# How *Not* to Become a Bag Lady: *Six Easy Lessons*

**"Bag Lady Syndrome": The irrational fear of not having enough money, and, in the extreme case, of ending up destitute and homeless.** According to one survey, a "startling 90% of American women said they felt financially insecure", and nearly half responded that they suffered "tremendous fear of becoming a bag lady", including 48% of those with annual incomes over $100,000.

Of course, we need to qualify these findings with a few caveats. First, the survey, described in an article published in *The Washington Times*[1], dates from 2006. Second, the survey in question was conducted by a life insurance company — that is, a company that makes money selling products that allay financial fears. And lastly, the finding, in the same survey, that more than one-third of women consider themselves "financially competent" doesn't square with the idea that 90% of them feel financially insecure.

Yet even if the numbers need to be taken with a grain of salt, the anxiety the article describes is real. Many women fear running through their resources. This is especially true of women who — because of divorce, the death of a spouse, or an inheritance—are suddenly thrust into a new role as the primary decision-maker for financial matters.

It doesn't have to be this way. With a few straightforward steps, women can inoculate themselves against "Bag Lady Syndrome"— and, more importantly, against the possibility of *actually* running out of money[2].

The lessons, listed roughly in chronological order, are as follows:

1. *The first thing to do is…nothing.*
2. *Fit your lifestyle to your wallet. Don't try it the other way around.*
3. *Be careful with debt.*
4. *Make sure your trust has been earned.*
5. *Ask questions.*
6. *Take care of yourself before you take care of others.*

## Lesson #1: The first thing to do is…nothing.

It's an inescapable fact that sudden financial responsibility is often accompanied by the emotional trauma and loss of control entailed by a divorce or a death. It is typical — and completely understandable — for women in these circumstances to want to feel they are reasserting direction over their lives by *doing* something. Selling the house, moving, quitting or taking a job, and liquidating the investment portfolio are all potential means of feeling more "in control".

It is smart to resist this temptation. Decisions made at times of emotional turmoil, at best, are not likely to be fully considered and, at worst, may be completely irrational. Some of them — such as quitting a job — are almost impossible to reverse. Others — such as selling a house or a portfolio of appreciated securities—might entail unintended consequences, like a substantial upfront tax and/or transaction cost.

Rather than making costly and irrevocable changes, often the best thing to do is to take a deep breath, set a time limit before any major decisions will be made (preferably a year, but at least a few months), and — when you're feeling up to it — book a vacation or other getaway. Let major decisions wait until calm consideration of the alternatives, and the pros and cons of each, is again possible.

## Lesson #2: Fit your lifestyle to your wallet. Don't try it the other way around.

This step comes second on the list, but for anyone living on a fixed pool of capital — such as a divorce settlement or inheritance — spending is by far the most critical factor in future financial well-being. Get this right, and Bag Lady Syndrome need never trouble you. Get it wrong, and running out of money becomes a real possibility.

The cold, hard fact is that financial markets are impersonal. They don't know, or care, how much we think we "need" in order to live the lifestyles we want. And pursuing much greater returns than the market is prepared to provide — say, seeking to make 6% interest when quality bonds are yielding 2% or 3% — will almost certainly result in losses. (Ask anyone who sought a "safe" 10% return, and thought they found it in Bernie Madoff.)

[1] *Nearly Half of Women Fear Life as a Bag Lady*, August 23, 2006.

[2] The same principles will also enable the gentlemen to avoid Bowery Bum-hood.

So how much *should* you spend? Well, if you want a high level of assurance that the value of your assets will keep up with inflation, after taxes and spending, no more than about 3% to 4% of the value of your assets each year.

There are many ways to get to this figure, but here's a relatively simple way. It looks at long-term rates of return on stocks and bonds, and long-term rates of inflation. These are, on average, roughly as follows:

| | |
|---|---|
| *Rate of return on stocks* | 9.0% |
| *Rate of return on quality bonds* | 5.0% |
| *Rate of return on typical 60%/40% blended portfolio* | 7.4% |
| *Minus taxes at 20%* | (1.4%) |
| *Minus inflation at 3%* | (3.0%) |
| ***Equals: Sustainable spending rate*** | **3.0%** |

You should have noticed some hedges (e.g., "long-term" and "on average") in the paragraph before this calculation. That's because at any given time the numbers may look quite different. Tax rates go up and down, as do interest rates and inflation rates. At the time of this writing, quality bonds yield much less than 5%, for example, but their low yields are partially offset by inflation and tax rates that are also below their long-term averages.

Can the sustainable spending rate be raised? Yes, if you can find investments that return greater than market averages or figure out how to reduce your taxes. (There's nothing any individual can do about overall inflation.) But this is hard to do, and in any case, these moves will almost certainly result in only minor increments of spending power, raising the long-term sustainable rate no more than a percent or so.

And there's another quirk here, too: Market returns don't actually occur "on average". Instead, they tend to occur in spurts and lumps that may seem surprisingly extreme. Below, for example, is a chart of when and how often stock market returns within given ranges have occurred, over the last 40 years. Anyone who expected an "average" return in a given year would have been disappointed. The number of times an actual calendar-year return fell within a band of 9% plus or minus 1% (that is, matched its expected long-term average) over this period was ***zero***.

Portfolio returns are also affected by the timing of cash flows; that is, *when* you are putting money into and taking money out of your investment portfolio. Having to take money out of your portfolio in the middle of a bear market — say, the fourth quarter of 2008 — is a recipe for future financial unhappiness, because the amount of assets that's left to capture the subsequent rebound may not be enough to recoup the amount you've withdrawn and spent.

And what if you absolutely, positively must spend, say, 6% or 7% or 8% of your assets a year? Then be aware that you will almost certainly dissipate your assets, and may deplete them completely over time.

According to studies based on leading-edge quantitative methods and reported in (among other places) *The Journal of Financial Planning*, setting an initial withdrawal rate of 8% of a portfolio's value, and then raising the rate every year with

**Distribution of Calendar-Year Returns to the S&P 500, 1972 – 2011**

| Range of returns | # of occurrences | Years of occurrences |
|---|---|---|
| Greater than +30% | 7 | 1975, 1980, 1985, 1989, 1991, 1995, 1997 |
| 25% – 30% | 3 | 1996, 2003, 2009 |
| 20% – 25% | 5 | 1976, 1982, 1983, 1996, 1999 |
| 15% – 20% | 5 | 1972, 1979, 1986, 1988, 2006 |
| 10% – 15% | 3 | 1993, 2004, 2010 |
| 8% – 10% | 0 | — |
| 3% – 8% | 6 | 1978, 1984, 1987, 1992, 2005, 2007 |
| -2% – +3% | 2 | 1994, 2011 |
| -7% – -2% | 2 | 1981, 1990 |
| -12% – -7% | 3 | 1977, 2000, 2001 |
| -17% – -12% | 1 | 1973 |
| Worse than -22% | 3 | 1974, 2002, 2008 |

the value of inflation, results in complete depletion of the portfolio (i.e., running out of money) within 30 years more than 60% of the time, and often much sooner. By contrast, an initial withdrawal rate of 3%, adjusted annually for inflation, almost never results in portfolio depletion.[3]

Maybe the probability of portfolio depletion is okay with you — you might not have heirs to benefit, or you might not mind the possibility of a severe curtailment of your standard of living in the future. Maybe your time horizon is short. Or maybe you have so much money that you don't think this will ever be an issue. But you should make that decision with full knowledge of the facts. If you want a single, five-word rule of thumb for future financial well-being, one that works 100% of the time for 100% of the people, here it is: ***Spend less than you make.***

### Lesson #3: Be careful with debt.

And be especially careful with highly-leveraged investments.

It would be fair to ask at this point, "What's a highly-leveraged investment, and why should I beware?" So let's start there.

A highly leveraged investment is one financed mostly with debt, or one that invests in financial instruments that themselves incorporate debt. The debt-financed asset that most of us know best is residential real estate that has been financed partly by a mortgage. The amount of money a homeowner has put down on her house, along with the amount of mortgage principal that has been repaid, is her equity. The amount of mortgage remaining is debt, which, in the investment world, is often referred to as leverage.

What's the potential problem with leverage? Well, as millions of homeowners have learned, leverage magnifies your gains in bull markets — and your losses in bear markets.

Take someone who bought a house for $100,000, putting down $5,000 (yes, this was possible during the real estate bubble) and borrowing $95,000. What happens if the value of the house rises 5%? The homeowner's equity doubles. And what happens if it falls 5%? The homeowner's equity is wiped out.

No matter whether the value of the house falls 10%, or 20%, or 50%...the debt balance doesn't budge. That's the problem with debt: Even if the value of the asset financed with debt collapses, you still owe the money. (But an underwater house does still have value as a place to live.)

The same principle applies to investments that include leverage.[4] And note: Debt-financed investments do not always announce themselves as such. In the portfolios of private investors, leverage is most likely to be lurking in hedge fund, private equity, or real estate investments.

Tread carefully here.

### Lesson #4: Make sure your trust has been earned.

Facing a sudden need to look after one own financial affairs can be overwhelming. In this situation, it is only normal and natural to seek help and advice.

And that's okay. Just be sure to ask yourself (and preferably your would-be advisor, too), two questions:

1. *What is this person's* **expertise***?*
2. *What is this person's* **motivation***?*

And make sure you are 100% comfortable with the answers to ***both*** questions.

With respect to expertise, there are two main concerns. The lesser concern is the obviously unqualified would-be advisor, such as the stock-touting hairdresser, or the physician with a "hot" investment idea, or the brother-in-law who means well but has no real experience in the matter at hand. You shouldn't be taking financial advice from them, and a polite demurral is probably all that's necessary.

The greater concern is the "almost-qualified" advisor: The attorney, accountant, or financial advisor who is a highly-qualified professional, but who may not have the exact expertise you need for a given project. Asking your accountant for investment advice, say[5] , is similar to asking your allergist to treat your hearing loss: Maybe it'll work out fine, but maybe it'll just make things worse.

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[3] There is a full discussion of the methodology and findings in "Rethinking Safe Withdrawal Rates: The Meaning of Failure", by Wade Pfau, published in the April 17, 2012 issue of Advisor Perspectives

[4] To cite an admittedly extreme example: Some years ago, as the tech bubble was bursting, this writer was consulted by a tech-sector executive whose on-paper net worth had, in the space of one year, declined from +$75 million to -$25 million — a -$100 million swing. How was this possible? The executive's entire initial net worth had been made up of shares of stock in his employer, an internet company that had gone public at a very high valuation. These shares had been acquired through the exercise of stock options, triggering a tax liability. Rather than sell shares to pay the tax and to diversify his holdings, he had followed advice — common-enough wisdom at the time — to borrow against his employer's stock and use the proceeds to diversify. He "diversified" into a basket of other internet companies. Essentially his whole portfolio collapsed, leaving him an un-payable tax and debt burden. He was shocked and desperate, and there was, unfortunately, nothing that anyone could do to restore his financial health.

[5] Or your investment advisor for tax advice, for that matter.

There's another situation in which you should keep a tight hold on your purse, and that's when you are offered investment sleight-of-hand: Much-higher-than-market returns, or high returns with no risk, or secret investment formulas, or the like. Investment magic does not exist; there are no secret formulas. (And anyone in possession of such magic certainly wouldn't be sharing it.)

So be sure the person you're trusting for advice has the right knowledge and experience to provide it. And at least as important, make sure the person you're trusting also has the right ethics and motivation. This means he or she should be putting *your* interests first, rather than being motivated by, say, his or her own compensation for selling financial products.

Putting client interests first is the definition of a fiduciary standard of care. Anyone whom you are trusting for advice about your financial affairs should be willing to affirm in writing that they are acting as a fiduciary.

If not…. best to move on.

### Lesson #5: Ask questions.

And don't stop asking until you get answers that satisfy you.

Asking questions is key to safeguarding your financial future. "Bag Lady Syndrome" arises, in large part, from a lack of understanding combined with a fear of asking.

So ask away. And since the financial industry is full of insider jargon, don't be shy about following up with, ***"What does that mean?"*** Nobody is born knowing what a basis point is, or how asset location differs from asset allocation, or what's good about positive alpha, or how profits on short sales are taxed. Or whatever words or concepts someone uses that you are the least bit unsure of. Keep probing.

There are two key reasons it makes sense to ask a lot of questions. One is to get the content of the answer (*What* did the person say?), and the other is to hear the tone (*How* did she/he say it?). The appropriate response to your queries is answers that leave you feeling (1) heard, (2) respected, and (3) empowered, with a full grasp of the issue at hand.

If you don't get that, keep asking. A trusted advisor will take the time to provide whatever information you need. And never, ever commit money to anything you don't understand completely.

### Lesson #6: Take care of yourself before you take care of others.

In some ways, this lesson is repetitive: Avoiding rash decisions (Lesson #1); keeping spending under control (Lesson #2); being careful with debt (Lesson #3) trusting only those people who have earned your trust (Lesson #4); and asking questions (Lesson #5) are all ways of taking care of yourself. But here we need to be a bit more specific.

Most women spend a good part of their lives taking care of others: Husbands, children, parents, and friends, for example. Often the caregiving expands beyond our immediate households to include community, too.

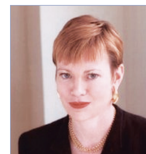
Receipt of significant sums of money may, naturally, feel like another reason or opportunity to provide financial care for others. And some of those "others" may also feel entitled to be helped. It's not unheard-of for money or gifts to be used to atone for non-financial ills, such as the break-up of a family. And distant charities and long-lost friends have also been known to arrive soon after the money does.

Be prudent and judicious here. Just as you need reserves of energy in order to provide proper care of others, so you need reserves of money. Make sure to keep plenty of both for yourself. Only then will you be able to take care of others.

### Summary

So there you have it. Six lessons to start putting "Bag Lady Syndrome" to rest.

And if this brief paper has raised any questions for you — look back at lesson #5. *Please ask.*



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