TheAnalysis Gap:
A Silent, Wealth-Destroying Parasite

by Kirk Loury

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The Analysis Gap:
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What you will learn:

1. Planning is necessary to accomplish anything important.
2. Financial/wealth planning software represents the advisor’s primary tool for building investment solutions.
    a. The investment solution represents the wealth plan’s executed form.
3. A wealth plan incorporates a variety of goals, but, if the goals’ forecasted cash flows are not interconnected to one another, gaps occur.
4. When the unplanned gaps appear as each year arrives, they must be funded.
5. An unplanned funding takes wealth intended for future years to pay for the present year’s inefficiency.
6. Each dollar pulled forward to fund the gap is the loss of a compounded dollar.
    a. Compounded dollars create wealth.

As a general construct, a modicum of planning is better than no planning at all. Clients of financial professionals, though, often want to go beyond financial planning as a discrete function to seek integrated wealth management services encompassing planning, execution, monitoring, and reporting.

The operative word here is “management”, which we can further define as an ongoing process that anticipates, controls, and delivers. Within this management process, two levers exist – efficiency and effectiveness – that distinguish one firm’s service package from another. (“Efficiency” addresses how wealth is used; “Effectiveness” measures achievement of the wealth’s intended purpose(s).)

Often lurking behind the financial plan’s tables, charts, and graphs is a parasite that destroys wealth as each year of the financial plan unfolds into an actual cash flow implementation. This parasite is the Analysis Gap, and it is a function of a planning tool’s analytical thinness concerning the difference between goal-based planning and incomplete—and disconnected— cash flow projections.

Financial Planning: Building Confidence in Light of the Uncertain Future

Financial plans answer a number of questions, but three stand out:

1. "From what our lifestyle is today and what we want to do in the future, can we do it with our resources?"

2. "How will our resources shift over time as we move through our different life stages?"

3. "Given our spending preferences, will there be enough money to last until [name of the surviving spouse] dies?"

Each of these core questions peers into an uncertain future. Planning brings attention and structure to the projected interaction of financial and economic variables. The variables at hand are cash sources, cash uses, and priorities. However, the shortfall risk – question #3 – is at the center of any discussion, since, should the answer be "No" to the question of "enough money", the planning process will have failed.

> As we look at the role of financial planning, it is vital that it be considered as an ongoing process that is deeply connected to the plan's execution. Suffice it to say that "wealth management" is the same as saying "planning with execution".

Goal-based planning methods focus on the goal (or want or desire) as a specific funding task, while secondarily modeling a client's normal lifestyle budgeting. On the other hand, cash flow-based tools build from the current budget and make projections into the future. Both approaches have advantages and disadvantages.

Whereas goal-based planning's compartmentalizing makes the process packaged, this very act misses the reality of interconnected cash flows in each projected year and across time horizons. Cash flow-based planning interconnects cash flows, but the process is tedious and it seems too restrictive (i.e. compared to the excitement about fulfilling financial goals/desires).

The false premise is goal- and cash flow-based approaches are mutually exclusive. There is no reason why the advantages of each method can't remain while the disadvantages are minimized. Consider that companies of all sizes around the world have ably integrated capital budgeting (i.e. "How we're going to fund the strategies we choose to undertake."; analogous to an individual's goals) with financial budgeting ("How we're spending our money.") for decades. So, too, can individuals achieve the best of both approaches.

Reality Check: Planning with Execution as a Single Connection

A financial plan, be it from dedicated software systems, a spread sheet, or notes on a sheet of paper, proposes some level of formality to the matter of wealth management. Regardless of the form, all plans have two views.

The first is the current-year view that identifies the client's present financial priorities, resources, and inefficiencies; it uses facts and known circumstances in representing the most accurate and detailed accounting. The second view projects assumptively from the current year to all future years spanning decades and, even, generations. Indeed, this second view often sits at the nexus for clients desiring planning in the first place.

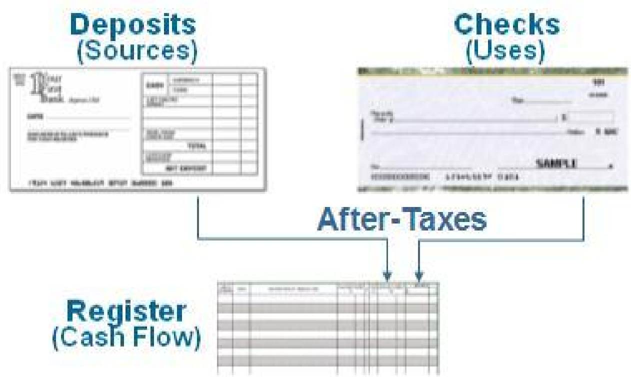
This long-term horizon is a heavy burden given the challenges of an uncertain future, but a burden, if carried well, that binds the client to the wealth manager for the duration (even to those succeeding generations). As we look at the role of financial planning, it is vital that it be considered as an ongoing process that is deeply connected to the plan's execution. Suffice it to say that "wealth management" is the same as saying "planning with execution".

Across advisors of all different types (e.g. RIAs; registered representatives; hybrids; CPAs; trust officers; insurance agents), financial planning naturally represents a specific task: one should first plan before one should act. However, this truism risks keeping the plan in a continuously disconnected state from its actual execution.

A financial plan, while operating at a level above the client's sea of day-to-day transactions, still must account for the interaction of cash inflows and outflows, future year by future year (as represented in an ongoing planning-to-execution connection).

A Useful Metaphor: The Financial Plan Operating as a Projected Check Register

With slight modifications to the metaphor of a checking account, the financial plan operates as a check register. Flowing into the register are



funding sources (e.g. sources of cash); flowing out of the register are uses of cash. There are vital characteristics about these flows that the financial plan must manage in order for it to be viable and the execution to be effective:

- **Processing Uses of Cash**
  Financial planning software commonly models needs/goals as though they are separate events and cash flows when, in fact, every single cash use from the

grocery bill to the vacation home cash down payment to annual estate gifts are paid through the client's annual cash flow.

- **Uses of cash: Paid in Net Amounts.** Everyone understands that "What I earn." is not the same as "What I have to spend." as a result of taxes and imposed fees.

- **Uses of cash: Paid in real dollars.** The impact of compounding on a value is known theoretically by clients, but it is often difficult to appreciate how a constant growth rate over a number of years can balloon the amount actually paid when the bill comes due. Putting $1,000 in the proverbial mattress today for a payment due in ten years will leave the client short of money because of inflation. Therefore, producing and presenting cash flows in future values – the amount expected to be paid in the year it is due – makes this point sharply.

- **Sources of cash: Net Amounts.** Payroll and other compensation have taxes withheld so the amounts flowing into the check register are essentially value-matched with the after-tax (i.e. net) dollars flowing out.

- **Sources of cash: Gross Amounts.** Many income sources do not have withholding and the dollars flowing into the register are over-valued to what will be available after the taxes and/or imposed fees are paid. In this case, the gross amount of the initial inflow represents a value mismatch to the actual net cash outflows.

- **Sources of Cash > Uses of Cash: Annual Surplus.** A check register with money left over after paying for all the uses has a positive balance. Excluding any balance kept as a cushion for emergencies, excess surplus is either reallocated to investments earning more than a checking account or spent on a cash use outside the scope of the lifestyle budget (and sometimes beyond the overall plan's expectation if the client is not disciplined).

- **Sources of Cash < Uses of Cash: Annual Shortfall.** Just as "insufficient funds" in a checking account must be immediately resolved by depositing money from other sources, a financial plan must identify the sources to fund annual shortfalls within the proforma cash flow register. A failure to account for these shortfalls in the year-by-year mapping sharply increases Shortfall Risk.

- **Unusual cash flows.** A bonus check gets deposited into the checking account; payments to fund an annuity or to give money to children are withdrawn from the checking account. These extraordinary cash flows passing into and out of the checking account need to be addressed: the excess cash from the deposit is moved to an investment account to grow, and the large withdrawals are funded by transferring money from an investment account.

Failure to act on these events leads to inefficiency (not investing) or higher costs (getting hit with extra taxes or fees).

Wealth management failure comes in varied impacts. While a financial plan's ultimate failure occurs when money runs out sooner than forecast, a less dire measure, but one that is very disappointing, arrives when it becomes clear that the resources planned to be available will not support the needs/goals identified at the time the plan was originally crafted. This is a failure in expectations; a failure found in what appeared to be a well-considered plan.

The Analysis Gap: Defining the Parasite

This failure should not just be chalked up reflexively to neglect or incompetence. Mostly, it's neither of these. Even within well-meaning, diligent processes a parasite can lurk that destroys wealth a little bit at a time and unseen to the advisor's eye. This is the "Analysis Gap".

An Analysis Gap exists when the financial planning systems' need/goal modeling system fails to account for the resulting cash flows in future years when the need/goal requires funding. Unlike a bank that alerts the customer when insufficient funds exist (not to mention the bank's requirement to fund the shortfall immediately), the Analysis Gap exists silently because the planning system's analytical framework does not recognize these mismatches.

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The Analysis Gap is different than the "Discipline Gap" in which the client deviates from a spending plan and creates a shortfall. No, the Analysis Gap is a systemic failure of the financial planning tool's tracking of cash flows from one future year to another, from one time horizon to another, and/or from one goal to another. Making this gap so insidious is it occurs under the premise of anticipatory planning; indeed, planning under the guise of precision to the nearest dollar.

Any forecast brings errors due to the necessity of using assumptions, particularly the unrealistic notion of straight-line or deterministic growth. This forecast error is an accepted planning reality.

The Analysis Gap is something quite different. The Analysis Gap, practically speaking, is an indicator of the planning tool's thinness in accounting for otherwise known future cash flows. In other words, it is <u>an unnecessary inefficiency introduced by the tool that results in actual wealth inefficiency</u>.

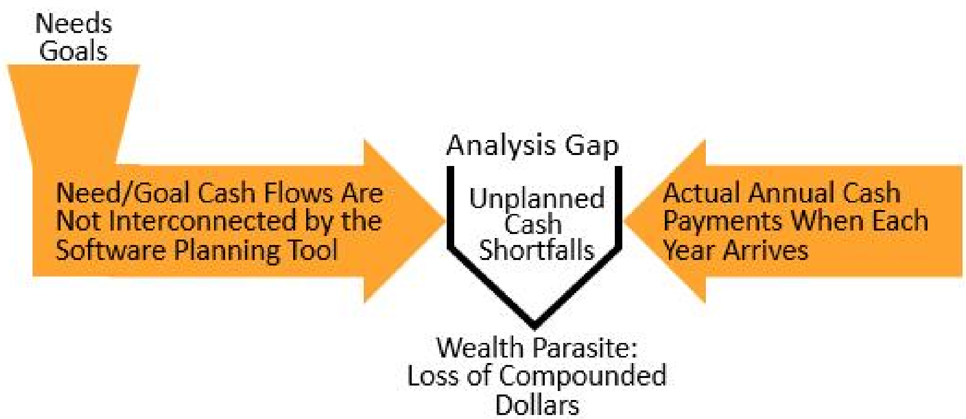
Cash Flows: Marching through Time

Each actual year that passes brings each future year closer to the present. The Analysis Gap actually feeds on itself year after year as unanalyzed, but to-be-paid cash flows, move from the long-term to the mid-term to the short-term to "this" year. This passage of time saps efficiency because the opportunity to match cash inflows – funding sources – is lost simply due to the plan's analytical thinness.

When "this" year comes, the failure to track matched funding sources through time places a burden on the sources flowing in the "this" or current year. If these sources fall short (i.e. planned spending + analysis gap > current year sources), the gap must be funded. It is here that the parasite thrives.

The unexpected shortfall must now be paid with future dollars (and dollars planned for future wealth effectiveness). <u>Future wealth is eaten not a dollar at a time, but a compounded dollar at a time</u>.

Regardless of the Analysis Gap's actual magnitude, it is an inefficiency that need not exist. Going back to the checking account analogy, funding the Analysis Gap has the same inefficiency effect as getting hit with a bank's fees for insufficient funds (e.g. returned check charges, shortfall fees, etc.) The more times these fees are incurred, resources available for other spending are reduced.



The Analysis Gap: Illustrating the Parasite in Action

A financial plan operating correctly with its projected cash flows interconnected, mapped to each future year, and marching through time together, acts like a healthy immune system that identifies and fights parasites. Lacking this immune system, a parasite that enters a body may first feel like a common cold, but left untreated, flourishes and saps a person's energy and strength.

In an unfortunate sense, the Analysis Gap emerges from the very things that create demand for financial planning in the first place: activating dreams; fulfilling passions; leaving legacies. These goals are beyond the annual lifestyle budget target and go to the opportunity for a client's wealth to provide real meaning to others.

Truly, a planning system's one missed cash flow execution makes little difference, particularly if it is a single goal or event. But if one cash flow execution is missed then it is likely that others exist under the same analytical thinness.

A larger cumulative effect occurs when a set of missed cash flow executions occur across time. The longer the missed string is, the more dollars are lost from compounding; this is the most damaging aspect of the Analysis Gap.

All planning system's handle single event and the "hear and now" valuations well (even if done on a spreadsheet), but not all systems accurately make the cash flow interconnections for future events. Missing these interconnections hit right to each projected year's target budget. The Analysis Gap parasite eats away at available future wealth that forms the foundation for addressing both the clients' core anxiety – shortfall risk – and/or core aspiration – caring for loved ones.

To illustrate the Analysis Gap as an on-the-ground reality, the examples in the Appendix identify how the parasite takes wealth away that could otherwise have a larger, even more magnificent purpose (e.g. family gifts, philanthropy, etc.) than filling an undiagnosed shortfall. (Note: straightforward goals such as planning a family reunion or funding a child's wedding – common goals referenced with goal-based tools - are excluded in the tables since such events are less prone to the Analysis Gap.)

About Kirk Loury

A thirty-year investment advisory, financial services, and technology veteran, Kirk Loury has worked across the industry as a chief investment officer (alternative and traditional investment firms), strategic consultant, chief marketing officer (mutual funds and venture capital), and the founder of two financial technology companies. As the founder of Wealth Planning Consulting, Inc. (WPC), he has developed two major, high-value components for financial and wealth management firms.

- The Balance Sheet Methodology (BSM) is a cloud-based financial planning, investment, portfolio, rebalancing, trading/execution, and monitoring platform with unprecedented integration and economic value. These qualities are noted in BSM's "no compromises functionality"™ and "5-pillar integration"™ market standards.

- Practice in Action! is a business coaching solution designed specifically for small- to mid-sized financial and wealth management firms seeking accelerated business performance. Using a unique combination of distance learning and the on-the-ground strength of Action! Groups (a pre-assigned accountability group of ten peer professionals), topics move quickly from concept to execution to results. Practice in Action! focuses its content on business planning, time budgeting, marketing, sales, service, and execution. The program spans twelve months and delivers a strong ROI arising from our extreme emphasis on execution.

Loury earned his B.S. in marketing from the University of Colorado, Boulder and his M.B.A. from the Harvard Business School.

Appendix

Identifying the Lurking Analysis-Gap Parasite

Potential Analysis Gaps: Lifestyle Planning

Planning Goal	Analysis Gap Exposure	Comment
Parental and/or Lifetime Dependent Support	• Ongoing payments for a specified period beyond the target lifestyle budget • Increasing payments due to inflation	Payments are in addition to the target lifestyle budget
Emergency Fund	• Annual transfers from a taxable portfolio to keep the emergency fund at its intended balance	Unless the emergency fund is kept in a separate account, the checking account balance needs replenishing each time it dips below the emergency funding level
Projected Annual Shortfalls	• Withdrawal from an investment portfolio	Planning systems typically account for annual shortfalls but do not always book a compensating funding withdrawal from the client's taxable portfolio; the gross estate declines
Projected Annual Surpluses	• Portfolio deposits • Funding source for purchasing property or securities	Surpluses in which the lifestyle sources are greater than the lifestyle should be booked as a deposit to the taxable portfolio; the gross estate increases

Potential Analysis Gaps: Asset Planning

Planning Goal	Analysis Gap Exposure	Comment
Property: Single and Multiple Acquisitions	• Percent of the purchase price to fund the cash down payment(s) • Ongoing loan payments for the remaining balance(s) • Ongoing increases in the gross estate due to the appreciating value of the property	Cash down payments and loans are in addition to the target lifestyle budget
Sale of Investment-Grade Property	• Payment of capital gains taxes • Transfer of the full proceeds to the taxable portfolio	Capital gains tax payments are in addition to the target lifestyle budget The sales proceeds need to get invested according to the investment plan
Exercise of Stock Options	• Payment of the exercise amount • Payment of the taxes • For a cashless exercise, transfer of the cash proceeds to the investment portfolio • For exercise and hold, transfer of the shares to a brokerage account • Increase in the estate's value	Upon exercise, the net proceeds increase the estate's gross value The exercise cost and the tax payment in each exercise year are in addition to the target lifestyle budget
Sale of Securities	• Payment of capital gains taxes • Transfer of the full proceeds to an investment portfolio	The sale of securities generally incurs a capital gains tax that is paid in the year of the sale; this is in addition to the target lifestyle budget Upon the sale, the proceeds are invested in a portfolio or to fund other wealth initiatives

Portfolio Income	• Yearly payment of taxes • Test for the net investment income tax Medicare surcharge	Taxable portfolios generally reinvest portfolio income, but the taxes on that income must be paid; this is in addition to the target lifestyle budget The Medicare surcharge (if applicable) is in addition to the target lifestyle budget
Investment Portfolios	• Investment of unusual deposits • Withdrawals to fund planned or unplanned shortfalls	The general, taxable portfolio is the dependent portfolio to handle extraordinary cash flows not accounted for in the target lifestyle budget

Potential Analysis Gaps: Trust and Estate Planning

Planning Goal	Analysis Gap Exposure	Comment
Funding Trusts and/or Family Foundations from a taxable portfolio	• Withdrawal from an investment portfolio • Reduction in the estate's value	Unless the funding amount is removed from the estate's gross value in the funding year, the estate becomes overvalued (i.e. double counting)
Funding Trusts with Property	• Payment of any remaining loan balance • Increase in income according to the trust document • Reduction in the estate's value	Depending on the type of trust, taxable income may be reduced (i.e. a charitable trust) in the funding year Loan repayments are in addition to the target lifestyle budget The funding amount must be removed from the estate's gross value
Annual Gifts not Subject to the Unified Credit	• Payments to each recipient in specified years	The annual gifts are in addition to the target lifestyle budget

Gifts Subject to the Unified Credit	• Gift amount paid in the year of the gift • Reduction in the estate's value • Gift taxes paid for the gift in the year in which the unified credit has been exceeded	While the current unified credit provides sufficient capacity for most high net worth families to avoid gift taxes, for those estates above the unified credit, gift taxes apply and the estate's value in the gift year must be reduced The gift taxes are paid in addition to the target lifestyle budget
Funding Family Foundations	• Transfer of either cash and/or property • Reductions of taxable income	The funding amount must be removed from the estate's gross value Ongoing contributions further reduce the estate
Funding Family Limited Partnerships	• Transfer of securities • Payment of any applicable gift tax	The unified credit amount is reduced by the discounted value of the partnership shares

Potential Analysis Gaps: Education Planning

Planning Goal	Analysis Gap Exposure	Comment
Education Funding	• Ongoing payments for contributions • Taxes on an unused balance • Penalty on an unused balance	Contributions are in addition to the target lifestyle budget With thoughtful planning, it would be unusual that an unused education balance would occur, but if it does, the tax payments and penalty need to be paid; the amounts are in addition to the target lifestyle budget

Potential Analysis Gaps: Retirement Planning

Planning Goal	Analysis Gap Exposure	Comment
Retirement Funding	• Funding annuities from a taxable portfolio	Lifestyle income is increased once distributions begin The funding amount for any annuities reduces the estate's gross value

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