Helping Spouses Plan

A financial divorce specialist can show how a fair sounding plan can lead to financial ruin

GUEST COLUMN

BY KATHRYN JANKOWSKI

Until recently, divorcing spouses often lacked the counsel needed to look into the future of a settlement agreement to determine its financial fitness. Yes, lawyers, pension analysts, business valuators, social workers and accountants have played an important role in advising spouses about their financial futures ("after-tax"). However, none of these specialists have been properly positioned to look behind a proposed settlement arrangement to determine a divorcing spouse's financial well-being down the road.

The Financial Divorce Specialist is a designation now being acquired by financial planners to zero in on a difficult area of transition in a divorcing individual's life. The FDS brings a divorce settlement to life to illuminate the financial opportunities and limitations that a spouse could face over the short and long terms.

Take the fictional, but close-to-real life, example of Kenneth and Kate. Kate is 46 years old and Kenneth is 52 years old. They have been married for 18 years and they have two sons, aged 11 and 7.

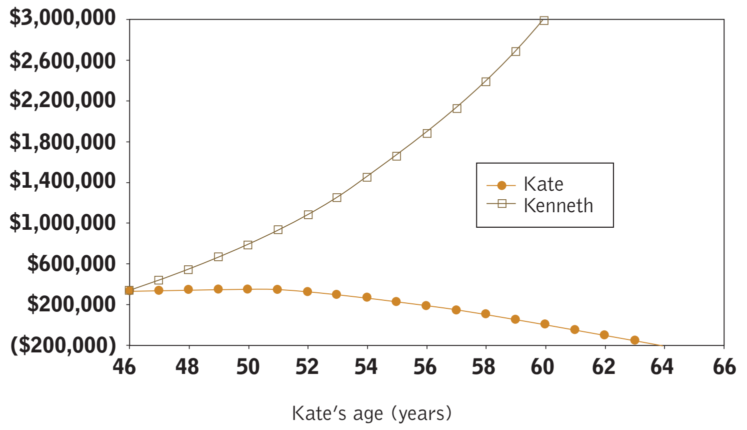
Kenneth's offer to Kate is to split the mutual funds and the RRSPs on a 50/50 basis. Kenneth would keep the business and Kate would keep the house. Both would end up with a net equity of $332,000. Kenneth is also willing to pay $1,000 a month in child support and $1,500 a month in spousal support for 5 years. With her own income of $21,600 and her RRSPs growing at a rate of 7.5% a year, this seems like it would be a fair offer, but how can Kate really tell?

A simple chart (*see Limited support, right*) demonstrates the financial track that each spouse would face. The reality is that Kenneth's offer will put Kate into a position of financial hardship in about 10 years, at a time when she should be thinking about retirement. In fact, by sixth year Kate would have to tap into her RRSPs to make ends meet. Kenneth, meanwhile, would be financially healthy at that time.

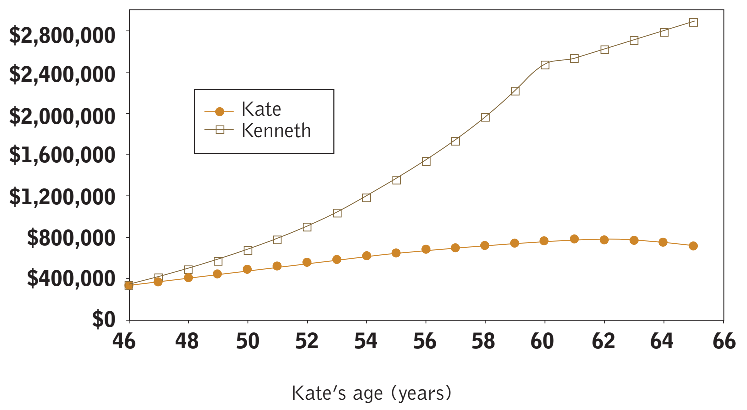
Kate's take home pay is $21,600 and Kenneth's take home pay is $132,000. These are their assets:

Home equity	$180,000
Mutual funds	$92,000
RRSPs	$212,000
Business	$180,000

Limited Support



An Amicable Divide



Half the assets and an income stream for a number of years seems okay but, the negative financial situation does not become clear until about five years later. A lawyer's worst nightmare is a client who comes back after that amount of time wanting to renegotiate their separation agreement. It happens all too often.

The divorce professionals we would normally think of would not be able to advise Kate and Kenneth on this basis. Conversely, an FDS does not replace lawyers or other divorce specialists. While these specialists provide financial information regarding the potential settlement being considered, they do not offer advice and do not answer legal questions.

Existing financial planners who do not have the FDS specialization might question why a FDS cannot give advice. Financial planners advise their clients all the time. The answer is that giving a divorcee advice is akin to telling them how to live their life. A FDS cannot say, "I think you should downsize your home and work full time to sustain your lifestyle." What they can do is show that if the client keeps their house and works part-time they will be put in a position of financial hardship going forward. With that in mind the client can make adjustments to their life depending on what is important to them and make their own decisions about the right financial options.

In this situation, Kenneth is likely to ask, "How much can I give Kate without putting myself in a position of hardship?" If Kenneth offers Kate $5,000 a month in spousal support for five years, then $4,000 a month for another five years, and another $3,000 a month for the final five years, will it actually rectify Kate's financial situation? And can he afford to be that generous?

A second chart (see *An amicable plan*, above) demonstrated the improved financial outcome where Kate has been advised about the long-term projections.

With Kenneth's new offer Kate is now in a position to be financially healthy on her own. Kenneth's net worth is still healthy as well. It is a win/win situation.

Software-supported projections are one thing an FDS can offer. However, there are other advantages: They are trained to find hidden assets to ensure that an equitable, not just an equal, division of assets occurs. They can also tell the spouse how things like an insurance policy and pensions configure into the settlement package. Another consideration is how to ensure spousal and/or child support is maintained in the event of a death or disability of the paying spouse.

Ultimately, it is important to make a correct calculation of income earned and the income tax and estate implications of separation of assets so that financial security for the individual is assured. Divorce is a highly emotional time and offering a viable financial solution can add emotional stability for someone moving forward in life on their own.

A financial planner with the FDS designation cannot invest a client's money while advising them through the divorce process. This is considered a conflict of interest.

Continued on page 20

Lifting the Hood

Continued from page 16

investing, focused differently (and with the extra degrees of freedom of shorting, leverage and derivatives, and arguably of 'exotic' investment strategies). This means you can think of traditional investments as a blend of an index (or an ETF) and a hedge fund.

In the institutional world, money managers actually combine index positions to alternative investments – it's called an alpha overlay (adding an alpha-generating mix atop an index-based, or beta, substrate). High-end advisors have been doing this, at least implicitly, for wealthy investors for years. And this, according to Holt, is the shape of things to come.

As Holt likes to say, "hedge funds and ETFs were separated at birth and are now being reunited in the form of alpha-overlay and portable-alpha strategies."

But an advisor may ask, so what? Holt believes that investors will migrate away from "index-hugging" mutual funds as they learn that these funds can be replicated by combining "off-the-shelf" components such as ETFs and hedge funds. As a former management consultant, Holt draws a parallel to another industry that experienced a similar upheaval a decade ago.

"The advent of travel websites undercut the travel agencies' golden goose – proprietary reservation systems – forcing agents to focus on consultative advice and less on commissions," he says. This may sound alarming to advisors whose bread and butter are mutual fund trailers. But, in part, it might explain the interest for fee-based advisory models where purchasing (cheap, no-commission) ETFs won't jeopardize advisor revenue streams.

While major institutions have embraced the cost savings and flexibility of this approach, advisors needn't pile their client's money into hedge funds to realize its benefits. Along with a software partner, Holt's firm is currently developing a tool that can calculate the amount of "embedded hedge fund" in a mutual fund, and uncover the price effectively being charged for this hedge fund (his research shows the MER for hedge funds embedded within major Canadian equity funds ranges up to 15%).

Advisors could then use this data to rank and select mutual funds. Eventually, they would be able to use ETFs to strip out the beta from a mutual fund and isolate the embedded hedge funds since not even the mutual fund manager itself would offer this "hedge fund version" of their core products.

But ultimately, advisors will win by having access to more tools in order to personalize client portfolios. And once this transition is complete, says Holt, the advisory function will be more important than ever.

Holt offers another way of looking at the separation of alpha and beta through vector analysis. He shows that one can decompose an investment's return/risk drivers in an orthogonal mix of alpha and beta. It's powerful because it can be graphically interpreted – you can draw a picture of it. Moreover, Holt gives a numerical example of how to 'rebuild' an investment (e.g., a fund) from its ETF and hedge fund building blocks.

This is an eye-opener as it changes your thinking on investments as 'black boxes', and worthy of further columns. In the end, focusing on the alpha/beta mix helps understand and focus on the sources of return, of risk, and the merit of the investment. This is a good thing. AER

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Helping Spouses Plan

Continued from page 16

A concern of many lawyers is that sending their clients to a financial planner can work against the client because the planner may be more interested in investing a 'windfall' settlement than informing the client of the financial issues surrounding their divorce.

Not many divorces end up in court these days. However, if that happens a FDS can be called to testify regarding the financial issues surrounding the divorce and the cash flow and planning projections can be admitted into evidence. The credibility of the reports and a FDS's testimony is strengthened by the recognition of the designation by the Financial Planners Standards Council and the International Association of Collaborative Professionals – both have standards that members must adhere to in order to maintain their designation. AER

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