MAY 2020

Here's a question that could drive you nuts. (Specifically, almonds.) ***What if getting better also puts you at greater risk of getting hurt?***

This is the dilemma of efficiency and resilience.

Efficiency is achieved by minimizing or eliminating waste and finetuning productivity. For both individuals and organizations, efficiency is a never-ending quest; there's always something to fix, improve, clean up.

In contrast, resilience is the capacity to absorb disturbance and adapt while maintaining the same function, structure, and identity. Rather than improving performance under stable circumstances, resilience is concerned with maintaining functionality when things go wrong.

Economists, management experts, environmentalists, even athletes, constantly wrestle with balancing efficiency and resilience. This tension between the two qualities is captured in the coaching mantra that says, "the most important ability is availability." A resilient athlete who continually shows up will often overcome a great athlete who is frequently injured.

About Those Almonds…

Almonds were one of first fruits to be grown domestically. Native to the area that is present-day Iran, almond cultivation spread from the eastern Mediterranean to North Africa in ancient times and was introduced to the Americas and the South Pacific in the 17th and 18th centuries. Today, almonds are a significant cash crop in places as diverse as Turkey, Spain, Australia and the United States.

But even though they are cultivated globally, more than 80% of the world's almonds are grown in California's Central Valley. A combination of climate, soil, resources and infrastructure make the Central Valley the most efficient place to grow almonds.

This efficiency delivers to consumers (worldwide) the most almonds at the best price. But it also increases the fragility of the almond market. In a January 2019 *Harvard Business Review* article, "Rethinking Efficiency," Roger L. Martin noted that "The almond industry designed away its redundancies, or slack, and in the process, it lost the insurance that redundancy provides. One extreme local weather event or one pernicious virus could wipe out most of the world's production."

Wait…Did he say "a pernicious virus?" You mean something like COVID-19?

Just as most of the almonds are grown in California, a global compulsion for efficiency has resulted in the consolidation of many industries, such as energy, transportation, textiles, electronics, or medicine. Entire supply chains are dependent on a few key producers, who are often clustered in one region.

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This highly integrated (i.e., more efficient) global economy was not prepared for the disruption of the coronavirus. On March 10, 2020, as the COVID-19 virus was morphing into a pandemic, the rapid implosion of economic and social normalcy prompted *Wall Street Journal* columnist William A. Golston to wonder:

"What if the relentless pursuit of efficiency, which has dominated American business thinking for decades, has made the global economic system more vulnerable to shocks?"

It's a plausible explanation for the sudden economic upheaval. But does it apply to personal finance, too? Is there a relentless pursuit of efficiency that makes our individual economies more vulnerable? It's something to consider.

Once you master the basics of personal finance (i.e., live within your means, avoid debt, save consistently, protect your assets), a lot of the "value-add" from the financial service industry is efficiency-based; particularly the idea that these "fixes" are the ticket to higher rates of return. For example:

- **Identifying the optimal mix of investments.** In fact, this process of determining "an optimal portfolio that offers the highest expected return for a defined level of risk" is sometimes referred to as an "efficient frontier" strategy.
- **Using algorithms and computer programs** to sift mountains of data, uncover marginal efficiencies, and automate decisions, like when to buy and sell, or how much to draw down in retirement.
- **Decreasing costs.** Segments of the investment industry market their services and products based on lower fees and transaction costs, as well as options to conduct business without using the services of financial professionals (because "all people are tax people," right?).
- **Encouraging households to skimp on (wasteful) cash reserves** so they can allocate as much as possible to investments with the potential for higher returns.

As the economic turbulence from COVID-19 has reverberated through the economy, these efficiency strategies have sometimes exacerbated the discomfort. In unusual circumstances, efficiency makes it harder to be resilient.

A March 16, 2020, *Wall Street Journal* article ("Why Are Markets So Volatile? It's Not Just the Coronavirus.") noted that "In recent years, traders big and small have turned to options, which give investors the right to buy or sell shares later at agreed-upon prices, *to juice returns*" (emphasis added). In calm markets, these options often are not exercised, and the seller pockets some additional cash. But when volatility and losses occur, the sellers of options may lose more money.

A March 10, 2020, *Fortune* article began "High-frequency algorithmic trading programs can make bad stock market days even worse." The *WSJ* expanded on this opinion, saying that computer-dictated investment programs can magnify swings in the market, because they are programmed to respond to many of the same indicators. "As a result, when things get wild, the computers…start selling—helping make it wilder still."

As COVID-19 news started roiling world markets, an email from a "discount" investment institution didn't offer much guidance to account holders, other than "stay informed" and "consider your plan." Since surveys repeatedly show it is difficult for individuals to exhibit perfect investor behavior and ride out market fluctuations even in calm economic times, it's fair to wonder if the "efficiency" of foregoing input from financial professionals will make individual investors more or less capable of staying the course.

And the exhortation to be fully invested has pivoted. Instead of dismissing cash reserves as a wasted allocation, there's this March 24, 2020, headline: "Companies Race for Cash to Tide Themselves Over in Virus Crisis," And a financial newsletter tells its readers: "When things get really bad, the only hedge is cash. It's the only thing that's not going down."

This doesn't sound like the reactions of resilient individuals or organizations. It's more like panic.

Efficiency? Sure. Resilience? Definitely.

When our Plan A seems to be humming along, it can be tempting to reallocate some of the apparent slack in our finances to more efficient options. We contemplate lowering cash reserves, dropping insurance, eschewing guarantees. Be careful. In a 2015 article, "How Efficiency Can Kill You," innovation expert Ulf Ehlert, says "Ultimately, we must afford ourselves some level of inefficiency." Slack is what allows for resilience.

The events of the past few months are not an argument against engaging in strategies that might squeeze a bit more return from your current activities; becoming more efficient with your personal finances is a good thing. But there must be an underlying resilience.

The financial professionals who distribute this publication emphasize the foundational nature of resilience in their financial philosophy. That's why there are in-depth conversations about cash reserves, life and disability insurance protection, along with an appreciation for guarantees, the necessity of up-to-date legal documents, and sensitivity to adverse risk. If your finances aren't resilient, attempts to become more efficient may also make you more fragile. ❖

Don't be caught off-balance.

Now might be an opportune time to meet with a financial professional to assess your economic resilience.

Cash Values[1] for Retirement Income:

A Case Study

Some financial professionals refer to whole life insurance as a "Swiss Army Knife" financial product. A versatile and stable asset, offering growth, tax-advantaged benefits and protection against untimely death – regardless of market conditions – whole life insurance can be used in a variety of ways, depending on your needs or opportunities.

One application often overlooked by the financial media is how cash values from a whole life policy can be used to offset investment risk during retirement by selectively alternating between cash values and other investments for income.

A Case Study

In June 2019, the Guardian Life Insurance Company of America produced a case study to illustrate a strategy for cash values in retirement. The study featured a hypothetical executive named John, who began retirement at 65 in 2000.

John's primary retirement assets were as follows:

- A $2 million balance in a regular IRA, invested in a mix of non-guaranteed investments.
- A $1 million, paid-up, whole life insurance policy, started when John was 38. Current cash value: $800,000. Current net death benefit: $1.56 million.

The following assumptions were applied to these assets:

- There were no additional deposits to the IRA or premium payments to the whole life policy.
- The annual rate of return for his IRA equaled the historical returns of the S&P 500 from 2000-2018. This index is generally considered representative of the stock market as a whole.
- The cash values and insurance benefit for the whole life policy for the 19-year period are hypothetical, based on a blend of male and female insurance costs, and the declared dividend rate in 2019.

Using these guidelines, two retirement income scenarios were constructed.

<u>Scenario 1:</u> The Straight Drawdown. John withdraws $150,000 on January 1 of each year from his IRA and pays federal income taxes of 20 percent[2] on the distributions, which gives him an after-tax income of $120,000 each year.

<u>Scenario 2:</u> The Selective Switch. John withdraws $150,000 from his IRA ***only if the S&P 500 showed a positive return for the previous year.*** If the S&P was negative, John takes a $120,000 withdrawal from the cash values in his whole life policy. (Assuming an effective tax rate of 20% on the $150,000 distributions from his retirement account, John would only need to withdraw $120,000 from his policy to have the same net withdrawal.)

The Results

<u>Scenario 1:</u> The Double-Whammy of Withdrawals and Investment Losses. One of the hazards of decumulation is a combination of withdrawals and investment losses in the same year, especially if it occurs early in retirement. Losses on top of withdrawals accelerate a depletion of principal, meaning there's less capital appreciation to provide future income. If withdrawals aren't trimmed, the account will quickly be depleted.

Unfortunately, this is precisely the scenario John encounters between 2000 and 2008. The S&P 500 produces negative returns for the first three years, and in 2008, it records a 37 percent decline. On January 1, 2011, John withdraws the last $102,000 from his IRA account. His $2 million account is exhausted, having delivered $1.6 million in retirement income.

<u>Scenario 2:</u> Toggling to Safe Money Preserves Capital. By drawing from cash values in the four bad years, John preserves principal in his IRA. The account still declines due to investment losses, but it doesn't suffer the double-whammy of withdrawals. In 2011, John still has an IRA balance of over $800,000. Combined with eight more years of positive S&P 500 returns, he maintains his schedule of $150,000 annual withdrawals through 2018. On January 1, 2019, at 83, his IRA balance is $285,338.

The four years of withdrawals from cash values decrease both the cash value accumulation and the net death benefit. But dividends[3] and paid-up additions also rebuild both numbers. On January 1, 2019, John has $782,000 in cash values and a net death benefit of $1.06 million.

> The best time to start a whole life policy is when you're healthy enough to qualify, young enough to allow the policy values to mature, and smart enough to see the multi-purpose possibilities.

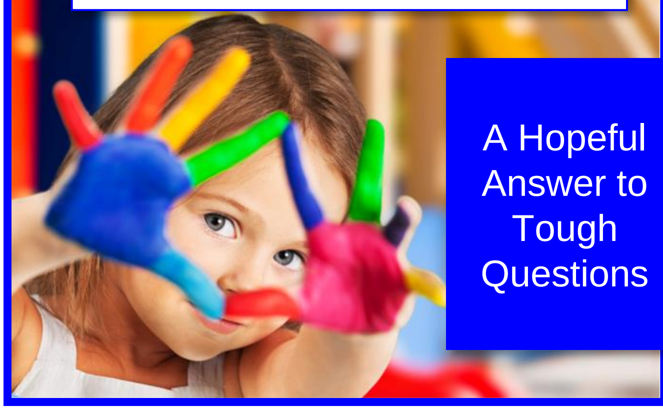
Takeaways

1. **Cash values are an asset class unaffected by market fluctuations.** They are guaranteed, tax-advantaged, and accessible. Properly managed, they can be a great stabilizer in retirement income planning.[1,4]
2. The case study highlights the **improvement in retirement security by making withdrawals from guaranteed accounts** instead of using variable assets that have incurred losses. It is possible that the same strategy could be achieved with other guaranteed assets. But reserving $800,000 in lower-return "safe" financial products for use in just 4 of 18 years might seem like a costly back-up plan. If cash values aren't tapped, they can help sustain or increase the life insurance benefit, enhancing the Swiss Army knife ability to use whole life insurance for a different purpose at a later date.
3. John is a fictional person who made **a critical decision 27 years before retirement to include a whole life insurance policy in his financial program.** It's a generalization, but whole life policies become more profitable the longer they are in-force because the guarantees have a longer time to compound. The best time to start a whole life policy is when you're healthy enough to qualify, young enough to allow the policy values to mature, and smart enough to see the multi-purpose possibilities.

4. **The concept is sound. Your details will determine its suitability.** This article is a brief overview of an 8-page case study, which includes tables and footnotes. One of the footnotes: "This case study should not be extrapolated to apply to anyone without consideration of a client's specific circumstances, and to ensure discussion with a Financial Professional about a particular situation." ❖

This case study is just one example of how cash values can be a valuable retirement asset. To conduct your own case study, you should connect with a Financial Professional.

The Special Needs Trust[4]:



A Hopeful Answer to Tough Questions

It is natural for parents to love their children. In fact, it is so natural that while we may be in awe of the sacrifices some parents make for their children, we are never really surprised. Loving and protecting children, especially our own, is a compelling motivation.

For parents of special-needs children, the imperative to protect and provide never diminishes. Their child may always be dependent on the protective covering of selfless and patient caregivers. It's challenging, yet most parents – because of love – willingly accept this lifelong responsibility.

But caregiving parents also wrestle with some unique concerns:

"What will happen if my health declines, or when I die?"

"Who will look out for my child if I can't?"

These are tough questions, and not having answers can trigger what psychologists call "future anxiety." Imagining a future where their children would be unprotected and alone causes extreme emotional distress today, and in despair, some caregiving parents give up.

John Schneider is a longtime newspaper columnist who speaks from personal experience about the struggles these parents face. The father of a daughter with developmental difficulties who died of an accidental drowning when she was 25, Schneider noted a recent incident in which the burden of care became overwhelming and led to tragedy.

A 60-year-old mother killed her 24-year-old daughter who had Down syndrome, then committed suicide. The mother had just received news that her cancer, once thought to be in remission, had returned. Police on the scene said the mother left a note, saying she couldn't bear more treatment, and didn't think anyone would take care of her daughter.

Schneider notes that this incident "although extraordinary, is not unprecedented. I know this because I have, stuffed into a book somewhere, a handful of yellowing newspaper clippings about similar tragedies. The common element is a reluctance on the part of the parents to leave their vulnerable children to an indifferent world…That's why we sometimes read about parents who just aren't willing to send their children to that place."

These tragedies are made even more tragic because there are options for caregiver parents to ensure their special needs children will not be vulnerable in an indifferent world.

The Special Needs Trust

One of the ways caregiving parents can protect the future of a special needs child is through the establishment and funding of a Special Needs (or Supplementary) Trust. This type of trust enables concerned individuals to bequeath assets for the specific benefit of a disabled person, without jeopardizing eligibility for government assistance such as Social Security and Medicaid.

Special Needs Trusts (SNTs) are very precise legal documents. To ensure maximum benefit for the child, a SNT must operate according to strict guidelines regarding control and distribution of assets. Some forms of financial assistance, such as cash payments directly to an individual with developmental disabilities, can reduce or eliminate benefits from government-sponsored programs. A recent *ThinkAdvisor* commentary estimated that 40% of these supplementary trusts are rendered invalid by the IRS because of inappropriately written provisions. Assistance from financial professionals with expertise in special needs law is strongly recommended.

A Special Needs Trust Can Be a Group Effort

Caregiving parents and guardians can feel isolated; their responsibilities often leave little time for other activities or relationships. Caregiving parents may also feel limited in their ability to fund a Special Needs Trust. But funding doesn't have to be a solo project.

A Third-Party Special Needs Trust can receive assets from parents, relatives or friends. Besides broadening the sources of funding, the SNT is an effective estate-planning device, both to ensure that bequests won't jeopardize existing benefits for the special needs beneficiary, but also to clarify inheritance issues for other family members.

Life Insurance: A Cost-Effective Funding Option

Financial professionals frequently recommend life insurance as a funding source for SNTs. For households that haven't yet accumulated other assets, life insurance is an immediate solution should a caregiver die. Practically, life insurance might be a default long-term funding choice as well. The Special Needs

Alliance notes that "Even for those with larger estates, a life insurance policy ensures that even if there are financial setbacks in the future, there will be a source of assets for the SNT."

The Alliance also highlights how life insurance directed to an SNT gives a family flexibility to "provide for the child with special needs while allowing the parents to direct retirement assets or business assets that may be inappropriate for an SNT to their other children."

Hope in Action

As Schneider says "…Where there is life, there is hope. I believe that. But I also believe hope is sometimes hard to see. It can sink out of sight, leaving a hole perfectly suited for despair."

Establishing and funding a Special Needs Trust can be a hopeful answer to the question "Who will look out for my child if I can't?" ❖

An actuary is a person who compiles and analyzes statistics and uses them to calculate insurance risks and premiums. Actuaries are the nerds of the financial services industry, so much so that even accountants make fun of them.

The average person (or even the smart person who took calculus in college) doesn't understand what actuaries do or how they do it. But what they should know is this: When actuaries increase the cost of insurance, it's because the risk is higher than previously thought. Which is why it's worth looking at the dramatic premium changes for auto insurance because of texting while driving.

Texting While Driving: From 0 to 20 in Five Years

One of the biggest factors in determining individual auto insurance rates is driving history. In general, more violations and accidents equate to higher premiums, with some incidents more costly than others. A minor violation, such as a speeding ticket, can increase renewal rates for an individual driver by 20 to 40 percent. (In some cases, a first ticket may not technically trigger a rate increase. But the offense may eliminate good-driver and multiple policy discounts.). A major violation, like driving under the influence (DUI), can easily double renewal rates, and "encourage" drivers to find a different carrier.

Currently, 45 of the 50 states have laws against texting while driving, but most of these statutes have been in effect for less than a decade. Because texting while driving is a relatively new violation, actuaries have only recently begun to quantify the costs associated with this offense.

Five years ago, according to the insurance comparison website Zebra.com, citations for texting hardly registered with actuaries; the average premium increase was barely 1 percent. Today? A texting while driving ticket means premium increases of 20 percent or more. And as more data becomes available, texting while driving is almost as dangerous as drunk driving!

The Drunk Driving Comparison

A 2009 study by *Car and Driver* put drivers on a closed course and measured reaction times and stopping distances when a flashing light appeared on their windshield. At 35 mph, researchers compared drivers who were reading a text message, sending a text message, or impaired (i.e., legally drunk). Compared to an unimpaired driver, the delayed reaction times translated to the following increases in stopping distance:

Legally drunk: **add 4 feet**
Reading a text: **add 36 feet**
Sending a text: **add 70 feet**

Drunk driving might have a greater impact on your motor skills and coordination, but the distraction factor of texting while driving is significantly higher. And subsequent studies have determined that distracted driving is dangerous driving.

- A report from the Virginia Tech Institute for Transportation found that you're 23 times more likely to get in a car accident if you text while driving, far surpassing other distractions.
- Texting while driving is six times more likely to cause a car accident than drunk driving.
- Using a cell phone while driving, whether it's hand-held or hands-free device, delays a driver's reaction time by as much as having a blood alcohol concentration at the legal limit of .08%.

You Don't TWD? Want to Prove It?

The National Safety Council says car accident rates have risen over 14 percent since 2014, with distracted driving primarily to blame. More accidents mean higher claims, which requires insurance companies to collect larger premiums.

Ideally, actuaries could assess premium increases to those most likely to engage in the risky behavior. But most of the time, the increase is passed on retroactively, after a driver has been convicted of a violation. To maintain adequate reserves, insurers also increase rates for all drivers. Unless you are willing to document your good-driving habits.

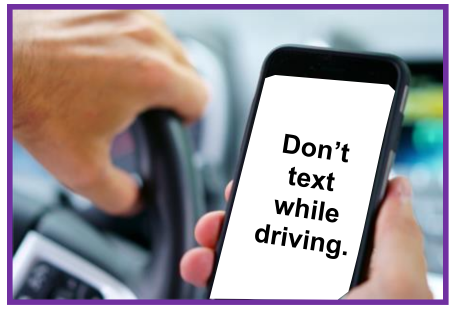
Many insurance companies offer technologies that track driving behavior. Known in the industry as 'telematics devices," these are either plug-ins that connect to a car's on-board diagnostics port or applications that work from a cellphone. Telematics track driving habits, such as the number of miles driven, the average speed, the frequency of hard braking, fast turns, etc. Insurance companies use this data to produce a "safe driver" profile and give discounts to drivers who match it.

Telematics are voluntary, and some privacy experts decry them as intrusive, particularly because the devices can also track a car's location. But from a big-data standpoint, insurers claim telematics do a better job of identifying good drivers and rewarding them for responsible behavior. Some telematics even give feedback, with the intent of nudging drivers toward better habits.

For those who are inclined toward self-discipline, there are cellphone applications to prevent texting while driving. When you get behind the wheel, you activate the app, just like you turn on "airplane mode" when you're in the air. You won't get a discount on your insurance for using them, but you will be less tempted to text and drive.

Big Numbers + Rate Increases = Serious Risk

You can always argue that you're unique, the rare person who's not a distracted driver when you're texting. But insurance of any kind is all about big numbers, involving lots of people. Actuaries don't know you, but they process lots of data about people just like you, and they know how to price risky behavior. This may read like a public service announcement, but when texting while driving compels actuaries to dramatically increase premiums, we should pay attention. ❖



Footnotes:

1. All whole life insurance guarantees are subject to the timely payment of all required premiums and the claims-paying ability of the issuing insurance company. Policy loans and withdrawals affect the guarantees by reducing the policy's death benefit and cash values.
2. For this hypothetical, the 20% effective tax rate does not take into account state, local or additional taxes that may be due from the retirement account withdrawal. Guardian, its subsidiaries, agents and employees do not provide tax, legal, or accounting advice. Consult your tax, legal, or accounting professional regarding your individual situation.
3. Dividends are not guaranteed – they are declared annually by Guardian's Board of Directors.
4. Policy benefits are reduced by any outstanding loan or loan interest and/or withdrawals. Dividends, if any, are affected by policy loans and loan interest. Withdrawals above the cost basis may result in taxable ordinary income. If the policy lapses, or is surrendered, any loans considered gain in the policy may be considered subject to ordinary income taxes. If the policy is a Modified Endowment Contract (MEC), loans are treated like withdrawals, but as gain first, subject to ordinary income taxes. If the policy owner is under 59½, any taxable withdrawal may also be subject to a 10% federal tax penalty.

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