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Personal Risk Manager: Driver of Resilience

By Max J. Rudolph

Today's wealth manager is part friend, part psychologist, part insurance expert, part investment expert. The list seems to go on forever. Whether a client is considering filing for Social Security benefits or buying a long-term care policy for parents, the wealth manager has historically been the go-to person for advice. For years, family wealth offices served the needs of the affluent, but today these services are vital to many below the top tier of income earners. Personal risk managers are prepared to perform these duties.

Financial wellness is a squishy marketing term that lacks definition. Each person is unique. A homeless person's goal is to secure food and shelter, while circumstances differ greatly for those living at the poverty line, in the middle class and those lucky enough to be in the "1 percent." This essay's required length does not allow time to consider many of these situations and so will focus on those fortunate enough to have savings for retirement.

Some families have the internal expertise to address many of these issues on their own and need only to bring in experts for a few topics. Others choose to outsource the entire role to a family office and want to be sure they can trust this team of experts. Most can benefit from an unbiased external perspective.

The role of a personal risk manager is to lead this team of experts (or provide peer review), building resilience for an individual, a couple, a family, even an extended family or group of families. The goal is to develop plans that bend but don't break during periods of adversity and stress, and be proactive about risks likely to impact the client in the near term but also have a vision that looks out far enough on the time horizon to see potential emerging risks.

Human emotions are a core part of our life experience, but there are times we should pause to consider options rather than follow our instinctual flight response. The personal risk manager allows us to overcome our personal cognitive biases. Don't be afraid to ask for help!

Margin of Safety

Many wealth advisers ask clients to estimate their needs in retirement and back into an accumulated amount that is likely to last for their expected lifespan, generally until a couple is 80 to 90 years old. The default is often to generate income as a percentage of final salary. Each situation is unique, but there are many sources, and uses, of income that might be considered in addition to this oversimplified technique.

An investor might think of this as getting a return on investment, while most others would consider it part of normal life. We often fall into events, but those who think proactively about scenarios, making periodic adjustments, tend to “make their own luck.” Proactive analysis leads naturally to what value investors refer to as margin of safety. For example, some nationally branded wealth advisers talk about calculating a “number” as if this is the ultimate goal. A personal risk manager can calculate such a target, periodically monitoring progress toward goals and objectives, but conservatism and personal preferences need to be built in.

Instead of trying to reach a single number, why not set a redundant goal driven by 120%, 150% or even 200% of the target? Instead of trying to save \$1 million, build a margin of safety by extending the goal to \$1.3 million. The additional hardships are minor, and the journey more likely successful, especially if encouraged to start early in life. This could be a qualitative assessment or use sophisticated techniques and metrics like conditional tail expectation (CTE), moving from 50% likely success (50/50 odds) to 65% or even 95%. The “right” number is one that allows you to sleep at night.

A personal risk manager can create a flexible game plan using a simple spreadsheet, considering possible expenditures like health care, retirement savings, college, vacations, second homes and nursing home care. This process combines a budget for today with savings goals and conservative returns. By building in a margin of safety, it is more likely the original goals will be exceeded. Assumptions can be regularly updated, perhaps every five years early in a career and more frequently within the last 10 years before and during retirement.

The entire plan should be reviewed, not just asset accumulation progress. Has there been a change in family health status, a divorce or marriage, a change in the family structure, a change in employment history or some other change that impacts frequency and severity of future events? Perhaps future needs have changed. For example, a parent has died, or an adult child with their own children becomes disabled. Tell a family story through scenarios. What could go right and require extra funding (e.g., medical school, long lifespans) or wrong (e.g., drug dependency, early death)?

Unearned Income

Income during retirement can come from many sources, including defined benefit plans, Social Security payments, investment income, release of qualified assets (like IRA, 401(k) and 403(b)) and so on.

One way of looking at asset accumulation is to consider its flip side: expected income. The investor adds up anticipated unearned income from things like bond coupons, retirement income, real estate income and dividends from stocks. This can be especially useful when close to retirement and the potential retiree is trying to determine if they can afford to fully retire or if a part-time job or extra year(s) in their current job are necessary.

For those close to having enough accumulated to live exclusively from income, it is extremely comforting to see how much cash is expected to come in each year. Of course, stock dividends are not guaranteed but they often grow, reflecting the upside of volatility risk. Retirees are also finding out their defined benefit income streams may not be guaranteed.

Conservatism is built in by ignoring a drawdown of assets, thus providing an initial scenario for those who would like to leave an inheritance or charitable gift.

Retirement Benefits

Only by considering various scenarios can someone eligible for Social Security or a defined benefit stream decide what is best for them. You and your employers make a lifetime of payments into the system, but you only get one chance to get it right when it's time to choose a payout option. And it becomes more complex if there is a spouse involved (special rules apply for divorcees, widows, parents of minors, etc.).

Running scenarios, looking at expected and cumulative benefits (with/without discounting), and merging them with other income streams can provide comfort or a wakeup call for how realistic retirement plans are. A personal risk manager will consider a variety of scenarios and can impartially help someone think through these options and choose one that meets their needs.

Tradeoffs

Families today are faced with many choices. The goal is to make them consciously and not by default. It may be best for your extended family to support children well beyond their college years, but there is a price to be paid. It may mean sandwich generation members will be more likely to live with their children during retirement than their parents were. It's all about tradeoffs. High student debt and an increasing likelihood of outliving assets in a nursing home is uncharted territory. Buying that condo in Mexico, building a McMansion or taking an annual cruise is fun now but may have financial repercussions later in life.

Decisions already made are sunk costs, water under the bridge. Today's decisions have consequences. Small amounts of saving now, like small amounts of exercise, build up geometrically using the power of compound interest. There is no time like the present to start.

Nudges

The human experience includes cognitive biases (e.g., confirmation bias, overconfidence, hindsight bias). Being aware that we are not perfect and viewing decision-making in this light can help us avoid these influences. We know that recent events have a larger impact on our choices than is warranted. Knowing a favorite aunt recently entered a nursing home or that a large earthquake occurred close by makes us think future likelihood for those types of events has increased.

Behavioral finance is the study of these biases, and self-analysis can leave your family in better shape. A school cafeteria might put apples at the checkout to encourage, or nudge, students to eat healthy. Your 401(k) plan may default to a contribution rate of 3%, investing in the stock market, rather than the historical defaults of 0% and cash. We often need more incentive than someone placing a treadmill where it is easy to use. We need to make it a habit to save. It is the most important component of a retirement plan.

Solutions to Consider

It's not easy to make choices that lengthen our healthy and productive lives, but habits formed early in life can have lasting value. It is never a better day to quit smoking than today, and the same is true with exercise and financial knowledge. Not everyone needs to get a degree in economics, but everyone can take the time to understand the drivers behind the tax system and how compound interest works. For those without the time or passion, personal risk managers and their team of experts are waiting to help. These teams are especially valuable during life events that make it hard to think straight.

Individuals should include the value derived from their immediate family's human capital in this analysis. This calculates a dollar value on future employment. Future earnings are driven by education, number of family members in the workforce and expected health of workers. Families already do this qualitatively when setting budgets based on current income. This analysis should anticipate longer employment time horizons.

When life events occur, make conscious decisions about what is best for your family. If you go back to school while children are young, will this add income in the long run, and will it overcome the time lost with children, spouse and friends? Will a promotion that requires extensive travel be worthwhile? This exercise is a cost/benefit analysis for a family, with personal as well as financial outcomes considered. Momentum choices, made by default, often lead later to second thoughts and poor decisions. Following the herd is easier than considering and making tough decisions, but may not be the best option in the long term. Buying every new technological toy that comes out is fun now

but, if it comes at the expense of saving, it can have a large impact on quality of life in the long run. Life is a complex adaptive system, and ongoing tradeoffs impact results later in life.

External Stakeholders

Government has a role in choices made. Regulations and laws can change over time. Employers play a role. Defined benefit valuation models should consider the limited lifespan of a business and use conservative return assumptions. Health care and how to finance it is always a challenging topic. In the long run, knowledgeable individuals and families who are accountable and consider scenarios will make the best decisions for their unique situation.

Conclusion

The key to a happy financial life is to make the individual/family accountable, giving them the tools and knowledge to make good decisions. These tools are often qualitative rather than quantitative, although rules of thumb tend to be based on more complex analysis. Keeping it simple is OK, and overthinking the multitude of potential scenarios just keeps you up at night. Focusing exclusively on today's enjoyment has potentially adverse consequences that may lead to big family households, as parents move back in (often needing care) and children never move out. Recent generations may be the aberration; multigenerational households may be the natural way of life. A large family unit has many positives, from lower expenses to the emotional support only family can provide. The key is to make these choices proactively based on what is best for you and your family. A personal risk manager can facilitate this discussion, considering longer time horizon risks like climate change and technology that have both positive and negative outcomes depending on choices made.

If your goal is to become independent of social and family safety nets, choices regarding education and saving early in adult life are keys to success and provide a margin of safety with respect to realistic goals. Taking care of today's needs, and proactively deciding which of today's wants can be satisfied without jeopardizing future needs, puts an individual on a strong path to success. There will be plenty of bumps in the road. Anticipate them. Provide a margin of safety in your goals so you can maneuver and avoid getting caught in a downward financial spiral. Being your own personal risk manager, or hiring someone to help you review choices, gives you flexibility toward your own financial wellness, building resilience through redundancy and conscious choices.

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