

THE
MACRO
ASSET
PERSPECTIVE®



A wealth accumulation strategy

Richard Stivers, CFP

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The Macro Asset Perspective®
A wealth accumulation strategy

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VERTICAL DIVERSIFICATION

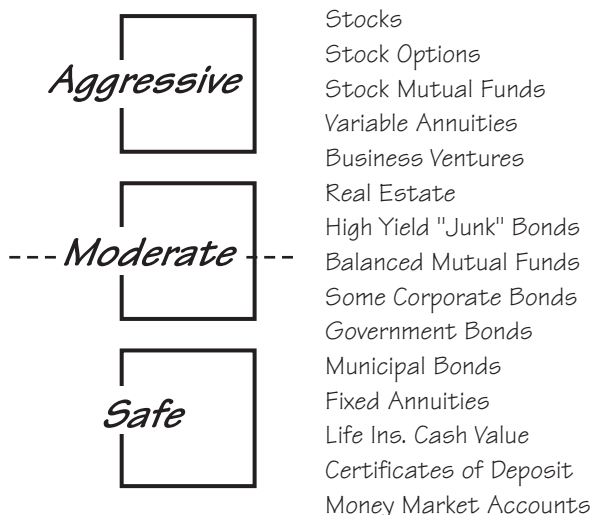
The first step to a *macro asset perspective* is understanding the value of “*vertical diversification.*” That is, diversification of risk.

Whether you hear it from a banker, a financial planner, an insurance agent, a stock broker, or an accountant, they all tend to speak in terms of risk diversification. And most reasonable people agree that diversifying risk, in some way or another, is a good idea.

But why is it a good idea? Let me explain. The diagram on the next page is designed to provide a visual picture of where assets can be placed and why. The vertical arrangement of the boxes signifies the concept of vertical diversification in three broad categories; “safe,” moderate, and aggressive.

Assets accumulated above the midline are sometimes referred to as *paper assets* because their values are not *fixed* until the time they are actually sold. When you look at your 401(k) statement, for instance, assuming it's invested in stocks or stock mutual funds, you notice the value moves up and down depending on a number of factors, all of which are outside of your control. Of course, we all hope our assets only grow, but the reality is these assets can both expand and contract.

Assets below the midline represent *real wealth*. Their values typically remain relatively stable or fixed, usually paying some sort of interest or dividends.



Your own personal vertical diversification may depend upon several factors including your age, risk-tolerance, holding period, etc. But generally speaking, the older you are, the more you might have assets below the line. In fact, a Wall Street rule of thumb suggests a percentage of assets equal to your age below the line. So a 20 year old might have 20 percent of her assets in the safe box and 80 percent aggressive, while an 80 year old might want 80 percent *below the line* with 20 percent at risk as an inflation hedge.

Periodic reallocation rule: Most individual investors tend to buy high and sell low, the antithesis of a winning strategy. This occurs because people tend to venture into the market from more conservative places, only *after* observing a period of sustained growth. Then, *after* the market turns south, they pull their money out in search of safer havens.

One way to combat this natural tendency is to select a vertical diversification mix, and stick to it. Let's say you decide you want 60 percent aggressive and 40 percent "safe." You will find that your percentages will shift automatically with market conditions.

In times of market gains, your aggressive percentage will increase. The temptation is to *let it ride*. Instead, convert some of those paper gains to "real wealth" by getting back to your predetermined mix. This practice causes you to *sell high*, that's one half of the age-old axiom. When market conditions reverse, and you find your mix is heavier in the "safe" component, you can practice the other half of the equation by *buying low* when you move some of those "safe" dollars back into the market to return to your desired mix.

Sounds reasonable, but don't underestimate the power of emotion. Both *greed* and *fear* are strong opponents to reason. Sticking to your plan, in good times and bad, will require a healthy dose of self discipline.



HORIZONTAL DIVERSIFICATION

While vertical diversification has been touted for decades, in recent years the concept of “*horizontal diversification*” has emerged. Horizontal diversification segments assets not by risk but between tax treatments.

This is a fairly simple concept to grasp since all saving and investing can be easily split into two fundamental categories: the *pre-tax* component and the *after-tax* component.

The pre-tax component consists of programs in which money is invested before it is taxed, such as 401(k) plans, 403(b) plans, traditional IRAs, and most pension plans. These plans are often referred to as “qualified” accounts because they qualify for tax deferral.

On the other hand, when you save or invest with dollars which have already been taxed, you are utilizing the after-tax component.

<i>Pre-Tax</i>	<i>After-Tax</i>
A	A
M	M
S	S

For years, when it comes to saving for retirement, the emphasis has been on the pre-tax component. Magazines, radio shows, and financial *gurus* have been stressing tax-deferral since the 1980s.

But what has made tax-deferral a good strategy?

I have conducted countless seminars on personal finance over the years, and I often ask that question. Here are some of the most common answers I receive from audiences across the country:

“It reduces my taxes.”

“It leverages my investment dollars.”

“I get growth from money that would have been paid out in taxes.”

These are all common *mis*understandings of the real value of the pre-tax component. There is one element needed in order for the strategy of tax-deferral to work properly; unfortunately it seems all but forgotten. Let me start it for you, and see if you remember:

"I'm going to defer my taxes now when I'm in my high income earning years because later, when I draw them out, I'll be in a _____."

If you said "lower tax bracket" give yourself a gold star. That has been the financial *mantra* since the early eighties when tax-deferral was popularized. Interesting though, how seldom people answer correctly these days. That's because very few actually believe they will be in a lower tax-bracket 10, 20 or 30 years from now.

Let me explain the evolution which has taken place.

The top federal tax bracket in the eighties was 70 percent. *Seventy percent!* And there were 15 different brackets. In those days, if you earned a little more you moved up a bracket or two; a little less might have dropped you down a few brackets.

A married couple earning \$100,000 at that time was in the 59 percent marginal bracket. So, the following conventional wisdom emerged: *"In retirement, we won't need \$100,000. We could easily live on \$80,000 and be in a lower tax bracket."* And that nugget of wisdom proved to be absolutely correct. For those retiring today the strategy worked perfectly. Back then, they deferred taxes at 50, 60, or 70 percent and are paying taxes today in significantly lower brackets.

But here we are today with just a handful of brackets, the highest of which is under 40 percent, with many people in marginal brackets between 25 and 30 percent. What's more, reducing income from

\$100,000 to \$80,000 doesn't help anymore. A married couple today would be at the same marginal tax rate at both income levels. Their income would need to drop another \$30,000 to \$40,000 before they would be in a lower bracket.

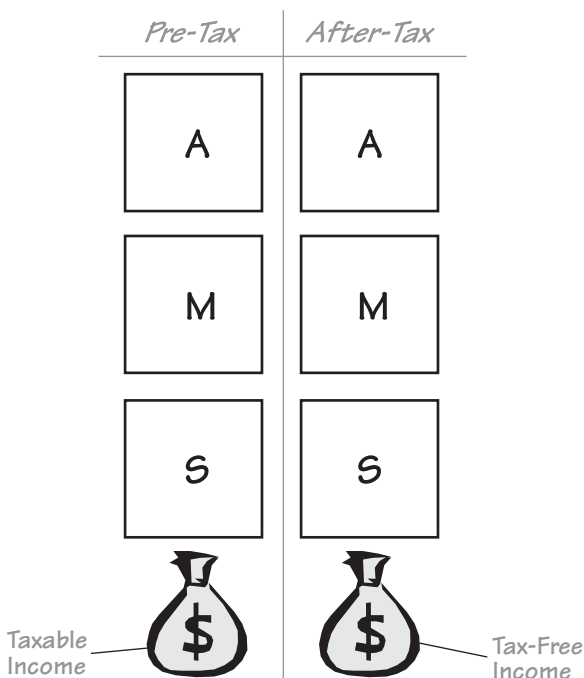
It's not simply that tax-deferral may not work as well as it used to, it actually may be a losing proposition for some. What if tax rates go higher in the future, as some people predict and as history would seem to suggest. Deferring taxes at 25 or 30 percent, only to pay them later at 35, 40, or even 50 percent would be a major disaster!

So how do we counteract this potential problem? Well first of all, let me tell you how *not* to approach it. Don't run out and cancel your 401(k) contributions, as some are beginning to advise. The pre-tax component can be a great place to accumulate wealth. What is needed now is proper diversification between pre-tax assets and after-tax assets. Let's take a look at how a horizontally diversified strategy can work very effectively.

The plan these days is to accumulate dollars in two different *bags*, on either side of the tax fence. If you want \$80,000 of annual retirement income, inflation adjusted, look at what could happen if you were able to draw \$40,000 per year from each bag? The income from the pre-tax bag would then be *significantly* lower, potentially placing you in a lower tax bracket. These days, that level of income lands a couple in the 15 percent bracket, making the old strategy work again. You deferred in one tax bracket, to pay later in a lower tax bracket. But you wouldn't have to live on that *half income* because of the additional income from the after-tax bag.

Ideally, you would want all of the income from the after-tax side to come out tax-free, since you've already paid taxes on the money that went into those

saving or investment vehicles. If you set things up properly, it is possible that you could have a tax-free flow of income coming out in retirement.



Receiving tax-free income in retirement doesn't happen automatically. We'll discuss more details later in Step 4, but for now, let us just assume that you are able to receive completely tax-free income from the after-tax side. That would be a total tax burden on post-retirement income of somewhere around 7¹/₂ percent, increasing your net spendable income after retirement when you want it most, *in retirement*. After all, the whole reason we are saving all this money isn't for the moment. It isn't primarily because we want a tax deduction today. It's because we want as much income as possible when we retire. The long-term objective in a macro asset perspective is more net spendable income in retirement.

In the following steps we will examine how to best accomplish that objective.

FEDERAL INCOME TAX BRACKETS

1981

70
68
64
59
54
49
43
37
32
28
24
21
18
16
14

2010

35
33
28
25
15
10

*For married couples filing jointly.
Percentages are rounded to the last whole number.
Actual brackets are not equally spaced.*

Source: Federal tax code.



PRE-TAX COMPONENT

Note: In the remaining steps I will be referring to above-the-line assets and below-the-line assets. It will help if you draw a mental line horizontally through the middle of the moderate boxes. “Above-the-line” represents the more aggressive assets. “Below-the-line” signifies the more conservative assets.

First let's focus on the pre-tax side. If you still have several years until retirement you may want to defy your 401(k) handbook's recommended principles of diversification by placing all your pre-tax assets above the line. Here's why:

There are three primary advantages generally associated with below-the-line assets, none of which are particularly advantageous on the pre-tax side. They are: *“safety,” liquidity, and tax advantages.*

Let's examine these elements in reverse order:

Tax advantages: There are still some financial tools left with tax advantages, many of which are found below-the-line. Tax free municipal bonds is a standard example.

Now, do you need tax advantaged investments inside a pre-tax plan? No. Because future income will be taxed according to the plan, not according to the investment, so that withdrawals from the pre-tax component will all be taxable when received.

Liquidity: Assuming you plan properly, do you need liquidity inside a plan that you do not intend to access for 10 or even 20 years, depending upon your age? Probably not.

Safety: Do you need safety? Certainly you always need some safety. But what kind of “safety?” The kind of “safety” achieved with money placed below the line is short-term safety. That is, what's there today you want to be there tomorrow, and the next day, plus a little reinvestment of interest or dividends. However, short-term “safety” is not what is needed in a long-term investment. What you really need is “long-term safety.” That is, what you sock away today, you want to be there 20 years from now, *and* you want it to have kept pace with inflation over that same time period. Historically, assets which tend to keep pace with inflation, or have the potential to exceed it, are found above the line.

But this kind of long-term “safety,” above the line, does not provide day-to-day safety. Values will move up and down. However, the more time you have to be invested, the less likely you are to lose value historically.

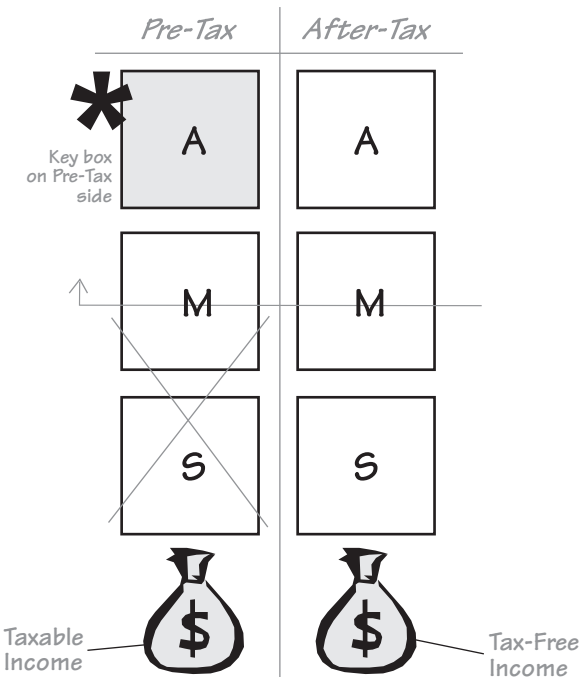
Now, this is a good place to introduce what I like to call “*the first rule of accumulation.*”

—TAKE THE FREE MONEY!

This probably doesn't need saying but let me just state for the record that within your company plans, you should generally contribute at least the minimum amount necessary to obtain all of your employer's matching dollars. It's tough to beat a 50 percent match, or even 25 percent, in the open market.

To summarize: in the pre-tax component you may generally focus your attention above-the-line to achieve your long-term objectives. So the primary pre-tax box in our *macro asset perspective* is the aggressive box.

However, you have now created a problem which must be resolved. If everything is above the line, you have lost the *vertical diversification* which I said earlier was so important. Not to worry. You can effectively obtain your vertical diversification with the after-tax side, as we will see in the next step.





AFTER-TAX BELOW THE LINE

Let us now direct our attention to the after-tax component. On the after-tax side, we want to focus on building a foundation below-the-line. Just as the aggressive box is the key to the pre-tax side, the “safe” box is the key to the after-tax side.

To build this foundation you will want to use tools capable of providing tax-free income during your retirement years. Now, those tools are limited primarily to three: The Roth IRA or Roth 401(k), tax-free municipal bonds and cash value life insurance policies.

Additionally, tax-deferred annuities can provide a future income stream (when annuitized) which is partially tax-free. And section 529 college savings plans can provide tax-free income if used for qualified education expenses.

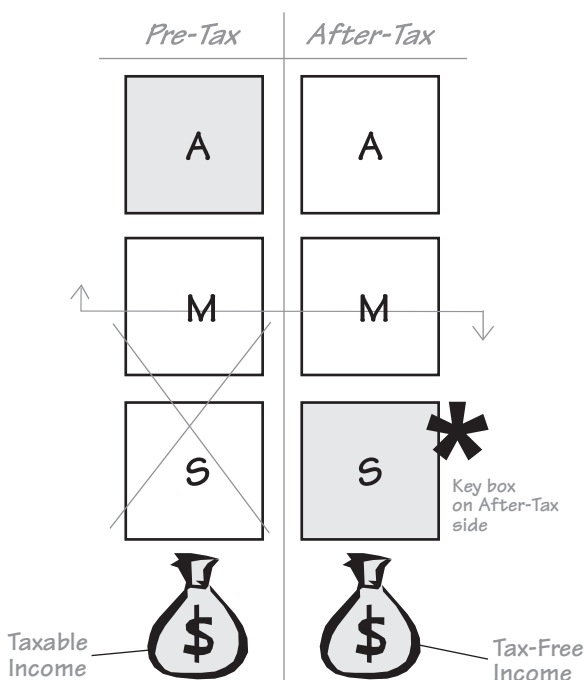
Let's briefly examine the attributes of the three which, if used properly, can provide future income that is completely tax-free. It is important to note that there are various rules and limitations for each one, which you will want to understand; so be sure to discuss the details with your own professional advisors.

Roth IRA/401(k): If you qualify for a Roth IRA under the federal income limits (check current limits to see if you qualify), or your employer provides a Roth 401(k), and can set aside access to your funds until age 59^{1/2}, this may be a very nice option. To be sure your Roth IRA is below-the-line, utilize financial vehicles not subject to market risk. (A Roth may also be placed above the line. More on that in the next step.)

Municipal Bonds: If you are at or near retirement, with an objective of consistent income, you might examine municipal bonds or municipal bond funds. Be sure to check the ratings on the bonds and, if avoiding your state's income tax is a concern, get bonds issued by municipalities within your state. (May be subject to AMT, depending upon your tax bracket, and any capital gains are generally taxable.)

Cash Value Life Insurance: Generally, if you have others dependent upon your income, and you can pass the required health examination, you can utilize a cash value life insurance policy. These policies are designed to provide both survivor benefits and cash value accumulation, which may be used for retirement income. Be sure to check the various ratings of the insurance company. (Policies and companies vary widely in benefits offered, guarantees and costs, so do your homework.) A cash value life insurance policy from a highly rated, financially sound insurance company can be a solid foundation for many.

Now the long-term rate of return you might expect to receive from below-the-line assets could range from almost nothing to 4, 5, 6 percent, subject to various economic conditions. Of course, if you're not paying taxes on that 5 percent, depending on your tax bracket, that might be the taxable equivalent of 8 or 9 percent. In other words, if you could earn 8 percent in the bank, then pay 30 percent tax on the earnings, you would net 5.6 percent after taxes (8 minus 30 percent equals 5.6).



Now 8 or 9 percent taxable equivalent return certainly isn't bad. However, it's still not what you might hope to get above the line. Many people hope to get 10, 12, 15, 100 percent above the line. But keep in mind, you are not trying to compare the returns of "safe," conservative products with the returns of aggressive or risky investments.

In a *macro asset perspective*, you are simply endeavoring to ensure that the percentage of your assets, which is held below-the-line, is achieving as much return and as many benefits as possible over the long-term. You need assets below the line, and you want them working as hard as they can.

So in summary, you want to build a foundation of “safety” coupled with tax advantages below-the-line on the after tax side.



AFTER-TAX ABOVE THE LINE

If you are a conservative investor, or just getting started, you may be content funding just the first two boxes (pre-tax aggressive *and* after-tax "safe").

For many investors, however, a complete *macro asset perspective* also includes this third component, after-tax above-the-line. Here you find such growth vehicles as stock portfolios, employee stock purchase plans, stock options, equity mutual funds, variable annuities, variable life insurance, real estate, business ventures, and more.

Let's focus on a few of the more advantageous tools available in this area.

Employee Stock Purchase Plans (ESPP): If you have access to an ESPP available through your

employer, count your blessings. Most plans allow you to make contributions of up to 10 percent of your salary via payroll deduction into a pool. This money is then used to purchase shares of the employer's stock at one or more specified times during the year, usually at a 15 percent discount and with no sales fees. What's more, the share price is typically determined by considering the price on the first day of the period versus the last day; then the stock is purchased at the *lower* of those two prices, minus the discount.

Do you remember the first rule of accumulation? *Take the free money!* This 15 percent discount may equate to a minimum 35.2 percent annualized rate of return. Here's how: Let's say you acquire stock worth \$100 at a cost of \$85 due to the 15 percent discount. That's a \$15 gain over your \$85 contribution. While \$15 is 15 percent of \$100, it represents a 17.6 percent increase on the \$85 contribution. (15 divided by 85 equals .176 or 17.6 percent).

But that's only half the story. Many ESPPs purchase stock every six months. If you receive a 17.6 percent increase on your investment over just a six-month period, that is equal to an annualized rate of return of 35.2 percent (6 months times 2 equals 12 months so 17.6 percent times 2 equals 35.2 percent).

How much money would you invest if you were expecting a 35.2 percent rate of return? Every dollar you could find, right? Of course. But remember, that rate of return is only secured if the gain is locked in, and the gain can only be locked in if and when the stock is sold. To secure your gains, consider selling your shares as soon as possible after each purchase is made by your employer, and the gain can be realized. In many plans, the gain from the employee discount, and any additional gain in the stock price, is considered ordinary income, and taxes are withheld from your paycheck for this

amount whether or not you sell the stock. In this case the subsequent sale of the stock, at the same stock price, does not trigger a tax. (Check with your employer and tax adviser concerning the details of your ESPP.)

Therefore, the first reason for intentional, periodic stock liquidation, is to realize the gain from the employee discount.

The second reason is diversification. You would probably not set out to devise a strategy that eventually invests the vast majority of your assets in a single company, especially if you also happened to work for that company. Even the greatest companies can run into trouble, and the result of such trouble could be devastating. It's one thing to have your money go away. It's quite another to have your money *and* your job desert you at the same time. Still, I have seen many people over the years in exactly that precarious situation.

For these reasons, an ESPP may be best used by many as a *funding source* for an investment strategy, and not as an accumulation vehicle.

This is what I like to call the “*funnel approach*.” Funnel as much money as possible through the plan, get the free money, then diversify into an after-tax strategy which might include an individual stock portfolio, mutual funds, or a variable annuity above the line, and cash value life insurance or tax free municipal bonds below the line.

Roth IRA: Another good planning tool to use above the line is the Roth IRA/401(k). We have already discussed how the Roth IRA may be used below the line; but because of its very long-term nature, you may prefer to fund it with equity investments above the line, such as mutual funds. (To give yourself permission to use the Roth IRA in the aggressive component,

just make sure you are accumulating sufficiently in the “safe” area through the use of the other after-tax tools previously mentioned.)

Real Estate: Rental or investment property enjoys favorable tax treatment and has always been considered a decent long-term investment. Just be careful not to get caught up in the cyclical euphoria of increasing property values. Real estate is an equity market that historically has moved both up and down. There are also costs such as property taxes, insurance and maintenance as well as illiquidity issues that must all be factored in. Still, all things considered, real estate can provide a unique long-term growth opportunity.

Long-Term Capital Gains: At times such as the present, when taxation on long-term capital gains is low, relative to income tax, it is often prudent to take advantage of these rates. Strategies such as periodic sales of stocks and low-turnover mutual funds can be used to capture the favorable long-term gain rate. Currently, income from dividends is equally advantageous from a tax legislation standpoint. Keep in mind that in this after-tax aggressive arena we are really after growth potential first, with tax efficiency playing a secondary or supporting role.



MACRO ASSET ALLOCATION

Now that we have examined the three primary funding boxes, we can wrap it up in this final step with some discussion on proper allocation percentages.

For the sake of this discussion, I will assume you are starting from scratch. But be aware that if your assets are already way out of proper alignment, you may need to assume an additional corrective strategy.

Start by calculating your total investable dollars (monthly, annually, or whatever). A common approach is to divide these dollars fifty/fifty, left to right, on each side of the tax fence. That's 50 percent pre-tax and 50 percent after-tax. This is a reasonable approach for many people. Since you

don't know what's going to happen to tax rates in the future, you will want to maintain reasonable balance so that you can lean one direction or the other, depending upon what actually transpires over the years. While a fifty-fifty split for horizontal diversification is reasonable for many people, let me give you a couple of exceptions:

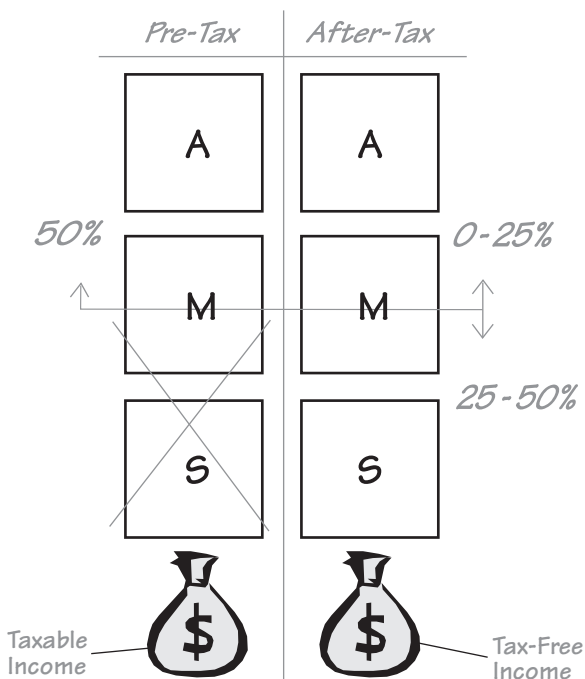
High Income Earners: If you are making \$400,000 now, and want to plan for \$300,000 in retirement, you probably won't want \$150,000 coming out of the pre-tax side at that time. In many people's opinion, you could find that level of retirement income taxed at a higher rate than it would have been taxed today.

If that's your concern, you may want to lean heavier on the after-tax side. Frankly, you'll likely end up that way anyway if you're doing a good job of investing, because your contribution to the pre-tax side is limited by law. And if you're earning a healthy income, hopefully you're investing a good portion of it. So you might consider something more like a thirty-seventy split, left to right.

Lower Income Earners: Conversely, if you have a household income of \$40,000, and you're hoping to retire someday on \$30,000, you are likely to be in one of the lowest tax brackets of that time. So you may still do what most of the national newspapers and magazines are touting. You may still be able to lean heavier on the pre-tax side since the old mantra of lower taxes at retirement may indeed be true for you.

Let's assume you're somewhere in the middle, and the fifty-fifty split is reasonable for you. I already said, in most cases, that the entire 50 percent on the pre-tax side could potentially be placed above the line.

On the after-tax side, a fifty-year-old may place the entire 50 percent below the line. A twenty-five-year-old investor might place as little as 25 percent below the line, leaving 25 percent above the line. This would provide an overall mix of 75 percent above the line and 25 percent below, which is as aggressive as most reasonable planners would likely recommend.



While the asset allocation mix you select is certainly important, it is even more important that you stick to your percentages (unless your circumstances or objectives change significantly). As I discussed in the first step, the temptations to stray from your plotted course will be strong, in good times as well as bad times.

So *plan* your course, *stay* that course, and let your MAP be your guide.



