GREENSPRING

Best Practice Financial Advice for Physicians

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Executive Summary

1. Avoid the biggest mistakes, and you'll be ahead of many doctors I meet
2. Minimize taxes with sensible strategies and the proper types of investment accounts
3. To protect your assets from creditors, a few simple steps can help
4. Get the insurance you need – nothing more and nothing less
5. Consider evidence-based investing when building a diversified portfolio

1. What are the Biggest Investment Dangers Facing Physicians?

Here are some of the most common errors we see doctors make:

- **Suboptimal Products:** Doctors get pitched lots of suboptimal products like annuities, private real estate transactions, alternative investments like hedge funds, etc. The vast majority of these are unnecessary products with high fees and poor performance. Ask lots of questions, understand the advisor's incentives, and read all of the details carefully.
- **Excessive Fees:** Understand fees, both of the underlying vehicle (e.g., mutual funds), and if you have an advisor, understand what he/she is getting paid directly and indirectly. We review many portfolios of doctors where their total all-in costs are as high as 2%-3%.
- **Conflicts of Interest:** My recommendation is to seek a fee-only advisor such as one found at www.napfa.org, which means that the advisor legally must act in the clients' best interests and receives no kickbacks or commissions for placing clients into certain products.

Below are three myths that many people believe:

Myth: Investing with someone who researches and picks individual stocks is better than buying a small piece of every stock in the entire world stock market.

Fact: Many doctors think, "Since I'm smart, I should be able to beat the market." However, the evidence suggests that it's nearly impossible to outperform the market over time. Diversified index funds do better than actively managed mutual funds over the long-term, as you can see in the chart below. On a similar note, most people who try to time the market (e.g., move money from one industry/sector to another each quarter) do not end up ahead.

The Failure of Active Management

Fraction of mutual funds that survived and beat their index for 15 years, ending 12/31/15

Survivors are funds that were still in existence as of December 31, 2015. Outperformers are survivors that beat their respective benchmarks over the period. See "Data Appendix" page in the Appendix for additional information.
Source: Mutual Fund Landscape, Dimensional Fund Advisors 1016. US-domiciled mutal fund data is from the CRSP Survivor-Bias-Free US Mutual Fund Database, provided by the Center for Research in Security Prices, University of Chicago.

Myth: Politics can greatly influence the stock market.

Fact: Do you think the stock market has performed better under Democrats or Republicans? Perhaps surprising to some of you, the market has performed better under Democratic presidents than it has under Republican presidents. Even more to the point, we believe that it's futile to try to predict investment results based on election outcomes. As always, it's best to stay invested, rebalance when necessary, and diversify. Keep politics out of investing!

Myth: All financial advisors must legally put their clients' interests first.

Fact: Unfortunately, some advisors do not have to do what is in your best interests. Confusing the matter, some advisors are registered in two different ways so wear both a fiduciary hat at some times and a non-fiduciary hat at other times. As noted above, our desire is that everyone gets advice from someone who operates under the fiduciary standard 100% of the time.

2. How Can You Minimize Taxes?

Where to Save – Saving into your workplace retirement plan (e.g., 401(k)) will generally be the best place to start because your contributions are tax deductible and tax deferred. Many doctors are in the fortunate position of already contributing the maximum amounts to retirement plans such as their 401(k)s. As mentioned earlier, the desire to save taxes can lead people to invest in suboptimal products (certain life insurance and annuity products). Instead, an often underappreciated vehicle is a regular taxable investment account. This offers flexibility as well as tax advantages due to lower long-term capital gains tax rates. Do not overlook this type of account for your excess cash.

You might be surprised you're eligible for many of these tax-saving strategies

There are additional vehicles and strategies that could potentially save you many thousands of dollars in taxes each year:

a) **Backdoor Roth IRA Strategy:** If your income is too high to contribute to a Roth IRA, and you have little or no Traditional IRA accounts (401(k) plans are OK to have), you should definitely look into this strategy. If done properly, very little to no tax should be due upon conversion to the Roth.

b) **Traditional IRA:** If you are not covered by a retirement plan at work, then you should contribute to a Traditional IRA since it will be tax deductible. If you are covered by a plan at work and earn too much, rather than contribute to a non-deductible IRA, it will often be better to invest in a regular taxable account since the tax rates on withdrawals from the IRA will be higher.

c) **529 Plans:** If you have children/grandchildren for whom you wish to help pay for college, this is a wonderful plan that allows for qualified educational expenses to be withdrawn without paying any taxes on the earnings. In many states, residents can also get a tax deduction. If you can't get a tax deduction or your home state 529 has high costs or mediocre fund options, I would strongly consider opening a 529 in another state. (Utah and New York are my favorite states if you choose to go outside your home state.)

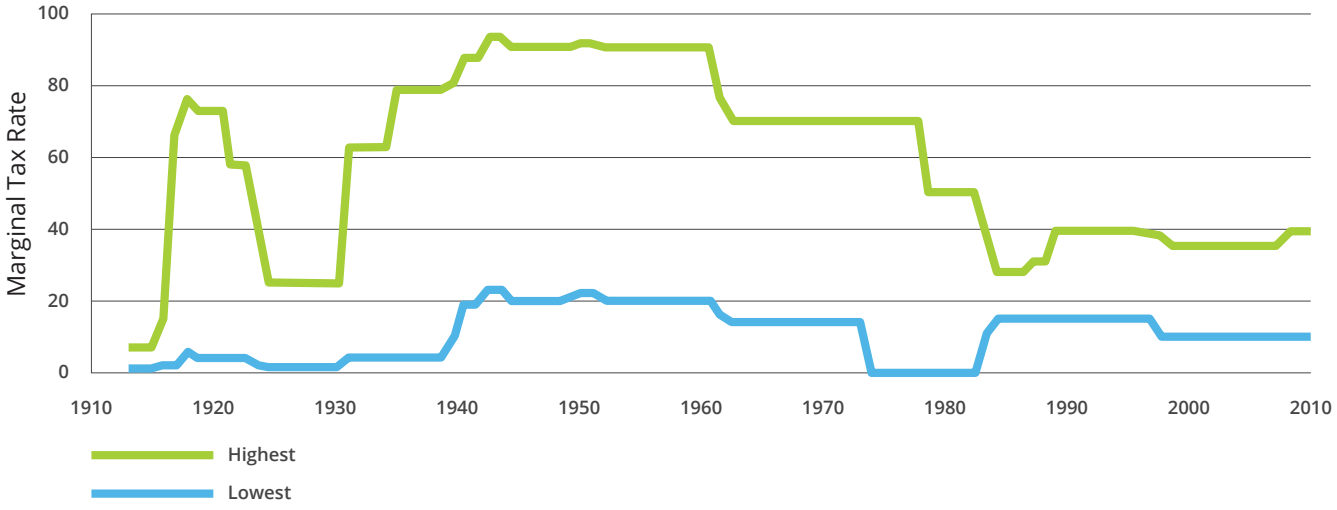
d) **SEP-IRA or a self-employed 401(k) account:** If you have any self-employment income, you can potentially save even more with either a SEP-IRA or a self-employed 401(k) account. In many situations, the self-employed 401(k) is superior to the SEP-IRA, although many people still incorrectly believe the SEP-IRA is best. If you own part of a practice, there are even more opportunities available (e.g., cash balance retirement plan, which can potentially let you deduct over $100,000 each year).

e) **Health Savings Account (HSA):** If you have a high-deductible health insurance plan, you should save money in your HSA because the tax advantages are huge. Unlike FSA plans, an HSA can accumulate over the years, so it is best to let it grow and plan to spend the funds as you approach retirement or are even retired.

f) **Tax Location:** Generally it's best to place stock index funds in your taxable account and leave all of the bond funds (and other income-producing funds) for your IRA or 401(k) since bond income would be taxed at a higher tax rate.

Tax rates can vary greatly over the years, as you can see below. So careful tax planning is vital.

Historical Marginal Tax Rate for Highest and Lowest Wage Earners



Source: Tax Foundation, "U.S. Federal Individual Income Tax Rates History, 1862-2015", 17 October 2015

3. How Can Doctors Protect Assets From Lawsuits?

Greenspring is not a law firm. Since each state and situation is different, it's best to seek customized advice on these matters from a local estate attorney. That said, here are some suggestions to consider if you seek to protect your assets from creditors.

- **Joint Tenants:** I come across many Joint accounts titled as Joint Tenants With Right of Survivorship (JTWROS). If either you or your spouse gets sued, a portion of assets in that type of Joint account is not protected. However, many states allow a Joint account called Tenants By Entirety (TBE) if you are married. With TBE, there is typically greater protection from lawsuits because it is one account that cannot be partitioned. If you currently have Individual investment or bank accounts, or have a JTWROS account, in just a few minutes, you can change it to TBE.
- **Umbrella Liability Insurance:** An umbrella policy sits on top of your auto/home policies and protects you if a huge event occurs (e.g., settlement or lawsuit costing hundreds of thousands or millions of dollars, though there are many exclusions, like all insurance). Because an issue this large is so unlikely to occur, the cost of this insurance is cheap (e.g., a few hundred dollars for a $1 million umbrella). Depending on your asset levels, it would be prudent to purchase between a $1 million and $5 million policy.
- **Employer qualified plan and IRA:** Most employer retirement plans, such as a 401(k), are protected from lawsuits. So are IRA accounts in many states. The more you save in these types of accounts, the better.

These three strategies are simple and effective yet underutilized. Additional strategies can offer even more protection but are extremely complex and come with a number of downsides (e.g., asset protection trusts, lifetime bypass trusts, outright transfer of assets to a spouse or children if they are at less risk of a lawsuit).

4. How Should Physicians Think About Insurance?

In general, it's good to think about what you wish to insure via an insurance company vs. what you will "self-insure." For example, unless you believe you are at a somewhat higher-than-average likelihood to experience a car or home insurance claim, it is best to raise those deductibles to $1,000 and self-insure (i.e., you cover) the amount up to $1,000. Similarly, you can apply this concept to disability insurance coverage. If you're not covered by a disability policy through your employer, you should likely consider purchasing a group plan or a private policy. In order to lower premiums on a private policy, you should consider a 365-day elimination period vs. the more traditional 90-day or 180-day periods. By self-insuring for an entire year, as long as you can afford it, you will save a substantial amount of premiums. Likewise, there are some costly riders with disability plans that we often don't recommend, such as the catastrophic disability rider.

Be careful because many insurance products are complex, costly, and unnecessary

For life insurance, in most cases, it is better to purchase a Term Life policy instead of a permanent policy such as Whole Life or Variable Universal Life. If you already have an insurance product (or annuity) with cash value, it almost always makes sense to have an objective advisor review the future returns associated with that policy. With interest rates at very low levels, we have found many policies are not performing as well as the assumptions suggested when they were purchased. Because of this, we generally see a higher probability of the policy lapsing. Often this is not caught by someone just reviewing their policy statement since it requires much deeper analysis. If it turns out that the policy is generating a sub-optimal return, a tax-free 1035 Exchange into a lower-cost annuity can potentially improve investment returns. In order to make these determinations, it is imperative to request in-force illustrations to help calculate internal rates of return.

Long-term care insurance has gone through many changes over the past decade. In general, if you will accumulate a high net worth (e.g., over $1 million in investment assets), we believe it's best to self-insure and save yourself thousands of dollars in premiums each year. The reason is because if you are in a nursing home (or require care at home) for the average 1-2 year stay, you will still be able to afford it. On the other hand, if you have a longer-term need (e.g., dementia), the majority of that cost will not be covered by long-term care insurance. In the old days, policies with unlimited benefits were sold; however, they are no longer readily available, so if you have a long-term need, you will be on the hook after the insurance runs out.

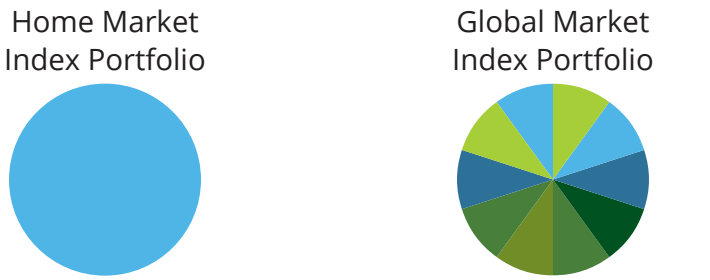
5. What is Evidence-Based Investing?

Follow the Evidence – Doctors utilize evidence to make decisions in the best interests of their patients. We believe investment professionals should review the evidence as well. Over the past 50 years, the evidence has been pretty conclusive. The key findings have been as follows:

1. Passive beats active management
2. Past performance is not predictive of future results
3. Diversification is the only free lunch
4. Structure determines performance

It shows that one should invest in low-cost broadly diversified mutual funds (data shows lower-cost mutual funds are the best predictor of success). Additionally, as you can see below, diversifying with a global portfolio has been shown to offer a better risk/reward profile than US only.

The Value of Diversification - Equities



	S&P 500 1 country, 500 stocks	DFA Equity Balanced Strategy Index 46 countries, ~11,500 stocks
Return	10.24%	13.47%
Risk	15.31%	15.34%
Growth of $1	$91	$346
Worst Cumulative 10-Year Return	-29.46%	37.42%

Returns from 1/1970 to 3/2016. Past performance is not a guarantee of future results. You cannot invest directly in an index.

Index funds have outperformed the vast majority of actively managed funds over time. But even better, data proves that tilting/overweighting towards Small and Value stocks (via mutual funds) has outperformed index funds over time.

If you could invest in either Apple or a start-up technology company, and they both offered you a 10% expected return, which would you choose? You'd pick the larger, safer Apple of course, assuming that you could earn the same return. So what happens is that the start-up company has to offer investors, say, an 18% expected return to attract their capital, while Apple only has to offer a 6% return. Greenspring believes it's best to own both, but overall, it is better to have a relative overweight in the smaller companies than larger companies compared to a typical market index fund. This effect has been proven, over time, in stock markets throughout the world.

Similarly, you can split the stock universe into Value companies (those going through some distress) and Growth companies (such as Facebook or Google). While Growth companies do better with metrics such as revenue or profit growth, they attract so much attention and interest that the prices are often high, which results in worse valuations and lower expected returns over time. At Greenspring, we like to own both types of stocks, yet we will tilt towards overweighting Value stocks which, like Small stocks, have been shown to outperform over time in global markets. Lastly, to be clear, we believe it is far superior to own these stocks via mutual funds and not by purchasing a handful (or even dozens) of individual stocks.

About Jeff Bernfeld

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Jeff received an MBA from Harvard Business School and earned a BBA degree in Finance from The University of Texas. He also obtained the CERTIFIED FINANCIAL PLANNER™ certification from the CFP Board of Standards. Jeff has the privilege of providing comprehensive financial planning and wealth management services for individuals and families. He works with a number of physician practices throughout the country.

Jeff is on the firm's Financial Planning Committee, where he has become an influential thinker on topics such as retirement planning, tax minimization, and social security optimization. Due to some of his recent work, Jeff has been quoted in several publications, including *Financial Times's FundFire* and *The Daily Record*.

Jeff is active in philanthropic efforts and is currently on the Advisory Board of Alternative Directions, a local non-profit organization. Jeff, his wife Erica (an ophthalmologist), and their son Jake reside in Towson, Maryland.

GREENSPRING

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