The best investment I'll ever make: Turning $10k into $20 million

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In this article, originally written for Merriman's educational newsletter, FundAdvice.com, Paul Merriman shares an investment plan he initiated in 1994 that he hopes will someday grow from $10,000 to $20 million.

No, that's not a typo. In 1994 I made an investment that is likely to grow from $10,000 to more than $20 million and you can do something similar. I'll tell you how, however, this plan comes with a caveat: you probably won't live long enough to see the final payoff.

This is a really neat investment idea and I can't resist sharing it with my friends, colleagues, clients and readers. And I hope some of them will be motivated to follow this example to create something with their assets that will make a big difference in the long run.

Simply making good long-term investments wasn't a big enough challenge.

With that mysterious introduction, let me tell you how this started. In 1994, my son, Jeff, became a proud father. I decided I wanted to do something really extraordinary for my new grandson, Aaron. I spent quite a bit of time thinking about what it might be. Simply making good long-term investments wasn't a big enough challenge to get my juices flowing. For this project, I wanted to think in really big, even preposterous, terms.

Finally, I established five ambitious goals for my gift to Aaron. First, I wanted to make a one-time investment that would give Aaron a comfortable retirement when he reaches age 65. Second, I wanted to make sure the money would be there at that time and not be used for anything else in the meantime. (I took some flack from several people for this. But it's my money and my plan and I get to set the rules!) Third, I wanted my investment to grow without any tax liability on the income. Fourth, I wanted this investment to eventually provide at least $20 million for charity. And fifth, I wanted to do all this for only $10,000! That was ambitious enough for me, and with the help of Jeff and a couple of professional advisors I found a way to accomplish all that.

Of time and trust

Besides the $10,000, this turned out to require only three essential tools: time (lots of it), a trust and a variable annuity. A trust is a legal entity that holds assets and is strictly governed by the documents that establish it. A variable annuity, which I discuss later in this article, is a product that combines the investment potential of mutual funds with the tax advantages of an insurance policy.

To obtain enough time for this to work, you have to get a little more creative, like forming a grandson-grandpa team. Aaron has the time, but not the financial resources. I have the resources and the ability to plan, but I don't have enough time left. However, put us together and you have a winning combination.

With the help of Jon, a Seattle financial planner, and Doug, a Seattle attorney, Jeff and I have worked out the details. I made a gift of $10,000 to an irrevocable trust for Aaron's benefit. This gift is not taxable to Aaron. Jeff and Aaron's mom, Barrie, are the trustees. Since Jeff and Barrie are the trustees they cannot gift any money into this trust without tax consequences, but anyone else can add to Aaron's account. (Any year that contributions are made the trustee must submit a simple tax return.) If Jeff did wish to make a gift himself he would have to appoint another trustee.

Under the direction of the trustee, Aaron's trust invested the $10,000 in a variable annuity. Jeff is the trustee as long as he is able, and the trust document tells how successor trustees may be appointed. Because the investment is in a variable annuity, it can compound on a tax-deferred basis. The trust is set up so that Aaron can't touch this money until he is 65 (in the year 2059). That will leave Jeff free to concentrate on very long-term investments, which we expect to provide a compound rate of return (CRR) of 10 to 12 percent over the decades ahead.

As trustee, Jeff chose to invest 50 percent of the money in a U.S. stock portfolio, and 50 percent in an international stock portfolio.

If these investments achieve a compound rate of return of 11.2 percent until Aaron is 65, the variable annuity will be worth $10 million. That's not bad for a $10,000 investment, but the best is still ahead. Under the terms of the trust, Aaron will receive 7 percent of the assets of the trust every year starting at age 65 and continuing as long as he lives. Hopefully the first check will be about $700,000. At an assumed inflation rate of 3 percent, that will be the equivalent of $135,00 in 2005 dollars. That won't make Aaron wealthy, but he'll have a comfortable retirement, especially if these payments are supplemented by his own savings and investments.

Meanwhile, if Aaron lives at least another 20 years after he starts receiving his annual distributions, and if the investments achieve a CRR of 11.2 percent, and he withdraws 7 percent a year, the variable annuity will be worth about $23 million.

At the end of Aaron's lifetime, the assets remaining will go to charitable organizations with a tax-exempt status. Those organizations are to be determined by the trustee or trustees, who could be Aaron's children or grandchildren. Jeff and I think there's a good chance that a Merriman Family Foundation will be formed by that time, and the remaining assets could go into it, with the earnings and proceeds directed to various charitable causes by our descendants. If a family foundation is established it will even be possible to reasonably compensate the family members for running the foundation.

What's wrong with this plan?

Jeff and I think this is an excellent plan, but some friends and other financial advisors (the two are not mutually exclusive, by the way!) have been critical. Friends say we should provide an "escape clause" by which Aaron could get the money before age 65 if, for instance, he is disabled or has huge medical expenses. Several of my colleagues have been critical of tying up money so irrevocably, for so long. "A lot of things can change in 65 years," they say. And of course they are right.

I realize that factors beyond my control, Jeff's control or Aaron's control could potentially unravel these plans or place some huge obstacle in the way of their realization. One real possibility is that Congress will limit variable annuity investments or find a way to restrict or eliminate the tax-deferred treatment they get. However, this won't happen without a lot of opposition from the powerful insurance lobbies. I assume (and hope) that any new law on annuities would contain a "grandfather" clause for existing contracts. In any case, I would bet all the money I have that the tax laws will change in some significant ways before the year 2059. There is absolutely no way to know now what those changes might be.

In over half a century on this planet, even my harshest critics would have to admit that I have learned a few irrefutable facts. And one of them is that the future is always uncertain. If you can't act until you know every fact, including those that can't be known, you will always be on the sidelines, never in the game. The total cost to me for this was the initial $10,000 deposit plus the costs of establishing the trust, which were less than $1,000. I can't think of any investment I'd rather make with $11,000.

A bum deal for Aaron?

Are we doing Aaron a disservice by locking the money up tight until his 65th birthday? Possibly we are. For instance, if Aaron dies before age 65, he won't receive a penny from the trust. If he lived only 65 years and six months, his long-awaited "pension" would be his for only the last half-year of his life. Some people think that is harsh and unfair. In addition, whatever family Aaron leaves behind at his death will get no benefit from this trust other than possibly the right to help give it away to charity.

Intentionally, we set up this trust so that it does not let Aaron off the hook. He will still need to provide for his family's security through prudent investments and insurance. He will need to earn a living and take care of whatever financial needs he has until age 65 without any help from this trust. And even when he is 65, Aaron won't suddenly have great wealth at his disposal. If you put your life savings in very low-risk investments, you are giving up an enormous opportunity. A few years ago I made $10,000 gift to each of my three grandchildren for their retirement years.

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Winning the lotto and more

But look at the other side of the equation. Just about anybody who won a $10 million Lotto jackpot, with the money to be distributed over 20 years at $700,000 a year, would consider himself or herself very fortunate. We in essence are giving Aaron that winning Lotto ticket, with an added feature you won't find in standard lotteries: The annual distribution will never stop no matter how long he lives. And because the payout to Aaron is based on the assets of the trust the last day of each year, that payout could grow every year. Try to find a Lotto deal like that!

We think this trust will give Aaron something else important: A very real financial incentive to live a long and healthy life. He'll also have some peace of mind about retirement. We think that if he saves a "normal" amount of money through a working lifetime, he may be able to fund his own "early" retirement at the age of 50 or 55, with the trust distributions kicking in when he's 65.

Finally, the ultimate disposition of this trust's assets will be to charity and Aaron may indirectly have much to say about that disposition. We hope this will prompt Aaron to think of himself as someone who plays an important role in society, encouraging him to pay close attention to charitable organizations and social needs. Through this trust, he will ultimately have the ability to direct a very significant amount of wealth to organizations he wants to support.

> It gives me great pleasure to establish a legacy for Aaron.

We cannot know in advance how Aaron will respond to this gift. But we hope it will give him opportunities he wouldn't otherwise have in life. And it gives me great pleasure to be able to establish a legacy that will continue to benefit him and society long after I am gone.

You can do this, too

I hope there are other people as excited about this concept as I am. And I hope some of them will want to use this example to establish some very long-term investments for their own children, grandchildren, nieces or nephews. I'm starting with $10,000, but a similar plan could be put in place for as little as $2,500. However, I think that is a practical minimum because of the legal costs of establishing a trust and the minimum investments required in most variable annuities.

For those who are interested, I have obtained permission to make copies of our trust document available. We are not offering this in order to give legal advice, and we don't recommend its use except as a starting point for discussion with your attorney and financial advisor. Nevertheless, we think anyone who wants to consider following in our footsteps could benefit from having a copy of the document we are using. If you want a copy, go to http://www.fundadvice.com/trust.html.

Why a variable annuity?

The variable annuity is the ideal investment for a plan like this, deferring taxes until the income is disbursed, in this case 65 years. In the meantime, the money can be invested in a portfolio of worldwide equities. With such a long time horizon, we think our chances of success are excellent. Variable annuities have become quite popular since 1986 when Congress wiped out most other tax shelters. These can be useful tools for some investment needs and a review of the product may suggest whether this is a suitable vehicle in your own case.

Annuities 101

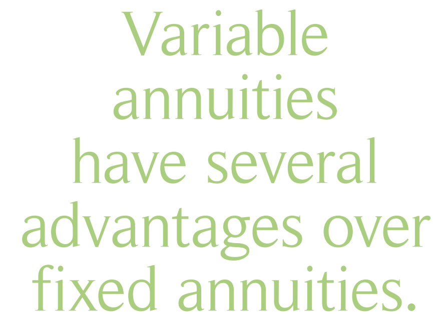
At its core, an annuity is a contract between an investor and an insurance company. The simplest type is a single-payment fixed annuity. You pay the insurance company $500,000, for instance, and the insurance company promises to pay you a fixed amount every month for as long as you live. The amount is based on your age and on an assumed investment return. The insurance company takes the risk that you might live much longer than average. It offsets that risk by making very conservative assumptions about the return it can get on your money. You take the risk that you'll die before you collect as much as you paid in (though many policies will pay the difference to your heirs or a beneficiary). And you take the risk that you could have achieved a higher investment return yourself instead of turning your money over to the insurance company.

Most annuities sold as investment products have an "accumulation phase" that lasts years or even decades before the insurance company begins making regular payments. What happens during that time depends on whether an annuity is "fixed" or "variable."

Don't fix it...

In a fixed annuity, the insurance company promises to credit the account by some guaranteed minimum interest rate, usually relatively low, during this accumulation phase. The actual rate is often higher than the guaranteed rate but it is always less than the insurance company expects to make on its own relatively conservative investments.

As investors and savers became more accustomed to having choices and higher returns, and especially as interest rates soared in the late 1970s and early 1980s, the fixed annuity lost some of its popularity. Fewer people wanted to tie up their money at a fixed rate of return. Thus was born the "variable" annuity. What varies is the investment return that builds up the account. Variable annuities offer investors the chance for substantially higher returns than those of fixed accounts, along with the lack of a guarantee and the chance that the returns could be lower than fixed-rate annuities.



Variable annuities have one other important advantage over the fixed variety. In a fixed annuity, the underlying assets are owned by the insurance company. If the insurance company should fail, creditors could eventually seize the money that backs the annuity contracts. This means investors in fixed annuities should be especially careful to do business with only the safest and soundest insurance companies-and those are not necessarily the ones that will offer the highest rates to attract new money. By contrast, the assets behind a variable annuity are not owned by the insurance company and creditors cannot make any claims on those assets. Those assets are separated, giving investors an added measure of safety.

In effect, a variable annuity is a shell inside which you can invest in equities and have the taxes deferred. If you imagine a non-deductible IRA without any limit on contributions, you'll have the idea. The annuity contract will let you invest in one or more private mutual funds, technically known as "subaccounts." These funds are private because they are available only to the insurance company's annuity accounts, even though they may be managed by large mutual fund companies and even though some funds attempt to "clone" the portfolios and performances of some of their most popular mutual funds.

Most people who buy variable annuities do so in order to defer taxes on their retirement savings. For this purpose, variable annuities have another advantage over many other retirement plans. While the rules of IRAs and 401(k) plans require you to start withdrawing the money when you reach age 70 1/2, many annuities will let you delay the start of the payoff stage until you are 85.

However, annuities come with several disadvantages. I think these disadvantages make this product appealing only to investors who can plan to leave their money in the annuity for at least eight to 10 years. The disadvantages fall into the categories of tax traps, limited investment options, fees and more fees. And they stack the deck against investors who change their minds or need their money back sooner than they had planned.

Two tender (tax) traps

The first tax trap facing annuity investors is common to IRAs and 401(k) plans: An IRS penalty for withdrawals before you are 59 1/2 years old. If you take money out before that age, you'll be slapped with the IRS' 10 percent penalty in addition to regular income taxes on your withdrawal. Second, investors in high tax brackets should understand an idiosyncrasy that variable annuities share with IRAs, 401(k)s, Keoghs and other retirement plans: Capital gains on investment sales lose their favorable tax treatment (the maximum 15 percent tax rate) inside a retirement plan.

Normally, for example, a long-term capital gain of $2,000 would be taxed at 15 percent (unless of course the taxpayer is in a lower bracket), leaving $1,700 of the gain for the investor. But within an IRA or a variable annuity, that gain will eventually be taxed as ordinary income, at your top tax rate, when you withdraw it. Under today's tax law, that could be as high as 35 percent, leaving you with only $1,300. The difference is $400 on a $2,000 gain and $2,000 on a $10,000 gain-more than most of us want to donate to the government if we have a choice! The full implications of this for any individual investor are impossible to assess without knowing what future tax rates will be. However, for long-term investors, this may be a price worth paying for the tax-deferred buildup inside an annuity.

What are my options?

Outside of retirement plans, you can invest in anything, including thousands of mutual funds. But inside a typical variable annuity, your choices are much more limited, just as they are in 401(k) plans. You'll have several investment options, as if you invested in a small family of mutual funds. You may have your choice of stock funds, bond funds, balanced funds and sometimes sector funds. If you're making a long-term commitment (as you should if you are buying an annuity) you should be sure to find one that has enough investment choices to meet your needs.

And speaking of fees...the biggest drawback of variable annuities is the complex matrix of fees that cut into your principal and erode your return. Typically these fees may be disclosed in fine print when you sign a contract but they are buried in your periodic statements so you hardly know what's happening to you. One quarterly annuity statement we studied recently contains an entry every month that says "policy processing" without explanation and without any number attached. That's a pretty underhanded way to collect fees, in my opinion, and it's one of my gripes about the insurance business. This is why I think it's vital to understand the types of fees and to shop carefully. If you do that, you can find low-cost variable annuities (four of which I'll suggest in a moment).

> Annuities should not be used within already tax-advantaged accounts.

Most variable annuities have four types of fees. First are "mortality and expense" fees unique to insurance companies. These annual charges average 1.25 percent to 1.7 percent of the assets in an account. Despite the name, most of this money pays sales commissions to brokers, salespeople and financial planners. In effect, the only thing an investor gets in exchange for this fee is the right to have a tax-deferred investment. That is why I believe adamantly that annuities should not be used, as they frequently are, within already tax-advantaged accounts such as IRAs and Keogh plans. Putting an annuity inside a tax-sheltered retirement plan is simply paying a high price, and paying it again every year, for something that you already have!

Second, most annuities come with a fixed annual charge of $15 to $40 to cover the costs of administration. Third, you'll pay a charge based on the assets on each subaccount to cover fund management. Pay close attention, as these fees vary widely. The total of these three fees often exceed 2.25 percent per year, significantly higher than those of a typical mutual fund. The fourth fee is called a surrender charge. It's really a stiff penalty to discourage investors from withdrawing their money in the early years of the policy-before sales commissions have been covered by the other fees you've paid. Surrender charges typically are in effect for four to six years and often require you to forfeit 6 to 8 percent of any money you take out in the first few years. Sometimes, the percentage declines by one percentage point per year.

The low-cost route

Fortunately for cost-conscious investors, three large investment houses, Vanguard, Dimensional Fund Advisors* and Schwab, have developed essentially no-load, low-cost variable annuities. None has any surrender charge for early withdrawals.

**DFA annuities are available only through approved advisors, like Merriman.*

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