“Meet the Smiths”

Abstract:

- In this article, a case study is used to help you further understand the roles of values and goals in forming your wealth management strategy.
- It is vital to determine if your assets are sufficient to provide for the cost of the goals that you have set.
- Each person has different values and goals; and therefore, each person should have his or her own unique wealth management plan.
- When your assets and/or other resources are enough to provide for your goals, then you are said to be financially independent.
- When your assets and/or other resources are not enough to provide for your goals, then you are said to be financially dependent.
- Financial independence is not based on a fixed dollar figure. Rather, it concerns whether you have enough resources to provide for the lifestyle that you have determined and want.

Wealth That Lasts

Meet the Smiths

by Robert J. Bancroft

The following case study is designed to help understand values and goals in relation to personal circumstances. This article and the next will be used to help define financial independence.

In the previous article, we defined values and goals as they relate to the development of your wealth management strategy. Since the range of individuals' goals can be infinitely large, I am going to introduce you to John and Betty Smith. They are a fictitious couple loosely based on a family that I did some work for a few years ago. The couple will be used as a case study to illustrate an example of values, goals, and realistic expectations. Much of the reasoning used in this scenario can be used to help you understand the characteristics of your own circumstances.

Scenario

John and Betty are both 57 years of age and have been married for 31 years. They have four children and five grandchildren. Two months ago, the Smiths closed the sale of their business and have decided that they may want to retire and follow their personal interests rather than pursuing another business opportunity. Our job is to determine if their assets are sufficient to provide for the goals that they have set. The Smiths' home is valued at $1,400,000; they have a $400,000 mortgage on this home. The couple has $6.7 million in investment assets (mostly cash from the sale of their business). The value of their personal assets is estimated at $180,000 (cars, jewelry, etc.). The Smiths have no liabilities other than their mortgage. Combining these assets and liabilities as listed in the sample Net Worth Statement below, you can see that their net worth is $7,880,000.

Net Worth Statement

Assets		
Investment Assets		
ABC Bank		$ 6,700,000
	Subtotal	**$ 6,700,000**
Personal Assets		
Cars		$ 110,000
Jewelry		$ 70,000
	Subtotal	**$ 180,000**
Real Estate Assets		
Residence		$ 1,400,000
	Subtotal	**$ 1,400,000**
Total Assets		**$ 8,280,000**
Liabilities		
Real Estate Liabilities		
Residence		$ 400,000
	Subtotal	**$ 400,000**
Total Liabilities		**$ 400,000**
Net Worth		
Total Net Worth as of 6/3/2011		**$ 7,880,000**

Because of their assets, one may reason that the Smiths can achieve any reasonable goal. However, we need to determine if the Smiths can achieve their specific goals given their available means. For our purposes, we need to determine how much each of the Smiths' goals costs immediately and in the future. We also need to determine which of their assets produce future income and which do not. At this point, the Smiths do not expect outside sources of income. They wish to know if their investment assets will be enough to satisfy all of their goals without interrupting the rest of their lives. It is important to the Smiths that in addition to providing for all of their lifestyle needs listed below that they leave a significant inheritance to their children, grandchildren, and favorite charities.

Defining the cost of their goals

John and Betty Smith have worked diligently to align their values with their personal goals, estimating the real cost of each element. By completing this work, they have been able to determine that their desired retirement lifestyle requires $240,000 per year after taxes. In addition, they hope to gift $20,000 annually to each of their four children ($80,000 total gifts annually). Since much of their success and satisfaction in life has been based on their education, it is a priority for them to help support the education of their grandchildren. For this purpose, they wish to set aside $60,000 for each of their five grandchildren ($300,000 one-time contribution). Regarding their mortgage, neither John nor Betty have ever been comfortable with debt, so they plan to pay off the remaining $400,000 home mortgage balance. Lastly, they wish to donate $40,000 annually to their favorite charities.

Characteristics of the Goals

As we examine the characteristics of their goals, we notice that two of the goals, namely the education of their grandchildren and paying off their mortgage, are onetime, lump sum expenses. The other three goals, specifically their lifestyle needs, gifts to children, and charitable contributions, all require annual expenditures. At this point, it is important to separate these two types of goals.

As noted above, the Smiths are starting with $6,7000,000 in cash. After satisfying the payment of their $400,000 mortgage and the $300,000 funding of the education accounts for their grandchildren, there will be $6,000,000 remaining to satisfy their annual goals. The Smiths' annual goals of lifestyle needs of $240,000, family gifts of $80,000, and charity donations of $40,000 sum up to $360,000 per year. This represents the total estimated amount of annual spending that the Smiths require.

Use Assets and Productive Assets

An important question to consider at this point is, "Why are we only considering $6,700,000 for the satisfaction of their goals rather than their entire $7,880,000 Net Worth?" The answer is that we need to divide assets into two types: use assets and productive assets. Some of the Smiths' assets, such as their $6.7 million in cash, will be made available for investment, which will provide income and growth. This will help them to reach their financial goals, so we refer to these as productive assets. The Smiths are neither considering selling their $1,400,000 home nor their $180,000 of personal assets, so any income or growth that could potentially be derived from these assets will not be considered at this time; that distinction makes these their use assets. As I said above, the Smiths plan to remove $300,000 to fund the future education of their grandchildren and $400,000 to pay off their mortgage. With those adjustments made, the Smiths' revised Net Worth Statement is listed below. I have drawn a line separating their use assets from their productive assets. Note that the lump sum for the funding of their grandchildren's education has removed $300,000 from their net worth. Also, note that paying off their mortgage did not reduce their net worth; it just removed $400,000 from their productive assets to their use assets.

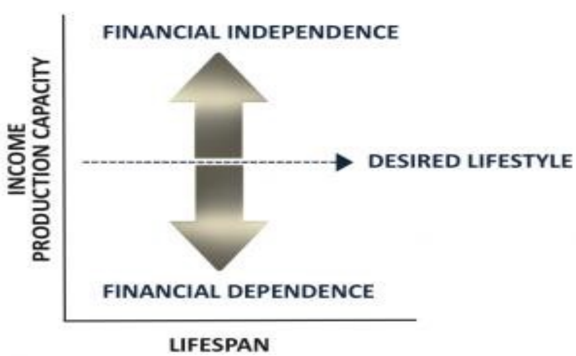
Net Worth Statement

Assets		
Investment Assets		
ABC Bank		$ 6,000,000
	Subtotal	**$ 6,000,000**
	Productive Asset ▲	
	Use Asset ▼	
Personal Assets		
Cars		$ 110,000
Jewelry		$ 70,000
	Subtotal	**$ 180,000**
Real Estate Assets		
Residence		$ 1,400,000
	Subtotal	**$ 1,400,000**
Total Assets		**$ 7,580,000**
Liabilities		
Real Estate Liabilities		
Residence		$ --
	Subtotal	$ **--**
Total Liabilities		**$ --**
Net Worth		
Total Net Worth as of 8/15/2011		$ 7,580,000

As you can see, after satisfying two of their immediate lump sum goals, the Smiths' Net Worth is $7,580,000, and their productive assets are $6,000,000. To this point, we have determined what the Smiths' goals are and what those goals will cost. We have also listed their assets and divided those assets between their productive assets and use assets. *To answer their initial question, we need to determine whether the Smiths, with their $6,000,000 of productive assets, can satisfy their annual spending needs of $360,000 without interrupting the rest of their lives and still leaving a substantial amount of money for their heirs and favorite charities.*

Values, Goals, and Financial Independence

The discussion boils down to this: all people have their own unique set of values and goals, and each of these goals has a cost in dollars and cents. Once this cost is determined, we can then decide if the resources we have (or will have) are sufficient to provide the income necessary to satisfy those goals. ***When our assets and/or other resources are enough to provide for our goals, then we are said to be financially independent. When they are not enough, we are said to be financially dependent.*** From this explanation, you will notice that financial independence is not a dollar figure that says, "When I have a million, five million, or even 25 million dollars, I will be financially independent." Therefore, the real criteria for financial independence is having enough resources to provide for the lifestyle that YOU have determined you want, given the realistic potential of the investment markets to provide it. There are families that are financially independent with relatively little, and there are families with what most would consider vast fortunes that are not financially independent. I have drawn my version of the financial independence chart below.



The Smiths have decided what it will take to live their desired lifestyle. Now, we need to help them in determining if their assets are enough to provide it. Do you feel, given the information supplied, that they are financially independent? Do you feel that their lifestyle needs can be met for the rest of their lives without interruption with the resources they currently have?

This discussion continues in the next article, "Realistic Expectations."

If you have any questions or comments, please email me directly at Bob.Bancroft@wtlcourse.com.

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