CHAPTER 1

# Getting the Nest Egg Ready to Hatch

*I'd like to live as a poor man with lots of money.*

—Pablo Picasso

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Like so many of my clients, Sharon came to me because she was worried sick about her money. A 67-year-old retiree, Sharon was so convinced she would outlast her savings that she'd begun depriving herself of the basic comforts of life, canceling her cable and turning the heat down in the winter. Most ominously, she'd started taking unnecessary risks. On the advice of her stockbroker, who was more concerned with maximizing returns than determining her real needs, she had invested in aggressive growth mutual funds to supplement what she saw as an insufficient nest egg.

While Sharon's stockbroker encouraged her to make risky investments, I took a different approach: I sat her down and comprehensively assessed every aspect of her financial situation. I looked at all her holdings—her pension, her retirement accounts, her 401(k), her Social Security—and the post-retirement income she'd been drawing from these resources. Next, we went over her monthly lifestyle expenses to determine what she needed to live comfortably through her golden years.

What I found was that Sharon's worries were largely unfounded, and that reallocating her money into a number of low-risk investments would provide a comfortable and sustained income for years to come. Had she kept her money in high-risk stocks, she likely would have lost up to half her nest egg in the recent economic collapse. Instead, I was able to all but eliminate risk from her portfolio, putting her mind at ease and allowing her to enjoy her retirement years to the fullest.

## A New Approach

Sharon's story is not unusual. In fact, you might be in the same place. You've spent your entire career building your nest egg for retirement. Now you're ready for it to hatch into what you hope will be a consistent, comfortable income for the rest of your life. You may be worried that it won't be enough. You may wonder if you're being too aggressive with your money—or not aggressive enough. You may wonder if your portfolio provides enough liquidity to prepare you for an emergency. When your livelihood is at question, it's understandable to be concerned.

As my clients know, I take a comprehensive approach to financial planning that ensures that all your concerns are addressed. I begin by sitting down with you and exploring what you have—the sum total of your accounts, funds, holdings, assets, and liabilities. Then I work with you to determine your current and projected income and expenses (e.g., the monthly income, accounting for inflation and taxes, you require to live comfortably, for now and for the years to come). Finally, I work with you to develop an investment plan based on your needed rate of return, and then position your assets with the goal of minimizing risk and protecting your principal while providing sufficient growth to attain that needed rate of return.

There is an old parable I remember from grade school I sometimes use to illustrate my comprehensive approach. It is about six blind men and an elephant. The story is that a wise king asked six blind men to approach an elephant staked out in his courtyard and to then describe the elephant to the king. The first blind man approached the elephant and touched its leg, and then told the king an elephant was like a tree. The second blind man approached the elephant and touched its side, and then told the king the elephant was like a large wall. The third blind man approached the elephant and touched its tail, and then told the king the elephant was like a rope. The fourth blind man approached the elephant and touched its ear and told the king the elephant was like a large fan. The fifth blind man approached the elephant and touched its tusk and told the king the elephant was like a spear. Lastly, the sixth blind man approached the elephant and touched its trunk and told the king the elephant was like a large serpent. The blind men all argued vehemently among themselves as to the true nature of the elephant, until the wise king explained to them that there was some truth in each of their perceptions yet none had grasped the whole truth of the elephant.

Think of the elephant as a metaphor for your life, large and complex, with many moving parts. (See Exhibit 1.1.) Think of working with a different adviser for each of these parts. Each adviser would have a different perspective, yet none would see the whole picture or how important it is for the different parts to work together.

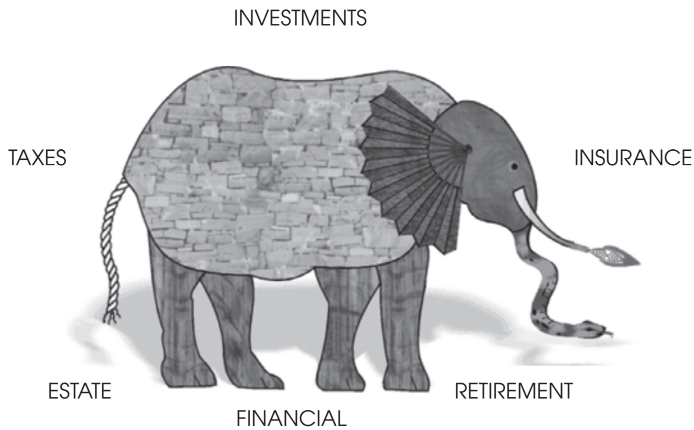


**Exhibit 1.1 Blind Man's View of the Elephant**

All too often, I see other financial advisers and brokers behaving very much like those blind men. Some are concerned solely with selling stocks, mutual funds, and other securities; to them, financial planning is simply a matter of putting together an optimum stock portfolio. Have you ever had the experience of going to an investment adviser who has you fill out an investment risk tolerance questionnaire? Their goal is to attain the highest return based on your tolerance for volatility within your portfolio. Do they discuss what tax bracket you are in? Tax favored portfolio design may improve your net returns, especially for those in the highest brackets. After all it is not just what you make, it's what you keep. Do they discuss your income needs, now or in retirement? This is extremely important when it comes to volatility in a portfolio as it can magnify losses and either dramatically reduces your income or the time your money will last. A comprehensive financial plan will accommodate your income needs and minimize volatility in your portfolio without sacrificing returns.

An insurance agent or adviser typically approaches planning from the perspective of minimizing risk. They may place a disproportionate emphasis on life insurance and annuities seeking the guarantees these products provide. Though these products may play an important role in a comprehensive plan they are *not* a complete solution.

Tax advisers and preparers typically seek to reduce your income taxes for the current year, when there may be instances wherein paying more taxes this year could save you much more in taxes in future years. What about state inheritance taxes and federal estate taxes? These are areas usually covered by your estate-planning attorney.

The ideal plan is one in which all your advisers are working together. Think of the elephant as a metaphor for your financial picture. If your advisers are focused on just one part—to the exclusion of your other goals—it may well have an adverse impact on your financial security.

If you're focused on one aspect and remain blind to the rest you're unlikely to devise anything resembling a comprehensive financial plan.

My approach considers the whole elephant, so to speak. While an insurance salesman might try to convince you of the virtues of annuities versus mutual funds, I have no interest in such debates. Just as the trunk is as crucial to the elephant as the tusks, annuities and mutual funds are two products that can and should play a complementary role in a complete financial plan. My process assesses where you are and where you want to be, and explores every available means to get you there.

In this chapter, I discuss the first step in the process: determining what assets you have available, where they are, and how they're working for you. Like Sharon, you may be pleasantly surprised at how easy it is to attain and maintain the lifestyle you want!

## What You've Got

Your retirement resources are most likely spread over various accounts: 401(k)s, Individual Retirement Accounts (IRAs), nonretirement accounts, your home, annuities, and Certificates of Deposit (CDs), just to name a few. You probably also have, or will have, sources of retirement income such as Social Security and possibly company pension plans. In addition, you may have earned income if you continue working into your retirement years. Today more than ever, people are finding ways to supplement their retirement income, whether through part-time work, setting their own hours as consultants, or simply pursuing their passions in ways that can keep them busy and bring in a little money on the side.

Here is a laundry list of the main retirement resources you may be able to draw upon:

- IRAs—Roth, Traditional, and inherited.
- Company-sponsored 401(k) or 403(b) plans, defined benefit plans, defined contribution plans, and profit sharing plans (PSPs).
- Social Security benefits.
- Annuities.
- Other assets, including inheritances and equity and capital gains in your investment/rental properties.

- Non-qualified (not part of an IRA or company retirement plan) savings and investments such as mutual funds, stock portfolios, bonds, Exchange Traded Funds (ETFs), and real estate investment trusts (REITs), as well as non-qualified accounts for liquidity needs such as CDs, savings/checking/money market accounts, and fixed annuities.
- Life insurance.

Each of these resources has the potential to contribute to your retirement income in different ways. Investment strategies will necessarily change as you grow older, and I develop plans for and with my clients that are flexible and allow for changes as we see what life brings their way. Once you are actually retired, your focus should shift more to generating income and maintaining your financial security by protecting the resources you've built up over the years.

Let's take a quick look at each available retirement resource.

### *Company Retirement Plans*

Many companies provide retirement plans as an employment benefit. There are two main types of company-sponsored plans: defined benefit and defined contribution.

**Defined benefit plans**, commonly known as **pensions**, are increasingly rare in the private sector, but still widely used for government employees. These plans provide you a specified monthly payment, the amount of which is typically based on your salary and the number of years you spent at the company or organization. You usually have the option of taking the payments over the course of your lifetime, or on a joint-life basis so your spouse can continue to get payments if you die first. The joint life option will result in a lower payout than the single life payout and if you die first, your spouse would typically get 50 percent of what you were receiving. If you wish to opt out of the joint-life provision, you will most likely have to get your spouse's (or ex-spouse's) permission in writing. You may also have the option of taking your pension as a lump sum. This has many advantages, such as putting you in control of this asset and how and where it is invested, choosing what income stream you wish to elect, and the ability to raise or lower it as needed. By rolling the lump sum into an IRA you can also control the tax consequences and thus increase the tax planning options available to you. This also allows your spouse to retain any remaining pension assets after your death and thus continue to provide for his or her income needs.

**Defined Contribution plans**, which include **401(k)s** and **403(b)s**, are established by your company, but rely on you to make contributions at your discretion; typically you can choose from investment options determined by your company. The money is yours, not the company's, though some employers match a percentage of your contributions to the fund. When you leave the company, you can normally take your money and any vested employer contributions with you.

Since this is your money, there are fewer restrictions on it, giving you more control. For instance:

- Your spouse (or ex-spouse) gets little or no say in how the money is paid out (although a spouse may have to provide written consent if he or she is not named the primary beneficiary in the event of your death).
- Even if you are age 59½ and have started taking income from these accounts, you have the option of stopping, making changes, or even contributing more money if you meet certain income requirements.
- It can be re-allocated in a number of ways to manage and reduce your taxes, as well as to increase your retirement income stream.
- The money can also be invested in ways that can greatly enhance the safety of your principal, as I demonstrate in later chapters.
- When you leave your employer you can transfer your plan into an IRA, which provides more investment options, greater control, and additional tax planning options.

Defined Contribution plans, including such similar plans as Simplified Employee Pension (SEP) plans, are covered in greater depth in later chapters.

### *Individual Retirement Accounts*

Individual Retirement Accounts (IRAs) are the most common personal retirement plans, and offer far more flexibility in investment options than a 401(k). Whether you have a traditional IRA (which is tax-deferred until withdrawal), a Roth IRA (in which taxes are paid up front, allowing for tax-free growth), or some combination of the two, you are the one who controls the money. IRAs have a greater breadth of investment options than Defined Contribution plans. You may increase or decrease distributions at your discretion without penalty after age 59½ (and for traditional IRAs after age 70½) as long as you at least take any required minimum distributions. The flexibility of IRAs also allows you more tax planning options, which can reduce the tax impact of your distributions.

IRAs, the benefits of Traditional versus Roth IRAs, and related accounts such as 457 plans are discussed in greater depth in the next chapter.

### *Other Pension Plans*

Most retirees are or will soon become eligible for Social Security or similar benefits (State, railroad, Federal, military, etc.). These plans are often adjusted for inflation, but not always as much as increases in the consumer price index. This still gives them a major advantage over defined benefit plans that, for the most part, do not adjust for inflation.

### *Non-Retirement Accounts*

You may have a significant portion of your assets invested in non-retirement accounts. Included in this category are mutual funds, bank accounts, and annuities.

**Equity Investments**, such as **mutual funds**, **stock portfolios**, and **REITs** can provide a major boost to your retirement income stream. While each of these investments is taxable, those investments involving long-term taxable gains are often taxed at very favorable rates. Others, including **variable annuities**, are not taxed until you take withdrawals or surrender the contract and are then taxed at potentially higher ordinary income tax rates. This is just one reason why these may not be the best option for someone wanting to invest in the market. Variable annuities and the tax implications of all of these investments are discussed in greater depth in Chapter 4.

**Fixed Investments**, which include both taxable and tax-free **bonds**, can provide a valuable income stream during retirement. I often advise my clients to structure their holdings in such a way that the bonds pay income at different times and mature at regular intervals. Another form of fixed investments are **traditional annuities**, which are used by many of my clients as a safe means of supplementing their retirement savings plan with a reliable income stream. You purchase this type of annuity from an insurance company with a lump sum, and in exchange they give you income payments guaranteed for a period of years or even guaranteed for the rest of your life.

**Bank Investments**, such as **Certificates of Deposit (CDs)**, **checking accounts**, and **savings accounts**, tend to be both safe and liquid, providing an excellent source for money to pay your monthly retirement income expenses, for emergency funds, and for other short-term income needs. The interest earned by these investments is taxed at ordinary income tax rates. I often "ladder" CDs by spreading the money over multiple accounts to achieve sufficient liquidity and maximum interest, as I demonstrate in later chapters.

**Fixed Index Annuities** have been around for over 15 years, with many improvements made in these products since their inception. As with any investment it is important to compare rates, crediting strategies, surrender penalty periods, and other features. Fixed index annuities provide the safety of a fixed investment with growth linked to the stock market through an equity index. They are linked to stock indexes like the S&P 500, but also have a guaranteed minimum interest rate, so your principal is not put at risk by unexpected declines in the market. Fixed Index Annuities can also provide you with an income stream guaranteed for life. Some companies even provide this guarantee while still allowing access to the accumulated lump sum value of your annuity. I use this feature to help my clients create their own private pension plan while maintaining the flexibility of having access to the lump sum.

**Life Insurance Cash Values** can be a major source of retirement income and they are typically used in more advanced planning strategies—whole life policies, for example, have an investment component that can grow tax-deferred. Remember that there are many considerations when taking money out of a life insurance policy. At the same time, many life insurance policies have been set up and funded in a way that allows you to take tax-advantaged income out at retirement without reducing the face value of the policy.

All of the above non-retirement assets provide you with the opportunity to withdraw money in highly tax-advantaged ways. This flexibility is essential when you find it necessary to adjust your retirement income stream due to unforeseen changes in your needs over the years. When such adjustments become necessary, it's important to know how to reallocate them in a way that reduces the risk of losing the principal while maximizing your income stream.

### *Additional Sources of Retirement Income*

Potential sources of retirement income are not limited to retirement plans, bank accounts, and stock holdings.

**Rental and Investment Properties** can be an additional source of retirement income if you have substantial equity in these homes. While you may not wish to touch this resource to gain tax-free cash, at least you have the peace of mind of knowing that there is another option available if you need it. There are people who tap their properties for equity lines of credit, take out reverse mortgages, or liquidate them altogether. Still others decide to downsize their home and take advantage of the $250,000/$500,000 (individual/couple) capital gains tax exclusion on the sale of a primary residence.

**Tip**

Taking advantage of the equity in your home or investment properties is generally reserved for advanced financial planning strategies, and as such should not be undertaken lightly. Always consult with a qualified financial professional before making such a decision.

**Inheritances** often provide a financial windfall for my clients. While it is not necessarily a good idea to plan on spending money you have not yet received, it would be similarly imprudent to ignore this potential asset when planning for retirement.

**Work**, as mentioned above, is increasingly popular among retirees, either to supplement income or simply as a way of being productive. Some people find ways to continue working in their field—I had one client who stayed in his job well into his 70s because it had great prescription drug benefits, and another who worked as a consultant a few days a week.

Others may choose to pursue a passion: I have another client who loves working with wood, and started a custom-made furniture and cabinet business in his home woodshop that provides him additional income while doing the work he loves. Yet another loves playing golf, and has a part-time job in the pro shop at his local golf course, where he gets paid to talk about golf all day! Another heads the music program at her local church, again doing something she loves for a cause she believes in and earning extra income in the bargain.

For that matter, a lot of retirees just like to be productive to continue to add value to our world, whether it is doing something they love, serving a cause, supporting an organization or charity they believe in, or just continuing to do something they are good at. They now have the freedom and the time to pursue these endeavors where the money is the icing on the cake.

## Where Are *Your* Retirement Resources?

As the preceding lists make clear, there are many retirement resources at your disposal, and you may not be clear on how best to utilize each resource with respect to taxes and inflation. If you are already retired, you have many steps you can still take that will enhance your cash flow and (more importantly) protect the financial resources you have already established.

For this reason, I work with each new client to inventory their resources, so that they can make the most of their holdings with the least amount of risk and taxation possible. Whether you are already retired or just getting your ducks in a row, Exhibit 1.2—an excerpt of the Financial Lifestyle Questionnaire™ I fill out with each new client—will help you develop a clearer picture of your financial state.[1] (See Appendix C.)

#### *With Assets Comes Expenses*

Of course, no discussion about your money would be complete without looking at your expenses, debts, and other obligations.

Many of your daily expenses will remain the same during retirement, while other income needs are likely to go up. Keep in mind that your former employer will probably no longer pay for your health insurance and that you will likely incur Medicare costs (though everyone's insurance and health care situation is different). You may also wish to travel or pursue hobbies and other interests. At the same time, other expenses may go down—you don't have to commute to work on a daily basis, for instance.

I work with all of my clients to paint a comprehensive picture of their lifestyle expenses, for now and for the foreseeable future. Let's look at some of the obligations and expenses you'll need to consider:

- Mortgage or rent
- Strategies for reducing taxes are covered in depth throughout succeeding chapters
- Utilities, such as gas, heat, electric, water, telephone, cable, Internet, cell phone, and so on
- Insurance, such as homeowners, renter's, auto, life, medical, Long-term care, disability, liability, and so on
- Food
- Entertainment
- Vacations
- Clothes
- Emergency repairs
- Medical expenses, deductibles, co-pays, prescriptions, and so on

[1] To download the full Financial Lifestyle Questionnaire™, you can visit my web site at www.hankparrott.com.

Checking, Savings, Money Market, CDs, and Cash

| Bank or Company | Account Type | Balance | Interest Rate | Term |
|---|---|---|---|---|
| | | | | |
| | | | | |

Mutual Funds

| Description | Number of Shares | Market Value | Original Cost | Cost Basis |
|---|---|---|---|---|
| | | | | |
| | | | | |

Stocks/Bonds

| Description | His/Her/Joint | Market Value | Original Cost Basis |
|---|---|---|---|
| | | | |
| | | | |

Annuities

| Company | Origin Date | Premium | Account Value | Surrender Value | Cost Basis |
|---|---|---|---|---|---|
| | | | | | |
| | | | | | |

Company Retirement Plans and IRAs

| Company | Account Value | Interest |
|---|---|---|
| | | |
| | | |

Partnerships

| Description | Type | Units | Value | Owner |
|---|---|---|---|---|
| | | | | |
| | | | | |

Real Estate

| Description | Market Value | Cost | Date Acquired |
|---|---|---|---|
| | | | |
| | | | |

**Exhibit 1.2 Asset Inventory**

- Gifts
- Personal care—haircuts, manicures, massages, and so on
- Auto expenses, including gas, maintenance, and replacement
- Other debts, such as credit cards, loans, and so on

In addition to expenses for yourself, you may also have any number of obligations—situations where you want to provide for others. These include:

- Child or grandchild's college tuition, and other educational savings plans
- Charitable contributions to your church, synagogue, or other organizations
- Volunteer activities

Finally, we have luxuries: items that you could reduce or eliminate, but would result in a significant decrease in the "fun factor" of retirement. Examples of luxury items may include:

- Season tickets and theater subscriptions
- Sporting events
- Travel and vacations
- A second home, timeshare, or recreational vehicle

In my mind, the worst thing that could happen to my clients would be if they had to give up anything that mattered to them or made retirement enjoyable. After working hard all your life, the last thing you want to do is have a bare-bones retirement, as Sharon had been doing before she met me. In my experience, there are always ways to make the most of your available resources to maintain your desired lifestyle throughout your retirement.

I send out the Questionnaire in Appendix A to help prospective clients talk and get some clarity with thought provoking questions in preparation of our meeting. Appendix B helps clients to create a list of expenses, obligations, and luxury items. Appendix C would be completed after our first meeting as we move forward into more detailed analysis (assets, liabilities, and more detailed personal information).

I think you'll find the questionnaire to be an excellent tool for managing your money, identifying the level of income you need, and helping your financial professional, tax adviser, and legal specialist offer the most educated advice possible for your personal situation.

## Looking Forward

Once you've determined what you have—your assets, liabilities, and income, which is your starting point; and have measured and identified the lifestyle you want to attain and maintain, which is your destination; then we are ready to map out the best route to get there without exposing your assets to unnecessary risk along the way. We start by determining the needed rate of return on your investments, then move on to the next step of my Smart Money Approach. In the next chapter, we start to look at ways to make your money work as hard for you as you did for it.