PART

2

Achieving Wealth

CHAPTER

1

How to Pick the Right Chief Operating Officer

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it."

—Ralph Waldo Emerson

Getting to the Chief Operating Officer Point

For the reasons explained in the Introduction, investors who have saved $100,000 or more should seek a Chief Operating Officer (COO) for their virtual company. But how do you get to this $100,000 point? The simplest way is to participate fully in your company's 401(k) plan or similar retirement or savings program. If your company offers this benefit, enroll immediately and save, save, save! If you aren't eligible to participate in a company-sponsored retirement savings program—or, better yet, as a supplement to your existing 401(k) plan—select a conservative mutual fund with a good three-, five-, and ten-year performance record and be religious about making monthly deposits. These conservative mutual funds typically contain a diversity of **blue-chip stocks** and other fixed-income instruments such as **U.S. Treasury bonds.**

Blue-chip stocks are dividend-paying common stocks of large ($5 billion or more market capitalization), well-established corporations that have been profitable over decades and have strong market positions. Examples include IBM, Ford Motor Company, Dow Chemical, General Electric, Wal-Mart, and Bristol-Myers.

U.S. Treasury bonds are marketable, fixed-interest U.S. government debt securities with maturity of more than 10 years. All U.S. Treasury instruments are backed by the full faith and credit of the federal government.

Once you reach the point where you need a COO for your virtual company, hiring that person will be the most important decision you will make in securing your financial future. Yet, believe it or not, many people spend more time and energy, and do more research before selecting a new car than they do before identifying a person to help manage everything they own.

Who Makes a Good Financial Advisor?

Whether the financial advisor is the COO or a specialized team member of You, Inc., the advisor should work for a major national or international investment firm. This is not because large firms have a monopoly on intelligence or experience; they don't. The reason to select a national investment firm is its resources. No single person or small group can read everything or know everything. Investment advisors at large firms have staff economists, investment strategists, and technical analysts who constantly feed them relevant information. Investment advisors at large firms have business relationships, service offices, and access to the leading money managers nationwide. These firms hold their top performers to strict standards of ethics and provide a level of oversight that, we believe, small firms cannot match. In other words, we are convinced that the large firms offer an assurance and an insurance—safety—that small, independent firms do not.

Good financial advisors operate on the basis of a soundly researched view of U.S. and global investment markets for the coming five years. They constantly update that understanding and check it against market activity every year. The financial planner's global view takes into account corporate earnings, interest rates, inflation, budget and trade surpluses and deficits, and the overall health of the U.S. and global economy.

Choosing a financial advisor from a large national or international investment firm ensures a global view that is not only the financial advisor's personal opinion. Rather, it should reflect the intelligence and analysis of the firm as well.

In addition, you and the prospective financial advisor need to be candid and thorough in exchanging information at your first meeting. We have detailed the information that both parties should bring to an introductory meeting in Appendices A, B, and C.

But I'm a Person, Not a Company!

Encouraging investors to regard themselves as virtual companies is not meant to dehumanize them—in fact, the intent is just the opposite. We urge our clients to plan their futures and take the necessary actions to fulfill their dreams with the organization, analysis, and dispassionate allocation of resources that CEOs use to drive successful corporations. We urge our clients to view themselves as the CEO, who sets the goals and the timetables. Many times we then become the COO who helps make it all happen.

We help our clients achieve their life goals—wealth as they define it.

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Harry and Janice Greenberg, Inc.

Harry and Janice Greenberg were earning an excellent income (more than $100,000 per year) and using the advice of several financial professionals—a stockbroker, an insurance agent, an accountant, and a lawyer. Yet, they were setting themselves up for financial worry, strain, and deprivation in what should have been their leisure years. Why? Because they were not viewing their family finances like a business, had no long-range plan, and had no single, trusted financial professional (no COO) to oversee their earning, saving, spending, and investing.

The Greenbergs' stockbroker would call periodically with hot tips—stocks he said were bound to gain substantial value soon. Occasionally, he was right; more often he was wrong. The accountant prepared their tax returns. The insurance agent made sure Janice was provided for should Harry die prematurely, and the lawyer had drawn up and executed a standard will.

Yet while most of these professionals had delivered their particular service acceptably, none of them had taken a comprehensive look at the Greenbergs' goals, assets, and spending patterns. In 1989, tired of losing money and with Harry's sixtieth birthday approaching, the Greenbergs assessed their financial situation. They quickly realized that without having saved prudently and purposefully during the previous 30 years, they were in no position to retire within the foreseeable future. They took control of their situation, formed Harry and Janice Greenberg, Inc., and hired us as COO.

At that time, they had saved about $200,000 for retirement and had been looking forward to Harry's ending his career as a structural engineering consultant at age 62. They thought of $200,000 as a lot of money, which it was, but they did not realize that it would not sustain their customary lifestyle after Harry stopped working. As stated earlier, a family should save 10 times its highest annual income for retirement. Basic arithmetic shows that the Greenbergs had amassed about one-fifth of the $1 million necessary for the retirement they sought.

As COO, it was our unpleasant task to deliver a bitter pill: Harry would have to work full time until at least age 65—and part-time until at least age 70—so he and Janice could live on his income, not draw down from the $200,000, and allow **compound interest** rates to build the $200,000. We showed Harry and Janice a long-range plan built on this foundation that would provide the needed $1 million by the time they reached age 70. Even though the plan called for Harry's complete retirement eight to ten years later than they had hoped for, the Greenbergs were enthusiastic. For the first time, they had a specific financial and lifestyle goal and a plan to reach it.

> Humorously called the eighth wonder of the world or Einstein's greatest discovery, **compound interest** refers to the way savings grow in value when left untouched. Invest $2,000 for 30 years at 10%, tax-deferred, and you will accumulate $34,898. Add $2,000 per year, and you will save $363,886.

We immediately consolidated the Greenbergs' $200,000, which was scattered over dozens of stocks, many of which were declining in value and a few of which were in free fall. We reinvested the savings in a combination of private money manager accounts and tax-deferred annuities. Since Harry was working full time, placing him in the highest income tax bracket, the tax deferral was important. Because of health, age difference, and the life expectancy of women versus men, the Greenbergs expected Janice to outlive Harry by 15 to 20 years. The annuities would provide income for her after his death.

From 1990 through 1993, the Greenbergs drew nothing from the $200,000. Beginning in 1994, they drew $1,000 per month, and by year's end, even with the withdrawals, the $200,000 had appreciated to $450,000. At this point, we told Harry that, as the CEO, he could cut back on his schedule but still had to work part time, increasing the drawdown from the portfolio to compensate for lost income.

By 1999, the portfolio had grown to $1 million and we were able to increase the Greenbergs' draw to nearly $1,000 per week. As this book goes to press, they are living on the $50,000 per year that they draw from the portfolio, Harry's $14,000 annual Social Security payments, Janice's $6,000 Social Security payments, and the $24,000 he continues to earn with a low-pressure, low-demand consulting practice. This permits Harry to work just a few hours per week and enjoy most of his time on the golf course with Janice or playing with the grandchildren. Harry and Janice Greenberg, Inc. is a prosperous virtual company, and the two-person CEO team has achieved wealth.

Lesson: Don't wait until age 60 to have a plan. By age 50, you should be operating your virtual company, guided by its business plan. Age 40 is even better. The sooner you establish your virtual company and appoint a COO, the sooner you can begin working together to build and execute a realistic plan to reach your goals.

Kathleen O'Hara, Inc.

In 1995, Kathleen O'Hara of Boston faced as desperate and extreme a need to adopt a businesslike approach to her finances as any client we have ever had. Fifty-two years old at the time, her 30-year marriage to a wealthy, high-tech entrepreneur was disintegrating. Furthermore, the marriage had not prepared her to manage her finances.

Her husband's commercial success had funded a luxurious lifestyle and relieved Kathleen of the need to plan or budget, to build a career, or to develop marketable skills and credentials. She had learned to spend money. If she wanted jewelry or clothing, she bought it. An avid golfer and tennis player, Kathleen would flee Massachusetts winters for resorts or spas in Arizona or the Caribbean. She never considered making herself a sandwich for lunch, instead eating at the country club or a fancy restaurant every day. She had two imported, high-ticket automobiles, a luxury sedan and a sports car.

The divorce was more amicable than most, and her husband, Sean, was a generous man. As a result, she received substantial alimony for 10 years, a $1 million cash payment, and their primary residence in a wealthy Boston suburb. As a millionaire, Kathleen did not realize that she now had to invest and manage her money expertly. Only 52 years old, she could easily outlive even this substantial divorce settlement. Indeed, with her customary spending patterns, she *would* outlive it.

So, Kathleen's challenge was not poverty or deprivation. Far from it. Even after the divorce, she had more money than most. Her challenge was twofold. (1) While she had more money than most, she had a good deal less than she had been accustomed to living on. (2) She had never had to think about money—to plan, to budget, or to live within her means. Now, at age 52, she had to limit the fulfillment of her wants, if not her needs.

It was Kathleen's long-time accountant who realized she needed to form Kathleen O'Hara, Inc., hire a COO, and include a competent financial advisor on the corporate team. That accountant became her COO and set about, as his first responsibility, clarifying the CEO's financial position to her. He pointed out that, if she invested and managed her money wisely, she need never suffer deprivation. He also pointed out that her free-spending days were over; no more flying to the Caribbean just because a cold snap had gripped New England.

"But I have $1 million," Kathleen argued. The COO responded that, if she spent 5% a year, her portfolio should grow. However, drawing five percent from $1 million would produce an annual income of $50,000, and she was accustomed to spending at a considerably higher rate.

"When the investment markets have a strong year, and your portfolio does well, you will be able to take an extra trip," he said. "In years when the market is flat, you'll have to cut back. No more luxury vacations on a whim."

Having administered a dose of merciless reality, the COO asked us, as financial advisors, to structure Kathleen's investments for maximum safety and return. We split the $1 million cash settlement between tax-deferred savings (40%) that she would not touch for at least 10 years, and a **liquid asset** account (60%) that she would spend down to supplement alimony.

> **Liquid assets** can be readily converted to cash, such as money in a savings account or, in Kathleen's case, corporate common stock for which an active market exists.

We invested the $400,000 tax-deferred portion in **variable annuities,** which provide compound growth, three-times tax deferred. This means that the principal compounds tax-free, the interest it earns accumulates tax-free, and the money that you would otherwise have paid in taxes compounds as well. To gain these triple tax benefits, the investor relinquishes access to the funds. Usually considered a shortcoming, this lack of access was actually a benefit in this case, because it prevented Kathleen from spending money she could not afford to dissipate.

> **Variable annuities** are contracts issued by insurance companies, purchased either lump sum or by installments. They feature an investment in an underlying portfolio of debt securities, like bonds, and equity securities, like corporate common stocks. They are called "variable" because the underlying value of the investments in the contract fluctuates over time.

The power of the three-times tax deferral is illustrated by the annuity's growth. With an average annual appreciation of 12%, Kathleen's $400,000 would triple to $1.2 million in 10 years. This was the point at which her alimony was scheduled to expire, and the age when she would become eligible for Social Security. She could then start drawing 5% from the $1.2 million annually, adding to her Social Security payments an income stream of $60,000 per year

($5,000 per month). The portfolio should then continue to grow faster than she would spend it.

For immediate living expenses, beyond what the alimony would provide, we invested the $600,000 in domestic **large-cap** and **mid-cap equities.** From this portion of her portfolio, Kathleen drew about $30,000 (5% of the total) per year to supplement the alimony. Assuming long-term annual appreciation of 10% to 12%, this portion of her portfolio has the potential to exceed $1 million by the time Kathleen's alimony runs out. If the market remains strong, she may be able to withdraw more than the 5% per year that, as this book goes to press, we anticipate.

Large-cap (capitalization) and **mid-cap equities** refer to the common stocks of large and mid-sized corporations. A corporation's capitalization, or total market value, equals the number of shares of stock outstanding multiplied by the price per share. The definitions of large, mid-sized, and small-cap equities are not precise. In general, a small-cap stock has a capitalization of less than $1 billion, a mid-cap ranges from $1 billion to $5 billion, and a large cap exceeds $5 billion.

Now five years into the investment plan for Kathleen O'Hara, Inc., the CEO enjoys a lifestyle that is more modest than that of her married years, but one that affords her independence, security, and a reasonable number of luxuries. She also has an investment plan. Until age 62, Kathleen will live on the alimony and the $600,000 of the $1 million cash payment that is invested in liquid assets. At age 62, she will start to draw on the $400,000 that will have been appreciating untouched for 10 years, using those withdrawals to replace the alimony. Social Security will begin at that time as well.

Lesson: Do not depend on your spouse or anyone else to earn, manage, and invest all the family's money, because death or divorce can remove that person suddenly and without warning. Even if you are not the breadwinner, help the breadwinner budget, save, and invest for the future. Someday, you may need that knowledge.

Select a COO whom you trust and who can bring to the team equally skilled and trustworthy financial colleagues.

Andrew and Hortense MacTavish, Inc.

The MacTavishes came to us in 1994, when Andrew was 62 and Hortense 61, dissatisfied with their financial advisor. Based on frugality and Andrew's distinguished career as a research chemist for a large, multinational pharmaceutical company, they had amassed nearly $2 million in investments and almost $1 million in real estate surrounding their rural Connecticut home.

After attending a seminar we gave, they followed the self-examination and analysis processes outlined in the three tear-out appendices at the back of this book. The MacTavishes were quite specific about the characteristics a new financial advisor/COO would need to possess in order to join their virtual company. At our first meeting, they quizzed us relentlessly about our experience, education, and investment philosophy. They also freely provided the necessary information about themselves.

The process revealed that, although they enjoyed a substantial pension and Social Security, which provided for all their living expenses, they had $650,000 of their $1.8 million portfolio in government and blue-chip corporate bonds. Their previous financial advisor had relied on generic, cookie-cutter, pseudo-analysis to devise their investment strategy. He said, "You're retired. You should be in safe bonds to provide a steady, reliable income. Stocks are too risky for retired folks."

The problem is not that such thinking is always unintelligent. Often, **investment-grade bonds** are the best vehicle for retired people—especially if their own investments generate most or all of their income. The problem is that the analysis is generic, not tailored to the specific situation of the client at hand.

> **Investment-grade bonds** are bonds that are assigned a rating in the top four categories by commercial credit rating companies. Standard & Poor's classifies investment-grade bonds as BBB or higher, and Moody's classifies them as Ba or higher. By contrast, high-yield bonds carry a credit rating from S&P of BB or lower, or a Moody's rating of Ba or lower.

A closer look at the MacTavishes' situation and frank input from the couple revealed that this formula had overlooked one crucial factor: With a pension and Social Security providing necessary living expenses, they did not need steady, safe income from their investments. They actually could afford the limited risk of investing in stocks of blue-chip companies to benefit from the superior growth that these stocks provide versus investment-grade bonds. Furthermore, they were paying significant income tax on the interest payments generated by the bonds. If instead the MacTavishes invested that money in stocks and subsequently encountered a need for more income, they could sell off shares and would pay 20% capital gains tax on any shares held for over a year, a far lower tax rate than the income tax bracket where their affluence placed them.

The MacTavishes had told their previous investment advisor repeatedly that they felt secure with their pension and Social Security and wanted to participate in the stock market. He had neglected to listen to the CEOs of Andrew and Hortense MacTavish, Inc., and after several frustrating years, the MacTavishes began their search for a COO who would consider their unique situation in developing a financial plan.

As their new COO, we worked with them to strategize using the pension and Social Security for income and reinvesting $650,000 from government bonds into blue-chip common stocks. By late 1999, that portion of their portfolio had appreciated to $1.5 million, providing their one prized luxury, an extended European vacation every summer.

Lesson: Remember this adage: "No generalization is true 100% of the time, including this one." The relevance of this saying to our discussion is that, by definition, cookie-cutter (often, nowadays, computer-generated) investment formulas cannot take into account the personal circumstances and goals of a real individual or family. You need to be sure that your COO listens to you and confident that he or she sets you on the right path for achieving your definition of wealth.

Lessons of Chapter 1

The stewardship of the money that any person or family earns is as important to their long-term security, happiness, and wealth as the earning of it. That stewardship requires a thoughtful, attentive approach—equal in seriousness to the effort devoted to the career(s) that produced the assets—and the advice of a financial advisor or advisory team. That individual or team must offer investment, tax, and inheritance expertise.

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Professional's Toolkit

Becoming a COO for Your Clients

If one of your clients approaches you about serving as COO because you have earned the client's trust as accountant, lawyer, or insurance agent, you should ask yourself the following questions: Can I function as my client's COO, bringing into the virtual company a professional financial planner—someone who knows investments as well as I know balance sheets, taxation, or insurance? Or, should my client appoint a financial planner as COO and retain me to continue to provide the financial service (whether it's accounting, estate planning, or insurance) that I have been providing?

Both approaches work. In some cases, the financial planner is the COO, calling in lawyers, accountants, insurance experts, and others as needed. In other cases, one of these other specialists will be the COO, turning to the financial planner strictly for investment advice.

Which route should you follow? That depends on such factors as how broad your knowledge is of tax law, investments, estate law, and insurance; how familiar you are with Modern Portfolio Theory; and how much trust the client places in you.

For more information about the issues and information to include at an introductory meeting with a prospective client, see Appendices A, B, and C, the tear-out sections at the back of this book.