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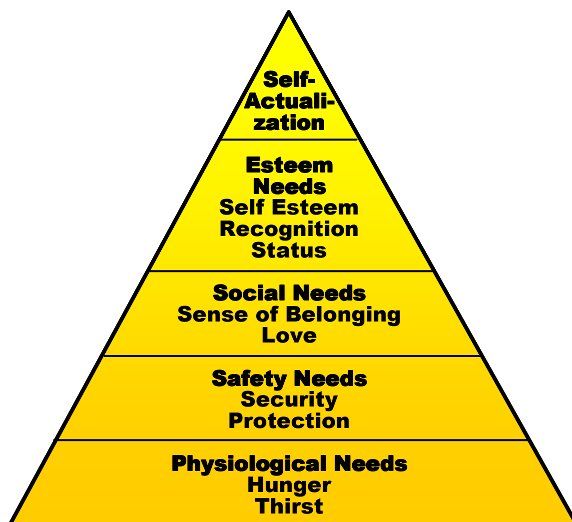
MASLOW'S FINANCIAL FUNDAMENTAL

The essential need in the hierarchy of planning your finances

Financially, what's most important?

Is it… A lot of money?
A comfortable retirement?
A bigger house?
A good credit score?

Abraham Maslow was an American psychologist known for developing a model to explain the driving forces in human behavior. Presented in his 1943 paper, *A Theory of Human Motivation*, Maslow's **Hierarchy of Needs** stated that normal, healthy people act to satisfy their needs and desires in accordance with a general protocol. This protocol is often represented in pyramid form, with the "basic" needs at the bottom, and less-essential, but more fulfilling desires at the top. In very abbreviated form, this is Maslow's pyramid:



Physiological needs are primarily biological, such as needs for oxygen, food, water, shelter and warmth. Because these needs are essential to staying alive, they are considered the strongest, and always take priority over other needs. When all physiological needs are satisfied, one's focus turns to the need for **safety** – personal security of body, property, employment, family.

Safety includes a desire for morality and stable social order. Next comes **needs of love, affection and belongingness** as a way to overcome feelings of loneliness and alienation. The fourth level is the **need for esteem.** Humans want a stable, firmly based, high level of self-respect, and respect from others.

The apex of Maslow's hierarchy is the **need for self-actualization.** When all of the previous levels of need are satisfied, then a person can begin to self-actualize, which Maslow describes as the need to be and do that which the person was "born to do."

It's important to note that Maslow's Hierarchy of Needs is theory, not fact, and not everyone agrees with his assumptions about human motivation and behavior. But for the sake of discussion, if Maslow were a "financial professional" – a broker, a CFP or CPA, an insurance representative – what would come first in his financial hierarchy of needs?

Here's a guess: **INCOME.**

Before any other financial consideration can occur, there has to be income. If there's no income, there's no ability to plan from a financial perspective. In order to meet higher-level financial objectives, the need for income must be addressed first. People with insufficient incomes can't plan for the future because they don't have enough income for the present, and they won't be able to retire because they don't have enough income-replacing assets available. As the most basic financial level, all planning starts with income.

INCOME PLANNING: A Three-Step Approach

Step One:
Income Generation

How do you generate an income? For most, the answer is by working. Some may inherit assets, but the

great majority addresses their income needs by working.

In this context, income planning starts with a vocational decision – "What do I want to be when I grow up?" For some, the decision may simply be a matter of pursuing one's interest – doing what you love. But from an income perspective, some careers pay more than others. That fact prompts additional questions that must be answered, such as "How much will I make with a college degree and how much will I make without one?" The reality is that financial and material aspirations may be at odds with vocational interests – doing what you love may not generate the income necessary to satisfy your financial wants and needs.

This doesn't mean that all career decisions should be based solely on the compensation package. In fact, the opposite is often true, since many people have developed significant incomes by pursuing their passions. And this is not an article about career counseling. **But the decision of how (or where) to develop an income is one that greatly impacts all future financial circumstances.** The financial return from your income, both currently and in the future, should be evaluated like any other investment.

Along these lines, the *Wall Street Journal's* Jonathan Clements recommends evaluating your paycheck as a bond ("Why Your Paycheck Is Really a Bond," July 11, 2007.). In exchange for a personal capital investment of yourself (which may include special training, degrees, etc.) your work delivers an annual interest payment (income). What is the quality of your income? Is it steady, reliable, with long-term growth potential? Is it irregular, but historically trending upward?

Step Two: Income Protection

Similar to Maslow's hierarchy, once the basic need to develop an income is satisfied, concern then logically moves to issues of safety. Since the ability to earn an income from your human capital is the asset that makes all other financial items possible, prudence dictates that such a prized asset should be protected or insured.

Two or three centuries ago, most wealth was held in property, usually agricultural property. Human capital was still required to bring income from the land, but the skill level wasn't very high. Since even children could serve as very capable farm hands, the disability or death of the main income producer didn't necessarily mean an end to the income, because other members could adjust to pick up the slack. The important financial issue was to protect and perpetuate the ownership of the property.

This is not the case in the Information Age economy. Especially at the beginning of your working life, the ability to earn an income is often your only asset, and usually not transferable to others. (It is unlikely that a teenaged child could step in and replace their parents as a business manager, accountant, electrician, etc. and "inherit" their parent's income potential.) A premature death or untimely disability could seriously disrupt the development of an income plan – and all the other financial plans that were dependent on the income.

According to M.P. McQueen, (Weigh the Risk of Disability, *Wall Street Journal*, March 11, 2007), "(p)eople tend to underestimate the risk of becoming disabled. Almost three in 10 of today's 20-year-olds will become disabled before age 67, according to the Social Security Administration." These disabilities will not necessarily be permanent, but any significant period of time without an income can severely handicap your long-term financial health.

If you are serious about income planning, you must also seriously consider the steps you must take to protect and insure your income.

Step Three: Income Augmentation/Replacement

The simplest way to maintain a constant income is to work your entire life. Until the last century, this was the general formula: work until you can't work, then die. Very few individuals had pensions or retirement plans to provide income after their working income diminished or disappeared.

Currently, demographic and economic factors make it less likely that the ongoing need for income can realistically be solved by planning to work all of one's life. People live longer, but find their physical capacities diminish to the point where they no longer are able to work – at which time they are replaced by younger, less expensive and/or more skilled workers. This means income for the rest of one's life must come from sources other than work.

Replacing wage-income with asset-income is a big challenge. "Today, 43% of the working population is at risk of not having a sufficient income to maintain their pre-retirement standard of living." says Mauricio Soto, research economist at Center for Retirement Research at Boston College, in a June 11, 2007 *National Underwriter* article. The struggle to replace wage income explains why Social Security remains a political hot potato. Even though there is some speculation that the program could go bankrupt; a monthly government check is many Americans' only long-term income asset. Fewer employers provide pensions, so individuals are left to build their own income replacement plan. Not surprisingly, individual annuity sales have increased, as many trade the opportunity for higher return in favor of the security of a regular income.

Besides not having enough assets for replacement income, there's also the problem of not having the right

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type of assets. High net worth doesn't always mean high asset income. For example, someone with large real estate holdings might have a high net worth because of equity, and an income *deficiency* simply because the carrying costs (mortgages, taxes, utilities, etc.) are high. These individuals may have assets, but they don't have much income.

Assessing Your Income Plan

Most people have financial objectives greater than providing an income. They want dream houses, special trips, college funds for their children, donations for their favorite charity. Everyone has a different vision of what it would mean to be "self-actualized" financially.

But revisiting Maslow's theories, it's hard to self-actualize when basic needs are not being met. That's why your income plan needs to be reviewed on a regular basis, especially in regard to assessing how much income could be produced by today's assets. Calculations like net worth, debt ratios, and retirement account projections can be relevant measures of your financial condition. But the bottom-line financial issue is:

What is your income?

- **If this is your chosen career…*What is your income?***
- **If you lose your job…*What is your income?***
- **If you keep on saving the same way…*What is your income?***
- **If you are disabled…*What is your income?***
- **If a spouse dies…*What is your income?***

NEED START-UP FINANCING?

CHECK WITH YOUR DELIVERY SERVICE

Delivery & Lending Services

A proven strategy for expanding business and acquiring new customers is to lend to them, especially to enable customers to buy more of your product or service. In fact, lending to customers can be a profit center even if business is bad. It's almost like the product or service can be a loss leader because the company makes so much profit on the financing (while the American automotive industry flounders, finance subsidiaries like Ford Motor Credit and GMAC have continued to be profitable).

One unique area where this financing approach is being applied is in the delivery service business. Both United Parcel Service (UPS) and Federal Express have **lending divisions**. According to a report in the June, 2007 issue of *Fortune Small Business*, UPS's Capital division made more than $190 million in SBA-backed loans in 2006. In 2004, FedEx, in partnership with the U.S. Commercial Service (a unit of the Department of Commerce that promotes U.S. businesses abroad) funded programs to teach small businesses how to export their products.

Another delivery company even offers grants. DHL, in partnership with AEO, the Association for Enterprise Opportunity, provides $1,000 grants for low to moderate income entrepreneurs, along with free or discounted shipping service for a period of time. Starting in 2005 with three grantee organizations selecting 30 entrepreneurs, the program was a huge success. In 2006, the numbers were doubled. For DHL, the program generates word-of-mouth-advertising and customer loyalty.

GOING DIGITAL: AN INTERNET VAULT

"Did you know your video camera can be worth thousands of dollars? And you don't have to make any embarrassing videos or use YouTube to do it. All you have to do is make a video of all your possessions and store the video away from your home." *Wisdom's Edge,* July 14, 2007.

A simple idea that makes sense, right? Most homeowner's policies state you must provide proof of ownership and the original condition prior to loss to fulfill your claim. So if you haven't done a visual inventory already, you probably should.

But before you start snapping Polaroids or using the VHS recorder, look at the last phrase – "store the video away from your home."

Obviously, the reason you store the video away from your home is because you don't want your documentation of what was in the house to be destroyed if the house burns down. But where is a good place "away from your home?"

How about storing your information online?

If you can digitize your information, there are many "storage" services available online whose primary purpose is help you be properly prepared in the event of a disaster by being able to locate your important pictures and documents within moments.

For a reasonable fee, these online services provide large storage capacity (maybe even unlimited), and the ability to "stamp" documents, photos and videos with additional descriptive information. Better yet, some financial institutions offer similar services on a complimentary basis for their customers.

In cyberspace, there are no fires, floods, or other natural disasters to destroy your back-up info. And while it's possible to "lose" a file online because you can't remember what you called it, finding a lost file online is a lot easier than finding a misplaced file at home, your office, your parent's or wherever else you might have left it for safekeeping.

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THE IMPORTANCE OF EARLY INCOME PLANNING *(show this to your kids!)*

The sooner you generate an income that is greater than your living expenses, the sooner you can begin saving. And when it comes to accumulating assets to eventually replace your working income, nothing helps as much as getting an early start. Here's a classic Person A-Person B illustration that presents this truth in eye-popping fashion:

The Details: Person A starts saving $2,000 a year at age 21, putting the deposits in an accumulation account that earns 8% annually. He does this for 10 years, then stops making deposits. At age 65, with only 10 years of funding, the account has grown to $462,000.

Meanwhile, it takes Person B awhile to get started. Perhaps he doesn't settle into a career right away, and just doesn't earn enough income to be able to save some of it. Deposits to Person B's account don't begin until age 31, 10 years after Person A started. But in an attempt to make up for the late start, Person B makes $2,000 annual deposits for the next 35 years. Earning the same 8% annually, Person B's account balance is at age 65 is $372,000 - $90,000 less than Person A! Check out the math below.

A few comments: Part of the impact of this illustration comes from the rate of return on deposits. If the annual rate of return was 10%, the difference is even greater in Person A's favor. If the rate of return was only 5% annually, Person B would be ahead at age 65 – primarily because he/she made so many more deposits. For the 45-year period illustrated, the break-even annual rate of return is approx. 6.6 %.

This illustration is primarily about *time*.

The sooner you take positive financial action, the better.

19-year-olds who begin saving now have an advantage the rest of their lives.

		PERSON A 8% ARR			PERSON B 8% ARR		
Year	Age	Amount Deposited	Annual Earnings	Account Balance	Amount Deposited	Annual Earnings	Account Balance
1	21	**$2,000**	$160	$2,160	$0		
2	22	**2,000**	333	4,493	0		
3	23	**2,000**	519	7,012	0		
4	24	**2,000**	721	9,733	0		
5	25	**2,000**	939	12,672	0		
6	26	**2,000**	1,174	15,846	0		
7	27	**2,000**	1,428	19,273	0		
8	28	**2,000**	1,702	22,975	0		
9	29	**2,000**	1,998	26,973	0		
10	30	**2,000**	2,318	31,291	0		
11	31	0	2,503	33,794	**$2,000**	$160	$2,160
12	32	0	2,704	36,498	**2,000**	333	4,493
13	33	0	2,920	39,418	**2,000**	519	7,012
14	34	0	3,153	42,571	**2,000**	721	9,733
15	35	0	3,406	45,977	**2,000**	939	12,672
16	36	0	3,678	49,655	**2,000**	1,174	15,846
17	37	0	3,972	53,627	**2,000**	1,428	19,273
18	38	0	4,290	57,917	**2,000**	1,702	22,975
19	39	0	4,633	62,551	**2,000**	1,998	26,973
20	40	0	5,004	67,555	**2,000**	2,318	31,291
21	41	0	5,404	72,959	**2,000**	2,663	35,954
22	42	0	5,837	78,796	**2,000**	3,036	40,991
23	43	0	6,304	85,100	**2,000**	3,439	46,430
24	44	0	6,808	91,908	**2,000**	3,874	52,304
25	45	0	7,353	99,260	**2,000**	4,344	58,649
26	46	0	7,941	107,201	**2,000**	4,852	65,500
27	47	0	8,576	115,777	**2,000**	5,400	72,900
28	48	0	9,262	125,039	**2,000**	5,992	80,893
29	49	0	10,003	135,042	**2,000**	6,631	89,524
30	50	0	10,803	145,846	**2,000**	7,322	98,846
31	51	0	11,668	157,514	**2,000**	8,068	108,914
32	52	0	12,601	170,115	**2,000**	8,873	119,787
33	53	0	13,609	183,724	**2,000**	9,743	131,530
34	54	0	14,698	198,422	**2,000**	10,682	144,212
35	55	0	15,874	214,295	**2,000**	11,697	157,909
36	56	0	17,144	231,439	**2,000**	12,793	172,702
37	57	0	18,515	249,954	**2,000**	13,976	188,678
38	58	0	19,996	269,951	**2,000**	15,254	205,932
39	59	0	21,596	291,547	**2,000**	16,635	224,566
40	60	0	23,324	314,870	**2,000**	18,125	244,692
41	61	0	25,190	340,060	**2,000**	19,735	266,427
42	62	0	27,205	367,265	**2,000**	21,474	289,901
43	63	0	29,381	396,646	**2,000**	23,352	315,253
44	64	0	31,732	428,378	2,000	25,380	342,634
45	65	0	34,270	**462,648**	2,000	28,571	**372,204**

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OUTSIDE-THE-BOX IDEA:

Buying the Retirement Home… Now?

The concept of delayed gratification is deeply ingrained in the financial planning culture. Delayed gratification proposes that a stable, secure, financial future can be attained only if you are willing to abstain from spending everything you earn today, and set something aside for use/enjoyment at a later date. This concept is the underlying rationale for all sorts of retirement plans (including the Person A - Person B example in this issue).

Rational adults understand the practicality of delayed gratification. But even in rational adults, there's always a little voice that says,

"Yeah, but what if I don't live long enough to enjoy my delayed gratification?"

It's a valid point. The money you have is only worth something when it's spent. If you never use it, the delayed-gratification accumulation is just a number in an account. There's always a tension between spending now, or holding off for the future. That tension is reflected in the lead paragraphs from a May 29, 2007 *Wall Street Journal* article by Jeff Opdyke:

> *From New York's Catskill Mountains to Oregon's rocky coast, younger couples who might otherwise be focused on building a nest egg instead are buying a lakefront house or country cabin that they hope to one day use in retirement.*
>
> *For these younger buyers, this isn't an extension of the real-estate investment bug that bit a few years ago and is now fading as home prices flag in many markets. And they're not throwing financial caution to the wind just because they want a second home.*
>
> *Instead, they're crunching the numbers and making hard decisions about their personal finances. In some cases, they're receiving an inheritance or a stock grant and are choosing to invest in their future real-estate needs rather than the stock market. In other cases, they're altering their expecta-tions about how long they'll work and the kind of returns they'll earn on their nest egg in order to pursue an emotional investment.*

One of the examples in the article involved a couple who liquidated 20% of their retirement savings to buy a cottage in the Catskill Mountains. Daniel Merkle acknowledged that "It was clear the money was better off in the index funds we owned. But there are factors you can't see on a spreadsheet…" Merkle concluded:

"We realized you never know what is going to happen in 20 years, and it's better to enjoy it now."

There are several interesting details in the Merkle's story. First, while it's possible the index funds will deliver a higher rate of return, it's reasonable to assume the vacation home will also appreciate in value, so it's not as if the money is "gone;" it's just invested in an asset that allows some of the value to be enjoyed now. Second, Opdyke notes that none of the funds used for the purchase came from tax-deferred retirement accounts, like an IRA or 401(k). **If you think you might be one of those people who doesn't want to delay all your gratification until age 59½ or later, it makes sense to consider other accumulation vehicles.**

Using 72(t) to make an "asset transfer"

For those who have most of their savings in tax-deferred retirement accounts, but are intrigued by the idea of buying a retirement home now, there may be a tax-effective way to execute the transaction. Internal Revenue Code IRC Section 72(t) allows individuals to access their IRA accounts penalty-free ***at any time*** if the withdrawals are taken as "a series of substantially equal periodic payments over the life of the participant."

This means you can begin drawing a regular stream of "retirement income" from your IRA at any age. While the income received is taxable, no additional penalty tax is applied. In order to be considered "substantially equal periodic payments," the distributions must meet the following criteria:

- Withdrawals must be on a regular basis, most often monthly, and at least annually.
- Withdrawals must conform to one of three IRS-approved calculation methods.
- Withdrawals must continue for at least five years or until you reach 59½, whichever is longer.

Depending on the size of your IRA and the cost of the property, these monthly distributions could be used to make the mortgage payment on the vacation home. For many individuals, the additional IRA income may largely be offset by the tax deduction for the additional mortgage interest paid, especially in the early years of the

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mortgage. The end tax result: more taxable income to report, but also more tax deductions.

By spending some of the IRA now, you lose the growth that could have occurred if the money had stayed in the account. But in this example, the IRA distributions are being used to build equity in the new home. Overall, your net worth is still growing, only the growth is in home equity instead of the IRA. And instead of delaying gratification, there's some immediate enjoyment.

Note: Not all tax-deferred retirement plans allow for 72(t)-type distributions. Additionally, the calculations required to be sure this "early retirement income" conforms to the law are complex. Do not attempt a distribution of this type without seeking some expert assistance.

ARE YOU LISTENING TO YOUR ADVISORS?

Because everyone's situation is unique, there may be times when a particular recommendation from one of your financial professionals seems against the norm. When it seems like all your peers are taking on *this* mortgage, and buying *this* mutual fund, and using *this* retirement account, it's normal to wonder why someone is proposing a different approach for you.

Acting apart from the herd can be psychologically uncomfortable, even if the ideas make sense. Looking for reassurance, some people naturally say, "Maybe I better get a second opinion before I commit." Often that second opinion comes from generic sources found in mass media. You read something in a magazine or do a search on the Internet. What will you most likely find? Probably a reason not to act. Why? Read this perspective from Jack Bobo, a veteran financial professional:

"I tried to think of people I know who have benefited from financial advice found in newspapers and magazines. In all my years in our business, I cannot recall a single person who has said, 'I followed the advice of Jane Bryant Quinn.' (I use Quinn symbolically, as a typical example of financial advisors in the media.)

Perhaps you have met such people, but I never have. On the other hand, I have encountered many who use Quinn's words of caution as an excuse for postponing or rejecting a solid proposal to provide security where none existed."

Generic financial commentary might be helpful in gaining greater awareness, but can become a rationalization for not acting at all. If a trusted financial professional provides solid, informed recommendations on your specific situation, does it make sense to ignore them, just because it might not be what "most people" are doing right now?

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