Saving the Day:
Consultants Experience in Damage Control

Closing the Gap

There is always a question of, "What is the market going to do?" I don't care what TV station you turn on or what radio station you tune to, they've all got different ideas. I think in the financial world, a lot more focus needs to be put on not where the markets are going and not what's going to happen in the economy, but on what people need to be doing with their own money. Taking control of what they currently own, taking control of their own decisions and deciding what they're going to do instead of relying on external forces that are out of their control is vitally important. What's the market going to do?

I remember a particular couple that came in for a meeting in 2007, right at the height of the real estate and stock market boom. For this article, we will call them "Mr. and Mrs. Know." They were both in their early 70's and were already taking their RMD's from their IRA accounts. They were both in great shape for their age. "Mr. and Mrs. Know" had 3 children, 2 of whom had great families and careers, but as it happens, the third child, their only son, was not in the best of shape. He not only had been divorced for a number of years but also had suffered serious injuries in an auto accident. Some of those injuries would be with him for the rest of his life.

"Mr. Know" had purchased (overpaid) some real estate with the hopes of having his son become his property manager. The remainder of his money, with the exception of about $15,000 he called "play money", was in accounts way too risky for his situation. I could tell that "Mrs. Know" wasn't comfortable with all of this risk by the way she looked down at her hands when I drilled down for more information from her husband. It was clear he was "the boss" when it came to financial matters in their household. The most worrisome aspect for their family was that the only income their portfolio was producing was rental income from their real estate. They had no dividend producing stocks, bonds or annuities. My recommendation to at least peel a minimal amount off their portfolio to fund an income plan that would give them an income floor, (an amount of money coming in each month to meet minimal living expenses) was laughed at by "Mr. Know" with his exact line being, "Not enough upside potential!"

To give a quick summary of their situation, "Mr. Know" continuously denied there was any risk in the hefty amount of real estate he had purchased. He further denied that investing in individual stocks with his IRA money was a bad idea – even when I stressed to him that owning 80+ stocks in his brokerage account was more stocks than many mutual funds have, and they have staffs of 50+ people to manage their operations. After weeks of not returning our calls for a "Future Financial Blueprint" meeting, they disappeared off our radar screen, just as both the stock and real estate markets soon did.

I still think of the heavy beating his portfolio sustained, and how a simple reallocation could have saved them a fortune. He didn't grasp the power of the two simple charts I went over with him. Chart 1, I call **"Core & Explore Retirement Portfolio Planning,"** is where I help explain that utilizing income planning techniques and annuity strategies to develop an income stream is vital but not totally encompassing of a financial plan. The chart helps the client understand why we isolate some money from risk and how much we should have in higher horsepower potential investment vehicles.

The 2nd chart, I call **"The 3 Aspects of Money,"** is used to show clients that everything sacrifices something in the financial world. In other words, we all would love a product that has unlimited growth with 100% safety & liquidity. Heck, might as well throw in a flying carpet and a unicorn too while you're at it. Those products just don't exist. But, the goal in the financial world is to get as much as you can of all three. Once clients can understand both the concept of the "Core & Explore" strategy and the "3 Aspects of Money," they become a lot more at ease with their planning. Too bad "Mr. Know" didn't take this type of planning more seriously.

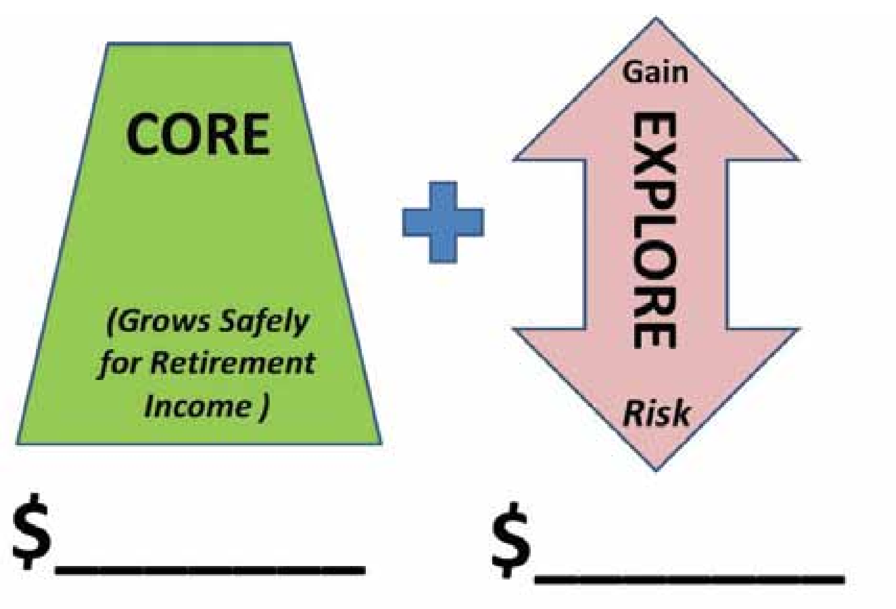

Chart 1: Core & Explore Retirement Portfolio Planning

Many folks today have probably heard time and time again about that Rule of 100. That's a good rule of thumb. One hundred minus your age (as a %) is probably the maximum amount that somebody should have at risk. For example, my advice, and a lot of sound advice out there would tell a 70-year-old to have at least 70% of their money insulated from market risk, including not just the stock market but also real estate market. A person who utilizes the proper safe/risk money equations often times finds it easier to sleep at night.

It seems almost everyone these days focuses on one aspect of returns and that is rate of return. Can this financial vehicle or whatever I'm investing in, return me a rate of 1% at the bank, or 5% bonds, or 10% in the market, or 20% in hedge funds, etc? Everyone is focused on rate of return. That's what we hear about all the time in popular media.

The one thing many investors and some financial consultants don't spend enough time thinking about is order of return. Sequential returns is really just in what sequence you are earning your returns. To break it down and keep it very simple, if you are earning a 2% rate of return on $1,000, that's very different than if you are earning a 2% rate of return after you have grown your money for a long time and now you have 1 million dollars. Realistically, everybody focuses on, "What is my average rate of return?" The markets averaged an 8, 9 or 10% return, whatever stats you want to look at out there. On a year by year however, how much is it returning compared to how much money you have built up?

When one hears about average rate of returns of 8% or 9%, whatever the number is it sounds great, but that's not real life. That's just something that can be featured on a brochure. Real life is year by year. What is this returning, how much do I have at risk in that vehicle and how does that impact me? Investors need to ask themselves before investing, where they are in their life cycle. How much money should be at risk, what should their money be doing for them, and can they absorb this average? Can they absorb what that brochure shows? This has been 30 years, and this is what is averaged. Most people aren't willing to stick something out for 30 years, so they're not looking at that long-term average. They are looking year by year and what direct affect it has on their lifestyle.

Many people that have had money invested in the market over the last 30 years have had phenomenal success in that market. We experienced in the '90s the biggest bull-run in the history of the modern world. People have had a love affair with the stock market, but at some point in time, most financial consultants need to transition their client's thinking, away from that accumulation mindset and into the distribution mindset.

People who have participated in the large market run up have a pile of money and need to ask themselves what they want their money to do for them. I suggest a quick 3-step process. Step 1: Sit down and consolidate all the assets into one statement. Take a look at what is at risk, what is safe, and determine the comfortable levels of each. This initial step is something that many people haven't done, and that amazes me. I do think that if people would sit down, look over what they have, and use the Rule of 100, they would see that they are overexposed to risk. Step 2: Determine the total amount of income needed in retirement. Is the need $4,000 a month or $6,000 a month? What's the magic number? Of that number, how much is coming from Social Security, pensions, and other guaranteed sources? Is there a gap?

For most people, there is a gap. If they need $5,000 a month, pensions and Social Security may take care of $3,000 of that, but there is a $2,000 gap. Looking back at all the money, now the question is, "What is at risk, what is safe, and where is my $2,000 a month coming from?" It needs to be coming from safe and guaranteed sources, not taken from risky portfolios.

Let's close that gap and let's calculate how to construct that desired monthly income in our example of $2,000 with as little to no risk as possible. Find safe and contractually guaranteed options out there to remove this sequential risk that we're talking about. If you remove all types of risks in the future, it is easier to go to bed at night and wake up in the morning knowing that your basic needs are taken care of.

Chart 2: The 3 Aspects of Money

Peter J. "Coach Pete" D'Arruda, CTC, RFC®

Peter J. "Coach Pete" D'Arruda, RFC®, CTC, is a Financial and Tax Coach. He is host of the nationally syndicated weekly radio show, ***The Financial Safari***, as well as the author of four books, including ***Fine Print Fiasco***, ***Financial Safari***, ***7 Financial Baby Steps*** and ***Have you been talking to Financial Aliens?*** Themes of these easy readers include helping others avoid being taken advantage of and translating financial jargon for any layperson.

Contact: 919.657.4201
pete@capitalfinancialusa.com
www.capitalfinancialusa.com