Retirement Rescue

A PRIMER ON HOW TO HELP KEEP YOUR RETIREMENT AFLOAT

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RETIREMENT RESCUE: A PRIMER ON HOW TO HELP KEEP YOUR RETIREMENT AFLOAT

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DEDICATION

To Dad, M.E. Nager, who led us into the financial services industry.

TEN, EMN

To Grandpa, Donald Habberjam, who led me into the financial services industry.

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FOREWORD

A Brief Story to Begin Your Rescue

Let us start with the story about the famous nuclear physicist who used to lecture around the country and the world. He was a brilliant man, but very much a creature of habit. Wherever he went, he always used the same airline and requested the same aisle seat. He also insisted on traveling with the same chauffeur who drove him wherever he needed to go.

After several years of travel and lecturing, he was chatting with the chauffeur one day who remarked that he had heard the physicist's speech so many times that he could deliver it himself. The chauffer's claim intrigued the physicist who agreed to swap places with him for one lecture. The physicist would be in the audience in chauffeur clothing while the chauffeur spoke.

Sure enough, the day of the lecture came and the chauffeur delivered the speech flawlessly. When the floor was opened for questions and answers, a hand shot up in the front row. It was a renowned academic who asked an extremely detailed question in four parts.
Without batting an eye the speaker responded, "My friend, that question is so elementary that even my chauffeur could answer it!" Our hope is by the end of this book, you will be like the chauffeur in the story and be able to discuss the rescue of your own retirement.
But unlike the chauffer, hopefully you will have an understanding of how to rescue your retirement and successfully navigate the financial waters in front of you.

The Southern Capital Services' Story

Southern Capital's founder, Terry Nager, began his career in the securities brokerage and insurance industries. He wanted to help others solve their financial problems by providing the quality of service to others that he would want for himself. As he grew in his financial knowledge, Terry founded his comprehensive financial planning firm in 1982. The firm was involved in helping others with estate and tax planning, as well as investment planning. The advantage of this approach was one-stop shopping for the clients.
The disadvantage was that it was hard to maintain expertise in each of the disciplines of financial planning.

By 1990, Terry realized that his clients primarily wanted help managing their investment portfolios. At that point, he gave up his brokerage license and started a fee-only advisory service (see below for the critical differences between an advisor and a broker). He took on David Lindsey as a business partner, who was also a Certified Financial Planner and at the time was teaching business courses at the University of South Alabama. Together they hired Dutch Coppejans and Sam Bugg to help with marketing efforts.

Most of the clients in those early days were those retiring from the workplace and rolling over their retirement plans into Individual Retirement Accounts (IRAs). Later in the decade, Terry realized that his investment approach for individuals also worked for businesses, so he developed the ability to manage 401(k) and other types of retirement plans.

By 2000, Sam had retired, and Dutch was about to, so Terry hired his brother, Eric Nager, who had been in the publishing industry. As the business grew, Southern Capital needed more space. They hired Michelle Hunt in 2007 to oversee the move to another office. She did such a great job that the decision was made to hire her full time. A few years later, David wanted to move to part-time work, and the company needed more advisor depth. In 2011, the firm hired Wendy Nelson Bailey. Wendy worked for 15 years at the Vanguard Group. She is also a Certified Financial Planner. She and Eric had gone to high school together. In 2013, the firm hired Charlotte Straight, who had worked with Wendy in the banking industry. Finally, in 2019, the team was completed with the hiring of Ashleigh Donnelly to replace Kristi Lawhorn, who left to become a full-time mother.

Southern Capital has honed the retirement rescue story shared here over three decades. Our goal is to provide our clients with the freedom and peace of mind to pursue their passions up until retirement and beyond. Now you can use this method, too.

The Differences between an Advisor and a Broker and Why We Chose the Advisor Role

Even those who rescue themselves need occasional help from a professional, and there are two basic models for the investment industry. The lines between these two models are often blurred by advertising, so we would like to draw a clear distinction between them for our readers. The two models are a broker and a Registered Investment Advisor, and the key differences lie in how each is compensated and the standard to which each is held.

Brokers are typically compensated by commission per transaction. They are paid a percentage up front for selling a stock, bond, mutual fund, CD or annuity. Of these, the largest commissions are often generated from the sale of annuities and illiquid limited partnerships that can pay as much as 10% of your investment. Of course, the broker hopes that the investment performs well so there will be an opportunity to sell more products, but in any event, the broker is paid up front. The standard a broker must meet is called “suitablility,” meaning any security sold must be suitable for the client to own, based on his or her goals and means. After that standard has been met, brokers are not required to disclose their compensation and they act in their employer’s best interest.

A Registered Investment Advisor is typically compensated based on a percentage of assets under management: a structure that makes the number of transactions generated by the advisor irrelevant to the advisor’s compensation. If the advisor’s fee is 1% annually, for example, it would take the advisor several years to earn what a broker generally makes on one upfront commission from the sale of a security like a limited partnership or an annuity. An advisor is also held to a “fiduciary standard,” meaning advisors are legally bound to place the interests of the client above their own.

At Southern Capital, we chose the advisor role where we only receive compensation from client fees. We get nothing from product vendors, therefore avoiding potential conflicts of interest. We also must disclose ahead of time how much we will be compensated.
Other professionals who serve in a fiduciary capacity include doctors, lawyers, CPAs and trust officers. One other important thing to remember is that the term “fee-based” is not the same as “fee only.” A fee-based advisor might receive both fees and commissions.

CHAPTER ONE: WHY IT'S LIKELY YOU NEED TO BE RESCUED

Some Sobering Statistics

According to recent articles from various sources, the outlook for the average American worker with regard to retirement is NOT optimistic. Consider:

- 43% of Americans plan to delay and continue working past their planned retirement date because of COVID-19.[1]
- 64% of Americans will retire essentially broke: 45% have no money set aside and 19% have less than $10,000 (exclusive of home equity and pensions).[2]
- 40% of people in a recent survey are concerned they won't be able to retire at all. 56% are more concerned about retirement than they were a year ago.[3]

The point of this book is not to focus on how we got into this mess collectively as a nation, but what to do about it. Even if you are off to a late start in your savings for retirement, it is never too late to try to make a difference.

[1] "43% of Americans plan to delay retirement due to COVID-19" www.foxbusiness.com/personal-fiance July 17, 2020.

[2] "64% of Americans Aren't Prepared for Retirement" https://finance.yahoo.com/news/ Sean Dennison, September 23, 2019.

[3] "40% of Americans fear they won't be able to retire, survey says" www.wtkr.com/news Erin Miller, May 20, 2020.

The Three Legs of the Retirement Stool

There are three elements that make up the potential pool of money for retirement years. These elements are likened to three legs of a stool. Ideally, all three work together to make the stool sturdy and strong. The legs consist of:

1. Social Security. Workers pay 7.65% of their income during their working years, which is matched by their employers, to the government for payroll taxes (6.2% for Social Security and 1.45% for Medicare). At retirement, workers receive a lifetime income stream based on how much they paid into the system, subject to limitations at the upper end of the earnings scale. Our government assures us that Social Security is funded into the 2030s, but they have borrowed against the trust over the years.

   If you talk to virtually anyone aged 20-35 and under, it is hard to find those who believe they will receive anything from Social Security. An important point to remember is that Social Security was never intended to cover your retirement income needs fully, but to act as a safety net for those in need. At the time of its founding in the 1930s, the average life expectancy in this country was around 67, so people worked until 65, retired and only drew Social Security for a few years. Also, there were many more workers than retirees then contributing into the system, about 40:1. Today, that ratio is closer to 3:1 and people are living much longer. The point is that one should not rely solely on Social Security for retirement.

2. Employer-sponsored Pension Plan. It used to be that people worked for one company their entire careers, retired and received a pension (think General Motors and the other car companies). But pension plans are expensive to fund and administer. People change careers much more frequently

now, and pension plans are largely a thing of the past. For most people, there is no second leg of the stool!

3. Personal Savings. Instead, pension plans have been replaced by 401(k) plans. In most of these plans, the worker (participant) must make his or her own investment choices, usually from a relatively limited list, with little or no guidance from the employer. Employers may match participant contributions up to a certain percentage. If you are a participant in a plan like that, our advice is to be sure you are contributing at least enough to take advantage of the maximum employer match. Otherwise, you are leaving money on the table. The ultimate goal, if it is affordable, is to contribute the maximum allowable and get the full tax deduction. When the participant retires, this money can be rolled over into an IRA. IRAs, along with anything that can be saved outside of the plan, are the third leg of the stool.

   In general, the United States is not a nation of savers. We are a nation of consumers. Because of this, we have one of the lowest savings rates in the industrialized world. Yet personal savings is the leg of the retirement stool over which the investor has the most control in preparing for retirement.
   This control factor arguably makes personal savings the most important leg of the stool for the purposes of this primer because each individual controls virtually all the inputs that determine the success of the chosen investment approach.

The focus of this book is to teach you how to make investment choices on the third leg of the retirement stool: your employer sponsored plan and your savings outside the plan. We will share with you our method of how we evaluate and select from various investment alternatives and why we choose what we do. We will also teach you the basics of how to do this yourself so that you can stay afloat in retirement.

CHAPTER TWO: THE SAVINGS AND INVESTMENT DILEMMA

One of the greatest fears retirees have today is outliving their resources. They don't want to run out of money and become a burden to their families or society. With people living longer and longer, this fear has become more common. According to statistics compiled by Ibbotson, a financial advisory research firm, for a married couple with each spouse age 65, there is a 50% likelihood that one of them will live to age 91. Longer life spans mean there can be a 26-year investment time horizon or longer beyond traditional retirement age. For many people, the length of time that they spend in retirement may be nearly as long as the time spent accumulating money during working years!

Living longer into retirement implies that your retirement assets need to keep working hard for you well beyond your retirement age.

It also means your assets need to earn a high enough return to overcome the rising cost of living. For example, let's say an investor could get an average annual return of 8% and withdrew 5% of the principal annually to supplement income from Social Security or a pension. The table below shows that not only would the principal continue to grow, but the annual amount taken would therefore also increase, giving the investor annual raises to help combat the rising cost of living.

		Year 1	Year 2	Year 3	Year 4	Year 5
Principal growing 8%	100,000	108,000	111,240	114,577	118,015	121,555
Withdrawal	5%	5,000	5,150	5,305	5,464	5,628
Net		103,000	106,090	109,273	112,551	115,927

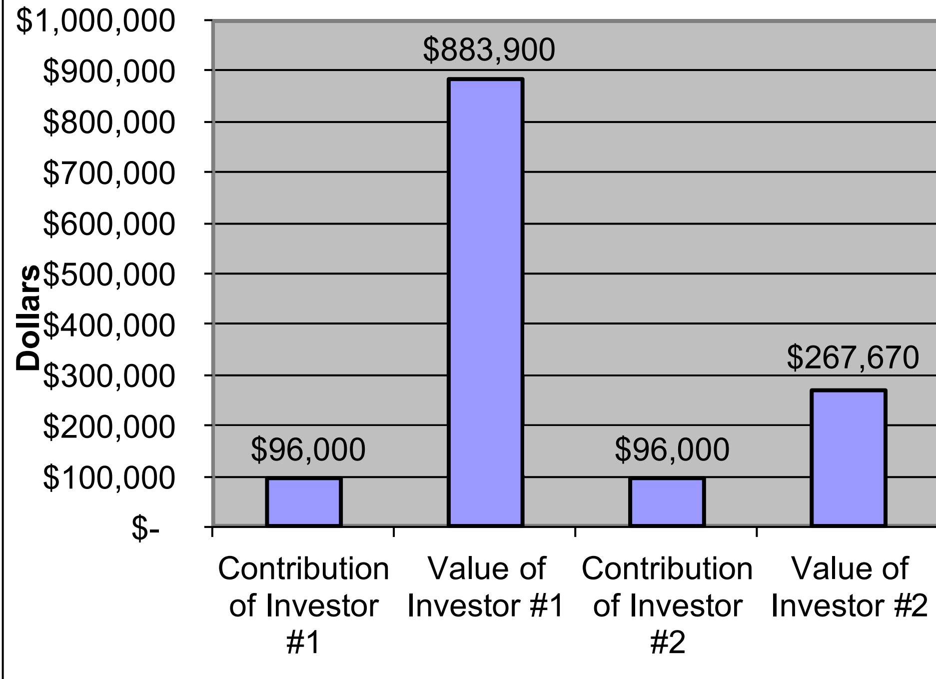
Of course, the big question is, “Where can you get an average annual return of around 8%?” If you invest in assets regarded as “safe,” you typically cannot get anything approaching an 8% return in the current interest rate environment. On the other hand, if you take on more investment risk in order to get a better return, there is the possibility of losing principal. *How to strike the proper balance has plagued investors for many years and is the crux of the Savings and Investment Dilemma!*

The Power of Compounding

Fortunately, there are laws of mathematics than can help you in the rescue. Albert Einstein said of compounding, “Compound interest is the Eighth Wonder of the World. He who understands it earns it.
He who doesn’t, pays it.” Compounding is a very good thing if you own an asset that is earning interest or some return, but it can also work against you if you are a debtor. That is why we strongly encourage any prospective clients to pay off credit card balances as soon as possible in order to avoid rapid compounding of debt.

To illustrate the power of compounding in a good way, let’s look at an example of two investors. The first investor started saving at age
25. She sets aside $200 every month for 40 years until age 65, so she saved a total of $96,000. The second investor also saved $96,000, but he started 20 years later. Starting at age 45, he sets aside $400 per month for 20 years. Assuming an average annual return of 9%, which investor would you rather be?

At age 65 the first investor has over three times the investment balance of the second investor. Because she started 20 years earlier, this allowed the power of compounding to work on her behalf for a longer period of time.



First contribution column: $200/month x 12 months = $2,400 x 40 years = $96,000.

First value column: $200/month x 12 months x 40 years x 9% annual compound rate of return = $883,900.

Second contribution column: $400/month x 12 months = $4,800 x 20 years = $96,000.

Second value column: $400/month x 12 months x 20 years x 9% annual compound rate of return = $267,670.

The Rule of 72

The Rule of 72 is another math rule that can help you understand the power of compounding. This rule is a quick way to determine how long it will take for your assets to double in value. According to the rule, any interest rate multiplied by a time period that equals 72 will yield a doubling in value. For example, if you earned 6% on an investment every year, it would take 12 years to double in value, since 6 x 12 = 72. Likewise, if you could earn 8% on an investment, the value would double in 9 years since 8 x 9 = 72. We will refer to this rule as we go forward in the book.

Some older readers might think it is too late to benefit from this rule, but please do not rush to judgment. According to IRS tables, the average life expectancy, upon reaching age 70.5, is around 87. That is another 16 years for assets to grow, so if you could get a 9% average annual return, according to the rule of 72, your assets could double twice in 16 years. A $100,000 balance doubling once would be $200,000, and doubling again would be $400,000. THAT demonstrates the power of compounding!

CHAPTER THREE: POSSIBLE RESCUE #1 - CDs AND MONEY MARKETS

The two opposing elements of the Savings and Investment Dilemma are Risk and Safety. Those investors who want to take no risk whatever are at the safety end. They are happy to park their money at a bank in Certificates of Deposit (CD) or money market accounts and collect the going rate of return. They feel that their investment is "safe" since the principal does not fluctuate. (This is assuming no extreme event where the bank goes under and the Federal Deposit Insurance Corporation, FDIC, is unable to pay off.)

Two factors can work against this "safety" theory. The first is inflation or the rising cost of living. If this cost outpaces the rate of return gained on a CD or money market, it is not a "safe" investment at all since your purchasing power is being eroded. In other words, it is possible in the environment of a rapidly rising cost of living, that a maturing CD will buy fewer goods and services than the value of the CD when you bought it. Another term for this phenomenon is going broke safely, and it is still a form of an investment risk that can swamp your retirement life raft!

The second factor that can work against the "safety" theory is the fact that the rate of return may be too low, regardless of inflation, to accomplish your retirement objective. As of this writing in 2020, interest rates were at historic lows. According to one national search, a one-year CD with a minimum $10,000 investment is paying anywhere from .50-1.00%. And for a money market account of the same size, you can earn anywhere from .65% up to 1.1%[4].

These low rates are a far cry from the early 1980s when you could get 20% on a money market account. THAT was the time to be in these cash type instruments.

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4 **www.nerdwallet.com**

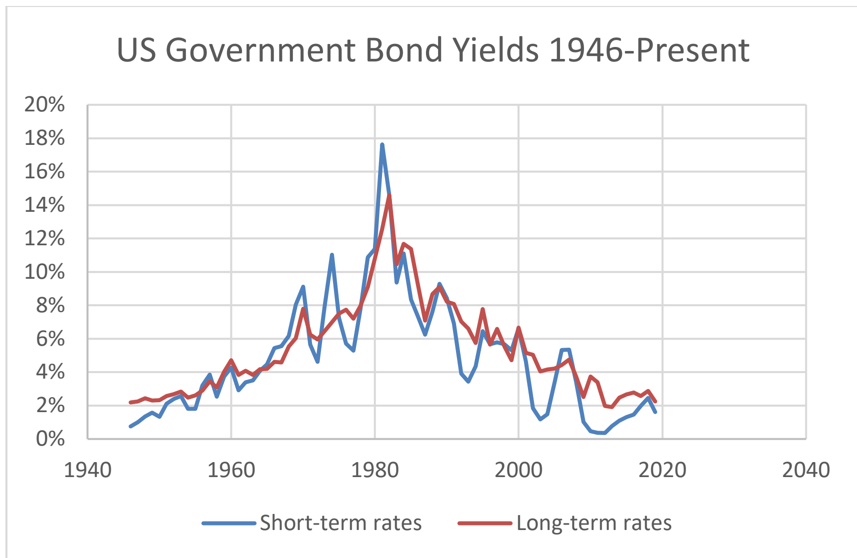
For today, as we learned with the Rule of 72, if you are earning 1% annually on your investment, it will take 72 years for that investment to double in value. While it is true that most people are living longer and longer, most of us do not have a 72-year investment time horizon in retirement! *So the investment vehicles of CDs and money market accounts by themselves fail the test of being a plausible rescue strategy in today's low-interest rate environment.*

CHAPTER FOUR: POSSIBLE RESCUE #2 – BONDS

Some also consider bonds to be "safe" investments, especially U.S. government bonds since the U.S. government has never defaulted on an interest payment. Again though, in a low-interest rate climate the returns are less than stellar. According to **www.money.cnn.com,** in August 2020, here are the going yields on various U.S. government bonds:

Maturity	Yield
5 Year	0.28%
10 Year	0.67%
30 Year	1.40%

The chart below shows U.S. government bond yields going back to 1946. The term "bond yield" is another way of saying the interest rate the bond pays. Short term bonds are defined as 1-3 year duration while long term is 10-30 years.



Source data from 1946-2000 Ibbotson; from 2000 onward U.S. Treasury Dept.

You can see from the chart that from 1946 until about 1980, interest rates were trending upward, and since 1980, they have been trending downward. What is important to realize is that bond values have an inverse relationship to interest rates. They decline in a time of rising interest rates and rise in times of falling interest rates.

Here is an example to illustrate this point. Let's suppose you bought a 30-year U.S. government bond at 3% and paid $10,000. You would have a guaranteed interest payment of $300 each year for 30 years, and at the end of that time, you'd get your $10,000 principal back.

Now let's suppose 30-year bond yields the following year moved up to 6%. (They don't fluctuate that rapidly, but this is just an example.) Your best friend buys a 30-year bond for $10,000 and is guaranteed to get a $600 annual interest payment. Her interest payment is twice as large as yours and will remain that way for the next 29 years that your two bonds overlap each other. You are not happy about this. Why should your friend get twice as much as you are getting? You want to do something about it, but now you have a choice of two very unpleasant alternatives:

1. You could do nothing and accept getting half as much as your friend for the next 29 years. OR…

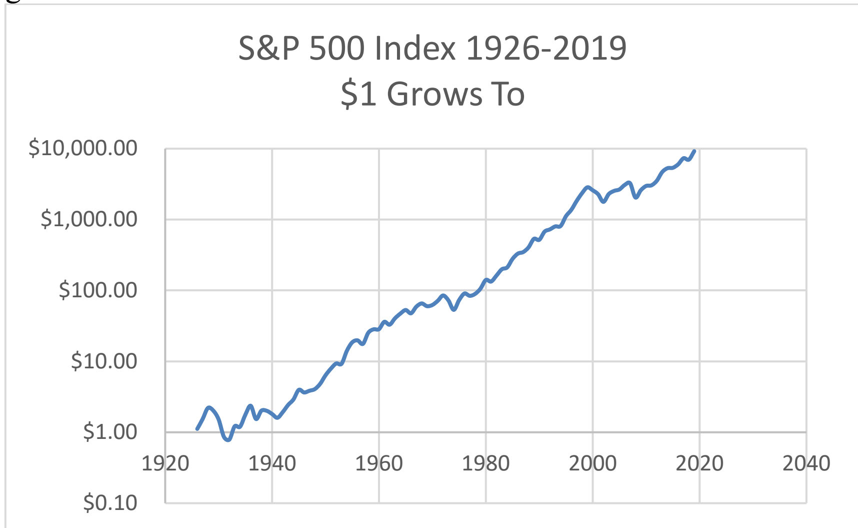
2. You could sell your bond and buy a new one at the prevailing interest rates. After all, U.S. government bonds are saleable at virtually any time. BUT the downside is that at prevailing interest rates of 6%, your bond is no longer worth the $10,000 you paid for it. In fact, it is closer in value to $5,000 since the $300 annual interest payment you are receiving is 6% of $5,000 and 6% is the current rate. *Rising interest rates have just cut your bond value nearly in half.* (Note: it will not cut the value totally in half because the bond is still worth $10,000 at maturity.)

As you can see there can be hidden dangers in the waters when investing in bonds, especially at times of low-interest rates such as we are experiencing now. The adage of "buyer beware" applies.

According to the Rule of 72, a 3% rate of return, as in the example on government bonds, will take 24 years for your money to double. If you could only get a 2% rate, it will take 36 years for your money to double. *These levels of return are inadequate for your retirement nest egg unless you have enormous sums of money. For this reason bonds, by themselves, are not a retirement rescue strategy in today's interest rate environment, either.*

CHAPTER FIVE: POSSIBLE RESCUE #3 – INDIVIDUAL STOCKS

At the risk end of the spectrum for the Savings and Investment Dilemma are individual stocks. The graph below illustrates that, over a 90-plus-year period, individual large company stocks have an average annual return of about 10%. An investment of $1 made in 1926 with reinvestment of all dividends and capital gains along the way would have grown to $4,671 by the end of 2019. The graph is logarithmic, meaning that it shows growth exponentially – in this case each horizontal line is ten times greater than the one below it.



Source data from 1926-2000 Ibbotson; from 2000 onward S&P 500 with dividends.

Remembering the Rule of 72, an investment that averages 10% will double every 7.2 years, and in this 94-year period, that equates to the initial investment doubling about **13 times**. So, roughly (**1**)1x2=2, (**2**)2x2=4, (**3**)4x2=8, (**4**)8x2=16, (**5**)16x2=32, (**6**)32x2=64, (**7**)64x2=128, (**8**)128x2=256, (**9**)256x2=512,

(**10**)512x2=1,024, (**11**)1,024x2=2,048, (**12**)2,048x2=4,096, (**13**)4,096x2=8,192!

Finally, we have found the type of returns that can keep a retirement life raft afloat! However, there are challenges to investing in stocks that can have the potential of swamping the raft: volatility, lack of diversification, and not being on a level playing field.

1. **Volatility**. Most investors never achieve this 10% historical return level. Why? Because when the market experiences a sharp decline, many investors cannot handle the psychology of a paper loss, and they sell out. The initial recovery phase after a decline in the market is usually sharp and explosive, and those who have sold out miss this upward move as well, thus making matters worse. Not only did they take most of the loss on the way down, they missed a major move on the upside. Even if an investor stays in the market, a big decline can take a long time to overcome. (For example you have a $1,000 investment, and you lose half, down to $500. It requires a 100% return from there just to get back to even, and 100% returns are difficult to come by.) Talk about big waves and choppy waters!

   The media do not help matters. During up times in the market, they can make it sound as if there is no danger, and during down times, they can turn fear into panic. A classic example is the market crash in October of 1987. There were only three major news networks then on television. Two of them suggested this could be the start of the next Great Depression, and the third suggested this could be the end of Western capitalism. What is a scared investor supposed to think? Shortly after the crash the market normalized and none of the gloomy predictions came to pass.

2. **Lack of Diversification**. An individual stock is a very narrow holding. To have a diversified portfolio, you will need to hold many, many stock positions. Otherwise, you

are putting your portfolio at significant risk if the main stock you are holding declines in value.

3. **It's Not a Level Playing Field**. The deck is somewhat stacked against the individual investor. It is not too difficult to do research and find a good stock to buy, but the tricky part is on the selling side. If you hear bad news about your stock and want to sell, the institutional traders on Wall Street already have that information and can dump thousands of shares at the click of a mouse. Examples of institutional traders are pension plans, mutual funds, exchange traded funds, and other large investors. It is very difficult for the individual investor to get in front of that line, and the difference in timing can mean the difference between a profitable transaction and a loss.

   Because of these factors, especially the volatility that most investors cannot stomach, individual common stock investing alone is a very complex rescue strategy.

CHAPTER SIX: POSSIBLE RESCUE #4 – REAL ESTATE & COMMODITIES

As with individual stocks, real estate over the years has delivered the type of returns needed for retirement. Any investor who is a home owner already has a significant investment in real estate. What we are talking about here are investments over and above a primary residence for the purpose of growing your retirement life raft. However, there can be multiple drawbacks to real estate investing:

1. **Limits Portfolio Diversification**. Purchasing real estate is usually a large investment. If a large part of your portfolio is tied up in one asset, there is less to diversify into other investments. We have seen over the past decade that it is possible for the real estate market to go into a prolonged slump.

2. **Illiquid**. Illiquid means that an investment in property cannot necessarily be turned into cash quickly. If you need to get your hands on cash, you might have to wait for the property to sell or take a loan on it. To sell, you might have to wait for quite a while or lower your price, and lose much or all of your profit, in order to get the cash that you need. Think of it as trying to jump off a sinking ship and having to wait a long time for your life jacket to inflate!

3. **Not a passive investment.** Real estate can involve

work. If you are a landlord, there is plumbing that needs fixing and repairs to be done. There can be extra costs for maintenance and administration, property taxes, or hiring someone to be a property manager.

In short, while real estate is a valuable holding for any investor, there is such a thing as too much of it. Real estate investment returns are adequate for retirement. However, more liquid alternatives usually are needed to complement any significant real estate holdings. *Real estate alone may not be a retirement rescue strategy*.

A WORD ABOUT COMMODITIES

Commodities are a fifth asset class after cash, bonds, stocks, and real estate. A commodity is an economic good that is typically the product of agriculture or mining. Examples include gold, oil, natural gas, corn, wheat, etc. Investors buy commodities with the hope that they will appreciate in value, and commodities tend to benefit during inflationary cycles.

Gold and silver are the most common commodities of which investors take physical possession and, over time, commodities can provide good rates of return. However, there are drawbacks to investing in them: first and foremost they are very volatile.

A second drawback is that commodities do not pay anything. There is no interest or dividend income. The investor is hoping for appreciation of the asset, and this is the only real form of return. Looking at the price of gold historically, it hit a high of about $850 per ounce around 1980, but by the year 2000 it was down to about $265 per ounce. It sharply rebounded in the following decade, but price depreciation for significant periods of time is a real threat.

A third drawback is that it costs money to hold

physical assets, such as the cost of a savings deposit box at a bank in which to store your gold. Most other types of commodities are not easy to collect and store.

A fourth drawback is that commodity markets are not that large. They do not have the depth of the stock and bond markets. As of this writing, there are trillions of dollars sitting in cash around the world, held by individuals as well as corporations. If the economy started to heat up and investors had the confidence to come back into the markets, the commodity markets could be overwhelmed if a significant portion of the cash flowed into them.

This is not to say that investors should not invest in commodities at all, such as a modest amount as an inflation hedge. As a primary retirement rescue strategy in and of itself though, the drawbacks outweigh the benefits.

CHAPTER SEVEN: POSSIBLE RESCUE #5 – ANNUITIES

We hear much about annuities and some investors are attracted to them since they often promise a "guaranteed" level of return. However, this guarantee often comes at a large price. As with most areas in life, when considering whether or not to make a purchase, it is best to go in with your eyes open.

What is an annuity? It is "a contract between you and an insurance company in which the company promises to make periodic payments to you, to start immediately or at some time in the future.[5]" Future payments indicate a deferred annuity while current ones are for an immediate annuity. Some potentially negative features to annuities can include:

1. **High Expense, plus Internal and Surrender Charges**. Annuities are expensive investment products, and it is not uncommon for those who sell them to get a 5-7% commission up front. The investor may be told, "All of your money will be working for you." In other words, if you buy a $100,000 annuity, you will see the full $100,000 on your statements, and not the $5,000-7,000 that is subtracted for the agent's commission. The insurance company that offers the annuity recoups the agent's upfront commission by charging high internal fees within the annuity. If the annuity owner sells the annuity before the surrender period, the insurance

[5] Financial Industry Regulatory Authority (FINRA)

company charges a surrender charge to pay the company back for the agent's commission. If you are considering buying an annuity, we recommend you ask the agent how much he or she will get paid as well as what the internal fees and surrender charges will be and listen closely for the answer.

2. **Loss of Control**. Another drawback for annuities is that you may give up control of your money in exchange for the guarantee. In other words, with most annuities you cannot access the money you put into an annuity without severe surrender charges. The surrender charges are in addition to a 10% penalty on earnings imposed upon early withdrawals for those investors under age 59.5. Thus, annuities can be a problematic investment tool for those with liquidity requirements.

3. **Disadvantageous taxation**. Annuity income is currently taxed as ordinary income, not as a capital asset. Today capital gains rates stand at 15% or 20%, depending upon income level. The corresponding ordinary income tax rates are higher and, for this reason, given the choice; it is preferable to have capital gain income over ordinary income. But there is no alternative with an annuity – all gains are ordinary income. In addition, annuities operate under LIFO accounting, which stands for Last In, First Out. LIFO means that all of the gains the annuity makes are taken out first at distribution time unless annuitized, and taxed as ordinary income before distribution of any of the principal. (Note: all taxes are deferred until distribution.)

   Annuitization means that a series of payments is triggered from the annuity. The payments could be for a set amount, a fixed period, for the lifetime of the annuity owner or some combination thereof. For

an annuity purchased with after tax money, a portion of each payment is a return of your principal, and a portion is taxed as ordinary income. The taxable portion depends on your life expectancy. In either case, you are paying the higher ordinary income tax rate on the taxable portion of the annuity. Of course, it is possible to have an annuity within an IRA, but it is redundant to have a tax shelter inside of a tax shelter.

4. **Limited Investment Options**. Two types of annuities are variable and fixed. Variable annuity returns vary with the performance of the investments within the annuity that you choose. Typical variable annuities contain mutual funds from which the investor can select. (Mutual funds will be considered in the next chapter.) A good variable annuity still only offers 300 or so mutual funds out of the universe of over 7,000 funds. This is a very limited selection and may not allow options for best management.

   With fixed annuities, the insurance companies guarantee the return and the payout. Fixed annuities offer no investment choices and are pegged at a certain level of return. The drawback to fixed annuities is that in a rising interest rate environment, the return on fixed annuities lags behind.

   A hybrid type of annuity is an indexed annuity that offers a fixed rate of return, as well as a portion of the gain, if any, from a market index. While there is very little downside to indexed annuities, the drawback is that the upside is capped and usually limited. Under today's interest rates, hybrid annuities offer better returns than CDs, but because their upside is capped, they do not provide returns in line with historical market averages.

As you can see, annuities can be an expensive and limiting rescue strategy because of their high internal expenses and long term surrender charges. Why buy a yacht to rescue yourself when all you need is a fishing boat? However, if your retirement is already in an annuity, there are no load options. For example, if an investor is trapped in an annuity because of the tax liability that would be triggered by cashing it in, and if the annuity is beyond the surrender period, an exchange could be made to a true no-load annuity under the Section 1035 tax free exchange rule. The rule allows movement from one annuity to another without generating a taxable event.

The bottom line is that if investment guarantees of any type sound too good to be true, there is usually more to the story, and it is worth investigating. Also, remember that annuities are guaranteed by the financial strength of the insurance companies that offer them, and not by the government.

CHAPTER EIGHT: POSSIBLE RESCUE #6 – MUTUAL FUNDS

A mutual fund is defined as a type of professionally managed investment that pools money from many investors to purchase securities or other investments. Money can be added or withdrawn at any time, with few restrictions, at net asset value (NAV, the per share market value of all securities held) minus any loads and fees.

In the universe of mutual funds, there are over 7,000 from which to choose. Every mutual fund has a stated objective that can be found in its prospectus. For example, a fund might specialize in stocks of large capitalization companies (those valued at $8 billion or more). Another might focus on mid-capitalization firms (those valued between $2 billion and $8 billion). Yet another might focus on small cap ($300 million to $2 billion). Or there are those funds that specialize in growth stocks, value stocks, domestic, international, different sectors of the economy, and the list goes on and on.

Mutual funds can be volatile and lose money like most other types of investments. They are not guaranteed. But they do have multiple advantages not enjoyed in combination by stocks or other instruments, and five of them are listed here. These advantages are explained in the rest of the chapter. (Side note: occasionally Eric has been an adjunct professor at a local undergraduate institution and has taught a class on business math. One of the chapters was on investing, and on the final exam he asked the students to name five advantages of mutual fund investing for extra credit. If you ever take that class with him, you will have a leg up on the final!)

1. **Professional Management**. As stated in the definition of a mutual fund, they are professionally managed. Some of the best money managers around

the world gravitate to become mutual fund managers. Why? For the same reason that Willie Sutton, the famous bank robber, gave when he was asked why he kept robbing banks: "That's where the money is!" A successful investment advisor might manage tens of millions of dollars in assets, but a fund manager might manage hundreds of millions or billions. In addition, these fund managers have full-time teams of analysts to help decide what to buy and sell.

These managers and their staffs comprise a large segment of the institutional investors on Wall Street referred to in the chapter on stocks. It's hard to move faster than they do when making a transaction. Furthermore, good management can offset some market volatility by not dropping as far as a market index in down years.

2. **Diversification.** It's not uncommon for a stock mutual fund to hold hundreds of positions. If one of those positions turns out to be a bad one, like Enron stock (a company that went out of business years ago), it's unlikely to have a large impact on the overall value of the fund. On the other hand, an individual stock investor with a significant holding in a stock like Enron would get hurt. Then, if the investor has several mutual fund holdings, each with multiple hundreds of positions in stock holdings, there is an added layer of diversification. One of our cardinal rules of investing is that there is no additional reward to the investor for taking on unnecessary risk. Through diversification achieved by mutual fund investing, some level of unnecessary market risk is removed for the investor.

3. **Liquidity.** Part of the definition of an open end mutual fund is that money can be withdrawn at any time with few restrictions. In other words, mutual

funds are easily bought and sold, down to fractional shares, and most fund transactions settle within 24-72 hours. It is, therefore, easy for the investor to get his or her hands on investment cash quickly if needed. (Note: an open end fund has an unlimited number of shares and trades at net asset value at the close of the day's trades. A closed end fund, on the other hand, has a set amount of shares and trades like a stock in that it is valued throughout the trading day.)

4. **No Load.** No load mutual funds are not expensive to buy and sell. The two categories of funds are load and no load, and there are roughly half of each type in the universe of funds. Load funds are purchased through a broker and have a commission attached, either on the front end or the back end. (Those with a back end load operate similar to an annuity in the sense that all your money is invested up front, but the fund company charges higher internal fees over time to recoup the commission paid to the broker. Likewise, they have surrender charges for a period of time, usually several years.) It is our opinion that there is a sufficiently large choice of funds in the no load category so that it is not necessary to purchase load funds. Here it is only fair to add that if the investor does not want to invest on his own, an investment advisor can acquire most load funds at no load. It makes sense that no load is the way to go.

5. **Access to all Markets**. Most mutual funds have very low investment thresholds. A fund in an Individual Retirement Account (IRA) may have a minimum opening balance as low as $500 or $1,000 with additional investments as low as $100. By blending various types of funds into a comprehensive portfolio, the individual can be a diversified investor for a very modest investment.

Exchange Traded Fund or ETFs are securities like index mutual funds, except that they are valued throughout the market day, as is a stock. Most broad-based mutual funds and ETFs have the historical returns needed to reach retirement goals, like stocks, yet they have much greater diversification. Unlike real estate or annuities, mutual funds and ETFs are liquid and can be turned into cash quickly without high fees or expenses. So how does an investor go about selecting the best ones?

What Does Jack Bogle Say?

Jack Bogle was the founder and former head of the Vanguard family of mutual funds and a legendary investor. Known as the "Father of Indexing," it is his premise that investors should only be in index mutual funds. Index funds are not professionally managed, but track a market index, such as the S&P 500. Not having a manager gives index funds lower internal costs, which is an advantage. According to Bogle's research, index mutual funds have historically outperformed 85% of managed funds. In other words, he feels that a passive approach, of buying and holding an index fund, is superior to an active approach to buying and selling multiple funds.

So why not go with just index funds? Index funds are, by definition, tied to the volatility of the market. If the market has a bad year, as it did in 2008 when the S&P 500 was down 37%, an S&P 500 index fund will be down about 37%. This is not to say that non-index funds are not volatile, but managers of these funds can take defensive measures in down times that index funds cannot.

Secondly, in a fund universe of more than 7,000 mutual funds, if you take out 85% of them as being inferior to an index fund, that eliminates about 6,000 funds. However, that still leaves around 1,000 funds, or 15%, that can and usually do outperform an index over time. That is a sizable selection from which to choose, and the performance is attributable to the fund's management rather than following a market index.

In fact, all there is to a mutual fund is management. It's not what the fund is currently holding since these positions can all be sold any time the market is open. The real question is what is the fund manager's demonstrated ability to manage in all types of markets, good and bad? Look for established track records of the manager or management team.

The classic example of the difference a fund manager can make is Peter Lynch, the former manager of Fidelity Magellan Fund.
Throughout the 1980s, he took Magellan to stratospheric heights and earned the reputation as perhaps the greatest mutual fund manager ever. Then he abruptly retired in 1990. After that, Fidelity continued to market Magellan's track record, but Peter Lynch was no longer there, and the fund performance drifted into mediocrity.

How Do I Learn Which Funds to Pick?

So if you want to invest on a more informed basis, where can you turn? A good start is subscribing to a service comparable to Morningstar. Morningstar is an independent rating service that provides reams of information on all funds. Investment advisors pay thousands of dollars per year for these services. The mutual fund industry is highly regulated and funds must report a variety of data. Morningstar compiles this into meaningful reports, and what follows in the next chapter is a real world example of some of what to look for in selecting funds.

CHAPTER NINE: MORNINGSTAR EXAMPLE

On the next page is a Morningstar report of an actual fund. The name and all identifying data has been removed. The goal of the example is to show how to use the analysis tool, and not to promote any particular fund. The highlighted areas show some of what to look for in selecting a fund. They are circled and numbered and the points below correlate to the report.

1. Within the circle at the top is general information about the fund. Under where it says “Load” you can see the word “None,” meaning that this is a no load fund. If there were a load, it would indicate the percent commission you’d have to pay to buy it. Under “Category” it says, “US Fund Health,” meaning this fund is in the health care sector. Under “Expenses” it says .86% that, according to Morningstar, is below average for this type of fund. These fees are used to pay the management team and administrative costs.

   Under “Initial Investment,” it says $2 million. Mutual funds have many different share classes. This particular one is a Class “I” share, meaning institutional. Because there are large investment minimums required for institutional shares, they have the lowest internal expenses, but it can be difficult for individual investors to afford them. However, one economy of scale enjoyed by investment advisors is that, since most have well more than $2 million in various different mutual funds, they can add new clients for nominal amounts.

2. The second circled area shows Morningstar Risk Measures. According to Morningstar ratings, this particular fund has a below average risk compared to an above average level of return. The risk measure is in comparison to other funds of its type, in this case 103.

Portfolio Institutional

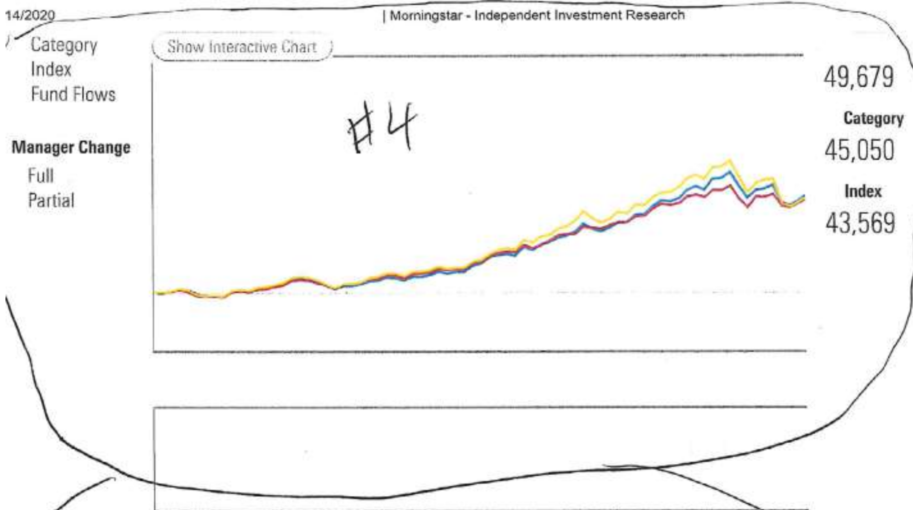
Shares ★★★★★ Silver

#1

NAV / 1-Day Return	Total Assets	Adj. Expense Ratio	Expense Ratio	Fee Level	Load
74.75 / -0.48%	9.7 Bil	0.860%	0.860%	Below Average	None

Category	Investment Style	Minimum Initial Investment	Status	TTM Yield	Turnover
US Fund Health	Large Growth	2,000,000	Open	0.42%	41%

USD | NAV as of Aug 14, 2020 | 1-Day Return as of Aug 14, 2020, 5:14 PM CDT | Quantitative Rating as of Jun 30, 2020, 5:00 AM

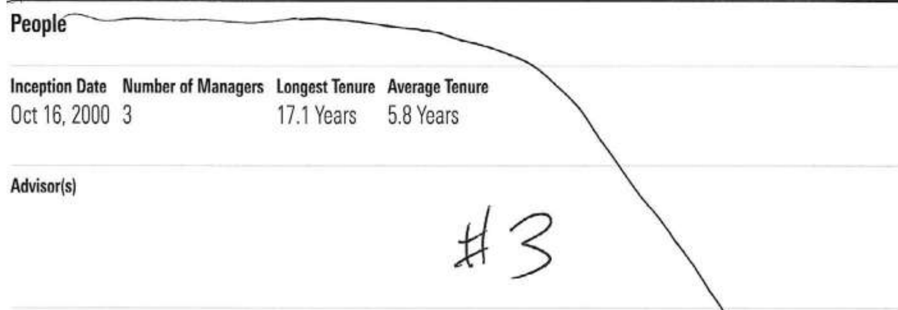


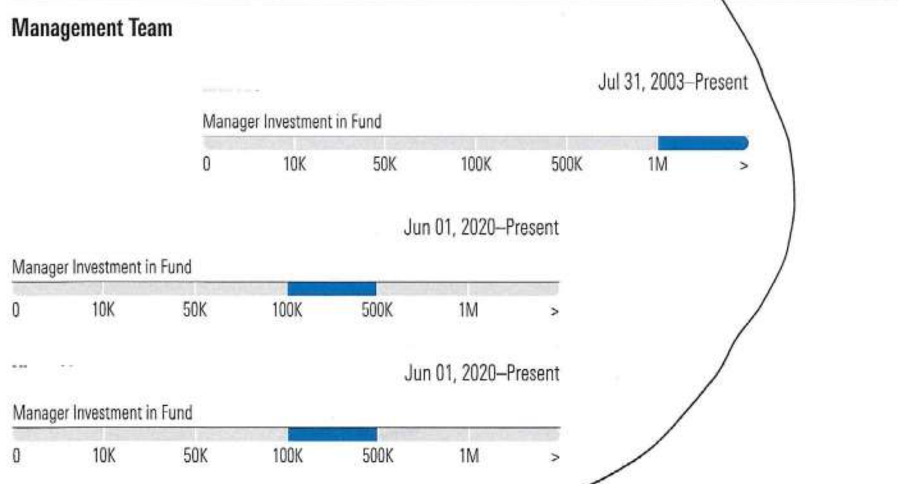
Total Return %	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	YTD
Fund	7.50	6.24	18.77	44.56	29.23	11.30	-5.79	25.15	8.28	25.64	9.81
+/- Category	-0.88	-1.42	-2.78	-3.61	1.98	3.26	4.81	0.85	8.68	-0.59	0.34
+/- Index	2.30	-5.64	0.41	2.37	4.44	3.89	-3.74	2.68	1.57	4.77	3.74
Quartile Rank											—
Percentile Rank	45	61	57	57	32	23	24	35	10	41	—
# of Funds in Cat	160	140	134	130	126	128	134	144	140	145	148

#5

YTD Fund as of Aug 14, 2020 | Category: Health as of Aug 13, 2020 | Index: S&P 1500 Health Care TR as of Aug 14, 2020

The highlighted area in the return means that this fund has had a better than average return for the amount of risk it has taken on. When evaluating any fund, look for the return category to be higher than the risk.





3. The third circled area is management. In the last chapter, the importance of the fund manager was highlighted. The names of this fund's management team were removed so as not to indicate the fund's identity, but it does show the tenure of each manager by when he or she started. In this case, the lead manager has been there over 17 years. Tenure is important since it is the fund manager who builds the track record for the fund. If the fund manager for a fund leaves the fund and you don't know the track record or history of his or her replacement, you will probably want to sell the fund. Also, we will generally not even consider a fund unless the manager or management team has been there since at least 2008, the last major down market before Covid-19. This tells us that the manager has built the track record for the fund and knows how to go through a difficult time in the market. (Note: this section also shows how much each manager has personally invested in the fund, illustrating how much "skin" each has in the game!)

4. Next is a graph depicting the growth of $10,000 if it had been invested in the fund over the past ten years compared with an index. It shows that this fund's balance would have grown to
$49,679 compared to $45,050 for the fund's health care category and $43,569 for a health care index. Clearly, this fund is one of the 15% that outperforms the index as identified by Mr. Bogle in the last chapter. Of course, the universal disclaimer in this business is that past performance is no guarantee of future returns!

5. The remaining circled area shows more detail of the fund's performance over the last ten years. The return is net of all fund fees. The top line shows the fund's annual returns. The next line is how it performed relative to its category. The third line is ow it performed relative to its index. Below that is the percentile rank

and the last line is the number of funds in the category. Taking 2018 as an example, you will see that the fund returned 8.28% which was 8.68% better than its category and 1.57% better than its index. The number "10" in the percentile rank that year means that this fund performed better than 90% its peer funds, and that year there were 140 funds in the category. Any time you see a low number in that column, it stands for a very good performance relative to its peers.

RESCUE SUMMARY

Now that you know how to rescue your retirement, here are the key things to remember:

1. Subscribe or have access to a service like Morningstar.
2. Look for high quality, no load mutual funds as evidenced by the performance of the manager.
3. Blend several different types of funds into a portfolio appropriate for your risk tolerance, monitor it on a regular basis, and make changes as necessary.

If, for some reason, you jump into the waters of this method and find the currents stronger than you'd care to swim, contact a fee-only investment advisor to throw you a line. The first consultation should be free.

CHAPTER TEN: QUESTIONS PEOPLE HAVE ASKED ABOUT THE RETIREMENT RESCUE

Following are some questions we often hear when talking to investors.

1. Q: What about the tax consequences of investing in mutual funds within a taxable account?
   A: Mutual funds are capital assets. They are eligible for capital gains treatment, which is a lower tax rate than the ordinary income rate (see chapter on annuities). Mutual funds buy and sell individual securities, generating gains and losses. They also collect dividends and interest on these investments. Mutual funds are not taxed at the fund level.
   Instead, they pass all gains and dividends through to investors. Investment advisors, who manage portfolios of mutual funds, consider the tax consequences of their positions for taxable accounts and will often realize losses, if any, late in the year to help clients lower their overall tax liability. However, the primary consideration is the appropriate investment position, and secondarily the tax impact so that the "tax tail is not wagging the investment dog."

2. Q: I get a dividend income stream from the stocks I own. How can I maintain a cash flow like that if I switched to mutual funds?
   A: Mutual funds are the ideal investments for maintaining an income stream. Unlike a stock or bond that has established dividends or interest payments, mutual funds can pay out based on the total return

instead of relying upon income only. As discussed, mutual funds are very liquid and trade down to the small, fractional percent of a share. Therefore, an income stream can be established on a monthly or quarterly basis for the exact desired amount. As long as the total return - which includes realized and unrealized capital gains, interest, and dividends - is greater on a long-term basis than the amount withdrawn for cash flow, the account will continue to grow and still pay out the necessary income stream.

3. Q: What are target date funds?
   A: These are funds that offer a fixed allocation method depending upon your age. These funds are designed such that if you are a certain age, you should have a certain percent of stocks and a certain percent of bonds in your portfolio, with the bond percentage going higher as you get older. The adjustment occurs regardless of other factors, like where we are in the interest rate cycle. In these times, this approach can be a tremendous disservice to the investor.
   When it comes to investing, one size does NOT fit all!

4. Q: What about socially conscious investing?
   A: It depends upon how strict an approach the investor wants to take. With mutual funds, if an investor wanted to exclude fossil fuel-based energy, for example, it is simple enough to avoid mutual funds in the energy sector that specialize in oil or natural gas. However, outside of the sector, it can be difficult to weed out funds that might have an oil company stock as an incidental holding, making up a very tiny portion of the overall portfolio.

Questions relating specifically to Southern Capital Services:

5. Q: Does Southern Capital have any account minimums? A: We do not in the sense that we take 401(k) and other types of retirement plans from start up. For individual
   clients, there is a certain threshold below which it is not cost effective for the investor to open an account; we can discuss that on an individual basis. That said, we feel that we can provide accessibility and personal service to our clients who might be somewhat overlooked by a larger firm.

6. Q: Do you take custody of the assets you manage?
   A: No. An investor safeguard is to have an independent third party custodian hold client assets and provide monthly statements and online access to view accounts. The only power we have over an account is to trade it and bill it for our quarterly fee.

7. Q: What fees do you charge?
   A: We charge 1% annually, and it grades down from there for larger amounts, billed as a percentage of assets under management. Up to the first $1 million, it is 1% annually, billed .25% per quarter. Our advisory fee is our only source of compensation. We do not get any compensation from any product provider or any transaction fees. Therefore, there is no conflict of interest about which funds to use or how frequently to trade an account. All returns quoted to our clients are net of our fees.

Terry Nager has been President of Southern Capial Services since its founding in 1982. In addition to being a Certified Financial Planner, CFP®, Terry also holds designations as a Charted Life Underwriter (CLU) and Chartered Financial Consultant (ChFC).

Eric Nager is an Investment Advisor Represenative with Southern Capital Services and a Charted Retirement Plans Specialist, CRPS®. He holds an MBA from the University of South Alabama and a Masters in history from Harvard. Eric is a retired Lieutenant Colonel in the U.S. Army Reserve with 28 years of commissioned service, his other books include Checklist for Checkmate: 15 Keys to Building a Successful Team, Your True Parent: Three Stories of Adoption and The Pawn Who Would Be Queen: The Story of Alabama's First National Champions.

Wendy Nelson Bailey is a Certified Financial Planner, CFP®, with a degree in finance from Villanova University and an MBA from Arizona State University. She spent the first fifteen years of her career with Vanguard Group of Investment Companies. She is Southern Capital's Cheif Compliance Officer and Co-Investment Management Officer.