The Importance of a Financial Plan

Goal Planning, Investment, Tax, and Estate Planning

Goal Planning

A customized, well-designed financial plan is discussed at the inception of relationships at Callan Capital and is critical to helping clients achieve their unique goals and objectives. A financial plan provides holistic advice that helps bring clients confidence and peace of mind as they make important financial decisions.

The first steps in financial planning are data gathering and goal planning. We help determine financial and philanthropic goals. We evaluate, review, and provide advice on areas such as entity optimization, executive compensation, business sales, investment, and asset allocation, trust and estate considerations, tax minimization, insurance, education planning, employee benefits, and financial leverage. With this information, we gather all the necessary documentation for review.

Retirement, or financial independence, is often the main objective of financial plans. Financial independence is the ability to retire at your discretion. Thus, many clients continue to work well beyond the point where they are financially able to retire.

As part of the planning process, we utilize Monte Carlo simulation to evaluate the likelihood of success, considering random market returns as well as risk, uncertainty, and variability. This projection also considers the various sources of income for the retiree.

We prefer this method over a straight-line calculation since the straight-line calculation assumes the same return rate each year and does not account for volatility. The Monte Carlo method is often used in investment and retirement planning to project the likelihood of achieving retirement goals. It also projects whether a retiree will have enough income to live on for life. This is given a wide range of possible outcomes in the markets. The underlying assumptions for these calculations typically include life expectancy, interest rates, the amount of the investment portfolio withdrawn each year, and portfolio asset allocation.

Investment and Tax Planning

Asset allocation and tax-efficient investing are critical parts of a well-designed, customized financial plan and integral to growing and maintaining wealth. Asset allocation is an investment strategy that distributes a portfolio's assets into different asset classes (stocks, bonds, cash equivalents, and alternative investments) according to an individual's risk tolerance, financial goals, and time horizon. Allocation of investments may be the most significant determinant of return given the amount of risk taken. It's imperative to remember that there is no "correct" asset allocation for everyone. Individuals should decide what allocations are best for them based on their own comfort level and ability to meet their financial goals.

Since all investments have risk, the balance between risk and reward can be managed through portfolio holdings and diversification. Building a diversified portfolio includes looking for assets whose returns haven't historically moved in the same direction. Therefore, even if a portion of the portfolio is declining, a portion is hopefully growing. Broad diversification reduces portfolio risk while providing the opportunity to benefit from markets' leading performers. Callan has adopted a process, and we believe it is best for investors to stay the course and remain disciplined through market volatility.

Tax-efficient investing is a crucial driver of portfolio returns and an integral part of financial planning. Tax-efficient investing includes tax-loss harvesting, asset location, and the use of exchange-traded funds (ETFs). Tax-loss harvesting involves selling securities in the portfolio at a loss to offset gains and income. If you know specific realized gains were incurred in a year, you can actively seek securities to sell at a loss to offset those realized gains. By reducing capital gains, taxes are lowered while maintaining a reasonable risk level.

Asset location involves placing tax-inefficient assets (like taxable bonds) in qualified retirement accounts (i.e., IRAs, IRA Rollovers, Roth IRAs) and tax-efficient assets such as stocks in taxable investment accounts (i.e., a joint or trust account).

A well-diversified portfolio may include both tax-efficient and inefficient assets, but each serves a specific purpose within the portfolio. While tax implications shouldn't be the primary driver of investment decisions, being smart about locating different assets for tax purposes can boost long-term returns.

Tax-inefficient assets like high-yield bonds generate income regularly that is often taxed at a high-income tax rate. Thus, it makes sense to put these types of assets in a qualified retirement account that is not subject to immediate taxes, so the tax liability is deferred (or negated in the case of a Roth IRA) for the investor. Tax-efficient assets like equities produce capital gains taxed at a lower rate, (0-23.4% plus applicable state income taxes). Therefore, it is beneficial to place these types of investments in a tax-exempt account.

Exchange-traded funds provide tax benefits over single stocks or mutual funds and typically have lower capital gain distributions than mutual funds. The capital gain distribution is often payable only upon the sale of the ETF. In contrast, a mutual fund passes capital gains on to investors throughout the investment life. Other non-tax benefits of ETFs include trading flexibility, low trading costs, and portfolio diversification.

Insurance and Estate Planning

Risk management and estate planning are critical parts of every financial plan. There are many types of risk addressed in a well-drafted financial plan such as risk caused by stock market declines, economic instability, death, disability, and loss of income. These unforeseen events can have devastating financial implications for finances and alter the anticipated outcome of a financial plan.

While risk is impossible to avoid, risks like death, disability, and loss of income can be managed appropriately through insurance. When risks have a low probability but a high financial consequence, insurance can be used to transfer risk. In a well-crafted plan, all forms of insurance should be considered, reviewed, and implemented where appropriate.

Family members' premature deaths can have a major financial impact on survivors and loved ones. In the event of a loss of life, life insurance is crucial to filling the economic void. Calculating the present value of future earnings, otherwise lost, is a prudent first step. Term life insurance policies are the least expensive and typically cover the income earner over their years of employment and potential lost earnings. Similarly, disability can cause major financial hardship, yet disability insurance is often overlooked. If the primary income earner in a family cannot complete their work duties, the financial loss can be devastating.

Depending on an individual's age, the risk of disability is much higher than the risk of death. This can in some cases create the same financial loss for the family.

Long-term care insurance helps pay for long-term care costs not covered by health insurance, Medicare, or Medicaid. Individuals who need long-term care may not be able to dress, bathe, walk, or eat by themselves. Insurance covers facilities such as assisted living, home care, hospice, nursing homes, etc. Long-term care has become increasingly important as people live longer. However, we believe long-term care is often unnecessary and oversold. If someone has a net worth of over $2 - $3 million, they may be able to self-insure. We recommend speaking to your advisor about whether to purchase long-term care coverage since it can be quite expensive and may not be used.

Along with risk management, estate planning is a critical piece of a comprehensive financial plan.

It encompasses arranging for an individual's estate during life and after death. Estate planning involves having documents in place to ensure one's wishes are met in the event of death or incapacity. In addition, a financial plan can help mitigate or eliminate death taxes associated with large estates.

The first step in a sound estate plan may include establishing a revocable living trust. During the grantor's life, a revocable trust is amendable, and all assets and income are available to the grantor. After the grantor dies, the trust becomes irrevocable and dictates how assets are distributed to various beneficiaries. Assets in the trust avoid expensive and lengthy probate proceedings. All the assets in a revocable trust are included in the grantor's estate for estate tax purposes so there are no tax advantages.

A comprehensive estate plan also includes naming guardians for minor children, directives for end-of-life medical care, assigning power of attorney for financial decisions in the event of incapacity, and naming representatives for health care in the event an individual is unable to make decisions. For high-net-worth individuals, more sophisticated planning is often needed to avoid or reduce estate taxes.

The best way to reduce estate taxes is to give gifts throughout one's life. Currently, one can give up to $17,000 per beneficiary ($34,000 per married couple) per year without filing a gift tax return and using the lifetime exemption. Payments made directly to a medical or educational institution for qualified medical and tuition expenses qualify for an unlimited gift tax exclusion.

Qualified medical expenses include expenses incurred for diagnosis, cure, mitigation, treatment, or prevention of disease and payments for medical insurance. Qualified education expenses are for tuition only and do not include books, supplies, room, or board.

When large gifts are made, grantors typically set up an irrevocable trust as the recipient of the gifts. Unlike outright gifts to beneficiaries, gifting to an irrevocable trust allows the grantor to define parameters for how and when the funds are accessed. It can also offer another layer of creditor protection for beneficiaries if set up properly. It's common to see provisions allowing children to manage their own trust once they reach adulthood. We also see trusts funded with permanent life insurance based on the grantor(s) life. The death benefit pays the trust tax-free upon the death of the grantor(s). This is called an irrevocable life insurance trust.

Charitable giving is an excellent way to reap tax benefits, make a positive contribution to society, and maybe a useful strategy for high-wage earners. Ideally, consider gifting in a year when you have substantial income at the highest taxable rate. An individual can gift cash or securities (or other assets), though there are distinct benefits to gifting appreciated securities.

If an individual has an appreciated stock position and is inclined to charitable gifting, it may make sense to gift all or a portion of the stock for a tax deduction to avoid paying capital gains tax. It may be beneficial to use a donor-advised fund or a charitable remainder trust as part of your gifting strategy.

A customized, well-designed financial plan brings clarity and direction to the financial choices clients make every day. Goal planning, investment, tax, insurance, and estate planning are essential elements of a financial plan that together create a client's holistic wealth picture. The peace of mind offered by a well-constructed financial plan is invaluable to help clients navigate periods of market volatility and stay on course to achieve their financial goals.

Definitions

The Monte Carlo Method: The Monte Carlo simulation is a model used to predict the probability of a variety of outcomes when the potential for random variables is present.

Stock: A stock, also known as equity, is a security that represents the ownership of a fraction of the issuing corporation.

Bond: A bond represents a promise by a borrower to pay a lender their principal and usually interest on a loan.

Cash Equivalents: Cash equivalents are securities that are meant for short-term investing.

Exchange-traded funds (EFT): An exchange-traded fund (ETF) is a type of pooled investment security that operates much like a mutual fund.

Capital gain distribution: A capital gains distribution is a payment by a mutual fund or an exchange-traded fund (ETF) of a portion of the proceeds from the fund's sales of stocks and other assets from within its portfolio.

Donor-advised fund: A donor-advised fund is a private fund administered by a third party to manage charitable donations for an organization, family, or individual.

Charitable remainder trust: A charitable remainder trust is a tax-exempt irrevocable trust designed to reduce the taxable income of individuals.

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