RISKS OF THE TRADE

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How would you like to lose $500,000 in annual revenue? This is the true story of an advisor with AUM clients who learned a costly lesson.

The Facts:

This story starts many years ago at a charitable ball where an advisor met a wealthy business owner. Over time, the advisory relationship with the business owner grew. A couple of years ago, the business owner decided to retire and sell his interest to his business partner. After paying taxes and splurging on the construction of a mansion, the wealthy business owner placed $80 million in a brokerage account with the advisor. This account produced approximately $500,000 in revenue for the advisor.

Life was grand... until the unexpected happened. The retired wealthy business owner suffered a heart attack and died. Nine months later the tax man showed up demanding cash. What do you think was liquidated?

After paying $42 million in taxes and expenses from the brokerage account managed by the advisor, the balance of the estate was split three ways between the spouse and two adult children. After the estate closed, and the spouse and son took their inheritance away from the advisor, the advisor was left with only $5 million to manage. This was a tragic ending for both the client and the advisor.

Good News, Bad News Story:

As tragic as this true story is, it could have been worse. The business owner could have died while still working in the business without a buy-out in place assuring the purchase of his business interest. This would have put his family at risk of getting a high estate tax value from the IRS with no way to pay the taxes, and a “fire-sale” purchase price from the partner.

Of course, the bad news is that a significant portion of the business owner’s estate had to be liquidated within 9 months at the investment assets’ market value to pay taxes and costs.

Lessons Learned

Studies show that business owners make up a large percentage of the high net-worth population. Consequently, advisors who focus on AUM likely have many business-owning clients. While most business owners are not as large as the one in the story, surviving family members often face the following similar problems...

- Where is the surviving spouse and dependent children going to get income?
- How do they make sure the heirs get a "fair" price for the business interest?
- How can business and non-business heirs be treated "equally" when the business is the largest part of the estate?
- Where does the family get money to pay for final expenses, attorney fees, federal and state "death taxes"?

The advisor in the story learned that he needed to do more than manage and grow his clients' assets – he learned that he needed to make sure they are protected if he wants to keep an account to manage in the future.

How Could the Advisor Have Approached this Case Differently? By simply diversifying a small percentage of a client's investments or using some of the investment earnings, the advisor could have purchased life insurance that would have created cash to help cover the immediate liquidity needs that occur at death, preserve his book of business, and likely preserve the faith of the heirs.

If you think about it, life insurance is actually similar to a 'protective put' option in that it is a contract between two parties to deliver an asset, the death benefit, at a specified price, and the face amount, at a predetermined date, the death of the insured. The buyer of the contract, the insurance policy owner, has the right, but not the obligation, to receive the asset at the face amount at the future date, while the other party, the seller/insurance carrier, has the obligation to deliver the asset at the face amount when the buyer exercises the contract.

The question is, how much does the "insurance put option" cost?

How DBS Can Help

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