that parents should assure their children that there is, indeed, a complete and updated plan in place. A letter of instruction should be left with adult children or the attorney, detailing where the estate documents are held. Funeral and burial instructions should be left in this letter, as the estate documents are not usually examined until after the funeral. The documents for the health-care power of attorney, living will, and wishes regarding organ donation should be shared with those who will have to make the decisions, as well as your physician.

If aging parents are unwilling to initiate this discussion, adult children must confront these issues squarely, perhaps by offering to

pay for an estate plan as a Mother's Day or Father's Day gift. Parents should not take offense when the subject is raised. I know that's easier said than done, so pass this chapter around to all generations of your family.

TERRY'S TO-DO LIST

1. Think today about what would happen to your assets if you died tomorrow.
2. Before seeing an attorney, make a list of instructions you'd like to leave about your financial assets, guardians for your children, burial wishes, and mementos you'd like certain people to have. That list will organize your estate planning session.
3. Contact an estate planning specialist. A personal reference from a banker is a good start, but you can search for an estate planning specialist at www.SearchAttorneys.com or www.NAELA.org, the National Academy of Elder Law Attorneys, Inc.
4. Insist on consideration of a revocable living trust.
5. If you establish a revocable living trust, be sure to transfer title to all your assets into the name of the trust.
6. Make sure your life insurance is owned outside of your estate if estate taxes might apply.
7. Remember to create your living will and health-care powers of attorney.
8. Have a serious discussion with your adult children. Details aren't necessary, but give them a general outline of your plans, and let them know where your documents are stored.

CONCLUSION ... AND BEGINNING

This is not the end of *The Savage Truth*. It is the beginning of your future, and your ability to exert control over the present. These Truths have survived market crashes and burst bubbles, and bull markets, too. They are the sound principles tested over time and based on history and hindsight. Sadly, it seems that each generation must learn them anew, because it's so easy to get carried away by emotion.

Once again, the Savage Truth: *The lessons that cost the most teach the most!*

If you're starting over, you now have a tremendous advantage. You've learned the lessons, and those mistakes are behind you. In front of you is opportunity. And if you are just starting out, I hope this book will save you some expensive tuition.

This is not to say that the markets and the economy can be predicted accurately. But they can be anticipated—if you will step back from current events and your own feelings about them.

Getting organized is the first step. Set up the system that works for you to track all your financial information. Technology is a tremendous advantage, whether in keeping track of your spending, or planning your investments, and certainly in managing your retirement. And be sure to visit www.TerrySavage.com for a link to my Personal Financial Organizer form, which you can fill in online and then print out to guide you—and your heirs—through the process of understanding your finances. It will serve as a checklist of things left undone, or that need updating.

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When you fill out the pop-up box at my website, you will also join my list of "friends" and will receive my free e-mail newsletters, with updates on the markets and financial planning. And at my website, you can also post personal finance questions on my blog and check back for a prompt response.

Now it's time to start planning. As you've learned, good help is available. Take it one step at a time. Ask plenty of questions—and be sure to trust your own instincts. After all, no one cares about your money as much as you do!

Always remember that the one ingredient that only *you* can add is self-discipline—the determination to stick with that plan. Self-discipline is required on the upside, when you can easily get carried away by *greed*. And self-control is required on the downside of each market cycle, when *fear* can paralyze you or make you dump your plan in a panic.

Can you do this—gain control over your personal finances and your financial future? Yes, I firmly believe that you can—*if* you believe in yourself and in the future of our country. You've survived so far, and now you can move ahead.

America is the country in which we live, work, and hope to retire. As I said at the start, no one ever got rich betting against America. I'm not oblivious to our problems. But I'm optimistic that, as always, we'll rise to the challenge. By planning for a better future and working toward it, you are part of the optimism that has always moved this country forward.

America *will* survive and prosper—and so will you, if you plan, save, and invest. That's the Savage Truth.

ACKNOWLEDGMENTS

I've had a long career in personal finance, and there are so many people who have helped me along the way. Countless market participants, fiduciary advisors, and industry experts have generously shared their knowledge in various fields. Similarly, all my editors, television producers, and radio show hosts have contributed to my success.

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In the category of "women helping women" a very special note of gratitude to one of the most respected women in the financial planning industry, Alexandra Armstrong. Her hug convinced me to do this new edition when I was wavering.

People frequently ask who I turn to for advice in my own life. I think it's time for a special mention to my team who have guided me for many years. (We all need outside experts to temper our thoughts and hold our hands.)

First and foremost, it's time to publicly state my gratitude to Mark Mann, who has been more than my accountant and financial advisor. He is a lifelong friend whose advice changed the course of my life. The aforementioned Michael Hartz has been my advisor on all things legal—and personal—as his frequent updates to my revocable living trust reflected the changes in my life. Peter Gottlieb is my personal stock market rock star and trusted confidante. Best of all, they all like each other and work together on my behalf. I wish each of my readers the blessing of creating a trusted team of advisors—or at least finding just one CFP fiduciary!

Technology is central to this book—and my own technology has been immeasurably aided by Joel Mathew and Shabbir Shaikh of Fortress Consulting for creating my updated website and being always available. Special thanks to Catherine Armstrong, my technology right hand and advisor on social media.

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Authors always thank their families, and I am no exception. I watch proudly as my son, Rex, and his wife, Janeen, raise my twin granddaughters to be smart and enthusiastic. That's something more valuable than all the financial tips can provide.

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I'm at a loss for words to thank the man who came into my life as my college boyfriend and re-emerged 17 years ago as my long-time true love. Harry, you truly embody the words of the poet: "Grow old along with me, the best is yet to be."

The individuals named above have generously offered their time and resources to respond to my questions and read sections of the manuscript. I am indebted to them, while I take final responsibility for all the advice herein.

Most of all, I send my appreciation to *you*, my readers. For many years, your responses to my columns, books, television spots, radio segments, and newsletters have encouraged me to keep bringing you The Savage Truth on Money.

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