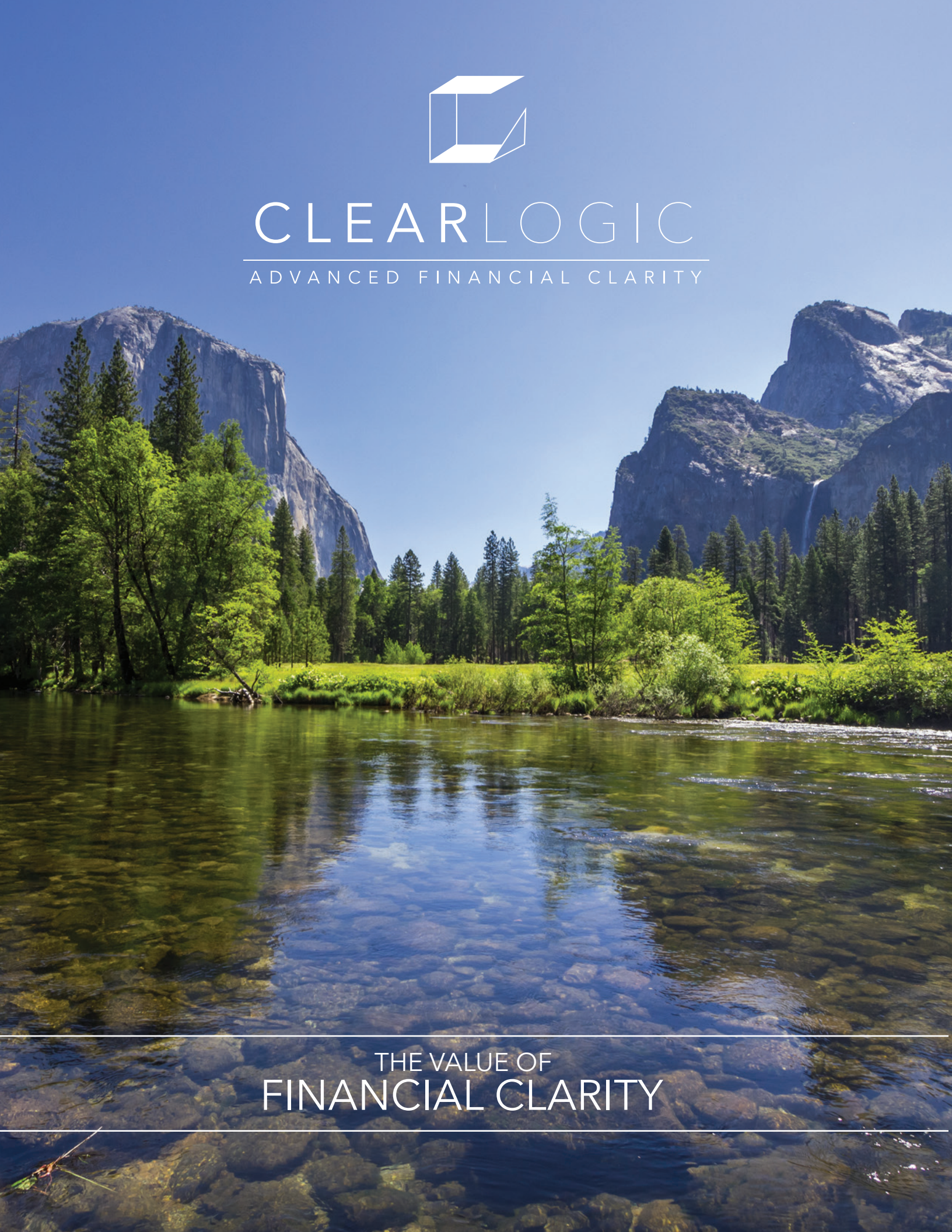
CLEARLOGIC

ADVANCED FINANCIAL CLARITY



THE VALUE OF FINANCIAL CLARITY

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Many people first hire financial advisors because they want help with managing their investment portfolio. Typically, they know the basics about investing, but as life events like retirement, an inheritance, or large expenses draw closer, they want to know they are maximizing their investment returns. We argue that these folks are missing a bigger, more important, objective: to gain financial clarity.




Financial clarity is sipping your morning coffee in your sunroom, reading the newspaper, and knowing that the headlines you are reading have no impact on you reaching your financial goals. You are reading the paper to stay informed, but know the headlines won't impact your plan.

Financial clarity is relaxing and unwinding after a stressful day at work, knowing there is a detailed plan in place to remove that stress from your life. All you need to do is execute the plan.

Financial clarity is playing with your children or grandchildren knowing exactly how college will be paid.

Financial clarity is knowing that if something happens to you, your family will be taken care of and will appreciate what you have done as the family's financial steward.

Financial clarity is so much more than just investment returns.

WHY IS FINANCIAL CLARITY IMPORTANT?

Financial clarity is liberating. Financial clarity means never having to agonize over financial decisions. Decisions are much easier when there is clarity. Financial clarity provides peace of mind and reduces stress during troubling times.

Since the mid-1970s, there has been a movement in the United States to make individuals more accountable for their own financial well-being. The onus has shifted from the employer to the employee to plan for retirement. Prior to ERISA laws in the 1970s, corporations typically provided a pension to their employees at retirement. Since those laws, which welcomed the 401k into existence, corporations have slowly done away with pensions. Even federal and state governments have changed their retirement pension systems, reducing pension amounts, to accommodate the rise of the 401k (or 403b and TSP for the public sector). This shift has resulted in the individual being primarily responsible for their own retirement planning.

HOW DOES ONE ACHIEVE FINANCIAL CLARITY?

First and foremost, you have to start with goals. Financial clarity cannot exist without knowing where you want to be and what you want to do. You won't know what path to take if you don't even know what the destination is. Believe it or not, this is the hardest part for most people when building a financial plan. Unless you are a "dreamer" or have the rare ability to see a very clear vision for yourself in the future, most people need guidance in defining their goals.

Knowing all of your resources is the second step in achieving financial clarity. Most successful, detail-oriented people know what their resources are. Where most people need help to achieve true financial clarity is how to maximize those resources, using them as effectively as possible to achieve their goals. In other words, making sure you are not wasting any resources.

The third step to financial clarity is determining your risk profile. Most people know what risk tolerance means. It is one's ability to live with the volatility of the markets and the risk of loss. Often though, people fail to consider the other key components to your risk profile: risk capacity and risk required.

Only after the first three steps are completed should one develop their investment strategy. Most individuals, and even most professional money managers, put investment strategy first. They search for stocks, mutual funds, bonds, or other investments that will maximize their return without thinking about what the money is for, or how much risk they should take. This is what the financial media focuses on to sell advertising. And this is why many people fail to reach their investment objectives. An investment strategy will not deliver financial clarity unless it is built with your specific risk profile in mind, and specifically designed to achieve your financial goals.

When you are on the financial market roller coaster, you want to know that when your portfolio seems to be racing downhill with no end in sight, you will be at peace.

And maybe even throw your hands in the air!
Even after all the above, financial clarity still is not in our grasps. Many people with large portfolios and high earnings do not have financial clarity, because they haven't planned for the potential, and unexpected, loss of that income, or those resources. And they don't know who will take care of their family's finances if they should die or become unable to manage the resources. Those that have true financial clarity aren't just reassured that they will be financially successful in life. Financial clarity is found when you know that the ones you love will be successful in life if you are unable to lead them.

UNDERSTAND YOUR GOALS

"People with clear, written goals accomplish far more in a shorter period of time than people without them can ever imagine." - Anonymous

This is by far the most important step, yet the most difficult. To achieve financial clarity, you must keep the end in mind. If you don't know where you are heading, it is impossible to chart a course. And it is more than just brainstorming and jotting down a list of goals. While most people don't even do that, it is not the end. That is knowing your goals. You need to understand your goals. Here is the difference:

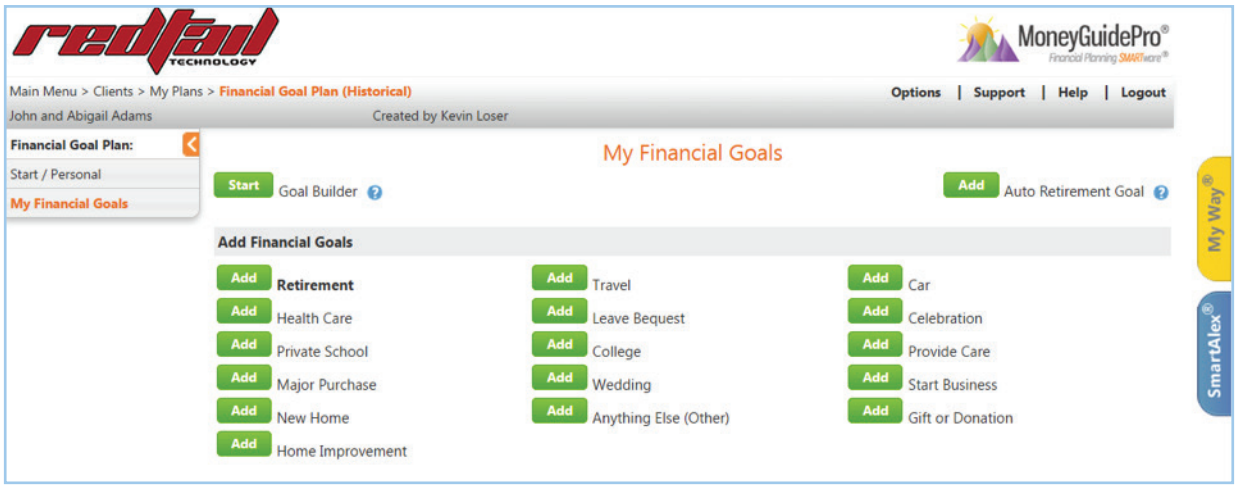
KNOWING YOUR GOALS	UNDERSTANDING YOUR GOALS
I want to retire in 5 years	It will cost me about $100,000 per year to live comfortably in retirement. With inflation over a 30-year retirement period, we will spend XXXX during retirement.

KNOWING YOUR GOALS	UNDERSTANDING YOUR GOALS
I want to pay for my kids' college educations, so they are debt-free leaving school	My kids will go to school in 2024 and 2026. Tuition will cost approximately XXX combined for the two of them.
I'll need to financially help my parents when it comes time to move them into a nursing home.	They are 83 and 81. They do not have Long Term Care Insurance. Based on community prices in their area, it will cost me $2,000 per month to subsidize their costs.
I do not want to be a financial burden on my children as I age. I want to ensure I have the resources to pay for my own care.	In my area, it will cost me $90,000, in today's dollars, per year to live in the type of community I want.
I'd like to leave some money to my kids, but not too much.	I'd like to leave $250,000 per child in today's dollars. Assuming I live until 90, that is just over $800,000 in future dollars.

Most people need help with this first, but important, step in obtaining financial clarity. Unless we are forced by another person, very few people sit down and list their goals. Far fewer actually then quantify their goals.

We use goal-based software that provides a database of costs for typical goals, like college tuition and health care expenses. The most important goal to quantify is the "Retirement Living Expense" goal. That's the month-to-month living expenses, excluding all your other discretionary goals (see a robust list of potential financial goals from our financial planning software below). This one goal has a larger impact on the financial plan than all the other goals combined. We have done financial plans where even a few thousand dollar swing per year has a material impact on the plan. Yet so few people have an idea of what they will spend on routine expenses in retirement.

A good starting point to quantifying this figure is to look at your current spending. Most people want to maintain their current lifestyle in retirement. Very few people who are working and raising children know what they actually spend though. If you don't know how much you spend now, you can't estimate what you will spend in retirement. And because it is the biggest driver of the success or failure of the financial plan, time needs to be spent on this task.



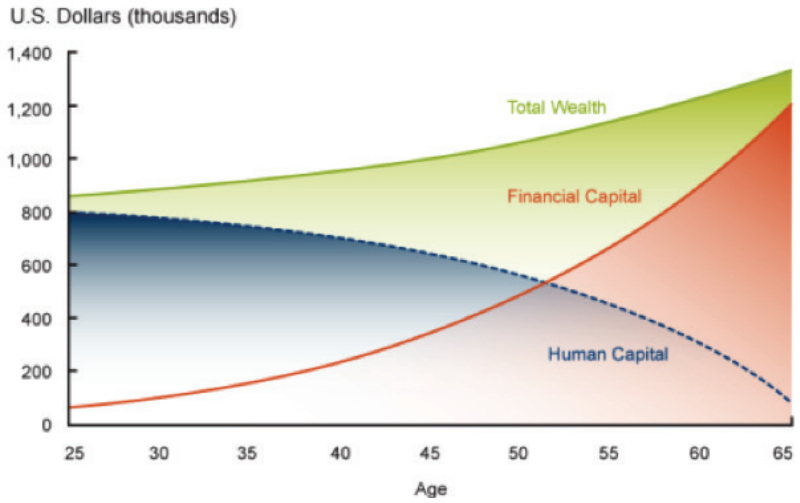
If you are working with a CFP® professional and you have gotten to this part of the process successfully, your hardest work is over. Establishing the goals and quantifying them is only one step, but half the battle. Now, you need to focus on what resources you have now, and what you will have in retirement, to achieve your goals.

UNDERSTANDING YOUR RESOURCES

Human Capital

During your working years, your human capital, the ability to earn money, is your largest resource. Your human capital decreases when you are near retirement, then goes away (but not entirely if you decide to work part-time) in retirement.

Expected Financial Capital, Human Capital, and Total Wealth Over Life Cycle with Optimal Asset Allocation



Source: *Lifetime Financial Advice: Human Capital, Asset Allocation, and Insurance.* Ibbotson, Roger G.; Milevsky, Moshe A.; Chen Peng and Zhu, Kevin X. CFA Institute, 2007

Hopefully, if you have taken the necessary financial planning steps to prepare for retirement, you have turned your human capital into investment capital. But this doesn't happen automatically. It is very easy to spend your entire income, particularly in high-cost areas like Washington, D.C. You need to create a financial plan.

During your working years, when human capital is increasing, you need clarity on how to turn that human capital into the most financial capital possible. It is the financial capital that will get you through a 20+ year retirement. In your 20s, your human capital dwarfs your financial capital. You have a lifetime of earnings ahead of you, but little savings. For most people, it is not until your early 50s where your financial capital surpasses your human capital (see graph above). If you have waited until your 50s to start saving for retirement, you will have a tremendous amount of catching up to do.

In order to determine how much you can save, you need to understand your cash flow. Once you know cash flow, you can determine realistic savings targets based on your ability to save. Then, you need to see if those savings targets achieve your goals. If not, you need to determine how to improve your cash flow.
Sound circuitous? That's why you need financial clarity.

Once you have determined how much to save for all those goals (retirement, college, weddings, etc.), you also need to determine into which accounts to save that money. Most people in their human capital stage have employer retirement accounts into which they can save. But some of those goals you have, particularly college funding, weddings, down payments on houses, and car purchases, often occur before age 59 ½, the minimum age you are able to withdraw from retirement accounts.

Having a detailed and well thought out savings plan that is structured around your specific goals provides financial clarity. And knowing that you are saving your money as tax-efficiently as possible using the proper types of accounts (tax-deferred, taxable, 529, tax-free, etc.) gives you the peace of mind that you are maximizing your resources.

Financial Capital

Many individuals seeking financial advisors as they approach retirement generally think about just the investment portfolio. But your human capital over your working life has led to some retirement income that is integral to financial clarity.

Retirement Income

Social Security is the most common form of retirement income. As those nearing retirement know, there are various options of when to take social security. There are also a few less-known planning opportunities to maximize your social security benefits, particularly for couples who both have work records and have paid into the system. Social security strategies can be complicated and all of the options available to you may not be fully understood. With the help of our robust Social Security software tool, we can bring clarity to these options and help maximize your benefits.

Federal and state employees, along with a few private sector employees, have pensions as well. Some folks have annuities, either that have been turned into an income stream already, or are invested for growth to annuitize later in life. Many people also decide to work part-time in retirement. Pensions, Social Security, Annuities, Part-time income all play a role in finding financial clarity. You need to know how all these potential income streams can work together in a tax-efficient way to maximize your after-tax income.

Investment Assets

As pensions become less available, leaving social security and part-time income as most retiree's available income streams, how you turn your human capital into financial capital will be the main driver of your financial success. There are a tremendous amount of savings vehicles in the market, which causes confusion. Investors today are often overwhelmed with the savings decisions they have to make.

- Do I use all my available cash flow to maximize my 401k account?
- Is the Traditional 401k or Roth 401k that my company provides the better choice?
- But I have college funding goals as well. Do I save some money into:
  - o A 529 Plan?
  - o A Coverdell account?
  - o UGMA?
- If a 529 Plan, which state's plan should I invest in?
- Should I save any money into a taxable brokerage account instead so I have more flexibility for my other goals?
- I am able to max out my 401k account and still have cash flow available. Should I continue deferring more taxes by purchasing an annuity or an IRA? What are the tax limitations?
- My company also offers an Employee Stock Purchase Plan (ESPP). Should I invest in that instead of the 529 plan or the taxable account or the annuity?
- Or should I just pay down my mortgage with extra payments each month?

With so many options for turning your human capital into financial capital, it's no surprise people do not maximize their savings and investment earnings potential. Even the most well-intentioned individuals, focused on being financial stewards for their families and save as much as possible, can be paralyzed by all the choices. Is it starting to make sense why you need to have complete clarity on your goals prior to making some of these decisions? Your goals for college funding, retirement lifestyle, career flexibility, and your feelings about debt (and how much debt you have) all should be answered prior to answering the questions above. When you have financial clarity the answers are very clear.

We just mentioned debt for the first time. When used appropriately debt is a resource as well. Good debt, to purchase income-producing or appreciating assets (typically real estate or businesses), can be an enormous resource during your human capital phase of life. Bad debt, typically credit card debt, vehicle loans, or other debt to purchase depreciating assets, can hinder your ability to achieve your goals. All liabilities need to be considered and factored into the plan to improve clarity.

Insurance

The final resource that provides financial clarity, and peace of mind, is insurance. Many individuals look at insurance as an expense. And yes, the premiums are an expense for the budget. However, if used effectively, with low-cost products, insurance can provide tremendous financial clarity. Financial clarity is not just about being clear about decisions while alive and healthy. Financial clarity also means having the peace of mind knowing that those you love will be taken care of should something happen to you. There are different types of insurance to consider, mitigating different risks, when building a financial plan.

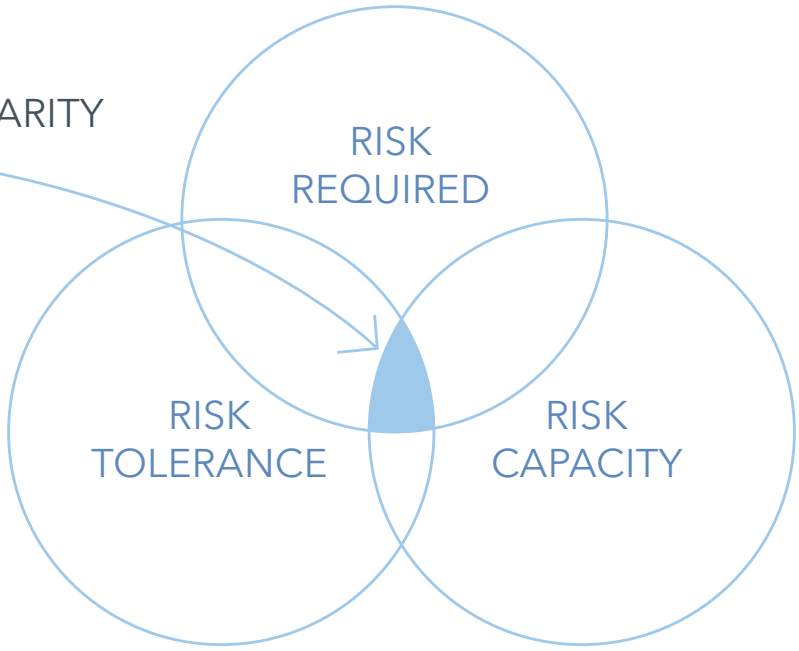
- Life Insurance
- Disability Insurance
- Long-Term Care insurance
- Property & Casualty

Risk

Besides the risks (death, disability, long term care needs, home and auto accidents) that can be transferred to an insurance provider, there is another risk we have not addressed: investment risk. Understanding the risks associated with your investments and how you will handle those risks is the next key step of the process.

To achieve, and more importantly in this case, maintain financial clarity, you need to be in an investment portfolio that helps achieve your personal objectives, while taking only the risks you must. Anything else either runs the risk of low returns that will not achieve your financial goals or too much risk that exceeds your risk tolerance. The latter typically results in emotional behavior during times of stress in the markets. And unfortunately, emotional behavior usually leads to poor investment decisions.

PORTFOLIO FOR FINANCIAL CLARITY



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The "Risk Required"

The risk required is determined by doing the following:

- Quantifying your goals
- Understanding how your other resources will be used to achieve your goals
- Calculating an investment return necessary for your financial capital

It is important at this point to restate a point we made earlier. For financial clarity and peace of mind, one should only take the risks needed to earn the investment returns to achieve one's specific goals. Taking more risk than needed can lead to mistakes made when assessing the next risk decision.

"Risk Tolerance"

Assessing risk tolerance, the willingness to live with the volatility of the markets and lose your investment, is almost always misjudged. People tend to overestimate their risk tolerance. Then, a financial crisis like 2008 occurs and people realize they do not have the stomach for the drop in their portfolio they just witnessed. In most cases, these people were also taking more risk than necessary to achieve their personal objectives. As the graph above illustrates, even if you have a large appetite for risk and love the roller coaster ride the markets can provide from time-to-time, if you want financial clarity, you will find the intersection between risk tolerance, risk required, and our third decision on risk.

"Risk Capacity"

Risk capacity is the financial capability for one to take a certain amount of risk. Three examples may help in understanding risk capacity.

- A 35-year old male, with a promising career and high earnings likely has a fairly high risk capacity. He is 20+ years from retirement, can save aggressively and can withstand market downturns. In fact, they can take advantage of those downturns by buying assets at a low price.

- A 85-year old widow, with $150,000 in remaining assets has a limited risk capacity. She cannot afford to lose much principal at this point in her life.

- A retired couple, both with federal pensions that amount to more than they need to achieve their financial goals, have a high risk capacity. This does not necessarily mean they have a high risk tolerance, however. In this case, because the couple is living within their pension income, and are likely investing the assets for the next generation, they could decide to take on significant risk with their portfolio. However, that does not mean they should. They need to assess their risk tolerance and risk required as well. While they might be on the extreme side of the Risk Capacity circle, their Risk Tolerance is likely not that high, and their Risk Required certainly is not very high, if much at all. Using all three factors to decide the proper portfolio and making each of them as important as the others will result in a portfolio that you can live with during the bull markets and the bear markets. And that is financial clarity.

Investment Portfolio

After quantifying your goals, determining all your resources, protecting against catastrophic events, like death or disability, and identifying your personal risk profile, you are ready to invest your investable assets. The myriad of decisions to be made with your investment portfolio are too numerous to address in detail in this paper. There are literally tens of thousands of available investments to choose from. That fact alone can make financial clarity feel like a daunting task.

How can one possibly ensure they are maximizing their resources when there are tens of thousands of investments to choose from?

Well, when you base your decisions on a scientific, evidence-based approach to investing, the clouds part and you can see clear skies ahead. Over 90% of an investor's expected returns can be explained and determined by just a few key decisions.

What about the investor that has a plethora of accounts? What types of investments go in the Traditional IRA? The Roth IRA? The brokerage account? The 529 account? The annuity? What about the 401k?

Again, without proper guidance, the decisions can be overwhelming. Many investors do not realize that the pivotal factor in making decisions like this is…….. taxes.

Yes, something we have yet to discuss in our quest for financial clarity is a key driver in investment returns and the decisions you make with your investment portfolio. Studies have been done comparing two portfolios with the exact same investments. The only difference is one portfolio was designed tax-efficiently. The other was not. The tax-efficient portfolio outperforms the tax-agnostic portfolio by more than 1% annually.

Many investors have heard of the concept of asset allocation. And that concept is extremely important. But for complete financial clarity – the confidence that all your resources are being used as efficiently as possible – asset location, what type of account (tax-deferred or other) you hold the investment, is an important, yet lesser known consideration.

Our investment approach is grounded in the science of investing. We help our clients make those few key decisions that drive 90% of the investor's expected returns and ignore all the noise. We rigorously focus on tax-efficiency, asset allocation and asset location to improve after-tax returns. We help our clients focus on the things they can control, like investment costs and taxes, and help them not get distracted by the things they cannot control. Focusing on the things you can control, and not thinking too much about the things you can't, helps provide financial clarity.

Financial Clarity

The output of this process is a detailed plan that shows your goals, your resources to achieve those goals, and how to use those resources most efficiently to ensure success. It includes various scenarios, mostly of things that could go wrong that you generally don't want to think about, to ensure you and your family will achieve financial success and have financial clarity.

Once the financial plan is completed and printed, the journey has only started. You have picked the destination and the course to take, but you still have a long journey ahead of you with lots of peaks and valleys. Having directions is important, but in all likelihood, there will be barriers and detours along the way. Financial planning is a process, not a product. It's not a report you put in a binder. It is a guide to use on your life journey. It needs updated from time to time when unforeseen events arise or when environments become cloudy.

BUT FINANCIAL CLARITY IS HEADING OUT ON THAT JOURNEY KNOWING THAT YOU CAN HANDLE ANY OBSTACLE OR DETOUR.