A TOP-DOWN FINANCIAL REVIEW: WHERE THE RISKS ARE LURKING

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In the first of our new Portfolio Makeover series, financial planner Paula Hogan reviews the financial circumstances of a professional freelancer who is concerned about adequately saving and investing for retirement. In the process, Paula exposes hidden risks and suggests some practical solutions for reducing risk and tweaking the investment portfolio.

INVESTOR PROFILE
- 40-year-old single professional woman
- Self-employed freelance writer who works out of her home
- Historically has maintained a high savings rate
- Comfortable and astute investor in both financial and real estate investments

GOALS
- Wants a financially secure retirement, which she defines as cutting back to part-time work before age 60

LIKE AND DISLIKES
- Is more knowledgeable about mutual funds and therefore prefers them over individual stocks, bonds, and annuities
- Wants portfolio costs to be low, and is wary of high fees associated with most annuities
- Strongly dislikes debt: In a financial crunch, would prefer to downsize to a smaller home and/or to sell rental property

PLANNING ANALYSIS

This individual's portfolio wealth is well thought out. She does a commendable job of living within her income and saving at an adequate rate, and her savings are prudently diversified.

However, there may be more risk in her financial circumstances than she perceives, and it comes from several sources:

Risk: Income is dependent on renewing or landing new freelance projects.
Historically, freelance income has come from two main sources. If one source evaporates abruptly, her income could also decline abruptly.

Solution: More liquidity and less debt.
Ample cash reserves and low debt are a high priority. Although she has high cash reserves at the moment, her typical reserve balance is low, and should be set at a higher level.

Financial advisors typically recommend having three to six months of income held in reserves. The less resiliency you have in your financial circumstances, the higher your reserves should be.

Risk: An income decline could be hard to manage because of the fixed mortgage payments.
A temporary cessation in savings would be the obvious first line of defense, but it is just that—temporary. A further possible concern is that the investment real estate property is held as tenants in common, which probably

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FINANCIAL SUMMARY

NET WORTH
- $547,831 net worth
- $96,100 cash reserves, unusually high because of the recent sale of a vacation home; the typical emergency cash reserve balance is about $20,000
- $121,131 all-stock financial portfolio
- $560,000 residence (encumbered with a $260,000, 15-year 5.375% mortgage)
- Half interest in a rental property valued at $137,500 (with a $107,000, 15-year 5.49% mortgage)

CASH FLOW
- Cash flow is variable, but net income of around $70,076 is typical, and the marginal tax bracket is 15%
- Income from the financial portfolio is assumed to be all reinvested
- Fixed expenses sum to $53,142 a year, suggesting discretionary monthly cash flow of $1,336
- Reflects a 31% savings rate, which is high, and is composed of annual retirement plan contributions and $450 per month of regular additional personal savings. Currently, new savings are directed to the financial portfolio, not mortgage debt reduction.

means that if the co-owner is not able to make timely payments, this individual would be obligated to step in with additional payments.

Solution: Prepay mortgages.

Routine aggressive mortgage prepayments are appropriate, especially given her expressed distaste for debt. While the low current mortgage rates are attractive, it is not likely that she would be able to match the pretax return of a mortgage prepayment with another investment on a risk-adjusted basis. Also, if you get rid of mortgage payments, personal cash flow increases—even after accounting for the loss of the mortgage interest deduction.

Risk: Insurance coverage appears low.

Here's the breakdown:
- Health insurance: Good group insurance
- Disability insurance: None in place
- Long-term care insurance: none in place
- Life insurance: None in place on her life, but father carries $300,000 policy on his life with her as beneficiary, also no need for her to carry life insurance because she has no financial dependents
- Property, car and umbrella liability coverage: Insurance has been purchased through the same company for many years. However, no umbrella liability is in place. Car insurance underlying liability limits is scant $25,000 per person/$50,000 per accident bodily injury and $25,000 per accident for property damage, and the same limits for uninsured drivers. For property insurance, there is apparently ample coverage for home, plus replacement coverage with inflation rider. Underlying liability limits are $100,000 per person/ $500,000 per incident, which is better than the car coverage. There is also professional liability coverage of $100,000 that we hope is adequately tailored to her actual profession.

This individual suggests that in the event of a financial hardship—for instance a disability—she would downsize her home and lean on family members for assistance. She places a low probability on financial hardship from disability because of these options, and because her job does not require peak physical health.

On the one hand, this plan is reasonable because she expresses a credible readiness to downsize to a smaller home and/or sell the rental property, and she comes from a close-knit family with a history of watching out for one another. On the other hand, having to sell real estate at a time in your life when, by definition, you are most personally challenged may not be realistic. And even though family members may be willing to offer both physical and financial assistance, they may not be able to help at the time she needs their assistance or to the degree that she might need assistance.

Solution: Close the most pressing gaps in insurance.

For property and liability, this would entail:
- Purchasing a $1 million personal umbrella liability policy that includes uninsured motorists; and
- Increasing underlying limits in car policy to $300,000/person and $500,000/accident (which will likely be required to get umbrella policy).

Absent these coverages, this individual is at risk of having a major car accident or other major incident in her personal life lead to a lawsuit with potentially catastrophic consequences for her financial future.

For personal insurance, she should investigate the cost of disability insurance and consider buying coverage up to two-thirds of her historical average earnings. In addition, she should purchase long-term care insurance, especially if the cost of disability insurance is deemed prohibitive, and purchase long-term care insurance earlier rather than later.

Having long-term care insurance, in combination with Social Security disability benefits and a family who would help her get quickly out of debt and into a manageable living situation, is a reasonable, but not risk-free, way to prepare for the possibility of a medical condition that would make it impossible for her to be self-supporting.

Long-term care insurance is now standard insurance. It provides financial assistance when you need help with daily living tasks either at home or in a facility. If you reach the age of 65, the odds of needing care are three out of five—much greater than the odds of having a major property insurance claim. Long-term care insurance also nicely complements disability coverage for mid-career professionals, since disability insurance provides income for housing and grocery-type costs, but not usually enough income for custodial care costs.

Risk: Incomplete estate plan documents.

This individual has durable powers of attorney for health and medical affairs, but no revocable trust or will. Durable powers for financial matters are not always honored by the major financial firms; revocable trusts offer a great probability of ease of transition in the event of incapacity.

Solution: Update estate plan.

Maintaining a current estate plan, including a revocable trust, maximizes the chance that personal preferences will be honored in the event of death or incapacity, an issue of particular concern for single individuals. People often think estate plans are only for wealthy people preparing for death. The reality is that all of us have a potential need for estate plan documents to facilitate our preferred agents being able to act for us in both financial and medical matters in the event of incapacity.

Risk: The 100% stock allocation is high.

Although stocks are expected to continue to be a profitable

ASSET ALLOCATION

	Current	Recommended
Stocks	100%	60%
Bonds	0%	40%

BALANCE SHEET

		December 2002
Liquid Assets		
Checking		$100
Money Market/Savings		$96,000
Cash Value of Life Insurance		$0
Total Liquid Assets		**$96,100**
Non-Tax Sheltered Investments		
T. Rowe Price Capital Appreciation (PRWCX)		$10,179
T. Rowe Price Equity Income (PRFDX)		$12,642
T. Rowe Price International Stock (PRITX)		$4,005
T. Rowe Price Total Equity Market Index (POMIX)		$4,714
Mutual Financial Services (TEFAX)		$9,673
Investec Wired Index (IWIRX)		$4,651
Total Non-Tax Sheltered		**$45,864**
Retirement Assets		
Regular IRA:		
Mutual Discovery (MDISX)	$9,673	
Mutual Qualified (MQIFX)	$16,203	
Total Regular IRA Accounts	$25,876	
Roth IRA: T. Rowe Price Blue Chip Gr (TRBCX)	$8,106	
Total IRA Accounts		$33,982
Money Purch/Profit Sharing:		
T. Rowe Price Equity Index (PREIX)	$10,329	
T. Rowe Price Small Cap Growth (PRDSX)	$7,862	
T. Rowe Price Mid Cap Growth (RPMGX)	$4,132	
T. Rowe Price Blue Chip Growth (TRBCX)	$6,962	
T. Rowe Price Dividend Growth (PRDGX)	$12,000	
Total Qualified Plan Accounts		$41,285
Total Retirement Assets		**$75,267**
Property		
Primary Residence		$560,000
Half Interest in Investment/Rental Property		$137,500
Personal Property		$100
Total Property		**$697,600**
Total Assets		**$914,831**
Liabilities		
Residence: Mortgage 15-yr fixed @ 5.375%		$260,000
Rental Mortgage: Half of $214k balance, 15-yr fixed @ 5.49%		$107,000
Car Debt		$0
Credit Card Debt		$0
Business Debt		$0
Total Liabilities		**$367,000**
Total Assets – Liabilities		**$547,831**

investment going forward, most investors, especially investors whose notion of "normal" returns was formed in the recent bull market, are at risk of underestimating the pain of a prolonged bear market. Good planning incorporates the idea that over a lifetime, the portfolio will likely be subjected to all parts of the market cycle. A 100% stock allocation does not recognize that reality.

Solution: Lower the stock allocation.

Lower the targeted stock allocation to 60%, plus or minus 5%, and use additions to the portfolio to keep the actual stock allocation within that range.

THE INVESTMENT PORTFOLIO

This portfolio has many fine attributes:

- It has average costs (0.90%, with no loads),
- It uses strong fund families, and
- It is well-diversified, including international diversification (16%), small-cap exposure (27%) and value stock exposure (38%), plus reasonable diversification across the various sectors of the economy.

However, there is, as noted earlier, an overexposure to stocks. What would a less risky allocation look like?

Suggested allocation:

- Lower the stock allocation to roughly 60%, plus or minus 5%, of the total investment portfolio.
- Maintain current small-cap and value exposure within the stock portion of the portfolio.
- Increase international exposure to 20% to 25% within the stock portion of the portfolio.
- Add fixed-income with modest inflation protection.
- In the Roth IRA, move the $10,000 holding of the T. Rowe Price Blue Chip Growth (TRBCX) to the T. Rowe Price International Stock (PRITX) in order to increase international exposure. Using the tax-deferred assets rather than taxable assets means that the switch can be accomplished with no taxes.

How, specifically, could she accomplish this within the context of her current holdings?

She is in the unusual—and fortunate—position of having a high level of cash reserves because of the recent sale of a vacation home. These reserves should be allocated to fixed-income holdings, rather than re-allocated to stocks, as would be the likely scenario if she were to maintain a 100% stock allocation.

In addition, her fixed-income holdings should be in shorter maturities to keep interest rate risk (rising interest rates cause bond prices to drop) at a minimum.

To get the lower portfolio costs to which she aspires, she would have to move to index funds—for instance, those provided by Vanguard, Schwab, or her current custodians, or exchange-traded fund offerings.

Specific recommendations:

- Establish first-line cash reserves in the Vanguard Prime Money Market of $35,000
- Add $55,000 to the taxable portfolio in Vanguard Short Term Corporate Fund
- Add next year's qualified plan contributions to T. Rowe Price Short Term Bond Fund
- Add next year's Roth contribution to the Vanguard Inflation Protected Bond Fund

In subsequent years, she can go back to building a diversified financial portfolio, with maximized retirement plan contributions. However, she should use taxable savings to first reduce mortgage debt.

One other issue that she should consider is setting up a solo 401(k) (which is new this year), with the set-up completed by year-end and funding by the due date of her tax return. This would allow her to contribute substantially more to her tax-sheltered retirement plans—although at the cost of not being able to make aggressive prepayments on the mortgage, which are done with after-tax dollars. Paying down the mortgage is important in this situation, but the 401(k) is a very powerful saving vehicle and should at least be considered. ✦