CONLON DART

wealth management

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> "There isn't time, so brief is life, for bickerings, apologies, heartburnings, callings to account. There is only time for loving, and but an instant, so to speak, for that."
>
> *Mark Twain*

The Long-Term Care Crisis

As baby boomers begin to enter their seventies, many in this 75-million-strong generation will be confronted with the need for long-term care assistance. Some will be able to handle the financial aspects of that just fine, but others will find themselves under great financial stress. At the extreme, some families will be financially imperiled with no means to fully recover.

Like many of you, I have experience with long-term care in my own family, including its financial repercussions. My late father spent four years in a long-term care facility, and required a good deal of medical attention for much of that time. While my parents did an admirable job saving for their retirement, like many folks, they weren't entirely prepared for the financial costs associated with my dad's extended struggle with Alzheimer's.

My parents did not have long-term care insurance. They weren't alone. In 2015, only 3% of Americans carried private insurance for long-term care. And of the 86 million Americans over age 55, only 7 million were insured.

This is not to suggest that insurance is the answer for dealing with age-related medical problems. On the contrary, in today's mostly dysfunctional insurance market, long-term care insurance frankly isn't capable of answering *that* call.

Insurance for long-term care has been around for over 30 years. But until home nursing care was introduced as a standard policy feature in the early 1990s, it was a fairly sleepy industry. Sales took off later in the decade, and soon more than a hundred insurers were in the business, all geared up for the aging of America. Sales peaked in 2001, when over a million long-term care policies were sold. But after that

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On Chasing Five-Star Funds

Last month, The Wall Street Journal rattled the investment community with a scathing admonition of Morningstar and its near-sacred star rating system for mutual funds (we weighed in on the subject in our weekly blog). Among other things, the Journal took a shot at Morningstar for leading investors to believe its star rating system could help them select mutual funds that would perform well in the future. Morningstar, as expected, fired back with a swift rejoinder, stating that they never claimed their system held predictive powers, and that their star ratings were largely intended as a starting point for investors. On and on it went.

In Morningstar's defense, the Journal presented its research in near-exposé fashion, almost as if it had uncovered an unknown truth about star rankings and what they mean for future performance. The truth is, there are countless studies available, many of them more robust than the Journal's, that demonstrate the difficulty of predicting future success based on past results. We will touch on some of those findings—but first, some background.

Morningstar was founded in 1984, the same year I entered the financial advisory business. Back then, the mutual fund industry was relatively obscure (though Peter Lynch and John Templeton were burgeoning stars), and the average investor barely knew how a mutual fund worked, let alone how to select one. So Morningstar came along with the notion of making fund data and performance tracking more transparent.

I was an early subscriber to Morningstar's research, which came in a huge three-ring binder broken up into

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Tis’ the Season

“You might be surprised at how much activity takes place on behalf of you and your investments in the final month of the year.”

The period between Thanksgiving and the end-of-year holiday season would seem like a sleepy time for financial planners, but in fact it is anything but. You might be surprised at how much activity takes place on behalf of you and your investments in the final month of the year.

For instance?

Even though this has been a good year in the markets, not all investments will have gained value. This is the last opportunity to harvest any losses we find in taxable accounts, by selling investments that have gone down and “booking” the loss. Then we can look for investments that have gained value, sell some of those to offset the losses, and thereby save capital gains taxes in the future. Up to $3,000 of ordinary income can be offset by investment losses as well.

This is also the time of year when mutual fund companies post, in advance, the amount of ordinary income and capital gain distributions they will make to their shareholders. Since the value of the shares drops by the amount that is distributed, this would seem like a non-event performance-wise. But in fact some mutual funds are poised to make 20% or even 30% distributions, and this cash is immediately taxable, unlike gains in the share values, which are only realized when you decide to sell. By selling funds before the distributions, and buying them back later, we can reduce your tax bill this year.

For people over age 70 1/2, this is the time to make sure that the required minimum distributions have been made out of IRA accounts, since failing to take that money out of the tax-deferred bucket would result in an IRS penalty. More broadly, this is also a good time of the year to determine if a Roth conversion pencils out or not.

And of course we keep an eye on the various tax reform proposals, and tentatively plan around them.

One possibility this year is to make charitable contributions before year-end, in case the deductibility of your donations goes away (assuming you elect taking the proposed higher standard deduction instead).

If you believe tax rates are going down, and especially if itemized deductions are about to be limited, we might consider accelerating expenses into this year and deferring income, where we can, into next year’s lower brackets.

Meanwhile, we hope you enjoy the holiday season, and that you gain a little extra comfort knowing that a lot of issues are being tended to on your behalf.

- Your Conlon Dart Team

Long-Term Care...

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they declined, and by 2016, fewer than 100,000 policies were sold. What went wrong?

For starters, insurers failed miserably when it came to pricing their policies. They failed to account for a series of variables that did not work in their favor, not the least of which was a precipitous drop in interest rates, which severely impacted their reserve portfolios. Secondly, they failed to account for the fact that most folks buying the insurance would hold onto the coverage as they aged, rather than letting their policies lapse. This misfire was further exacerbated by the fact that Americans were living longer, which meant that more insured people would claim policy benefits.

Eventually, all but a handful of carriers left the business. Those who stayed shared their worries with state insurance commissioners, who in some cases agreed to bump up annual premiums or reduce benefits for entire classes of policies already in place. This happened at a time when most policy owners were still buying coverage with a promise of fixed, not variable premiums. But carriers learned they could bump rates and benefits as long as they did it for an entire class of policy owners, rather than cherry-picking those in poor health.

Insurance providers also got more creative. In recent years, they've been selling products that combine life insurance and annuity-based long-term care. According to trade group LIMRA, 220,000 of these combo policies were sold in 2015, up from 15,000 in 2007.

Unlike traditional long-term care insurance, these new policies come with liquidity features and offer at least some return on investment. Even so, the newfangled policies are terribly complicated and don't do all of what they claim to do particularly well. Typically, insureds will get more bang for their buck with traditional coverage, as they would by buying their life insurance and investment products separately. All-in-one products often sound good when presented by a seasoned salesperson, but the fact is, they are almost always sold after heavy persuasion, as opposed to being requested by customers.

Insurers such as Genworth, who continue to sell standalone long-term care policies, have aggressively lobbied state insurance commissioners for the right to make changes every year to their premiums. Certainly, that would slow some of the egregiously high rate hikes seen in recent years, but it wouldn't do anything to make coverage affordable, let alone predictable in cost for policy owners.

As messy as the long-term care insurance market is, many middle-class Americans would be wise to explore coverage and obtain quotes. In a perfect world, all of us would have the means to self-insure for this risk, or if not, perhaps buy coverage in some form of a currently-unavailable Medicare add-on. As of now, Medicare won't pick up any of the tab for long-term care. Government help is only available if you're eligible for Medicaid, which means you would have to deplete most of your assets first. Otherwise, you are on your own.

When running financial planning projections for couples, Conlon Dart frequently "pressure tests" different outcomes. With long-term care, we assume that lifestyle spending remains constant late into retirement, then we layer on several years of a long-term care stay for one partner in the relationship. Not every financial plan can withstand that unwanted layer of expense, of course, but proper planning well ahead of a crisis can at least help avert a financial meltdown.

- Mitch Conlon

Stat Bank

7.3...Percentage annual increase in student loan debt nationally over the last 5 years.

(Federal Reserve Bank of New York)

170...Amount in billions of exported goods to China from the US, up from $17 billion in 1999.

(Commerce Department)

16...Percentage of business owners who actually have a documented succession plan in place, compared to 50% who claim to have a succession plan. ...

(PwC)

4.1...Current unemployment rate through October 2017, the lowest unemployment rate since December 2000.

(Department of Labor)

34...Percentage of American households headed by a senior at least age 65 who receive 90% or more of their annual income from their Social Security retirement benefits.

(Government Accountability Office)

Finding

Clarity

in

the

Complex.

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Five-Star Funds...

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maybe a dozen sections. Each month, I would eagerly pore through the latest release, digging into updates and working my yellow highlighter dry. By the early 1990s, Morningstar began delivering this data via disk, and later, CD-ROM.

Nirvana! Rather than shuffling through my binder, I could sort through hundreds of mutual funds and create my own filtering system on my desktop computer. That was a game changer.

Along with others in my firm, I soon learned how to sort and filter funds in myriad new ways, such as excluding those with high expenses, a recent manager change, high turnover, volatility, and so on.

As our firm's research capabilities became more robust and our ability to screen funds more nuanced, we began to realize that placing too much emphasis on star rankings was counterproductive.

While the system provided an excellent filter for finding funds that had experienced solid risk-adjusted returns in the past, trial and error taught us that consistency and sustainable success weren't most fund managers' strong suit. Nevertheless, we did find Morningstar's fund data invaluable, and Conlon Dart still subscribes to certain of its more robust research services to this day.

Early on, though, Morningstar grew fast, gaining credence with individual investors for its increasingly popular star rating system. Which leads us back to the company's skirmish with the Journal.

The data in support of its proprietary star ranking system, as Morningstar claimed in its retort, could in fact be construed as *moderately* predictive. For proof, Morningstar noted that a fund with an overall five-star ranking had a 14% chance of remaining a five-star fund over the next 10 years. By comparison, a one-star fund only had a 2% chance of becoming a five-star fund over the same 10-year period. This point is not a slam dunk in Morningstar's favor, but it counts for something.

What Morningstar could not defend, though, was the Journal's claim that once a fund achieved five-star status—often producing a flush of new assets—results suffered. This is true, though it's hardly new information. It's possible that the infusion of money itself contributes to the problem. Studies as early as 1999 have demonstrated the negative impact of rapid cash inflows into a previously successful fund.

Robert Huescher of Advisor Perspectives looked at the issue another way. He and his team compared the performance of randomly-selected five-star funds to four-star funds with similar risk-adjusted returns. Performance was only slightly better for the five-star funds—rendering the fund selection a mere coin flip.

Further studies by Vanguard and others show that on average, funds with lower expense ratios do better than funds with a great Morningstar rating.

In the end, Morningstar's success became part of its problem. The tools the firm offers investors can be invaluable if they're used properly. But the fact remains: star ratings wield a great deal of power. Funds flaunt them in their advertising, and too many individual investors rely on them without looking any deeper. Even some investment professionals sell funds based on their stars.

That's not a good idea. In finance, it's essential to do your homework and have a plan. We learned long ago that there are no shortcuts. So should you.

- Mitch Conlon