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Attracting Sudden Money

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By Rebecca McReynolds

October 1, 2000 - Eric Nilson knows about windfalls first hand. In 1989, when he was 29, the state of Ohio decided it wanted to locate a factory on the site of his small farm and lovingly-restored house. Since the state's right of eminent domain prevailed over his desire to keep his home, Nilson found himself with an eviction notice -- and a check "well into seven figures."

The first thing he did was take 10 percent of the proceeds and splurge on decorating a new house he and his wife were buying in the city. Then they took an extravagant vacation. Finally, he withdrew another 10 percent and set up a family charitable trust.

With all of that spending and giving out of his system, he was able to get down to the serious work of responsible investing, adding the proceeds to his existing investment plan. Now that he's a broker with Prudential Securities in Cleveland, Nilson uses his experience to give sound advice to clients who stumble into their own windfalls.

"There's an enormous emotional context to windfalls," he says. If the money comes from an inheritance, he notes, people don't want to squander something their parents or grandparents worked so hard for. If it's lottery winnings or a slot machine payoff, they are scared they'll blow their "one big chance" at financial freedom. Pulling against those emotions is the very human desire to celebrate one's good fortune and share the wealth.

"Unless you recognize both of those themes, you are not going to have a very happy client," Nilson warns.

Nilson defines a windfall as any amount that is 10 times greater than what the recipient already has -- a sum that would substantially change their life. For someone with $10,000 in assets, for example, a $100,000 jackpot winning could make a huge difference. For someone who already has $1 million, an extra million wouldn't change much, but $10 million certainly would.

No matter what the final amount is, Nilson uses the same formula. First he tells the client to take 10 percent off the top immediately and spend it on whatever extravagance they had been fantasizing about -- a Porsche, a vacation home at the lake, a college savings account for their children.

"I have found that if you don't give people permission to spend some of it, they will probably end up spending more than that," he says. "But if you give them permission and set a limit, you'd be amazed that they'll stick to the 10 percent limit and won't go beyond it."

After the splurge spending, Nilson suggests they take the next 10 percent and gave it to charity.

"That's another way to celebrate success, feel really good about yourself -- and it certainly helps with taxes," he says.

Following those two steps, Nilson says most people are ready to sit down and focus on the job of goal setting, financial planning and investing.

"I find that unless you deal with the emotional context first, you lose the whole financial planning battle," he says.

Reining in emotions, though, is probably the toughest issue that brokers face when dealing with the suddenly wealthy. The euphoria is intoxicating, and clients feel as if they have a bottomless pit of money to spend. They've stayed up nights making mental lists of all the things they are going to buy for themselves, their friends and families. Sometimes they'll quit their jobs the day after coming into the windfall without having any understanding of their true financial picture. They just feel "rich."

A quick way to sober them up is to slap their tax bill in their face, says Phil Behnen, a financial planning manager at A.G. Edwards in St. Louis. A $3 million jackpot quickly dissolves to about $1.5 million after Uncle Sam takes his share, Behnen says, and if your rich Uncle Joe left you $5 million but didn't set up his estate properly, you could see as little as $2 million, once all the taxes are paid.

After backing out the taxes and coming up with the net purse, Behnen has his clients sit down and write out a list of everything they want to do with the money, and then he puts the price tag next to each item and tallies up the list.

"People are often surprised when they see it on paper," he says. "They find out they can't do everything they want to do."

That happened recently with a client who had just won $42 million in the lottery, Behnen says. With his winning ticket in hand, the client felt invincible. He wanted to quit his job, buy a big, fancy house and three new cars, and give all of his friends a nice fat check. The only problem was that the client had chosen the lump-sum lottery distribution, which cut his $42 million jackpot down to $21 million. After taxes, $11 million was left. Only when the reality of his actual winnings sunk in was the client ready to sit down with Behnen and draw up a workable plan, which included trusts for the winner's four children and a budget.

"The winner had bought homes in St. Louis, Lake of the Ozarks, and Scottsdale, Ariz.," he says. "The upkeep, maintenance, taxes and furnishings for those homes was a huge cash drain. They were surprised by the amount."

On the other side of the spectrum are the clients who are so overwhelmed by the number of zeros on the check and the array of options suddenly opening up before them that they become paralyzed. With these types of clients, you want to move very slowly, says Peter Allis, a broker with Dain Rauscher in Denver.

He has spent more than a year putting together investment and spending plans for a mother and daughter who each had inherited $1 million from a grandmother who had sold the family farm to a shopping mall developer. Both women were unsophisticated investors who wanted to put everything into Treasuries.

The first thing he did was set up a money market account with $1 million so that they could write checks to cover the estate taxes and other immediate needs. Then he bought $1 million worth of three-month T-bills, just to give them peace of mind. He spent the next year meeting with both of them, helping them define their goals, educating them about different investments, and explaining risk vs. return. By the time the estate finally settled, each had about $600,000 to invest, and Allis had developed a relationship with each woman. They then were ready to move ahead with a well-structured financial plan.

"Over that year, I just wanted to keep that money safe," he says, acknowledging that the clients would have zero tolerance for even the slightest market correction. "I wanted to make sure the relationships were going to stay there for a long time and assure them that I was not going to blow their money. That's why when I got the money a year ago

I didn't do anything with it."

Once emotions ebb, it's time to put together a financial plan that a client can live with and live on. The tricky part is that the newly rich are usually also new to investing and unfamiliar with it. They typically are very unsophisticated investors with little understanding of long-term financial planning.

John Lynch, with First Union Securities in Columbia, Md., is working with a team of blue-collar workers who were part of Baltimore Air Coil's employee stock ownership program (ESOP). Most of these workers had lived paycheck-to-paycheck their entire working lives, as their parents and grandparents had before them. Suddenly, because the plan was so successful, many of the employees were coming home with lump-sum payouts of six and seven figures.

"You can't talk to these people about modern portfolio theory or standard deviation," Lynch says.

It turned out that he couldn't even talk to them about annual income needs; they thought only in terms of how much money they needed each week.

"You've got to go down and talk to them at their level," he says. "You just have to communicate differently."

Finding each client's comfort zone is a critical first step, Allis says. He does that by looking at investment objectives five ways: in terms of liquidity, tax issues, safety, safety vs. risk, growth and income. After explaining each concept, using specific examples and different scenarios, he gets the client to talk about which of those five objectives is the most important to them.

"A lot of that process just takes time and teaching," he says. It can take as many as four or five meetings, each lasting an hour or two, before the client is ready to start committing to an investment plan, especially if the client is afraid of the stock market but needs growth in his or her portfolio.

"If they have a low risk tolerance, it's my job to get them over the hump," he says. "I need to train them and teach them that at least some of this money has to go into good quality stocks that will keep up with inflation."

At A.G. Edwards, when any client comes into a windfall of $5 million or more, both the client and the broker are flown to the company's St. Louis headquarters. There, the two work with a team of tax accountants, attorneys and financial planners to come up with a viable program.

"You must start at ground zero," Behnen says. "You need to specifically detail all their investment goals. Do they want to fund their child's education? How about their nieces' and nephews'? If they say they're charitably inclined, you have to find out just how charitable they are."

Behnen does that by setting up different scenarios, such as showing how a charitable lead trust will affect their taxes and what will happen to their income if they decide to go that route. If they want to give money to friends and family, he explains the $10,000 tax-free gift limit and then runs examples of how that outflow will impact their long-term goals. If a winner's brother-in-law wants $50,000 to start a business, for example, Behnen goes through the client's entire financial plan, explaining how such a gift would impact the client's portfolio, his taxes and his own retirement plans.

"It's a constant revision," he says.

Katana Abbott, with American Express Financial Services in New York, is working with a young couple that just inherited shares of stock in a privately held family business. The stock is worth millions of dollars, but is essentially illiquid. There is a buyer in the wings, though, and the couple should end up with a substantial amount of investable assets when the deal goes through. They came to Abbott to plan for that transition.

"They want to sit down with me to do a comprehensive plan," she says. "They want to look at their personal needs, what they need to live on, making sure their children's education is covered, and then figure out how much must be earmarked for retirement."

Even though these clients are only in their 30's,

they are already worrying about what would make an appropriate legacy for their children.

"When someone gets those kinds of dollars, it's really important to find out how much they are going to need for their entire lifetimes," she says. "If there is a surplus, then you can do something with that surplus -- maybe buy a Ferrari."

Clients like Abbott's young couple are becoming an increasingly common sight in brokerage offices as the stock market produces its own version of lottery winners. Over the last few years, hundreds of thousands of instant millionaires have been created among high-tech jockeys who took their pay in the form of stock options instead of salaries. Once their companies go public, these 20- and 30-somethings have more money than most people ever dream of -- on paper at least. Usually the investment bankers who set up the initial public offering are standing in line to catch these new investors as they come off the IPO merry-go-round. But many of these newly rich young people end up working with someone they already know, either through their parents or their friends.

A key issue for these investors is the seesaw effect that the market can have on their portfolios, especially if their wealth in tied up in unexercised options. Abbot is working with a couple who started their own high-tech business and then sold out to a larger company for stock. That company got bought out, and the acquiring company later merged. After the dust settled, the clients were holding more than $1 million in stock in the surviving company.

"My client called me all excited, saying Katana, I'm a millionaire,'" she says. But the clients were handcuffed with trading restrictions, and before Abbott could get a plan in place to diversify those assets, the market crashed, wiping out two-thirds of the value of their stock.

"Timing is the key issue in these situations," she says. "Clients need good advice on how to exercise these options and how to get diversified."

Unfortunately, the odds of having a lottery winner walk through your door with a seven-figure account are about as high as winning the lottery yourself. Usually, the suddenly wealthy end up working with someone they already know.

"You never really see a referral on something like this," says Behnen. "Huge amounts of money usually come through an existing relationship -- a parent, an uncle, a friend -- or from someone they already been working with and feel comfortable with."

Prudential's Nilson hit the jackpot when a client of his won the lottery, but that was just the luck of the draw, he says. Still, there are a few things you can do to get yourself in front of some potential windfalls.

One area to focus on is the inheritance market. Baby boomers are expected to inherit an estimated $17 trillion from their parents over the next 20 years, and many are starting to analyze how those expected proceeds will fit into their retirement and estate plans. Nilson recommends putting on a series of seminars about planning for an inheritance that target 40 and 50-year-olds. It also makes sense to establish good working relationships with a network of attorneys and accountants. These are often the first people that a windfall recipient turns to for advice, particularly if they don't have an existing relationship with a financial planner.

And, of course, you can always buy your own Powerball ticket.