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Helping You Secure Your Future™

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Winter 2020 Newsletter:

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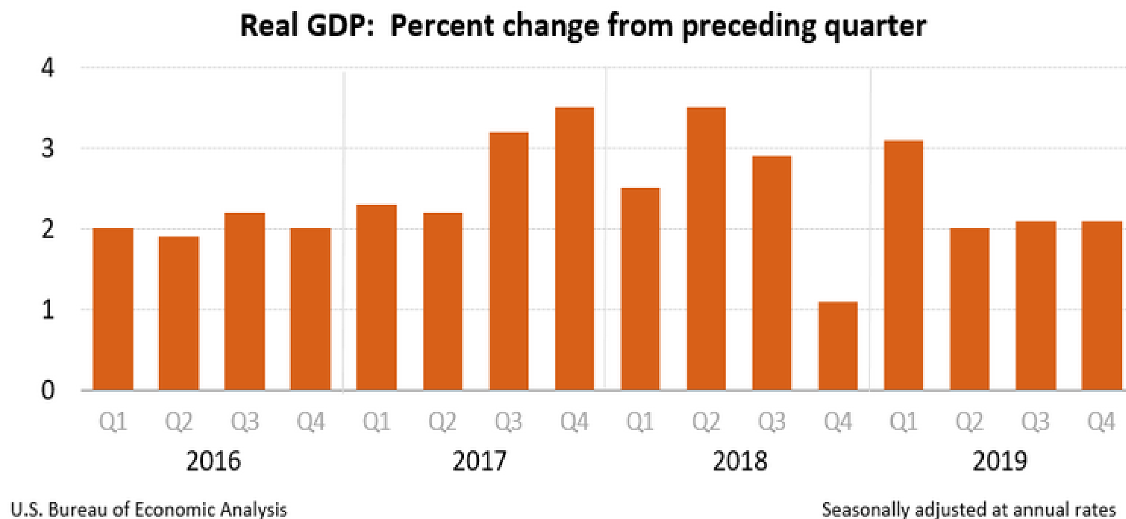
Hey Mr. Econo-ExpandiUS! You're Not as Good as Some Say, You're Not as Bad as Others Say, but You Do Keep On Truckin'!

Here we are already into 2020. The US economic expansion has now exceeded ten years in length, making it the longest on record. All indications are that the first quarter GDP (the change in Gross Domestic Product, our measurement of how the economy is growing) will still be positive, although lower due to the coronavirus. Since the technical definition of a recession is two consecutive quarters of negative GDP growth (contraction), there is an almost certainty that we will reach the second half of this year without seeing a recession, thus making the expansion cross the 11 year mark.

So why do we see all the glumness and hand wringing? A big part of this consternation is politics. We have tried to steer clear of this subject in our research and writing. Consider that on one side, we are told that the cup is half empty (or worse) and this economy is not working for all/most/many/fill in the blank. The other side counters that this is the best economy that has ever been. Not only glass half full, but overflowing. Which side is correct? The real answer is: neither.

The Trump administration did promise us 3% GDP growth. This has not been achieved as a running average. However, GDP growth in the last three years (2017-2019) has unquestionably been ahead of the 2016 pace of the Obama Administration. This is easily demonstrated by a chart from the Bureau of Economic Analysis[1].



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We have previously written about the "white spaces" between the 3% line and the orange bars. These are the gaps we need to fill, in order to really feel like this is a recovery. But looking at the above data, we are reminded of the Federal Reserve's policy mistake (interest rate rises) in 2018. This led to a slowdown in growth in the fourth quarter and a strong stock market correction.

Tariffs and trade tensions with China and the EU replaced the Fed as the pain points slowing growth in 2019, as business leaders grappled with uncertainty as to how to manage their global supply chains. GDP growth in the 4th quarter was announced recently as being 2.1%, with a full year 2019 change as +2.3%. While this was down from 2.9% in 2018, it was higher than the flat 2% of 2016.

Different administrations have different policy objectives. It would not be partisan to say that the Obama administration was more regulatory focused and therefore less business friendly, while the Trump administration has been less prone to regulate, but more prone to tariffs and trade disputes.

We hope for the best with both the new USMCA (US, Mexico and Canada trade Agreement) and the phase 1 China trade deal. Will these agreements result in less business uncertainty, leading to more capital investment, transactions and expansion? While the obvious answer is yes, time will tell if this can move the needle on GDP growth.

While our economic expansion is now the longest we have recorded, it certainly has not been the best in terms of growth. In fact, we have not had a solid year of 3% plus growth for about 15 years and we have not seen a 4% year for about two decades. As we have stated in the past, true recovery is where we make up for previously lost ground. We have not seen this happen. But something else has become evident.

Lower but still positive (since we do not see negative rates in the US any time soon) for longer, may not only apply to Federal Reserve short term interest rate policy. Lower, but still positive economic growth for longer, appears to be in the cards. Since most bear markets precede recessions, the longer we post positive growth numbers, the longer this bull market may run (but with corrections). This is not as trivial as it may first sound.

Let's take a step back and clear up a misconception. Many people expect that an economic cycle usually takes about seven years (give or take) from trough to expansion to peak and then to contraction. Then it repeats. But while this is the way it happens most of the time, we need to remind ourselves of the following:

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Economic expansions, as well as bull markets, do not die of old age. Something happens. For instance, Australia has not had a recession in more than twenty years. Of course, their economy is more like the size of one of our most populous states, rather than the entire US.

Typically in a free market, some participants can eventually misjudge what the next rational set of actions should be. Production may expand by too much, inventories build, sales slow, workers are let go and so on. Monetary policy may start out as being too loose, inflation ensues and then policy becomes tight through increasing short term interest rates (i.e. the Fed Funds Rate). At some point, these increases could choke off an expansion.

But there is a season for everything. Funny money pumping out and interest rate policy too low and loose can keep so called "zombie" businesses going. This is where unprofitable businesses find that they can continue borrowing at very low rates, continue plowing ahead and delaying the inevitable. When their house of cards falters, the debacle is even more spectacular. So recessions periodically wipe the slate clean, although at the cost of inflicting pain along the way.

So here is our theory of the present situation. A combination of actions from the last administration (heightened regulatory emphasis), the current administration (tariffs and trade uncertainty) and Federal Reserve policy shifts (long term quantitative easing followed by rapid tightening, oops, more easing and then... OK, let's hold it steady), just might keep this economy truckin' along for a while.

If two wrongs don't make a right, what do three wrongs make? If what doesn't kill you makes you stronger, could this combination be the strange elixir that keeps growth positive (albeit lower) for longer? We should point out that forecasts more than twelve months forward are not worth the paper they're written on, or the bits and bytes they're written with. So for now, we don't see a recession in 2020.

Just take my word for it? Heavens, no! How about I give you some evidence?

The chart below shows Real Median Household Income (RMHI). These numbers are released with quite a delay. The 2018 value of $63,179 came out last September[2]. This income measurement is adjusted for inflation. This last reading is the best ever recorded. Note how there is a well defined peak in RMHI before each of the last three recessions. While we do not have any evidence suggesting that the 2019 value will be anything but higher, time will tell. Watch this number. Income goes down when overtime slips and other employee hours are cut, layoffs begin, etc. So far, we do not see this happening.

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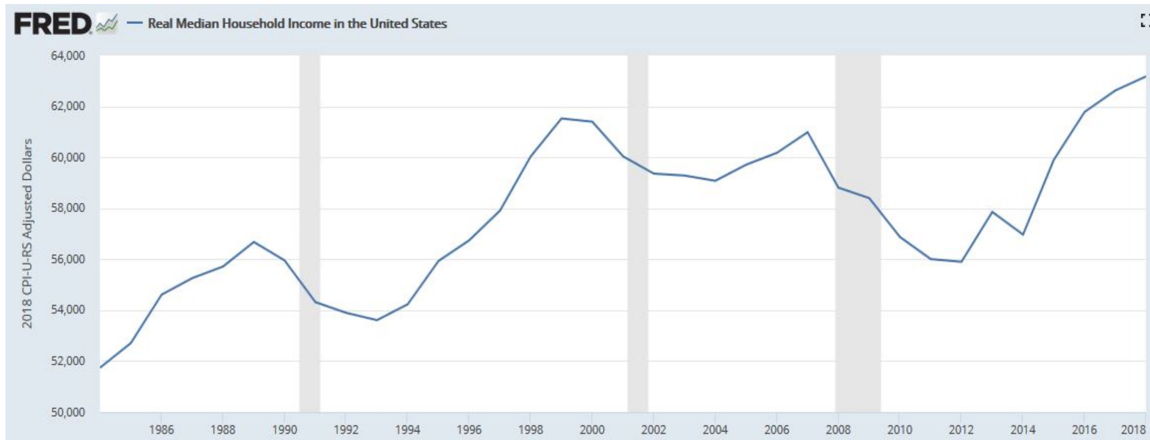
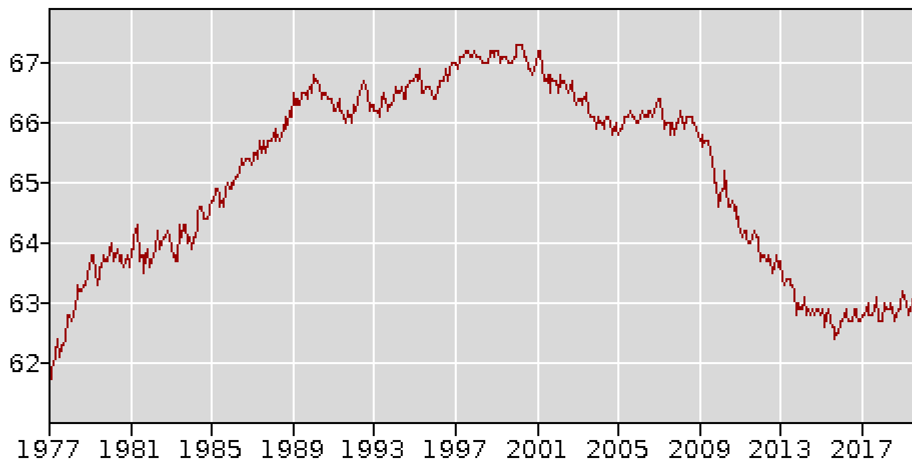


Next, let's move beyond the headline unemployment rate of 3.6% and look into something much more useful, called the Labor Force Participation Rate. We define this as the number of currently employed workers along with the number of those actively seeking employment, divided by the total working age population available for employment. This includes civilians, but not military personnel. It also excludes those who are institutionalized (such as the incarcerated)[3].

The Bureau of Labor Statistics supplies this chart and the accompanying data[4]:



The currently quoted value is 63.4%, which is the highest level reached during the Trump administration. But it is obvious from looking at the above chart, that we are very far away from reaching the all time peak of 67.3% (set in April, 2000) and are even below the lows set during the 1982 recession!

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It should be kept in mind that we are dealing with "working age population", so it is not an acceptable excuse to respond that many boomers are retiring each day. That may be true but is, nonetheless, completely irrelevant.

Moreover, the Obama administration never explained just how the economy could have been recovering under their stewardship, yet the labor force participation rate was significantly lower after he left office at 62.8% (January, 2017), than the 65.7% value when he took office (January, 2009).

Please keep in mind that our economy is consumer driven. It is often modeled as being 70% based upon the consumer. The consumer is fueled by their income and available debt financing that they are willing and able to take on. Collecting welfare benefits instead of working for a salary or wage, is definitely not the way to lead consumer spending and spur GDP growth.

Therefore, any mention that the headline unemployment rate (3.6%) cannot go any lower or that we are running out of workers, is complete nonsense, plain and simple.

We did a backward search through the BLS data and found that the first time the US posted a participation rate above the current 63.4% was back in November, 1978 (63.5%). What was different back then, besides a trend toward disco music? For one thing, women were still entering the labor force.

Our analysis does not focus on the politics, but only on the policies. And the end results. We see that we still have quite a way to go, but growth is being sustained. "Lower (but still positive) for longer" may be the proper way to describe Federal Reserve interest rate policy. But we think that this also applies to our GDP growth. We would be thrilled to see 3%+ growth, but sadly, do not think it will happen in 2020. But as long as Mr. Econo-ExpandiUS keeps on truckin' along at 2%+, I don't think we will be complaining at all.

But wait! There's more....

You may ask what all this means relative to the future of the stock market. Adding to economic growth uncertainties, trade tensions and the upcoming presidential election, we can add a virus outbreak in China that has gone worldwide and may soon be classified as a full fledged pandemic. It has slowed down the Chinese economy significantly, with ripple effects on the rest of the world, due to a slowdown in factors such as the global supply chain, travel and hospitality. The impact on GDP growth is still uncertain.

"Aren't we overdue for some kinda crash or something?"

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Glad you asked.

With all the news and data coming out, we needed to combine a story about the economy along with our annual review of the valuation of large cap US stocks. The quick answer is that yes, the stock market has been overvalued.

"So should I sell everything, take my marbles and go home?"

Only if you are losing your marbles...

The real answer is that the stock market correction in the fourth quarter of 2018 restored valuations to a somewhat more reasonable level. Virtually no one predicted the ebullient market of 2019. According to our calculations, at the end of 2019, we were overvalued by an amount that was last exceeded at the end of 2007.

"So should I be scared, also considering the new virus outbreak?"

Only if your finances are not well organized and you have no plan, no asset allocation and are driven completely by your raw emotions.

The real answer is that stocks are nowhere near as overvalued as they were at the end of 1999. Not even close. Coming out of the 2002 bear market, stocks were still about as overvalued as they are now. Yes, we have already entered into a new correction. Even so, this would not be a time to panic and sell everything.

To give this some perspective, we include a chart of our valuation indicator, below. It should be pointed out that this is not a stock market timing tool.

A true change would be the end of this economic expansion and the start of the next recession. For the reasons mentioned earlier, we do not see this happening, as yet. But even if we did, it would still not be advisable to do wholesale panic selling.

In any case, please stay tuned.

"Whew. That gave me about as much relief as the burrito I ate last night."

We do our best.

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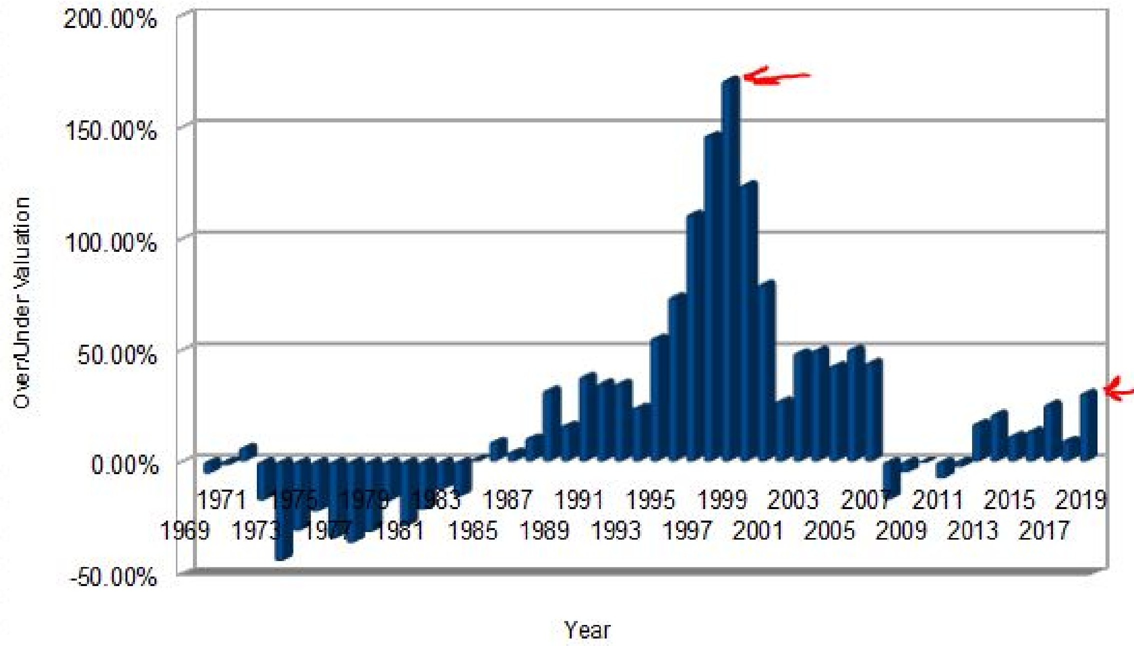

RETURN

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Castling Defensive Portfolio's 12% Return Underwhelms in 2019...It's the 20 Year Risk Number You Should See Instead

Many years ago, we came up with an asset allocation to showcase what we felt an extremely risk averse investor could tolerate and we named this hypothetical portfolio the **Castling Defensive Portfolio** (CDP; see page 11 for an asset allocation/investment breakdown). We based it on rolling period analysis and felt that we needed to avoid changing the allocation. It was meant to rely on our concept of “consistency”, derived from the rolling period analysis of asset classes, within our proprietary asset allocation database. Many others focus on day to day or year to year returns. We do not. We like to look at five year and multiple of five year, rolling periods.

In moving from an asset allocation into real live investment vehicles, we picked high quality and low cost mutual funds, almost all of which have been sourced from Vanguard. We added some cash in the form of bank certificates of deposit. We made only a few changes since it was put together. We also did some back testing in addition to taking it forward and reporting on it, year to year.

In 2019, the CDP had a total return of 12.19%. This certainly is underwhelming, compared to Vanguard 500 Index fund's (ticker: VFIAX) 31.46% whopper. Two other funds we use for comparison purposes: Wellington (VWELX) had a 22.51% return, while Wellesley Income (VWINX) had a 16.39% return[5].

The CDP's purpose was to minimize risk over longer periods and not take a lot of time to manage, all while trying to achieve a 7.2% net, pre-tax annualized return. But due to the fall in interest rates and the low level that has persisted for the last decade, the CDP has pulled up a little short.

Our 20 year (2000-2019) annualized total return for the CDP was 6.54%. But this was really a tale of two decades. For 2000-2009, the CDP posted a 7.51% annualized return. For 2010-2019, this was cut to 5.58%.

We should point out that the CDP is invested in equities (the stock market) for only 31% of its allocation. If we conservatively estimate that the fall in interest rates was at least 2.5 percentage points for the entire decade (2010-2019), then the 69% of CDP invested in various fixed income funds was short about 1.7 percentage points of total return. If that could have been achieved on top of the 5.58%, then viola! 7.28% would have been the result, instead of 5.58%. But c'est la vie.

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Castling Defensive Portfolio (CDP) Comparison	2014	2015	2016	2017	2018	2019
Castling Defensive Portfolio Yearly Returns	6.71%	-0.22%	6.77%	5.44%	-2.74%	12.19%
Back-Tested Cumulative Return Since 2000	189.81%	189.16%	208.75%	225.55%	216.61%	255.21%
Hypothetical Growth of $10,000 Since 2000	$28,981	$28,916	$30,875	$32,555	$31,661	$35,521
Annualized Return (2000-2019)	7.35%	6.86%	6.86%	6.78%	6.25%	6.54%
Standard Deviation (2000-2019)	4.65%	4.88%	4.73%	4.60%	4.99%	5.03%
Coefficient of Variation (2000-2019)	0.63	0.71	0.69	0.68	0.80	0.77
Wellesley Income (VWINX) Yearly Returns	8.07%	1.28%	8.08%	10.20%	-2.57%	16.39%
Back-Tested Cumulative Return Since 2000	208.62%	212.57%	237.82%	272.28%	262.71%	322.16%
Hypothetical Growth of $10,000 Since 2000	$30,862	$31,257	$33,782	$37,228	$36,271	$42,216
Annualized Return (2000-2019)	7.80%	7.38%	7.42%	7.58%	7.02%	7.47%
Standard Deviation (2000-2019)	6.07%	6.10%	5.91%	5.76%	6.08%	6.27%
Coefficient of Variation (2000-2019)	0.78	0.83	0.80	0.76	0.87	0.84
Wellington (VWELX) Yearly Returns	9.82%	0.06%	11.01%	14.72%	-3.42%	22.51%
Back-Tested Cumulative Return Since 2000	209.52%	209.70%	243.80%	294.41%	280.92%	366.67%
Hypothetical Growth of $10,000 Since 2000	$30,952	$30,970	$34,380	$39,441	$38,092	$46,667
Annualized Return (2000-2019)	7.82%	7.32%	7.53%	7.92%	7.29%	8.01%
Standard Deviation (2000-2019)	11.24%	11.06%	10.73%	10.53%	10.59%	10.82%
Coefficient of Variation (2000-2019)	1.44	1.51	1.42	1.33	1.45	1.35
Vanguard 500 Index (VFINX/VFIAX) Yearly Returns	13.51%	1.25%	11.82%	21.67%	-4.52%	31.46%
Back-Tested Cumulative Return Since 2000	83.58%	85.87%	107.84%	152.88%	141.45%	217.41%
Hypothetical Growth of $10,000 Since 2000	$18,358	$18,587	$20,784	$25,288	$24,145	$31,741
Annualized Return (2000-2019)	4.13%	3.95%	4.40%	5.29%	4.75%	5.95%
Standard Deviation (2000-2019)	19.22%	18.61%	18.08%	17.92%	17.61%	18.04%
Coefficient of Variation (2000-2019)	4.65	4.71	4.11	3.39	3.71	3.03

So let's move on to discuss risk. One measure of risk is standard deviation, which in this case, looks at the dispersion of returns around its average. Here, the CDP 20 year value is a very low 5.03%. But our preferred measurement of risk is called the "coefficient of variation". This could also be called "risk per unit of return", where lower is better and under 1.0 can be considered outstanding. The CDP's measure is 0.77 over this 20 year period. Wellesley Income, at 0.84, is also outstanding. By contrast, Vanguard 500 Index measures in at a whopping 3.03, or almost four times that of the CDP!

Such measures may be too esoteric for some readers. Well then, how about if we recast the issue in a somewhat different light? The 21st century has definitely been a study in contrasts. For example, 2010 through 2019 saw the Vanguard 500 Index achieve a very impressive 13.4% annualized total return, which was quite above the stock market's long term average of 10%.

As an aside, we would like to point out that "averages" really make sense only in the context of rolling period returns and not individual years. If you check the year to year returns of the overall market, you will be hard pressed to find years that look "average", yet many investors get obsessed with the year to year results, as if missing the forest for the trees.

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	The Castling Defensive Portfolio:	Ticker	% Allocation	Expenses	Equity %	Weighted Exp.	Min. Invest.	Initial Min.	2019 Return	Contribution
1	FDIC Insured Certificates of Deposit (Avg. of High Yielding)	Bank CD's	9%	0.00%	0%	0.000%	Varies	$6,750	2.25%	0.20%
2	Vanguard Short-Term Treasury Investor Shares	VFISX	9%	0.20%	0%	0.018%	$3,000	$6,750	3.59%	0.32%
3	Vanguard Short-Term Investment-Grade Investor Shares	VFSTX	9%	0.20%	0%	0.018%	$3,000	$6,750	5.74%	0.52%
4	Vanguard Intermediate-Term Treasury Investor Shares	VFITX	12%	0.20%	0%	0.024%	$3,000	$9,000	6.29%	0.75%
5	Vanguard Inflation-Protected Securities Investor Shares	VIPSX	12%	0.20%	0%	0.024%	$3,000	$9,000	8.06%	0.97%
6	Vanguard GNMA Admiral Shares	VFIIX	11%	0.21%	0%	0.023%	$3,000	$8,250	5.83%	0.64%
7	Vanguard Wellesley Income Investor Shares	VWINX	11%	0.23%	4%	0.025%	$3,000	$8,250	16.39%	1.80%
8	Vanguard Small Capitalization Value Index Admiral Shares	VSIAX	15%	0.07%	15%	0.011%	$3,000	$11,250	22.76%	3.41%
9	Vanguard REIT Index Admiral Shares	VGSLX	8%	0.12%	8%	0.010%	$3,000	$6,000	28.94%	2.32%
10	Vanguard International Growth Fund Investor Shares	VWIGX	4%	0.43%	4%	0.017%	$3,000	$3,000	31.35%	1.25%
	Totals		100%		31%	0.17%		$75,000	Thru 12/31/19	12.19%

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For example, the 2000-2009 decade saw the annualized total return of 500 Index come in as a wicked **-1%**. Comparing the first decade to the second, the difference is over 1,400%! This is what we mean by being NOT consistent.

As stated, the CDP achieved 7.51% in the first (2000-2009) decade and 5.58% in the second (2010-2019). This difference is only 26%.

Kudos go to the Vanguard Wellesley Income Fund (also a component of the CDP) which all by itself gained 6.96% and 7.98%, in the first and second decades, respectively. This represents only a 15% difference.

Consistency is most valuable in a core investment portfolio where you are concerned with total return and where sequence of returns represents one of the chief risks. Lowering expected return in exchange for tamping down the sequence of returns risk may be a very worthwhile trade-off.

We would next like to demonstrate the value of a sprinkling of gold in your portfolio, by showing what a small percentage allocation to the iShares Gold ETF (IAU) would look like. Because this gold ETF has not been in existence for the entire CDP time period, we use 2006 as the starting year for our gold analysis. As you can see in the table below, setting the gold allocation anywhere from 1% to 10% lifted the annual returns of the mixed portfolio (CDP and IAU), but still limited the coefficient of variation to around 1.

Did the gold help? In the second decade, a 1-10% allocation of IAU along with a 99-90% allocation to the CDP had very little change versus just investing in the CDP. In fact, there was a tiny decrease in total return. But over the entire 2006-2019 fourteen year period, a 10% allocation to gold resulted in a 5.80% total annualized return versus 5.49% with no gold. The risk measurements (coefficient of variation) were essentially the same.

So called "paper gold" as represented by the BlackRock (IAU) ETF has a huge advantage over physical gold in a core portfolio. Since distributions are expected each year in the core portfolio during retirement, it is a very easy task to annually rebalance back to the target allocation for gold. If this were physical bars or coins, it would be cumbersome and costly to sell off a small fraction to maintain your asset allocation going forward.

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Castling Defensive Portfolio (CDP) Comparison	2014	2015	2016	2017	2018	2019
Castling Defensive Portfolio Yearly Returns	6.71%	-0.22%	6.77%	5.44%	-2.74%	12.19%
Total Return: BlackRock iShares Gold ETF (IAU)	-2.05%	-10.66%	8.21%	13.01%	-1.84%	18.08%
Return: CDP: 100%; Gold ETF (IAU): 0% Allocation	6.71%	-0.22%	6.77%	5.44%	-2.74%	12.19%
Annualized Return (2006-2019)			5.69%	5.67%	4.99%	5.49%
Standard Deviation (2006-2019)			5.18%	4.94%	5.29%	5.42%
Coefficient of Variation (2006-2019)			0.91	0.87	1.06	0.99
Return: CDP: 99%; Gold ETF (IAU): 1% Allocation	6.62%	-0.33%	6.79%	5.51%	-2.73%	12.25%
Annualized Return (2006-2019)			5.71%	5.70%	5.02%	5.52%
Standard Deviation (2006-2019)			5.21%	4.97%	5.31%	5.45%
Coefficient of Variation (2006-2019)			0.91	0.87	1.06	0.99
Return: CDP: 95%; Gold ETF (IAU): 5% Allocation	6.27%	-0.74%	6.85%	5.82%	-2.70%	12.49%
Annualized Return (2006-2019)			5.82%	5.82%	5.14%	5.65%
Standard Deviation (2006-2019)			5.37%	5.12%	5.45%	5.58%
Coefficient of Variation (2006-2019)			0.92	0.88	1.06	0.99
Return: CDP: 90%; Gold ETF (IAU): 10% Allocation	5.83%	-1.26%	6.92%	6.20%	-2.65%	12.78%
Annualized Return (2006-2019)			5.95%	5.97%	5.28%	5.80%
Standard Deviation (2006-2019)			5.66%	5.40%	5.71%	5.83%
Coefficient of Variation (2006-2019)			0.95	0.90	1.08	1.00
Return: CDP: 85%; Gold ETF (IAU): 15% Allocation	5.39%	-1.79%	6.99%	6.57%	-2.61%	13.07%
Annualized Return (2006-2019)			6.08%	6.12%	5.42%	5.95%
Standard Deviation (2006-2019)			6.06%	5.78%	6.05%	6.15%
Coefficient of Variation (2006-2019)			1.00	0.94	1.12	1.03
Return: CDP: 80%; Gold ETF (IAU): 20% Allocation	4.96%	-2.31%	7.06%	6.95%	-2.56%	13.37%
Annualized Return (2006-2019)			6.20%	6.26%	5.55%	6.09%
Standard Deviation (2006-2019)			6.53%	6.23%	6.47%	6.54%
Coefficient of Variation (2006-2019)			1.05	1.00	1.16	1.07
Return: CDP: 75%; Gold ETF (IAU): 25% Allocation	4.52%	-2.83%	7.13%	7.33%	-2.52%	13.66%
Annualized Return (2006-2019)			6.31%	6.39%	5.68%	6.23%
Standard Deviation (2006-2019)			7.07%	6.75%	6.94%	6.98%
Coefficient of Variation (2006-2019)			1.12	1.06	1.22	1.12

RETURN

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Did the SECURE Act Make Your Retirement More Secure?

Actions that we take or events that happen all around us, are often viewed as making us more secure in our lives, or less secure, depending upon what they are, how we understand them and what use we make of them. Listening to a traffic report that causes us to avoid a road closure, may save us valuable time when we are trying to arrive at a scheduled appointment, for example.

In financial planning and especially with investing, we are often asked about current events and what short term impacts these will have on investment portfolios. It would be exceedingly rare that we would advise asset allocation changes based upon such information. We so often rail against Event Level Predictors (ELP'ers), so why try to emulate them?

Then do we simply refuse to take any new action, regardless of the events occurring around us? Not at all. We're simply referring to asset allocation changes based upon short term economic events. However, there are some events that can and should prompt serious financial planning discussions:

1. The loss of employment or change in employment or career.
2. The birth of a child.
3. The death of a spouse or very close family member.
4. A healthcare concern that is expected to impact one's budget.
5. A change in one's own financial objectives or overall goals.
6. A change in income tax rates, or changes in tax law impacting us (even locally).
7. Changes in Federal law affecting retirement plans or any government benefits.

This last one is especially interesting now, since changes occurred at the end of 2019 that did not make front page headlines, yet may wind up impacting you for the better or for the worse, depending upon your circumstances. President Trump signed a large spending bill into law late in December. This legislation included the SECURE Act, which had previously passed the House of Representatives on a near unanimous vote of 417-3[6]. It took effect as of the start of 2020. This means that for any death or attainment of the magical 70 ½ years of age mark in 2019, the old rules still apply.

For those who engage in verbal contortions as sport, this whopper of an acronym stands for: "**S**etting **E**very **C**ommunity **U**p for **R**etirement **E**nhancement ".[7]

While there are many pieces to this legislation, we are only going to cover the main elements that would normally impact our readers and clients. We will only very briefly

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touch on aspects that affect employer sponsored retirement plans and so called IRA trusts. One thing to keep in mind is that the SECURE Act could be considered the biggest change to affect retirement plans in the last ten to fifteen years. So what are these changes and why should I care?

The biggest change that could be considered positive is moving the required minimum distribution (RMD) age from 70 ½ to 72[8], along with (in the near future) enactment of a new IRS life expectancy table that acknowledges the obvious: "Yes, we are living longer". The end result of such a change is that calculated RMDs will be somewhat lower, which will result in a smaller Federal income tax bite if you simply stick to withdrawing based upon your RMDs.

But if your withdrawals are based upon your budget and your need to maintain your standard of living and as a result, they are already greater than the RMD anyway, this specific change will not impact you at all.

The biggest change that could be considered negative is the almost total elimination of the so-called "stretch IRA"[9], except for certain exemptions. Some may ask, "What is a stretch IRA and why didn't I already have one?" or "Oh no, so what do I do now?". A stretch IRA is not a special type of retirement account. It simply referred to the fact that you could have previously designated a much younger person (such as a grandchild), as the designated beneficiary on the account (or a trust whose beneficiary is a grandchild). Then after your death, that person would be in possession of an "inherited IRA" (your IRA during life newly re-titled, or that portion of your old IRA that they were entitled to based upon the beneficiary designation percentages set during your lifetime). The rules stated that while that beneficiary could take the entire amount out and pay regular income taxes (at their own tax rate) but no penalty, they could also take annual RMDs based upon their own life expectancy. Since an 8 year old has a longer life expectancy than an 80 year old, this meant that the distributions could be much smaller and the amount of taxes collected would be much lower. But the bigger implication was that the remainder of the account could then be left intact and continue to grow.

This was turned upside down by the SECURE Act. Limitations put in place will shorten the time-frame for withdrawals for most beneficiaries to only ten years. This will effectively pull in the collection of income taxes on those accounts and will probably increase the income tax rates at which those taxes will be collected. However, this ten year rule has no annual RMD requirement. This means that the amount in an inherited IRA could be left intact and then simply withdrawn, in total after ten years, or be taken in unequal portions. Of course, Federal income tax (and possibly state income tax, depending upon the state) would be due with every annual withdrawal. Might this impact

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your financial planning? Think first about who your designated beneficiaries are and what their ages may be. You do have designated beneficiaries on your IRAs, right?

OK, no beneficiary shaming, please. The basic concept here is that any retirement account, whether it be an IRA, 401(k), etc., can be set up with one or more named, living persons listed as beneficiaries. If you were to die today, those accounts would get distributed to those beneficiaries, at the percentages listed, all of this happening outside of your Will. Contingent beneficiaries can also be set up, thus making the others "primary". In the event that a primary beneficiary predeceases you or disclaims their portion after your death, the contingent beneficiaries come into play. <u>A complete lack of beneficiaries simply means that the retirement account is left to your estate by default</u>. This would mean that <u>its disposition is then governed by your Will</u>. This is not necessarily a good thing, since <u>the official legal process for transferring such assets is called probate</u>. Good estate planning should strive to make one's probate estate as small as possible, thus saving on the legal expenses involved, unless there are other reasons for desiring probate.

But stretch IRAs have not been eliminated entirely. The SECURE Act defines the term "Eligible Designated Beneficiaries" as being exempt from the ten year limit. Here is a list of who qualifies as being eligible for this important exemption[10]:

1. Surviving spouses.
2. Children up until the (state definition) age of majority.
3. Disabled persons (following a strict IRS definition).
4. Chronically ill persons.
5. Persons less than or equal to ten years younger than the owner of the account.

Conspicuously absent from this list are grandchildren. This is where we should take a moment and mention what we think the impetus is behind all of this.

A few years back, the Supreme Court, in a unanimous decision, ruled that <u>inherited IRAs (or other inherited retirement plan accounts), are not retirement funds</u> and therefore, are not subject to the same creditor protections as provided to the (living) owners of retirement accounts[11]. In addition, we have heard on more than one occasion, legislators and Trump Administration officials state that <u>IRAs are not estate planning tools</u> (sorry, we do not have the specific references for these). The bottom line is that retirement accounts are tax favored tools to be used to fund the owner's retirement and that of his or her spouse. Given the difficulty most people have with saving enough for long enough and then investing those sums to build up and then manage the amounts through to the end of their lives, anything left over is considered essentially "gravy". We should also point out that the increased tax collection due to eliminating most stretch IRAs is one way of "paying" for the slightly enhanced income tax benefit of delaying those RMDs.

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Next, let's look at an actual RMD example under both the old and new rules, using hypothetical sisters, Jane and Jill.

Jane's 70th birthday was February 20th, 2019. This means that she turned 70 ½ on August 20th of last year (the "trigger" year). This was still 2019, so the old RMD rules still apply. The Required Beginning Date (RBD) for her first IRA distribution is April 1st of the year following the trigger year. This means that technically, the distribution can be no later than April 1st, 2020. The major problem with having waited until 2020 to take this first distribution is that the second year's distribution will be due by December 31st of 2020. This could result in a major income tax hit. We next look at her traditional IRA account balance as of December 31st of the year prior to the trigger year (2018), which was $500,000.

Keep in mind that Roth IRAs do not have any RMD requirements; this was not changed by the new law.

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RMD = Balance in IRAs as of December 31st of prior year / Life
                                                     Expectancy
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The life expectancy factor is given in an IRS supplied Uniform Lifetime Table (a different table would be used if her spouse was more than ten years younger, but that is not the case here) and is 27.4 for the year when the age attained was 70.

So Jane's first RMD is $500,000/27.4 = $<u>18,248.18.</u>

Then for each subsequent year, the process would be to take the ending balance in the IRAs as of the previous year and go into the table again to get the life expectancy value. It is not a matter of simply subtracting one from the original value and this is a good thing. These values decrease by less than a full year (< 1.0). A higher life expectancy means that the RMD is a smaller value and therefore, results in a lower tax bite as well as a slower depletion of your account.

It should be noted that you are able to take a distribution greater than the RMD at this age, without any penalty. Obviously, if the higher amount is required to meet your budget, then this would be your priority. The only issue could be if your account balances are depleting too quickly. Also, we should point out that nothing prevents you from owning multiple IRA accounts. You could then take the RMDs from each individually. Or, you could aggregate them in value and take the distribution from one, two or more, but not necessarily from each. So you have tremendous flexibility here.

Now, let's turn our attention to Jill, whose 70th birthday will be on June 25th, 2020. This means that she will turn 70 ½ on December 25th of this year. Since this is 2020, the new

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RMD rules now apply. The Required Beginning Date (RBD) for her first IRA distribution is April 1st of the year following the trigger year. But her trigger year has now been pushed out to the year she turns 72, which will be on June 25th, 2022. So her first distribution can be no later than April 1st, 2023. It would still be advantageous to get this first RMD in 2022, so that two RMDs would not need to be taken in 2023, given the tax issues previously mentioned.

Now, looking at her traditional IRA account balance as of December 31st of the year prior to the trigger year (12/31/2021), we don't yet know her balance. For consistency sake, let's assume it will also be $500,000. The RMD formula remains the same, but a new Uniform Lifetime Table has been proposed, which takes into account longer life expectancies. Since we have not yet seen its official release, we simply quote values which we believe will be used (please refer to the updated table for the confirmed values, when they become available). For age 72, this new value is expected to be 27.3.

Therefore, Jill's first RMD will be $500,000/27.3 = $18,315.02.

I realize this difference with Jane probably did not excite you all that much. But please keep in mind that Jill did not need to take RMDs for age 70, nor for age 71. In addition, the age 72 life expectancy value from the old table was 25.6. If it had been applied, then the RMD would have been $19,531.25. So delayed RMDs and slightly lower amounts are to be expected, as a result of the new law, potentially saving you a bit in taxes. While the expectation is that the new Uniform Lifetime Table should be usable by everyone immediately, we should probably wait for its official release in the IRS publications first.

Next, we briefly cover the major areas of the SECURE Act[12] dealing with retirement accounts and comment on each, as to whether we think it makes your retirement more or less secure:

1. **Elimination of the "stretch" IRA –** As covered in detail above, this does not change YOUR retirement. IRAs and other retirement plans are no longer considered to be estate planning tools and this would require some new analysis that may involve more Roth conversions, trusts, life insurance and potentially charitable giving. But your retirement is still secure.
2. **Pushing RMDs to Age 72 –** As covered in detail above, this change along with longer life expectancies in the new IRS tables, makes it slightly more secure.
3. **But Not Changing the Starting Age for QCDs (70 ½) –** A QCD is a Qualified Charitable Distribution. It permits up to $100,000 to be removed pre-tax from an IRA, per year, if the distribution is made directly to a charity. By "directly", we mean via a check from the IRA custodian (not from you) to the charity. By allowing an IRA owner to continue to make these distributions from the age of 70

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½, this is making your retirement more secure. Why? For those who would like to give to charity, IRAs are among the very best vehicles to use. The amount of the QCD reduces your RMD, but does not get included in your adjusted gross income(AGI). This is the equivalent of getting a charitable income tax deduction without itemizing. Since more than 90% of income tax filers no longer itemize, this is important to keep in mind.

4. **Annuities Could Become More Available in 401(k) Plans –** The law relaxes some fiduciary responsibilities that previously prevented employers from making annuities available, for fear that the wrong choice of insurance company would expose them to legal liability in the future. This should make your retirement more secure, if the annuity product available from your employer plan is better and cheaper than the one you could have purchased directly after doing a rollover. However, this must be analyzed first and a good place to compare is: immediateannuities.com. While a financial adviser would be the next logical person to ask, our typical warning about depending upon the advice of someone who gains by selling you a product, holds especially true here.
5. **Small Business Access to Multiple Employer Retirement Plans (MEPs) –** Retirement plans are fantastic tools, if they are used. One of the biggest issues with retirement security is that many employers do not offer any plan due to the cost. Therefore, many employees are left on their own and can only use IRAs. The new idea is that if employers pool together, they can access new plans in a cost effective manner. New regulations will hopefully deal with the issue that one unscrupulous, rule breaking employer, does not invalidate the entire plan for employees of all participating employers. This sounds great in theory, but we need to see it in practice. This makes retirement more secure for those who will get into a new employer based plan. For all others, there is likely no impact.
6. **Tax Credits for Employers that Auto-Enroll Employees –** There is now abundant research that workers do not object to being automatically enrolled in a retirement plan, but often fail to enroll themselves if this is not done by default. Why can this be true and yet we, as a society, complain about the "looming retirement crisis"? Perhaps we need to be serving free broccoli in the cafeteria as well? More security for those newly enrolled and no change for the rest of us.
7. **Repeal of Age Limitation on Traditional IRA Contributions –** Although the standard IRA has been around longer, both Roth IRAs and 401(k) plans allow those older than 70 ½ to continue to contribute. But not traditional IRAs. We never could figure that one out. Now, this age limit has been repealed. This will make older workers' retirements more secure. Couple this with the strategy of making sure you have 35 years of earnings on your Social Security work history, along with delaying SSA benefits until age 70, and now even someone who had a very late start, could still end up with a more secure retirement.

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8. **Distributions for Birth of a Child or an Adoption: Without Penalty –** A total of $5,000 can now be withdrawn early and without the 10% penalty (ordinary income tax still applies), for a "qualified" birth or adoption. Since this is not a retirement issue, we find it does not make retirement more or less secure. However, loans do not exist for IRAs, as they do for most 401(k) plans. Therefore, your adult children may find this helpful when starting families.
9. **Defined Contribution Plans Must Disclose Lifetime Income Estimates –** A defined contribution plan, such as a 401(k), will need to provide a disclosure to plan participants each year, showing an estimate of how much income the current balance in their account could provide. However, some plan custodians have already been doing this. The form of this estimation is still being worked out. If you do absolutely no other retirement planning, this number will give you perhaps some much needed shock therapy. So we would give this a very small positive in terms of making your retirement more secure. But retirement takes much more planning than this one calculation. It should involve all your assets and accounts of both yourself and your spouse. Oh well, baby steps...

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For Some, Their Most Important Estate Planning Document Won't be Drafted By an Attorney and Won't Have Any Legal Standing...Say What?

Imagine a couple who, in their late sixties, decide to finally do some estate planning. They contact their family attorney and ask for a meeting. They state to other family members that they intend for one of their adult children to be the executor for both of their estates. They are confident that this meeting will reach the desired end result, in that the necessary documents (a Last Will and Testament for each of them) would have been drafted and that their estate planning would then largely have been completed.

As it turns out, this couple ultimately gets a divorce. Then at their deaths, each of their Wills turns up missing, having either been intentionally destroyed or lost. They each pass away in different years and their estates are settled based upon the laws of intestate succession (i.e. what happens to you when you die without a valid will) in their respective states of residence at the time of their deaths.

But neither had any children from other relationships. Their original intention was for each of their adult children to inherit an equal portion of their estate. Guess what? That was the end result, anyway.

In this specific case, is it not a valid question to ask just what exactly did they gain by having Wills drafted that never got acted upon? It is probably a safe bet that their family attorney talked to them about the importance of having a Will. But did this attorney ever discuss the difference between what would happen with and without having a Will, based solely upon their situation and intent? The end result was essentially the same for each case, except for having paid the fees to the attorney to draft those unused Wills.

But when the time came to deal with the passing of each of them, questions arose about what the final burial arrangements should be. Where were important documents located? How were the funeral and final expenses to be paid for? Were there any special bequests of individual pieces of tangible personal property (since a lifetime accumulation of "physical" memories was intentionally missing from those Wills, from day one; the attorney did not want to complicate the legal documents with such "unimportant stuff")? No one had this information. It simply had not been written down.

It should be kept in mind that the reading of a Will and the actions of estate administration usually occur well after the final arrangements for the deceased have been made.

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Our purpose here is not to bash attorneys or Wills. Wills are very important legal documents and attorneys should be the ones drafting them. In various situations, other documents, such as trusts and powers of attorney, are also needed. But does this mean that the only important estate planning documents are those drafted by an estate planning attorney?

Our true to life case shows that the time and money spent on getting Wills drafted was basically wasted. The actual disposition of the estate went essentially the way the couple wanted, but practical and useful information that was necessary to have immediately following their deaths, was still nowhere to be found.

Time to step back and again remind ourselves what this is all about. In our view, estate planning is part of financial planning (FP). The objectives of estate planning should begin in FP with a plain, English language description of objectives. It then continues with (as always, our favorite word): **analysis**.

There is a wonderful part of estate planning that is largely ignored by many estate planning professionals. It is a document, but with no legal standing. However, it can guide the way for everything else. Where needed, it can reference the existence and location of the legal documents that have been drafted, such as Wills and powers of attorney. It can also serve as a valuable guide for the estate's executor (also called the personal representative or administrator), since that person may not have knowledge and experience in administering an estate. It can also do much more.

This document is called by several different names which all mean the same thing: Side Instruction Letter, Letter of Instruction or Letter of Intent[13]. We will refer to it as the Letter of Instruction and use the acronym: LOI.

In perhaps a thousand pages of estate planning material within the courses I have completed during my financial planning education, I went back and could only find a single paragraph discussing this document[14]. Why has it been given so little importance? Could it have anything to do with the fact that this document is not a money maker for the estate planning profession?

In our view, when this document stems from the goals of personal financial planning, it becomes much more robust and can actually serve as the “heart and soul” of the estate plan, for many people.

What should the LOI look like? There is no single “approved” form or template. Since it has no legal standing, the LOI can be put together by a person for his/her own estate. Certain family members and a trusted adviser can and perhaps should be involved. If

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there is a financial planning professional involved who has some background in the use of this document, so much the better. But there should be no coercion involved in generating the document and any professional involved should not be in a position to gain anything from the implementation of the LOI (at the person's death), other than having charged for services rendered to help construct the document in the first place.

The LOI will potentially be updated many times before a person's passing. Therefore, it should be constructed with the idea that it will need to get updated at some point. It should then be very easy for the person to do it alone. Handwriting such a document is, therefore, not very efficient. It clearly needs to specify the date of the current revision on its cover page and should also clearly revoke all prior versions, as a Will does.

The other useful content on the LOI's cover page is a table of contents. This breaks apart the document into major sections, each covering a different, but important, aspect of the person's estate. However, not everyone's LOI will contain the exact same sections. For example, some people will want to detail individual bequests of personal property. Their estate planning attorney may balk at including dozens of such line items within the text of their Will. Others may decide to leave their entire estate (including all personal property) to a single person mentioned in their will. No such section would be needed, in that case.

In other instances, a person may have numerous “digital assets”. Estate planning and the law are still coming around to figuring how to handle such intangible personal property when it does not carry the same level of documentation as intellectual property, such as patents and royalties. Logins and passwords may be the access methods to online accounts that must not only be safeguarded, but also accessed after death, in order to achieve final disposition. And speaking of disposition, what should become of social media accounts such as Facebook? Once again, the LOI provides a solution where a simple Will may not.

Even though the LOI is not a legal document, I believe that it always should be notarized on its final (let's refer to it as the “signature”) page. While this costs little or nothing in terms of money or time, it lends credibility to the person(s) who will be working with the document when the time comes. That person will be able to take a copy of the cover page and only those pages containing a certain section, along with the signature page and pass this LOI subset to a service professional, such as a funeral director. There should also be a space at the bottom footing of each page where the person writes in his or her initials at the same time that the notary public verifies the signature on the last page.

The existence of the LOI can and should be referred to in a person's Will. Any estate planning attorney should be able to draft a simple Will with a one sentence mention of it. However, if an attorney were to refuse a request to add this reference, we recommend

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finding another lawyer to draft your Will. The LOI, likewise, should mention which estate planning legal documents have been drafted and their location and/or who has access to them.

Some people advocate that the LOI also include a so-called "ethical will", a personal statement detailing values and beliefs that the person would like to pass along to surviving family and friends. While there is nothing wrong with this, it would probably be best to place this into a completely separate document and refer to it from the LOI. The same holds true for final messages to individual family members and friends that carry an emotional impact. Since there may be several such messages and they may be private in nature, it would be better if these were referred to in the LOI, but not contained within the LOI. The existence of, location of and access to such personal messages can be covered in the LOI, thus making this a "just the facts, ma'am" document.

The LOI is the perfect document to contain everything regarding a person's wishes for their final arrangements, whether this should involve burial or cremation, a grave site, a memorial service, notifications, flowers, a luncheon, etc. This brings us to a huge financial planning issue: Final arrangement pre-planning does not necessarily require pre-funding. Many service providers would desire that a person not only plan their funeral arrangements with them, but of course, pay for everything in advance. If you feel most comfortable doing it that way, we do not object. However, please keep in mind that some service providers have gone out of business by the time the person passes away. The extent to which amounts already paid for are safeguarded, is still a valid question.

This is also a place where you can specify the quality and expense of those final arrangement items. If you really do not wish to be buried in an expensive casket, then why not state exactly which one you would like, within the LOI? The family member responsible for making the funeral arrangements can simply take the relevant section of the LOI and present it to the funeral director, telling him to please implement the dear departed's wishes. No up selling or cross selling, please.

We are somewhat skeptical of pre-funding. This is not a knock on the funeral or cremation industries. As we have mentioned in prior estate planning articles, we value a dollar in our pockets today as being so much more valuable than a dollar in our pockets after we're gone. Why don't I care so much? Because at that point, I'm dead! Death is a certainty, but the timing of death and the circumstances are anything but. Do we know how many of those dollars in our pockets (meaning within all of our accounts) we will need to live on? After we are gone, if it were to cost much more to accomplish the final arrangements, we may not mind, as long as we have made provision for them in our LOI and in our remaining bank accounts.

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Which brings us to the next point. Funding of, identification of and access to, a bank account to pay for the final arrangements, needs to be included in the LOI. Is the executor a family member who can be given "convenience access" to a checking account for benefit of the person in question? This does not mean that they have the right to withdraw any funds for their own personal benefit. But it does mean that they will be able to pay for the final arrangements, if and when the time comes. All of this needs to be stated clearly in the LOI.

We close our discussion with a sample outline of the major sections that an LOI[15] should contain. Please be aware that it can be longer or shorter than this, depending upon individual circumstances. The language for each section should be plain English with a minimum of technical jargon. It needs to be clear and precise, even if it is anything but concise. It should be reviewed periodically and updated as needed. Treat it as the "master blue print " for your estate plan and it will serve you well, even if it winds up costing you essentially nothing to create!

1. **Cover Page** – Title (Letter of Instruction), personal identification, date and statement about revoking any prior LOIs, Table of Contents listing major sections.
2. **Final Arrangements** – Burial or Cremation, grave site, funeral services and instructions, obituary, notifications, luncheon, etc. This is especially where pre-planning does not require pre-funding. However, identification, location and access to the funding mechanism, such as the particular bank account to use, is especially important to make known here, unless this is already being put into the next section.
3. **Bank Accounts for the Estate** – The identification, location and access to one or more bank accounts to be used to fund final expenses and for administration of the estate. This is especially important for the executor. Anything stated in this section should not contradict statements made in the Will, since the latter document will be legally enforceable.
4. **Financial and Personal Records** – The identification, location and access to the Will and other estate planning documents, as well as all of the financial and personal records that the executor should work with to administer the estate. This may include all bank, mortgage and brokerage accounts, location of life insurance policies with policy numbers, birth certificate, marriage license, diplomas, valued awards, etc. If any records are locked up or located offsite, locations need to be identified and access to keys/key-codes/fobs/combinations must be included.
5. **Offsite Safe Storage** – The identification, location and access mechanism for such things as bank safe deposit boxes and public storage units, should they exist. This brings up the issue of who will have access in the event of the person's death. A co-owner who is a trusted family member, or the executor of the estate, could

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be added to the bank's records. Please check with the institution to see what their specific requirements are after a joint owner has been declared dead.

6. **Personal Property Bequests** – While the Will may specify the disposition of some high value probated property, or speak to what happens to the residual of an estate, many estate planners avoid giving someone free rein to list dozens of individual items of personal property. The Will can and should refer to the existence of the LOI. Then you have the freedom to make the list as long as you like. We recommend that this definitely be a separate section of the LOI.
7. **Digital Records** – Unlike drawers of paper based records, digital records comprise the identification, location and access to all electronic records and accounts. This should include the location of logins/user ids and passwords, along with security question answers and any PIN numbers. PDF copies of bank and brokerage statements and tax returns are other examples. A person organizing their estate by creating the LOI should take this opportunity to organize how they keep their logins and passwords. Some use specialized password keeper software, while others have spreadsheets. Being shut out from something as basic as an email address and associated password, can stymie family members from accessing needed electronic records being sent from all sorts of business and healthcare providers, since these are stored on the email provider's servers.
8. **Digital Assets** – Here we draw a distinction with digital records. These are anything of value for the person, that are not stored on physical media. Photos, music, movies, recordings of special events, etc. Some may be irreplaceable. Where are they stored? How are they stored? What are the access mechanisms and passwords, if any? Is there cloud storage involved? Or a flash drive located at the bottom of a dresser drawer? While this may cause a person to evaluate how they could better organize their digital property, simply listing its existence, whereabouts, access methods and final disposition (who gets what), would go a long way to making sure your estate is handled the way you would like. Please keep in mind that an ever larger number of items are going to be stored in a digital format. Having a family member sell your Kindle for five dollars at an estate sale, not knowing that a hundred of your favorite books are going along with it, is probably not the best thing to have happen. List them all out in your LOI.
9. **Pets** – Some people want to address what should happen to their pets within their Will. At the very least, care for each pet should be specified here in the LOI.
10. **Final Messages to Family and Individuals** – Our recommendation is that final messages and letters, whether to the entire family or directed to any individuals, should probably be kept out of the LOI, but definitely be referenced in the LOI. The existence and location of each message should be listed, so as to keep matters more private and keep emotions out of the LOI.

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14. Dalton, Michael A. and Langdon, Thomas P., **Estate Planning for Financial Planners**, Third Edition, published in 2004 by Your Money Education Resource, St. Rose, LA 70087, pp. 32-33. This is an older edition of a popular college and CFP textbook for estate planning. Credit to the authors for including a concise description of the "Side Instruction Letter" within this older edition. The latest edition of this book can be found on Amazon under a slightly different title using the following link:
https://www.amazon.com/Estate-Planning-Michael-Dalton-Langdon/dp/1946711519/ref=pd_sbs_14_1/142-9035915-4903228?_encoding=UTF8&pd_rd_i=1946711519&pd_rd_r=0c1ce6c5-e2df-47ef-9d87-71d8f9a9ca67&pd_rd_w=mCGrt&pd_rd_wg=Il6r4&pf_rd_p=7cd8f929-4345-4bf2-a554-7d7588b3dd5f&pf_rd_r=BG5FGGDJ493CZE5HKT00&psc=1&refRID=BG5FGGDJ493CZE5HKT00
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15. Kelly, Caitlin, "You Need a Letter of Intent as Well as a Will", **Investopedia**, updated August 5, 2019. This article has a nice list of things that could be included in the LOI, although we added some of our own ideas in our list, which we thought were important. The article can be accessed via the following link:
https://www.investopedia.com/articles/personal-finance/051414/do-you-have-crucial-financial-letter.asp
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