

## CHAPTER 5

# MANAGING RISK ONE BUCKET AT A TIME

BY CHRIS MORRIS

When I was growing up, I lived next door to my grandfather, Dee, who was a builder. I dated a beautiful girl named Jennifer, whose dad was a wealthy builder, and one of my good friends, Steve, was the son of perhaps the wealthiest builder in Maryland in the 1970s. I didn't have to wonder why they were so wealthy and Dee wasn't. They told me their secret was borrowing from banks, so I took this secret to Dee.

Well, Dee wasn't impressed. He told me that banks make you bankrupt. He told me the real secret was to take the profit from the house you built and sold, put half of it into a savings account, and use the rest to live on until you built the next house.

Not realizing the importance of his advice, I went away to college, and when I returned the next summer, I decided to call on Jennifer. So I went down the street and knocked on her door. Some strange woman answered and I asked, "Are you the maid?" She looked miffed. It turned out Jennifer's dad had gone bankrupt while I was at college. I couldn't believe it.

When I got home, Dee explained, "Chris, all of the builders went bankrupt except for me. They borrowed from banks and the 1970s recession hit. Now you know why you should never borrow from banks. They loan when you don't need the money and take it from you when you do. And don't knock on Steve's home because his dad went bankrupt too."

That's when Dee told me his story. He had been a builder in the 1920s and 1930s. He borrowed money from a bank to help finance the construction of houses. When he couldn't sell the houses he'd built, he discovered he couldn't pay the bank back, so like most people during the Great Depression, he went bankrupt.

When Dee died years later, just a day shy of 100, his birthday party became a celebration of his life. I remember several people telling me what a fine man he was and how they respected him for becoming successful after all he'd gone through. Dee, whose family lived on chickens and vegetables that he grew in his backyard, left millions to his children, and he invented how to become your own banker years before Nelson Nash wrote *Becoming Your Own Banker*.

You see, gaining wealth has more to do with financial discipline than with anything else. It was Dee's ability to save and not borrow from banks that allowed him to accumulate wealth. And now that I'm older, I can see only one improvement that could be made to Dee's methodology, and that is his investment formula.

When Dee was growing his savings, he only used CDs. Not the worst way to save, because they are "safe." You'll always get your money back, as long as the government doesn't go bankrupt, but it doesn't help accumulate wealth like other strategies. One strategy is Bank On Yourself<sup>®</sup>, but I'm going to take this one step further: risk management.

It may not seem like it, but Dee managed risk by not borrowing from banks to build houses. Dee limited possible overexposure to the real estate market by not building houses that he couldn't pay for outright and he only spent half the sale proceeds of a house on building more houses. If he built a house he couldn't sell, then he had to wait. Once the house sold, he built a new one to replace the old one. This system effectively cut his spending on real estate when that market was drying up and increased his spending on real estate when that market was booming. Wouldn't it be nice if we had such an easy guide to investing in other markets?

Dee did not understand the full ramifications of what he was doing, or his other investments would have mimicked his investment in homes. CDs are great things, but they aren't risk-free. Just as in the real estate market, they have a market and all markets have risk. For CDs, most

of the risk concerns purchasing power. So once your CD matures, you want it to have grown enough to keep up with inflation so that you have at least as much spending power as you gave up to invest in the CD. CD rates rarely keep up with inflation before tax and their growth is taxable, and therein lays the risks of owning CDs.

CDs need to mature before money can be used. If Dee knew about Bank On Yourself® whole life insurance that grows without taxes, pays dividends, and is friendly to loans, his money would have been readily available to build new homes. Instead, he often had to wait for CDs to mature. The Bank On Yourself® policy also has the advantage of growing without taxes. You can borrow the money without taxes and when you die it goes to heirs without income taxes and without probate.

On the other hand, putting all of your money in high tech stocks in 2000 is the other extreme of risk. There, the upside potential could be great, but the downside risk could wipe out a fortune built over a lifetime in a few short months.

The markets do not move in straight directions, and success when investing can often be boiled down to an exercise in risk management more than an exercise in stock or bond picking. That's why William O'Neil, one of the ten best traders in American history, defined success in investing as being right 6 out of 10 times, as long as you kept your losses to a minimum.

In the 1950s, a mathematician named Harry Markowitz tried to quantify market risks in a book titled *Portfolio Selection*. This theory tried to optimize returns by considering the risk tolerance of an investor. The result of this mathematical treatise was the creation of a new field in finance taught at business schools called "modern portfolio theory," and later called "asset allocation."

Here is a simple explanation of how it works. If an investor invests 100 percent of their money in bonds, bonds have a standard deviation (quantified risk) of 12. The higher the standard deviation, the greater the risk. Large cap stocks, such as those listed on the S&P 500, have a standard deviation of 18, which is 50 percent riskier than bonds.

The average return of all bonds over the last 100 years is 5 percent per year. The average return of the S&P 500 over the last 100 years is 11

percent per year. One would assume the average return of a portfolio that was half stocks and half bonds would be 7.5 percent. And that is correct. The average return is 7.5 percent.

Now consider the standard deviation (quantified risk). One would expect it to be the average of the two standard deviations or 15 for the portfolio. But Markowitz found it was 12. So a portfolio that contains 50 percent stocks and 50 percent bonds amazingly has the same risk of a portfolio containing 100 percent bonds, but has a 2.5 percent higher return.

The reason the risk stayed the same was due to the correlation coefficient, which is a fancy term for the measure of how close bond returns correspond to stock returns. Since stocks and bonds aren't highly correlated, it works out more often than not that when stocks rise, bonds fall, and vice versa. The result is risk reduction to the overall portfolio. The reason is risk management: Gains in one asset class (bonds) offset losses in the other (stocks), and vice versa.

By adding other classes, such as commodities, real estate, international stocks, absolute return funds, international bonds, REITs, limited partnerships, venture capital and futures contracts, to name a few, one can manage risk. Each class has a unique average return, standard deviation and correlation coefficient that one can use to optimize a portfolio by one's standard deviation (or quantified risk), such as 10. The balance of classes is used to get the highest return possible, given that risk. And, while this is much more complex than my grandfather Dee's management of overexposure to debt, this is still risk management.

Markowitz, his student, Sharpe, and another professor named Miller received Nobel Prizes in Economics in 1990 for their work, and now every business school in America teaches asset allocation as the best way to invest. This theory has morphed into more complex theories as the science has progressed through articles published in the *Journal of Portfolio Management* and the *Journal of Investing*.

Today, universities, such as Harvard and Yale, use these theories to manage their endowment funds. The results over a 20-year period have been astounding. Harvard and Yale's money managers beat every mutual fund manager in America over the same 20-year period. In fact, their returns were 15.5 percent per year at Harvard and 16.1 percent per year at Yale from 1984 to 2004\* when the S&P 500s average return was

a mere 10.6 percent a year. No mutual fund manager came close.

One of the inherent problems with the modern portfolio theory is the assumption that the investor is an institution, such as a bank, not a person. Thus, the theory assumes that the investor (the institution) will stay fully invested forever and never take large distributions like an individual would in retirement. So here's a real life problem:

John and Amy retire in 2007. They have \$1 million. Their financial advisor tells them the Dow Jones Industrial Average has an average return of 10 percent per year. John and Amy realize 10 percent of \$1 million is \$100,000, and they can take that out and not touch principal, so they invest all of their money in the Dow Jones Industrial Average and begin taking \$100,000 per year. Using the ending value of the Dow Jones Industrial Average from Oct. 31, 2007 to Oct. 31, 2012, their assets decline from \$1 million to \$337,525 net of distributions.

If John and Amy panic when the market drops and sell 100 percent of their stocks after the market bottoms out around February 2009 and buy bonds yielding 5 percent but continue taking \$100,000 per year in distributions, we estimate they would run out of money by February 2013.

Over the long-term, the market may grow at 10 percent per year, but short-term drops with distributions can wipeout a lifetime of savings. Since Markowitz's theory deals with minimal distributions from institutions, such as insurance companies and banks, they really did not foresee the need to plan for large portfolio distributions.

In an attempt to deal with his clients' need for distributions and still manage risk, Ray Lucia, CFP, wrote a book titled *Buckets of Money: How to Retire in Comfort and Safety*. His theory has a simple solution to the problem above.

Ray studied the markets in the United States and concluded that we never had a market, since the creation of the U.S. markets, where the general markets made no gains for more than 14 years, even during the Civil War and the Great Depression. So Ray created the Three Bucket Theory, which allocates seven years of investment income needed to one of two buckets with the rest of the investment money in bucket three:

*Bucket 1:* Years 0-7, Investments that have little or no principal at risk

*Bucket 2:* Years 8-14, Investments that can lose some principal

*Bucket 3:* Years 15+, Investments that can lose a lot of principal

Using modern portfolio theory and Ray’s Three Bucket Theory, we help our clients manage their risk. We run computer models to determine their asset allocation based on their risk profile. The model mathematically recommends different classes for each client to achieve the highest return for their risk. For example:

Cash equivalents	0.94%
“Safer Investments”	70.00%
Long-term govt. bonds	2.10%
Corporate bonds	2.89%
Small value stocks	3.53%
Real estate	6.27%
Commodities	5.21%
Limited partnerships	0.86%
International stocks	1.91%
International bonds	4.27%
Emerging equities	<u>.02%</u>
<b>Total</b>	<b>100%</b>

After the computer quantified Paul and Marcy’s risk or standard deviation at 11.19, it then generated an asset allocation to get the clients an average return of 8.52 percent. The return of a Bank On Yourself® policy alone is not so robust, but it plays the role of managing risk in this portfolio.

Here's how we broke up the preceding assets into three buckets:

	<b>Bucket 1</b>	<b>Bucket 2</b>	<b>Bucket 3</b>
Cash equivalents	0.94%		
Long-term govt. bonds			2.10 %
Corporate bonds			2.89%
Small value stocks			3.53% (a)
Bank On Yourself® policy	35.00%	30.00%	5.00%
Real estate		6.27%	
Commodities			5.21%
Limited partnerships		0.86%	
International stocks			1.91% (a)
International bonds			4.27%
Emerging equities	_____	_____	<u>2.02% (a)</u>
<b>Total</b>	<b>35.94%</b>	<b>37.13%</b>	<b>26.93%</b>

Sum of (a) = 7.46%

Each year, Paul and Marcy spend one-seventh of Bucket 1. At the end of each year, we move enough money from Bucket 2 to Bucket 1 to keep a seven-year supply of funds in Bucket 1. We also move enough money from Bucket 3 to Bucket 2 to keep a seven-year supply of funds in Bucket 2. And the growth in Buckets 2 and 3 provides enough money to keep Bucket 1 fully funded.

Notice how the Bank On Yourself® policy is broken up into the three different buckets representing how it helped fund retirement for this couple. Bucket 1 needs a seven-year supply of money for the client to live on without principal risk and Bank On Yourself® provides that, along with more money for the other buckets.

Almost all the cash value is created by redirecting interest that would have been paid to creditors, but Paul redirected it to himself for retirement

using the Bank On Yourself® methodology. Even more important, they couldn't retire without having saved the interest others paid to creditors.

This money came to Paul through discipline to never borrow from creditors again. We find Bank On Yourself® policies can add hundreds to thousands to more than a million dollars to someone's assets in a lifetime, simply by redirecting interest they would have paid to others back to themselves.

Now consider John and Amy, who invested their \$1 million in the Dow Jones Industrial Average. Imagine they were like Paul and Marcy and only had 7.46 percent of their money in stocks as the (a)s indicate in the previous example. Stocks dropped more than 50 percent from 2007 to 2009. What was Paul and Marcy's actual loss? Well, if you take 7.46 percent and divide it by two, their loss is 3.73 percent. How panicked do you think Paul and Marcy were compared to John and Amy? Even better, the Bank On Yourself® policy did not lose any value during the market correction and actually added money to their portfolio to offset the stocks' losses.

Since Paul and Marcy won't need the money in stocks for 15 years, the market will recover long before they have to sell. Knowing this helps everyone sleep soundly at night, even when the markets unravel.

## EPILOGUE

Based on conversations with hundreds of financial advisors in America, Canada, England, New Zealand and Australia, we have never met one financial advisor who offers "tactical asset allocation" as a method of investing for their individual clients.

One of the skills to be a successful "tactical asset allocator" is the ability to time markets. William O'Neil, one of the best traders in American history, said, "It takes three years as a full-time money manager before a person can successfully master market timing." It is so difficult to teach market timing that few people even admit it can be done. The lay press is replete with pundits who say no one can time the markets. Yet it is a minimum requirement that a person must master before they can perform "tactical asset allocation," or in William O'Neil's words, "...

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\* "The Money Game," by Marcia Vickers, Oct. 3, 2005, Fortune magazine



before they can become professional traders.” So it is highly unlikely that the investment techniques used at Harvard and Yale will be available to most investors.

Doing the mathematical calculations needed to perform either “strategic” or “tactical asset allocation” manually requires weeks per investor per year to rebalance their portfolios annually. Since the average investment advisor has over 1,000 clients, such a method is too time-consuming to use. Fortunately, there is software published for financial advisors that does the complex calculations needed to perform “strategic asset allocation” in hours instead of weeks. This software is too expensive and too complex for most individuals to use, but there are numerous financial advisors that use “strategic asset allocation” as their method for money management. *“Strategic asset allocation” is acceptable and can be combined with the models above, although the returns are typically lower than they are with “tactical asset allocation.”*

On the other hand, professional money managers who work for insurance companies use “tactical asset allocation” for managing their company’s money. Institutions demand that their professional money managers use “tactical asset allocation” because it is the best way to invest. This is one reason for buying a Bank On Yourself® policy. Professional money managers who work for insurance companies use “tactical asset allocation” and should be able to get higher returns than other investment methodologies. The fees in insurance policies are high. But the client gets the life insurance they badly need and the tax benefits of life insurance. Plus, they should benefit from the higher returns of “tactical asset allocation” because mutual insurance companies pay profits back to their policy holders through dividends.

We have done comprehensive written financial plans for hundreds of individuals. To date, not one client (who was not already financially independent) had an adequate amount of life insurance. Considering this, along with the fact that most of our clients and the general public need a tax-advantaged method to save money, Bank on Yourself® is a great alternative to most other investments.

Many of our clients are maximizing their 401(k) and IRA investment contributions. But according to their financial plan, they need to save more money each year to achieve their goals. One solution to continue

receiving some form of tax deferral is to use an insurance policy, whether that is a Bank On Yourself policy or some other form of insurance, such as an annuity.

It is the combination of all these points that makes Bank On Yourself® a wonderful solution to the complex problem of retirement planning. Again, not everyone should have a Bank On Yourself policy. It is one solution of many. But it is extremely compelling for a variety of reasons, and in general, we feel this is a fabulous foundation for building a successful financial future, especially for young people.

Clearly the best way to achieve all your goals is to find a professional financial advisor who can combine a Bank On Yourself® policy with the Nobel Prize-winning investment methodology called “asset allocation.”



## About Chris

Chris Morris started at a Big 8 accounting firm, and went into industry where he held positions ranging from planning manager to assistant secretary and treasurer and chief financial officer for several large corporations in Georgia. He was also president of two divisions of companies. He took four companies public. During that time period, he also managed money for three insurance companies and ran a hedge fund. In 1990, Chris started a CPA practice, Chris Morris & Associates, PC. Subsequently he created a financial planning company known as CMA Financial Services.

CMA Financial Services' mission is to serve and work for the client. We offer "tactical asset allocation" and the three bucket system as part of our services. Our comprehensive financial services also include: money management, estate planning, insurance, tax preparation and tax planning. Our firm was founded on the highest ethical standards and puts every client's success first. Our goal is not to sell but to help our clients achieve their goals for reasons that are important to them. Aligning our clients' goals with their most deeply-held values allows us to guide them on a path that ensures their future success and happiness.

CMA is unique because we use a team of professionals who work together to guide our clients through the world's financial challenges. Most people have to seek out and hire a certified financial planner, money manager, insurance specialists, attorneys and tax professionals separately. They then have to meet with them individually, extract the advice and piece that advice together themselves, in hopes of finding a path that will help them achieve financial success. These same people often wind up frustrated when the uncoordinated advice of their professionals, who don't meet together, doesn't work and their path takes a turn for the worst.

We guide our clients along the path to achieving their goals for reasons that are important to them. We bring this team together to offer comprehensive, coordinated and consolidated advice to each client. Our professionals span a wide range of financial services and include all of the professions listed previously. We believe the best way to ensure that our clients achieve their goals is to have these financial professionals meet and recommend client action as a team instead of individually. The team also must see our clients' future success as paramount. The better the quality of our services, the greater will be the success of our clients. The greatest reward we receive is when our clients achieve all of their goals for reasons that are important to them.

For more information about CMA, call (770) 493-7578 or visit [www.cmawizards.com](http://www.cmawizards.com).