Multi-Faceted Planning Essential For Client Financial Success

Joseph E. Godfrey III, MBA, CLU, AEP
and Martin M. Shenkman, CPA, MBA, JD[1]

Introduction

The reality is that too many financial and estate plans view the issues and risks clients face from too few, or even just one, dimension. This is, in part, due to the lack of meaningful collaboration and the narrow perspective many advisors still tend to take in planning. An estate planning attorney might be focused primarily on legal documentation and perhaps, if applicable, estate tax minimization. Maximizing income tax basis may be viewed as just another aspect of estate tax minimization. The client's CPA may be compliance-focused, and the wealth manager might be largely focused on asset allocation and investment returns. The insurance professional is focused on insurance coverage. While these considerations are essential to a successful client plan, it is often the integration of these different planning objectives, and consideration of a range of other facets of planning, that is necessary to have a robust and successful plan. This article will help explore how practitioners can better craft a broader more robust plan, using three-dimensional chess as an analogy.

Three-Dimensional Chess Insight into Better Planning

Three-dimensional chess is played like traditional chess, but the player must look through the layers of glass to try to see the chess pieces in the same dimensions as the opponent. If the player improperly reads the dimensional moves, or gets confused moving between plane and solid geometry, the player will lose. If the player looks through all the dimensions and moves properly, the player can win. This provides an important construct for estate and financial planning. Practitioners need to look through the dimension of their planning scope to see how their planning and the actions of other advisors and other client issues are all connected.

Personal financial and estate planning should be viewed in at least five dimensions. In all planning cases, practitioners need to look through the "glass" of the various dimensions of planning and, through collaboration, be certain that all of the various aspects are coordinated.

[1] Joseph Godfrey is Managing Director of The Ross Companies in New York City. Martin M. Shenkman, Esq. is an estate planner in Fort Lee, NJ.

First Dimension: Type of Financial Institution. With what type of financial services firm does your client work? After the passage of the Glass-Steagall Act in 1932, it was easy to identify the type of financial institution as a bank, brokerage firm, or insurance company. After the Glass-Steagall Act was repealed in 1999, it became much more difficult to differentiate the institutions from one another. From the client's perspective, they would not have considered some of the major financial firms to be brokerage firms. While some large firms can provide integrated solutions to all a client's banking, investment and insurance needs, other advisors prefer a focus toward one of the basic disciplines of banking, investments or insurance. This allows the sophisticated advisor to drill down more deeply into his or her specialized area of expertise rather than being a jack-of-all-trades-and-master-of-none.

The Second Dimension: Asset Allocation and Diversification. The range of asset classes that might comprise the holdings in a client portfolio is potentially quite vast. Asset classes might include: U.S. bonds, foreign bonds, tax exempt bonds; large-cap, mid-cap, and small-cap growth/value/blend U.S. or foreign stocks; mutual funds; ETFs; natural resources; hedge funds; private equity; and many other possibilities.

There are many ways for people to save and invest or spend their money. Personal use assets are often excluded from what is viewed as a client asset allocation but for many clients a significant part of their net worth might consist of personal use assets such as a home, vacation home, art, automobiles, plane, boat, or jewelry. All advisors have seen estates that were a disorganized array of tangible (and even financial) assets – often with conflicting ownership. There are now professional organizers who create a digital inventory of tangible items that may belong within the client's home, office, or storage unit. Clients can use the digital inventory to make informed decisions about what they want to keep, gift, or dispose of. Organization can facilitate optimally protecting client wealth with various legal, estate, insurance and other planning structures. The practitioner can guide clients to fix problems before they arise, and prepare them for any life transition such as an unforeseen incident, a medical emergency, or death.

The asset allocation used will be critical to minimizing the risk in the client's portfolio, meeting retirement goals, and other objectives. Too often, the allocation is made without regard to other factors in the client's plan. For example, if a client has a substantial family business in the tech field, the advisor should consider lessening that client's portfolio allocation to tech stocks. If the client has significant real estate investments, the composition of that client's asset allocation would differ from one whose only investment assets are the portfolio.

Third Dimension: Risk Categories to be Mitigated. This facet of planning is too often overlooked in personal financial planning. No single risk management tool can eliminate all of the risks any client faces. The most astute asset allocation or life insurance plan might prove to be of limited or no benefit if risks that could undermine the integrity of those plans are not reasonably addressed. Perhaps the most significant shortcoming of many client plans is the unreasonably narrow assessment of the risks the client faces. Examples of the multiple types of life's different risks include:

- *Financial risks:* currency, credit, liquidity, volatility, market, inflation or deflation. These risks might be mitigated by better investment allocations, hedging, or other strategies.
- *Health risks:* disability, premature death, long-term care costs. These risks can be mitigated by having proper health, disability, life and long-term care insurance. A topic receiving new attention recently is planning for health as part of the wealth planning process. Clients who give careful attention to medical care, exercise, diet and so forth tend to live longer and incur lower medical expenses. Thus, health risks can be mitigated by addressing them directly, a topic few financial advisors (other than insurance specialists) have tended to address.
- *Expenditure risks:* outliving financial resources. This can be the biggest concern for many clients. Proper investment planning, budgeting, financial forecasting and other steps can help mitigate these risks if longevity health care risks are not forgotten.
- *Personal risks:* divorce, fire, theft, property damage, liability claims and more. Proper insurance, entity and trust planning, and other steps can mitigate these risks.
- *Business risks:* business failure, malpractice suits, etc. Proper insurance, entity and trust planning, and other steps can mitigate these risks, but these steps are not always identical to those taken to mitigate personal risks.
- Tax risks: income tax planning, harvesting gains and losses, planning charitable contributions, using trusts and other techniques to mitigate estate tax, and so on, can preserve or enhance the economic value of the client's estate. Optimizing the investment allocation between a client's taxable and tax deferred (e.g. IRA) accounts may be an important part of this process.

A client who appears to meet his or her financial targets, but has not allocated sufficient resources to risk mitigation, may never reach those targets. Clients should include proper insurance coverage and legal steps to protect assets (e.g., the use of entities for businesses and investment real estate, trusts, etc.).

Fourth Dimension: Estate and Related Planning. Regardless of the size of a client's estate, planning is essential. Proper documentation to address the risks of disability, illness, or advancing age is critical. These certainly include a durable power of attorney and perhaps a revocable living trust for managing financial assets. These include a will, proper beneficiary designations, and various trusts which can be used to transmit assets to future generations. This same planning is essential for asset protection planning to mitigate some of the risks identified in the prior paragraph.

Estate planning also creates a range of potential legal and tax structures that directly impact how the assets comprising the client's asset allocation should be held. For example, if a client has taxable investment accounts, tax deferred IRA accounts, and irrevocable trusts that are outside the client's estate, consideration should be given to which assets comprising the family asset allocation should be in which of these receptacles. This is referred to as asset location, as differentiated from asset allocation. Asset location is critical to the success of the overall planning but requires that the investment manager be familiar with the structures that might have been created by the client's attorney and the tax aspects of which may be addressed by the client's CPA. Again, all the advisors need to look through the chess board glass at the planning on higher and lower levels to be sure all are optimally coordinated.

Fifth Dimension: Advisors' Compensation Systems. How various advisors are compensated can affect their advice, how clients perceive that advisor, and the results of a client's plan. Contrary to many of the passionate statements in the media about how one form of compensation is better than others, the realities cover the full spectrum and the answer ultimately depends on the size of the client's investment portfolio, the client's financial needs and goals, and other planning.

Some advisors at institutions are compensated on a salary, perhaps salary and bonus, or a success fee. Their institution may provide services or advise for a flat fee or some other basis. The fact that the advisor is generally salary-based is interpreted by some as implying that the advice provided is more impartial. Stock brokers and insurance agents are often compensated on some type of commission basis. The planner might receive a draw, work on straight commission, or a percentage of assets under advisement after that. Fee-only advisors are paid a fee for the planning process which may be a flat fee, may be offset by assets under management, or may be in addition to the fee for assets under management. All of them can offer for purchase only those products in which they have been trained and for which they have state and federal licensing and some form of compliance oversight. Attorneys and accountants generally bill on a flat fee, or hourly basis, or some combination of the two. Their input and planning is integral to the financial and estate planning process. Client perceptions of compensation and products can have a significant and perhaps detrimental impact on the way they pursue planning. For example, some clients are so negative towards commission-based compensation that they might forgo a product they need, or use a less capable advisor, because of this perception.

Some clients do not view indirect compensation (e.g., an investment advisory fee deducted periodically from an investment account or an insurance commission built into the product) with the same displeasure as a direct fee (e.g., a bill for hours worked from a lawyer or the cost of a tax return billed by a CPA). The result of this latter attitude is that the client may refuse necessary legal or accounting advice and rely only on whatever knowledge the investment advisor can add. This too can undermine the planning. In each of these scenarios if the advisors look through the chess board's glass at the interplay of all the facets of planning, they can advise the client of the importance of the various roles in the decision processes.

Case Study

Assume the client is a widow age 77. Before making any recommendations, the advisor should seek information on the widow's health, family health history, her spending habits, her sources of income, and her current investment situation. While every discipline in the estate and financial planning profession is facing significant competition from what can generically be called "commoditization," tailored, multi-faceted advice by a collaborative team can outperform the disjointed commoditized competitors. A robo-advisor, LegalZoom, and TurboTax cannot collaborate and look at the unique nuances of any client that should be addressed. They will be less costly and often will be less successful.

A Monte Carlo simulation shows our 77-year old widow has a 90 percent probability of not running out of money by age 95. However, she is worried that might happen if she lives past 100. There is longevity in her family as her father lived to 98 and her mother lived to age 103 and she absolutely wants to eliminate that risk with the right financial instrument. There are many investment options that might be considered to mitigate some of the risks the client faces:

- She might proactively address her health thereby potentially reducing future health care costs.
- The financial forecasts should be re-run to at least age 100. If the likelihood of success is not adequate, can the client reduce her expenditures and/or accept more investment risk to improve the results?
- The allocation of some portion of the portfolio to a Single Premium Immediate Annuity ("SPIA") with a top-rated carrier would mitigate some of the longevity risk. This could provide a continuing stream of income for as long as the client lives. But, while a SPIA might mitigate longevity risk, it does not address inflation risk. A securities portfolio with an appropriate allocation to stocks and other investments can mitigate inflation risk because of the upside potential against inflation risk. However, while mitigating inflation risk, the securities portfolio is exposed to market and volatility risk. Thus, there is no single tool in the financial toolbox that will always be right for every situation or to solve all problems. One dimensional answers are often insufficient and inadequate.
- In addition to investment, longevity and similar risks, the plan should address the potential risk of the client getting dementia. The average age of diagnosis of Alzheimer's disease is 73. A client in good health could purchase a new hybrid life insurance product that pays a percentage of the face amount (1-2 percent) in the event of a chronic illness where two or more of the activities of daily living are lost so long-term care (LTC) benefit payments are due. If there is never an LTC claim, the life insurance goes to the family or trust. The proper legal documents, which might include a durable power of attorney, and/or a funded revocable living trust, with trustworthy fiduciaries and successors named, and additional safeguards may be more vital to the planning success than the budget or asset allocation.

Let's consider how the above example can be viewed from the five dimensions of planning outlined above:

- The client's investments should be appropriately diversified in the **First Dimension** by evaluating whether they should have funds with more than one or two firms. Will this reduce the array of risks faced? Some advisors suggest that clients not put all assets in any institution or with only one advisor. For example, some advisors suggest insurance be considered as an asset class. During the 2008 financial crisis when credit dried up and commercial and investment banks were not lending, life insurance policyholders were able to execute policy loans and obtain much needed cash from virtually all the life insurance companies.
- The client should evaluate diversification in the **Second Dimension.** This might include funds in cash values of life insurance, liquid cash holdings, appropriately diversified securities and bonds that endeavor to incorporate sufficient growth assets to address inflation and longevity risk and other risks.
- Be diversified in the **Third Dimension** by identifying risks to mitigate and allocating funds to offset them either through increased insurance coverage, self-insuring, and taking asset protection steps.
- Have an appropriate and complete estate plan in the **Fourth Dimension**.
- The client might benefit by being diversified in the **Fifth Dimension** by working with tax advisors and financial planners who are compensated in diverse ways. They have differing areas of expertise that enables them as a collaborative team to synthesize varying points of view as lawyers, CPAs, PFSs, CLUs, ChFCs, CFAs, CFPs, etc.

Questions to Evaluate

When completing a comprehensive plan collectively the various client advisors should be certain that critical planning questions be addressed. These questions might include:

- How is the client's health? What are the client's plans to pay for long term health care costs?
- How are assets titled?
- What is the size of the client's estate? Is the estate of a size that Medicaid planning is appropriate? What happens if Medicaid benefits are drastically reduced?
- Has a budget been prepared? Have financial forecasts been created? What assumptions are reflected in the forecasts and should any be revised? Forecasting issues that should be explored assume cost reductions following retirement which may not be realized, life expectancy which in some situations is underestimated, etc. What is the client's cash flow situation? Can the client reduce spending if necessary?
- Will investable assets last as long as the clients are anticipated to live? Is some of that income 100 percent safe and secure? Have adequate reserves or insurance for later-in-life medical costs realistically been considered and established?
- What is the client's state and federal income tax situation? Can lower state income taxes or lower federal income tax brackets be achieved? Might relocating to a lower cost/lower tax state be a viable option?

- Are there Roth IRA conversion opportunities? How will this affect income taxes now and in the future? Will it provide asset protection benefits?
- Do the clients have children or other heirs? Do they wish to leave an inheritance to any or all of them? Has this objective been factored into the plan? A client whose financial forecasts suggest an 80 percent likelihood of not running out of assets by age 90 might be secure financially, but if she lives to 100 there may be nothing for intended heirs.
- What are the estate planning needs? Are there special needs beneficiaries that require special planning and legal documentation?
- Are there less affluent or unhealthy generations up or down or siblings or others who potentially are going to need financial assistance?
- Do the clients have charitable intent?
- How do the various estate planning documents, including beneficiary designations, coordinate?

Conclusion

Planners should make efforts to look through all planning lenses to be certain that each client has an integrated plan that addresses and coordinates all relevant planning issues. Using the paradigm of the three-dimensional chess board might be useful to illustrate the approach that can provide for better planning results.

