WHITE PAPER

Sudden Wealth:
Avoiding the Twelve Deadly Mistakes

TGS
FINANCIAL ADVISORS
A Registered Investment Advisor

“The wealthy are different than you and I.”

F. Scott Fitzgerald to Ernest Hemingway

“Yes, Frank. They have more money.”

Ernest Hemingway to F. Scott Fitzgerald

WHO ARE THE SUDDENLY WEALTHY?

We are a wealthy country. As many researchers have documented, wealth in the United States is extraordinarily dynamic. The old wealth of chemicals, steel, and banking is replaced by new wealth from software, communications, and technology.

In the next twenty years, over $15 trillion of wealth will pass through inheritance from the Greatest Generation (those who endured the Depression, and fought the Second World War) to the Baby Boomers.

Incentive compensation in the form of stock options is a key factor in recruiting, retaining, and motivating corporate employees, from top executives to brilliant young engineers. When leading corporations are successful, these individuals may find their wealth grow into six or seven figures literally overnight, as their option grants vest or their companies go public.

The defined-contribution revolution in retirement savings has created trillions of dollars in 401(k) and 403(b) savings. Upon retirement, many are finding themselves with the option of rolling over lump-sum distributions that can range into the millions. As the baby boomers begin to retire, rollover accounts (based on lump-sum distributions from retirement savings plans) are actually growing quicker than 401(k) plans.

To these secular phenomena can be added lottery winners, newly qualified thoracic surgeons, NBA rookies, life insurance beneficiaries, successful entrepreneurs, and literally millions of other Americans, all confronted with the problems, challenges, and opportunities of sudden wealth.

COPING WITH SUDDEN WEALTH

New wealth can be of great benefit, enhancing confidence, improving financial security, facilitating more meaningful career choices, helping to build strong families and communities. Unfortunately, these positive outcomes are not the long-term experience of most recipients of sudden wealth.

What happens to sudden wealth? The simple and unfortunate answer is, it usually goes away. Experts in the management of sudden wealth observe that the typical sudden fortune is entirely dissipated in three to five years. Pension consultants report that the recipient of a lump-sum distribution has spent every penny, on average, within seven years.

During the 1990s, there was an explosion of new wealth, as the stock market soared. New wealth drove consumption in many areas, most conspicuously in new home construction. But as wealth increased, debt increased faster, and the savings rate of the wealthy plunged. For the first time in fifty years, mortgage debt exceeded bank deposits and money-market fund balances. Bankruptcies almost doubled. The proportion of wealthy Americans (the top 10% of income earners) with monthly debt payments equal to more than 40% of income increased by almost 50%, with the overall percentage of the "wealthy" carrying such dangerous debt levels equal to the percentage among the poorest 25% of the population. A larger proportion of new bankruptcies occur among the affluent than ever before.

If you are facing a sudden and significant increase in your wealth (through winning the lottery, or having my stock options vest, or receiving an inheritance, or as the beneficiary of a life insurance policy, or retiring with a lump-sum distribution), how can you avoid the mistakes that could dissipate your new wealth?

In this paper, we will outline twelve mistakes that the newly wealthy often make, then outline our suggested strategies for avoiding them and assuring that your new wealth will be a benefit for the rest of your life.

"Experience is the name everyone gives for their mistakes."

Oscar Wilde

THE TWELVE DEADLY MISTAKES OF SUDDEN WEALTH

Mistake #1:
Making impulsive decisions

Sudden wealth is often overwhelming. The money typically arrives without the habits needed to protect it and manage it. Everyone you know (including those with absolutely no wealth of their own) is full of advice about what to buy, how to invest, how to act like a rich person, or which charity to support. Business and investment opportunities are offered. Loans or gifts are requested, or demanded. The entire experience can be terribly stressful, confusing, and difficult. It can also be exhilarating, sort of like a big party, until the money begins to run out and regrets set in.

Strategy #1:
Call a time out

Establish a "decision-free zone" for a specific time period, during which you will consider your options, seek advice, and evaluate your emotional reactions to your new wealth. During this period, follow these rules: Keep your job. Keep your existing home. Keep in touch with your friends and relatives. Make no promises. Make no loans or gifts – to anyone. Make no investments until you have a written financial or investment plan.

Mistake #2:
Confusing wealth with status

As best-selling author Thomas Stanley, author of The Millionaire Next Door, has observed, most self-made millionaires have modest lifestyles and spend little. By contrast, most new wealth recipients spend above their means, believing that the material trappings of conspicuous consumption demonstrate their "wealth" and success. In a sense, many Americans are victims of Lifestyles of the Rich & Famous, Dallas, and a thousand other powerful images from television and the movies, all equating wealth with material possessions, expenditures, and a lifestyle of conspicuous consumption. To keep our new wealth, we need to differentiate between wealth and status. Wealth is a lifelong condition of abundance, characterized by a sustainable balance between expenditure and the income produced by capital. Status is the often transient display of material possessions -- the big house, new car, European vacations, and designer clothes. The two values are always in tension. The choice of a higher-status lifestyle can compromise the real financial security of stable and sustainable wealth.

Strategy #2:
If you want to stay rich as long as you live, choose wealth over status

Clarify your values and priorities. Make explicit and deliberate choices between competing priorities: Is it more important to live in a larger home, or retire at a younger age? To drive a newer and more luxurious car, or quit an unrewarding job? To fund your childrens' education in full, or take them on a costly vacation? Your choices should reflect your values.

Mistake #3:
Buying a big, beautiful, expensive house

Comment: Nothing is associated more strongly with wealth and success than a large and lovely home, and nothing is more potentially dangerous to our long-term financial security than buying too much house. (What constitutes "too much house" will obviously vary significantly from one person to another.) This common mistake is a variation of the prior mistake, confusing wealth with status. An expensive home not only consumes a great deal of capital for the initial purchase, it also drives a host of other higher costs, from upkeep to furniture to expensive cars to costly private schools. The old concept of "Keeping Up with the Joneses" is not a joke. One of our clients, a very bright guy with significant stock option wealth, works for a prominent tech company. Within a year after his options vested, he bought a very expensive new house, somewhat against our advice. About six months after moving into his new home, he commented that everything had cost much more than he expected, and that the overall effect on his finances was significantly more negative than he expected. His conclusion: "Never bet against the house."

Strategy #3:
Wait for at least one year before buying a new house

Think of a house as an expense, not an asset, and only buy a house with funds that you have already liquidated, and on which you have already paid all taxes due.

Mistake #4:
Spending nothing

Comment: Some individuals fall into the opposite trap. They spend nothing, feeling obliged to preserve every penny of a windfall. In some cases, they may even pay the taxes on their new capital with the earnings from their job, witness their lifestyle eroding, and come to bitterly resent the new wealth that they find only a burden, and not a resource.

Strategy #4:
Establish an amount you will allow yourself to spend without guilt, and spend it

A figure of 5% of after-tax new wealth is a good place to start. Always require your wealth to "pay its own way" – the taxes on your capital should be borne by your capital (and minimized whenever possible).

Mistake #5:
Failing to create a long-term plan

Comment: It is easy to enjoy all of the benefits of new wealth (a bigger home, newer cars, terrific vacations), and fail to establish a long-term plan to sustain your new lifestyle for as long as you live.

Strategy #5:
Work with an advisor who has experience with the issues of sudden wealth, and establish a written financial plan

At a minimum, the plan should address cash flow needs, investment strategy, education funding, and retirement planning. A crucial component of the plan should be cash flow projections that address the question, "In the worst case for the economy and the markets, how much can I spend each year, and remain totally confident that I will never run out of money?"

Mistake #6:
Keeping all your eggs in one basket

Often, significant wealth comes from ownership of one great company's stock, usually the company you work for. It is tempting to continue to "dance with them that brung you" -- to stay entirely invested in a single company's stock, anticipating that recent superior performance will continue indefinitely. It is also tempting to think that owning multiple investments in your own industry is real diversification. It is not. Don't be seduced by the idea that you should have all your money in "investments you understand", and remember that if you don't own some things you don't like, you probably aren't sufficiently diversified. Advisors or investors will sometimes comment, "I prefer to keep all my eggs in one basket, and to watch that basket very, very closely." Well and good. If all your eggs were in (for example) tech incubator Safeguard Scientific, at what point did you recognize that the stock was heading for zero, and sell enough shares to secure your future? No one understood technology better than Safeguard Scientific's Pete Musser, but he still lost a billion dollars by having all of his money in one high-tech basket, which he watched declining day by day, until a forced margin call took away most of his shares. Enron employees saw their 401(k) values soar – until the company's collapse reduced the stock price by more than 99%, and halved the value of their 401(k) plans. Everyone knows about Dellionaires or Microsoft millionaires, but nobody remembers the Pets.com millionaires (because most of them aren't, anymore).

Strategies #6:
Diversify

Especially, diversify away from your core holdings, and your industry. For example, if most of your wealth is in shares or options of your tech company, your diversification strategy should be away from technology. Don't own just technology, or pharmaceuticals, or finance, especially if you are employed in that industry.

Working with an experienced financial advisor, create a diversified, professionally-managed core portfolio sufficient to provide some threshold level of financial security – for example, an amount of capital sufficient to generate enough after-tax income to allow you to walk away (to never work again unless you choose to, doing work you love and at which you excel). Once this core financial security is assured, you may confidently take higher risks with a concentrated, self-managed portfolio with your surplus (non-core) dollars.

Mistake #7:
Confusing capital with income

Comment: Without wealth, many individuals tend to adjust their spending to their income, or to the combination of income and available credit. When the checking account is empty, that is an indication that it is time to stop spending. When a large pool of capital suddenly appears, these habits do not change. Without the "no more money in the checking account" signal, it is hard to keep a rein on spending. To someone with an annual income of $50,000, a million dollars of capital seems an amount so large as to be incapable of being spent. Our experience is that very large amounts of money can be spent shockingly quickly. Once a process of spending principal starts, it inevitably tends to accelerate.

To make wealth last for a lifetime, new habits must be adopted, and effective strategies put in place. It is crucial for the newly wealthy to understand the difference between income and capital, and the very large amount of capital it takes to reliably and permanently produce even a modest lifetime income. It is very difficult to accumulate capital, and very easy to dissipate it.

What is a realistic long-term level of withdrawals from a portfolio? Depending on how it is invested, one million dollars of assets might not generate $50,000 of annual income without gradually being consumed. Legendary stock investor Peter Lynch suggests that you can probably spend 5% of an all-stock portfolio each year, and never run out of money. Money manager Charles Ellis suggests the prudent number is much lower – no more than 1% above the dividend yield of the stock market (about 1.5% in late 2001).

Strategy #7:
Set realistic spending limits

Do retirement cash flow planning, using conservative (translation: pessimistic) assumptions about long-term investment returns. Remember, you must plan to increase your income each year to keep pace with inflation. Structure your investment accounts to help create spending discipline. For example, only set up checking and credit card access to one account, and transfer a specific amount of cash flow into that account each month. Don't quit your job, until you are certain your wealth will support you, in the style to which you are or wish to become accustomed, for as long as you live.

Mistake #8:
Counting pre-tax, not after-tax wealth

Comment: This is especially important for anyone whose wealth is in an asset that is subject to tax before the money can be spent. Some examples: employees of companies with stock option wealth, either incentive stock options (ISOs) or non-qualified stock options (NQSOs); retirees with lump-sum distributions; or beneficiaries of an inheritance where a large part of the assets are in retirement plans or tax-deferred insurance annuities.

Strategy #8:
Understand the tax implications of your asset picture, and the pre-tax amount of assets needed to realize a specific sum of after-tax capital that can be spent, given the tax costs of liquidation

For incentive stock option (ISO) holders, understand the two different clocks that must expire before you get favorable long-term capital gains treatment. Avoid disqualifying distributions. For non-qualified stock option (NQSO) holders, recognize that there is no attractive way to avoid paying tax on exercise at ordinary income rates. Exercise your stock options for only three reasons: Consumption, diversification, or change in your employment circumstances. In any case, only count your after-tax wealth. For example, an individual with non-qualified stock options on 10,000 shares of XYZ common stock, vested today, with a strike price of $5 per share and the stock trading at $105, has an apparent net worth of $1 million. (This is a hypothetical illustration only, not intended to reflect the actual performance of any particular security.) In reality, since the in-the-money portion of the NQSO's value is immediately taxable upon exercise, even if the resulting stock is not sold, a tax bill of up to $396,000 would be due upon sale. In other words, the apparent $1 million wealth figure is really only about $600,000. (This tax figure assumes the maximum Federal income tax rate, but no state income tax. In a high-tax state like California, the tax bill could be as high as almost 50% of the total profit.) Never exercise a non-qualified stock option without immediately selling the underlying shares. Keep in mind that up-front taxes (for example, the taxes due on exercise of stock options) are only part of the full tax picture, and prudent tax management strategies will need to be part of your investment program for as long as you live.

Mistake #9:
Giving away too much, too soon

A loan to a family member, friend, or associate should usually be treated as a gift, because you are unlikely to ever get the money back. Generosity to churches, charities, or political parties should be tempered by an enlightened sense of self-interest, and an understanding of your own economic needs, both now and for the rest of your life.

From a portfolio perspective, gifts to family members or charities are simply expenditures.

Strategy #9:
Do not make loans, period

You are not a bank. Defer making decisions about gifts, whether to family members, friends, or charity, until your written long-term plans for spending and investing, and your mechanisms for keeping track of your progress, are in place.

Mistake #10:
Unrealistic return expectations

During the great bull market of the 1980s and 1990s, returns of 15% to 20% per year were common. A study of investor expectations in mid-1999 found the median return expectation of under-40 investors was 27% per year -- a wholly unrealistic number.

In the wake of the tech meltdown, many wealthy investors have lost faith in the stock market, and are searching desperately for new investment opportunities, where they can continue to earn the double-digit returns they need to sustain their costly lifestyles. Today, the wealthy are turning in increasing numbers to hedge funds, venture capital, and private equity transactions, all of which claim to offer superior investment returns, as well as the cachet of limiting access to wealthy, sophisticated, and well-connected investors. Observers from Vanguard founder John Bogle to Forbes magazine have recently warned about the perils of "alternative investments", especially hedge funds.

In the late 1970s and early 1980s, an earlier generation of greedy rich folks fled the stock and bond markets after a decade of disappointing returns, placing their money in real estate partnerships, oil and gas drilling programs, commodities futures funds, and tax shelters. Like hedge funds and private equity, these investments advertised high profit potential and structural advantages over publicly-traded securities. Like hedge funds, these investments were risky, non-liquid, poorly regulated, and had very high cost structures. Many investors in the "alternative investments" of the early 1980s saw those "investments" decline to zero. Richard Marston, a professor of finance at the University of Pennsylvania's Wharton School, and a leading consultant on investment strategy to pension funds and other institutions, recently observed, "In America, one of our most cherished values is upward mobility. Unfortunately, in order to get upward mobility, you also need to have downward mobility – rich people have to get poorer. How do rich people get poor? Alternative investments."

Strategy #10: Keep your expectations realistic. Beware of over-optimistic projections, especially the temptation to extrapolate long-term returns from recent favorable trends. Know the long-term historical returns on each asset class, and be very skeptical about claims that your returns will be higher. Recognize the principle of reversion to the mean, and the possibility that a period of unusually high returns (the 1980s and 1990s) might be followed by a period of unusually low returns. Never invest more than 10% of your total investment portfolio in alternative (exotic, non-liquid) investments, and invest nothing in such vehicles unless your total net worth is more than $5 million.

Mistake #11:
Not keeping score

Comment: "I can't be out of money. I still have checks left." Spending money is easy. Protecting, accumulating, and growing capital is hard. The three classic ways to squander a lump sum are through excessive spending, poor investments, or misplaced generosity. One of the best protections against exhausting your capital is reviewing your financial progress at scheduled intervals. If you realize your portfolio is declining in value, or is not keeping pace with inflation, or that your investments are under-performing the market, you have time to correct the problem – for example, to reduce spending or improve investment performance.

Strategy #11:
Complete a written review of your investment portfolio each year

Track your investment net worth in nominal terms, and against inflation. Know the absolute and relative performance of each investment in your portfolio. Only count investments. Do not include the value of your home(s), your cars, your art collection, your wine cellar, or any other non-investment asset in this calculation. All of these items are drains on your financial security, not contributors to it.

Mistake #12:
Failing to get good advice, or refusing to pay for it

It is easy to believe that having more money makes you smarter -- for example, to assume you are smarter than your parents, from whom you just inherited a modest fortune, just because you are younger, better educated, and watch more CNBC. Expertise in one field may be justly and generously rewarded – for example, by stock options in a fast-growing technology company. But the stock option wealth received as compensation for technical expertise does not imply a similar expertise in a vastly different field – investment management. As Carl Russo, CEO of Cerent Corporation (formerly Fiberlane and now a key part of Cisco Systems), said in October of 1999, "In the tech sector, smart is a given. The question is, how well are your smart people led, and how well do they execute?" There are thousands of very smart tech workers who were briefly rich, and who might have stayed rich had they respected the intelligence, experience, and expertise of the community of professional financial advisors. Unfortunately, most of them tried to run their own online portfolios, in many cases losing everything in a variety of tech stock disasters. Recognize that ability in one area (for example, computer software programming) does not imply expertise in another area (investment management). A corollary of thinking more money makes you smarter is thinking you do not need the smarts of other people. In his book The Millionaire Next Door, Thomas Stanley notes that a key characteristic of the self-made millionaire is a commitment to getting the very best legal, tax, and investment advice available, and a willingness to pay for it.

Strategy #12:
Hire smart advisers

To quote Ben Franklin: Rent experience, don't buy it. Do not learn by making costly mistakes yourself, with your own money, obtain guidance from experts who have seen those mistakes

"There are two ways to obtain experience. You can buy it, or you can rent it."

Benjamin Franklin

before, and can help you to avoid them. Educate yourself. Your advisor should be willing to be a teacher, as well as a strategist.

The key strategy: Hiring a competent and trusted advisor

As wise old Ben pointed out years ago, it is better to "rent" experience by hiring an experienced advisor and taking advantage of his accumulated experience, in particular the wisdom that comes from making costly mistakes, than to "buy" experience by making costly or disastrous financial mistakes yourself.

One can acquire technical knowledge from a variety of sources, but there is absolutely no substitute for experience, in particular for the experience of working with clients and managing money during both good and bad markets. A good advisor can put his experience, expertise, and training in the service of your long-term financial security.

Money can facilitate many positive and exciting life options, but few of us (even those of us with millions in stock option wealth, or large inheritances) will have enough money to do everything we might conceivably want to do. Make sure you understand what is most important in your life, and place your capital in service of your core values.

A good advisor can help you to clarify those values, and make powerful choices in support of your unique life plans. TGS Financial Advisors offers several planning tools designed specifically to help individuals with large new infusions of wealth, whether from stock options, newly-public stock, inheritance, retirement, insurance settlement, or other sudden event.

- We prepare a written L*ifetime Wealth Plan*™ or *Investment Analysis & Review*™ for each new client. These helps translate values and goals into actions.
- We measure your progress with a written *Annual Progress Report*™ each year.

It is our goal to become your long-term partner, a trusted counselor in every financial decision you make.

TGS Financial Advisors is a fee-only, discretionary wealth management practice located in Radnor, PA. The managing directors of TGS Financial Advisors, James S. Hemphill, David A. Burd and Marvin L. Barron III, have each been active in managing client portfolios for over 32 years. James Hemphill and David Burd co-founded TGS Financial Advisors, a Registered Investment Adviser, in 1990. At last count, they had each seen five bear markets (1982, 1987, 1990, 2000 and 2009). All securities are held by, and all securities transactions effected through, Raymond James Financial Services Inc., a registered broker-dealer (Member FINRA/SIPC), which is a subsidiary of Raymond James Financial (NYSE: RJF). If you or a friend, relative or colleague would like more information about TGS Financial Advisors please e-mail us at questions@tgsfinancial.com or call us at (610) 892-9900 or (800) 525-4075.

Please remember to contact TGS Financial Advisors if there are any changes in your personal or financial situation, or investment objectives for the purpose of reviewing, evaluating and revising our previous recommendations and/or services. Please also advise us if you would like to impose, add, or to modify any reasonable restrictions to our investment advisory services. A copy of our current written disclosure statement discussing our advisory services and fees continues to remain available for your review upon request.