Case Study #2

GETTING READY FOR RETIRMENT

1) CLIENT OBJECTIVES / NEEDS

A practical and realistic strategy and specific action plan to achieve the following:

- Maintain current lifestyle until retirement, and then after retirement, maintain a lifestyle with an after-tax spendable income of $75,000 per year, indexed by 3% for inflation, for the rest of their lives.
- Retirement to occur by client's age 61 and his spouse's age 59.
- Lifestyle of surviving spouse to be maintained at 67% of current retirement lifestyle.
- The bulk of the investment assets are to be professionally managed in a diversified, tax efficient portfolio – clients do not want to manage it themselves though they do enjoy making small speculative investments.
- Taxes to be minimized without taking unacceptable risks.
- Upgrade house if feasible by an increase in capital of $140,000 in today's dollars.
- Allow for car upgrades in the amount of $10,000 per year until the client's age 84.
- Estate to be maximized for beneficiaries but without encroaching on the clients' current and retirement lifestyle.

2) CHALLENGES

- The 59 year-old client and his 57 year-old spouse are undisciplined investors – they have no formal investment strategy and have not properly considered the risks of investing in high tech stocks. Although most of the interviews were held with the client only, both the client and his spouse make all major financial decisions together. Because of their undisciplined investment strategy, they lost over $40,000 trading in speculative high tech stocks.
- The client and his spouse both worked for the same company. The vast bulk of their wealth was tied to the fortunes of this company through personal shareholdings, stock option plans and employee stock purchase plans.
- The company is a highly successful Canadian high tech company listed on the NASDAQ exchange in the US. The balance of power had shifted to California, making the careers of both the client and his spouse uncertain. My worst fears were later realized, when, at the height of the high tech meltdown, both were laid off. The company stock was at an all-time low, and their retirement plans were in complete disarray.
- The clients' financial affairs are highly complex, with the client and spouse both participating in stock option plans and employee stock purchase plans. The employee stock option plan is subsidized by the employer by way of a complex set of rules relating to the historical stock price. This results in a taxable benefit, which varies depending on how the stock performs. Some of the stock options relate to when the company was a Canadian-controlled private corporation (CCPC), prior to going public, which has certain tax ramifications. Fortunately, the client had very cleverly negotiated a clause in his employment contract that made all his options vest if he was terminated.

- The stock price of the company was very volatile, which means that, given that most of their wealth was in the form of shares in the company plus vested and unvested stock options, the client's net worth was highly sensitive to variations in the company's stock price.
- This volatility also makes portfolio planning difficult, because in order to reduce risk, we have to diversify from 67% Canadian equity to other asset classes, which reduces the projected return on their portfolio from 9.89% to 9.08%. Explaining to clients that you want to reduce their projected return in order to reduce risk presents quite a challenge. I also had to explain a limitation in our own investment planning software, which assumes that the client's Canadian equity holdings are in a diversified portfolio, rather than in one company. This, of course, significantly understates the existing portfolio risk.
- The client's were using a number of different stockbrokers and banks to manage their investment assets and were unhappy with the service levels of all of them. No one person knew the complete picture of their financial affairs and no formal planning had ever been carried out.
- In the previous year, the clients used the services of a chartered accountant to prepare their taxes, but had not engaged him to develop tax minimization strategies. They used a portion of the $500,000 capital gains deduction to reduce taxes on the pre-IPO shares that they had owned for more than two years, prior to the company going public. However, these shares have now all been sold, so no more of the small business capital gains deduction is available.
- The clients have not pursued any significant income splitting strategies.
- The client recognized that his investment assets were very poorly diversified, with 84% represented by his company shares and vested options, but he was very reluctant to sell his holdings when the stock was much below it's historic high. Furthermore, as a senior officer, he was subject to extensive blackout periods when he was not permitted to sell his company stock (over 50% of the year). These factors significantly affected his efforts to diversify.
- The client had at one time tracked expenditures, but stopped doing this several years ago. The clients couldn't account for a large portion of their after-tax spending. On the other hand, they made a wise decision in eliminating all non-deductible debt. The client also does a good job in estimating his tax liability on exercised stock options and always maintains enough liquid holdings to pay his taxes.

3) DEVELOPMENT OF SOLUTIONS

My first planning effort consisted of carrying out an initial assessment of the clients' situation in order to identify the benefits of using a formalized planning process. The client had received proposals from several other investment advisors but hadn't yet made a decision. Based on my report, they decided to retain my services, and I then started the formal planning process as follows:

Goals & Objectives: I held several meetings to discuss the clients' goals and objectives. In terms of specific objectives, they wanted to retire within the next 2 years (client's age 61 and spouse's age 59). They felt they needed an after-tax and after-inflation income of $75,000 per year. They also wanted to upgrade their home from $280,000 to $420,000, if possible. In further discussions, we determined that they would need to have an allowance of about $10,000 to allow for car upgrades up till the client's age 84. In terms of qualitative goals, they wanted to minimize current and future tax, including estate taxes, and they wanted a plan to reposition their investment assets with particular attention to reducing risk, yet improving returns, and ensuring that the risks of premature death or disability were adequately covered. The clients were quite clear that, although they preferred to minimize taxes on death, they did not want to give up current or retirement lifestyle for the sake of their children, both of whom were well established and independent.

Information Gathering & Analysis: After gathering extensive information on their financial picture, including stock option and employee stock purchase plans, employee benefits, investment statements and tax returns, I assessed their current situation and determined the following:

- Their current lifestyle could not be accurately determined. Their income was quite variable because of the interaction between the stock option and stock purchase plans and the stock price, and the discretionary bonus plan. They had used the proceeds from selling shares in the past to pay down personal debt and to refurbish their home. I determined that, from their total non-stock option income of $282,000, identified living expenses accounted for $54,000, savings accounted for $44,000, leaving $75,000 unaccounted for.
- By a different method, I then calculated their lifestyle to be about $126,000. Using this number, I determined that with their current asset mix, and including only vested stock options, that they could maintain a retirement lifestyle of $75,000 after tax and after inflation, upgrade the home, allow for car replacement, and still leave an estate of $1,301,500. I used 40 years of statistical history to calculate an expected return of 9.89%, but as mentioned above, this understated the risk because 84% of their investment assets were in their company's stock. I assumed that the client and spouse would live to the client's age 99. I always tell my clients that we are very romantic in our firm: we assume that both husband and wife go at the same time.
- There were sufficient funds to ensure the remaining spouse maintained 67% of the retirement lifestyle on the other spouse's death (the objective as stated by the clients). This objective is lower than our usual standard of 85%, which I pointed out to them. They are considering revising the objective. This helps to highlight that financial planning is a dynamic process, with client objectives and financial situation subject to change from time to time.
- There was no need for a disability analysis since the client's had more than sufficient funds to retire now if necessary.
- The clients did not have up to date wills or Powers of Attorney for Property or Personal Care prepared. We strongly recommended doing this as soon as possible. Most lawyers prepare wills and Powers of Attorney as part of a package, so I recommended that the clients do both at the same time. I would help prepare a letter of direction to the lawyer to ensure that the wills and Powers of Attorney met our standards. Both wills and Powers of Attorney are an integral part of a proper estate plan.

Financial Strategy – I completed the initial planning process, but in the middle of implementing the plan, both the client and his wife were laid off. The salary in lieu of notice seemed reasonable, but the client was given only 30 days to exercise his options. The stock price, meanwhile, had plummeted. I gave the client the name of a good employment lawyer, whom he consulted. I advised the client to concentrate on getting the option period extended with his former employer, since this would have by far the greatest financial impact, yet would result in little cost to the company. The client then successfully lobbied the board of directors, and the exercise period was extended to a year. A small trade-off was that some of the options would vest after 12 months. This was a significant victory, because the stock price tripled over the next 2 months. Better still, my client was now free to sell his stock with no restriction, because he was no longer considered an insider. I will now revise the original plan to incorporate the latest developments. The strategy as it now stands is:

- To take advantage of the current strength in the company stock exercise all vested options in a carefully staged but rapid divestiture. High trading volumes meant that the client's trading activity would not affect the market. I analyzed which options should be sold first, and determined that he should sell the options with the lowest exercise price first. If the stock price went higher, the profit would be the same, but if the stock price went lower, a higher profit would be locked in.
- The client wanted to maintain a two tiered investment strategy: the first tier, a conservatively managed portfolio of assets dedicated to funding their retirement objective and a second tier of more aggressively managed assets that are surplus to their retirement needs. We decided to defer consideration of this strategy until after we have successfully diversified from their heavy concentration in one company. I also suggested establishing a limit for investing in aggressive high growth stocks.
- To sharply reduce the risk in their portfolio, I recommended reducing the target return from 9.89% to 9.08%, which decreased volatility from 18.25% at one standard deviation to 13.73% at one standard deviation, while increasing the efficiency of the portfolio as measured by the Sharpe ratio. As mentioned, the calculated volatility understated the risk significantly because virtually all of the Canadian equity asset class was in one stock. Changing the projected rate downwards reduced the projected estate to $571,000. This is a more realistic approach because of the risk inherent in not diversifying their portfolio.
- Exchange U.S. funds directly through the exchange desks of the major banks. After exercising and selling his stock, the client was left with well over a million in U.S. funds. I recommended that the client not exchange funds using posted bank rates, because, he could save thousands by dealing directly with the foreign exchange desk.
- Lower taxes by:
  - Continuing to maximize RRSP contributions.
  - Depositing surplus capital into tax-exempt life insurance to shelter capital from tax and/or create a supplemental non-taxable retirement income (see description that follows).
  - Investing in film production service limited partnerships to defer tax, and investing the resulting deferred taxes into a tax-sheltered environment using the universal life insurance mentioned above.
- Reduce estate taxes and legal fees by having named beneficiaries for insurance proceeds and registered plans.

Action Plan – After developing a strategy, I then provided a specific outline of the steps needed to take to make the strategy work. The action plan, covering the next 12 months, included the following:

- **Cash Management**
    - Maintain the existing unused line of credit, which is more than sufficient to fund 3 to 5 months of lifestyle expenses.
- **Tax Management**
    - Continue to maximize RRSP contributions, but make these in advance rather than in arrears as is now being done. The client's contributions should be into a spousal plan to help split income. The client has still not decided whether to seek employment.
    - Apply for CPP benefits 6 months prior to the anticipated retirement date after turning 60. The clients should apply to split the benefit as another way of splitting income, to save over $300 per year in taxes. I generally recommend that clients apply for benefits at the earliest of their retirement date, or age 60, whichever comes first, based on calculations that my firm has done. These show that clients would have to live longer than 84 (greater than their life expectancy) to be harmed by the age reduction in the benefit.
    - Consider having the spouse sell her half of the family home to the client in exchange for some of his non-registered investment assets. This will increase her retirement income and decrease his retirement income, resulting in potential savings of $7,500.
    - Use tax-exempt life insurance to shelter non-registered funds from taxation. This concept is particularly appropriate for people who are maximizing their RRSPs and need additional investment vehicles for tax deferred growth. Deposits greater than the risk charges can be invested in a similar fashion to standard mutual funds, including maintaining an asset allocation model. We can maximize the tax effectiveness by funding the policy to the maximum allowed and structuring it so that the risk charges drop over time (eventually to zero) and are replaced by the funds invested. Once the risk charges are eliminated, the policy becomes a 100% tax shelter. I will coordinate the allocation of the investments within the policy to ensure that the overall asset allocation is maintained in line with their risk tolerance and long-term objectives. In addition, we may be able to use the policy as an income splitting strategy. Once sizable capital has been deposited into the policy, ownership can be transferred to the lower taxed spouse, who can then draw a taxable income from the policy's investment account. The estate planning implications of this strategy are described below.
- **Asset Management**
    - Reduce the target rate of return from 9.89% to 9.08%, in order to decrease portfolio risk.
    - Diversify existing portfolio into 6 asset classes as investments come due (5% Cash, 15% Canadian Fixed Income, 10% International Fixed Income, 30% Canadian Equity, 15% US Equity, 25% International Equity). Use an asset management service to rebalance on a regular basis using a combination of 70% value-based and 30% growth-based investments. Historically value outperforms growth, but there can be significant periods when growth outperforms value. An optimized combination of both helps reduce volatility and increase the predictability of results.

- Use a highly tax efficient asset management service that charges management fees charged directly to the spouse who is taxed at the highest rate, resulting in tax savings of about $5,000 per year.
- Invest funds held outside of registered plans and exempt life insurance plans in equity investments which tend to generate mostly capital gains and dividends, which are taxed much less. Of course, overall asset class allocations still have to be maintained.
- Set-up a program to exercise and sell the company shares on a systematic but rapid basis to become more diversified and properly balanced. A systematic reduction over time will ensure that the clients are not trying to time the market, but instead are achieving the average price for the company. If the company's stock price increases over time, it will be reflected in the remaining unvested stock options.

- **Risk Management**
  - There is no shortage of capital on either the client or spouse's death, based on a retirement lifestyle of the surviving spouse of $50,000. Even using our standard factor of 85% of joint lifestyle (equal to about $64,000), there is no capital shortage.

- **Estate Planning**
  - Apply for the tax-exempt policy described above on either a joint-last-to-die or single life basis, depending on the clients' health. Although this is designed primarily to defer taxes, for the first 10 to 15 years, it will also help to maximize the estate. As the risk charges are gradually replaced by growth in the investment account, the policy takes on the character of a pure tax shelter and it's role in maximizing the estate is diminished. Of course, tax sheltered growth will also have the effect of increasing the estate. After underwriting was completed, I determined that depositing $125,000 a year for 4 years would result in an estate value of $2,729,000 by the spouse's life expectancy of 83 versus $1,467,000 for a non-tax deferred investment alternative (assuming an investment return of 8% within the policy and 9% for the investment alternative). Alternatively, we could establish a capitalized line of credit secured by the policy to generate a tax free income of $52,000, indexed at 3% per annum, starting at the client's age 70 till age 90, and still have a death benefit after paying off the line of credit of $928,000. At that point, the death benefit will start to grow faster than the line of credit because risk charges reduce to zero at the clients age 85. The line of credit is only paid off when the client dies. Any portion of the invested assets within the policy that are not needed during their lifetimes will pass to their children completely free of income or probate tax.
  - Have new wills and Powers of Attorney for Personal Care and Property prepared immediately to ensure that their wishes are carried out. I will help them with this process, to ensure that the appropriate clauses, as recommended by my firm, are included in the documents.
  - Name specific beneficiaries on registered plans and life insurance in order to reduce estate taxes and legal fees. Together these can amount to over 5% of whatever estate assets are probated. Reducing the proportion of assets subject to probate will save about $30,000 in estate taxes and legal fees.

The steps above represent the 12-month action plan. It details exactly what they need to do, when they need to do it, and why it's important. It covers everything from when to do their RRSP contribution to when they have to send in their tax material to have their tax returns prepared. Because I have their total financial picture, I can make sure that nothing important is missed or forgotten.

4) RESULTS

The clients have a much better understanding of their financial affairs, particularly with respect to the risk of their portfolio being dominated by one company. When they were both let go, and their future looked bleak, it was comforting to know that they had a plan in place and a trusted advisor to consult with. This comprehensive strategy will help to reduce current and future taxes and fees and make the right decisions when significant events take place. The clients now understand that regular review and follow up is essential and that the financial planning process is a dynamic one.

Cash Management

- The clients' existing unused line of credit was determined to be sufficient to fund their short-term needs.

Tax Management

- Approximately $7,800 per annum in tax savings from future income splitting.
- Tax-exempt life insurance is used to tax shelter surplus estate assets. Now that we have assured significant surplus income, this strategy has become particularly important.
- Large potential tax deferrals using film production service limited partnerships (approximately $75,000 in tax can be deferred in 2000 and 2001, which when invested results in savings of $60,000 net of tax by year 10). Further tax shelters may be purchased for 2001 once we have determined the tax impact of the severance payments and exercised stock options.
- Charging investment management fees to the higher income spouse results in savings of about $5,000 per annum.

Asset Management

- Significantly reduced portfolio risk through diversification from one company to many companies and institutions, spread over 6 or more asset classes.
- Profits were locked in and the risks of market timing avoided through a systematic reduction in the amount of company stock owned. The proceeds were exchanged into Canadian rates at the best rate possible. The clients now have more than sufficient capital to fund their retirement (over $2.0 million).

Risk Management

- Quantitative analysis has determined that no capital shortage will exist in the event of either the client's or spouse's premature death.

Estate Planning

- The clients were approved for a joint second-to-die universal life policy. This will allow them to increase their estate by a minimum of $1 million, and still derive a tax-free income of $52,000 indexed at 3% a year from the client's age 70 to his age 90. This takes advantage of the tax sheltering capabilities of a universal life policy.

- Properly set-up wills and Powers of Attorney ensure that the clients' wishes are carried out in the event of death, or physical or mental impairment.
- Naming beneficiaries on registered holdings and life insurance will reduce probate and legal fees by about $30,000 at the time of the last person's death.

One of the main purposes of financial planning is to give people peace of mind in knowing that every aspect of their financial life has been properly planned and structured. With this plan in place, these clients will be assured that the correct decisions will be made, no matter what happens.