Post-Divorce Investments – What do I need to plan for now?

Divorce is the final step of a long process. Whether the marriage was long or short, the end of marriage brings about the conclusion of an important phase of your life.

Divorce is an emotional event sometimes anticipated years in advance and at other times coming totally out the blue.

In all cases whether anticipated or not, divorce is a stressful event. According to the Holmes-Rahe Life Stress Inventory Scale divorce ranks as the second most stressful event that a person can experience in a lifetime.

The transition from being a couple to being single again is often difficult for people to navigate. As William Bowers writes in his book Transitions , before being able to start a new life you have to go through a period of questioning and indecision that he calls the "Neutral Zone".

The legalese-heavy final divorce agreement is but one step in the path toward a new beginning. A legal document can't change how you feel about the divorce. In order to move on the change must be internalized.

Divorce almost always brings about a questioning of values and life assumptions never mind changing relationships, routines and roles. It also frequently brings about a loss of confidence and a whole set of fears ranging from "will I ever be happy again" to "will I be able to survive financially on my own".

The "Neutral Zone" or time until the new beginning takes shape may take a few months or a few years depending on how you typically deal with change as well as how life altering the divorce has been.

Asides from the emotional adjustments that new beginnings require other aspects of your "new" life need to be also dealt with such as your finances.

Divorce can be expensive and both your psyche and pocket book tend to suffer in the process. Going from living as a couple to setting up your own household almost always means higher expenses than what you were contributing during your marriage.

Understanding your new reality in terms of cash flows and budgeting is a first step. Another step and the focus of this note is re-configuring your investment portfolio to suit your new situation and needs.

Typically when you divorce you end up with an investment portfolio that is ½ of your old couple's portfolios. Invariably, your new portfolio will not be suitable anymore. If you haven't been the "financial" person in your marriage you may not even know what you own.

Most likely you will need to make changes to your portfolio to suit your new situation. You are now also solely responsible for your financial health.

Your "new" portfolio should reflect your needs, objectives and comfort level with investment risk. This may not be what you bargained for or you may feel ill-prepared to handle this on your own. You may feel that your life is out of your sync, but aligning your financial assets to your new situation is entirely under your control.

"Incredible change happens in your life when you decide to take control of what you do have power over instead of craving control over what you don't."

― **Steve Maraboli**, **Life, the Truth, and Being Free**

Why do you need a new portfolio once you divorce?

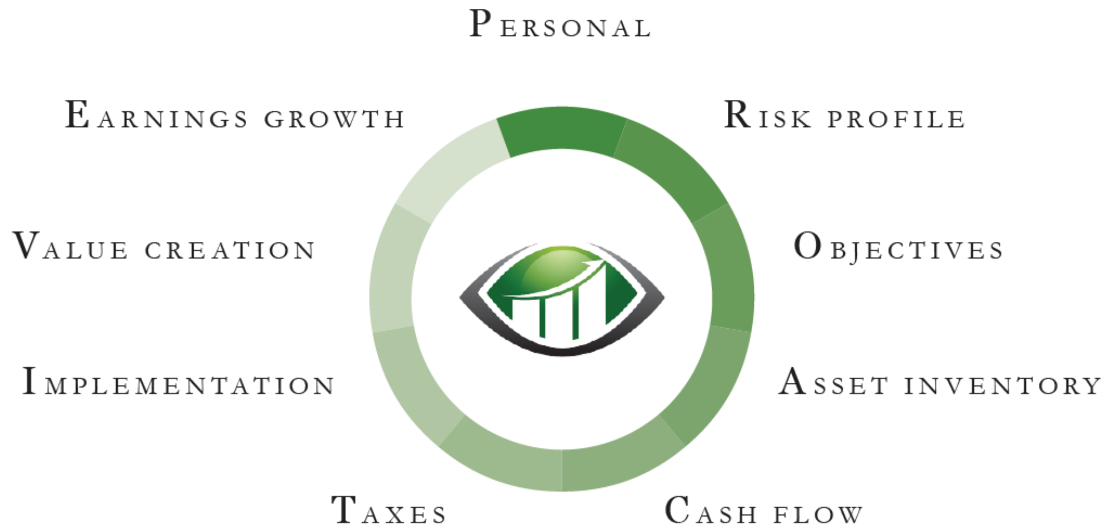
For one, the dollar amounts are less than before and your current investment strategy reflects your goals as a couple rather than your own objectives going forward.

Moreover, most likely your confidence is a bit shot and your desire to take much investment risk is lower than before.

Ok, are you with me? You can control this aspect of your new life. What steps should you take to get the ball rolling?

We suggest an approach rooted in our **P.R.O.A.C.T.I.V.E** methodology. The first step involves thoroughly examining your new situation from a non-financial standpoint. Where do you want to live? What type of lifestyle are you looking for? If you have children what type of issues do you need to account for?

Figure 1 – P.R.O.A.C.T.I.V.E PROCESS



The second step is to re-evaluate your comfort with taking investment risk. Now that you are solely in charge of your financial life how do you feel about taking on risk? Are you comfortable with the inevitable stock market swoons that occur periodically? Are you able to think as a long-term investor given your recent divorce?

How much risk do you need to take to meet your financial goals? There is a strong link in capital markets between risk and return - higher return investments usually imply higher risk and the chance of larger losses. Do you understand these tradeoffs between safety and return? You can't avoid investment risk but you can decide how much you want to take.

The next step is really important. Your post-divorce portfolio needs to work for you. Establishing a hierarchy of financial objectives will drive the type of strategy that is most appropriate for you. Is your primary objective to save for retirement? Do you have any major objectives besides retirement? Maybe you need to fund college tuitions for your two kids. Maybe you plan on buying a new home in 2 years once your life has settled down?

Next you need to deal with the nitty gritty of figuring out exactly what you own and cash flow budgeting. What you own should not be difficult to figure out as you have just gone through the divorce process.

The second part of cash flow budgeting is often highly sensitive for people not used to budgeting during their marriage. If you have never had a budget or stuck to one this step seems like a major imposition. But unless money is so plentiful you have no choice.

At least for a period of time you will have to keep track of your expenses and gain an understanding of where the money is going. The reason this is important is that you may need to tap into portfolio gains to fund your living expenses. If that is the case, your portfolio should be structured to write you a monthly check with a minimal amount of risk and tax consequences.

The next step in the **P.R.O.A.C.T.I.V.E** process is to evaluate your tax situation. If you are in a high tax bracket you might want to favor tax-advantaged investments such as municipal bonds. If your income is going to be taking a hit post-divorce you probably will end up in a lower tax bracket increasing the attractiveness of a Roth conversion to your traditional individual retirement account.

The last three steps all involve figuring out how best to construct your investment portfolio. Going from your pre-divorce portfolio to something that fits your needs and goals will usually require some major re-adjustments in your strategy.

Going through our **P.R.O.A.C.T.I.V.E** process or a similar approach is probably the last thing you want to do on your own. Most likely you will need the help of an advisor to work through this.

Keep in mind that the reason you are doing this is to regain control over your financial life. You sought the help of a lawyer during your divorce. Now is the time to move forward and seek the help of financial professionals with an understanding of your situation and new set of needs.

What is the typical profile of somebody that has recently gone through divorce?

- A redefinition of priorities and questioning of beliefs
- A temporarily lower level of confidence
- A greater aversion to losing money
- A desire to focus on working on themselves and regaining their happiness

What type of a portfolio structure typically appeals to a person transitioning from a recent divorce?

- A portfolio that can grow with a reasonable level of risk
- A portfolio that is risk managed especially on the downside
- A portfolio that is liquid and flexible
- A portfolio that keeps up with changes in purchasing power, i.e., inflation
- A portfolio that is tax efficient
- A portfolio that can be easily modified once you transition into a new beginning
- A portfolio that is professionally managed with a clear cut research driven approach

What is the best way to implement a portfolio strategy for newly divorced people?

The most important aspect of your new portfolio is that it fits you and your new circumstances and desires. Using our P.R.O.A.C.T.I.V.E methodology as a framework for evaluating your needs and desires we suggest implementing a portfolio structure that encompasses three “buckets”.

A “bucket” is simply a separate portfolio and strategy that has a very specific risk and return objective. Each bucket in our approach is designed to give you comfort and clarity about its role in your overall portfolio.

P.R.O.A.C.T.I.V.E Implementation

Your portfolio is constructed to reflect your primary desire for **safety**, **growth** and **ambition**

What is the role of these “buckets”?

Each “bucket” has a very specific role in the overall portfolio as well as very explicit risk and reward limits.

We label our three “buckets” as the **Safe**, the **Purchasing Power** and the **Growth** portfolios.

The role of the **Safe Bucket** is to provide liquidity and cash flow to you to meet your short-term lifestyle needs. How much you have invested in your Safe portfolio is a function of how much money you need to fund your lifestyle over the next few years.

Typically we suggest funding four years of expected expenses. The idea behind this bucket is to allow you to remain worry free in the face of the inevitable market fluctuations.

We construct this portfolio using very liquid, high quality short term fixed income exchange traded and mutual funds with minimal potential loss of principal. The safe bucket is a low risk and low return strategy uncorrelated to the fluctuations of stock markets. Most important the probability of loss is negligible thus allowing you to remain confident about meeting your lifestyle expenses over the near term.

The second bucket – the **Purchasing Power** portfolio – is designed to allow you to enhance your lifestyle in terms of real purchasing power. What this means is that every year your portfolio should have a return exceeding inflation.

With increasing life spans even small amounts of annual inflation can seriously deplete your purchasing power. Consider the cumulative effects of seemingly small amounts of inflation on your purchasing power.

Table 1 summarizes the loss of purchasing power assuming a 2,3 and 4% annual inflation over a 10, 20 and 30 year time period. Suddenly the amazing power of compounding goes in reverse and works viciously against you.

Table 1

INFLATION/YEARS	10 YRS	20 YRS	30 YRS
2%	18%	33%	45%
3%	26%	46%	60%
4%	34%	56%	71%

If inflation averages out to 2% per year your loss of purchasing power over the next 10 years is 18%. Over 30 years it is 45%. If we slightly raise our inflation assumption to 3% (consistent with the US historical experience) the loss of purchasing power is 26% and 60% for 10 and 30 years in the future.

Some of your income streams may be inflation-protected such as wage income or your social security payments if you are retired but most income sources are not. You therefore need to build in your portfolio a requirement the loss of purchasing power with a safe margin – this is the key role of the second bucket.

The Purchasing Power bucket is designed to maintain and hopefully enhance your lifestyle requirements over a period lasting about 10 years into the future. The strategy of this bucket will encompass a mix of equities, corporate fixed income and liquid alternative assets. The exact proportion will depend on your risk profile and the outlook of the various asset classes.

The risk of loss given capital market fluctuations will exceed that of the Safe bucket but so will its expected long-term return. The price of beating inflation is some short-term volatility but over intermediate periods of time such as a decade the history of capital markets is encouraging.

Because your short-term lifestyle income needs are met out of the Safe bucket, you will be better able to deal with the short-term fluctuating portfolio values of your Purchasing Power bucket.

Finally, the third bucket – the **Growth portfolio** – is designed to grow your portfolio in real terms. This portfolio is designed to maximize your returns from capital markets and will be almost exclusively invested in higher risk/higher reward equity securities.

The returns will be expected to be significantly above inflation and the risk of short-term fluctuations in portfolio values will be high. Over the long-term 10 to 30 years out it is expected that these short-term fluctuations will even out. Periods of capital market stress will likely appear as mere blips on a chart of portfolio values.

The role of the Growth bucket is purely and simply growth. Growth that you will need over the long-term to fund your lifestyle many years out in the future and potentially subject to your wishes to leave a long-term legacy to your heirs and favorite civic causes.

Your Growth bucket will involve significant equity market risk but over the long-run if history serves as a guide this segment of your overall portfolio should achieve the highest returns. You will need to adopt a long-term mindset as the money allocated to this portfolio should be viewed as off-limits for a long time.

How do the three buckets work with each other?

The three buckets comprise your overall portfolio. Each bucket is designed with a very specific role in mind. As you progress through life the composition of the portfolios and size of the buckets will change depending on your life circumstances and requirements as well as with the return potential and risk of the various investments.

For example, as you transition into a new beginning in your life your comfort level with taking on more investment risk may increase. Divorce has a way of temporarily lowering people's risk appetite but after a period of adjustment you may be ready to search for higher returns in your portfolio.

While the composition of your Safe and Growth portfolios will stay fairly constant, the composition of your Purchasing Power bucket will change to reflect your updated desire to achieve higher returns.

Assuming your circumstances and risk appetite do not change materially from one year to the next the three buckets are re-aligned with each other to always keep enough assets in the Safe bucket to fund your short-term lifestyle requirements.

For example, as one year goes by we replenish the Safe bucket with assets harvested from the Purchasing Power bucket. Depending on market conditions and trailing performance we may also take assets from the Growth Bucket to use in the Purchasing Power portfolio. In this way your overall portfolio is always in sync with your lifestyle requirements.

Conclusion:

Going for divorce is one of the most stressful situations anyone can face. Transitioning to a new beginning may take a short term for some but for most people the period of adjustment is fraught with uncertainty and doubt.

People often worry about their finances and whether they can maintain their lifestyle. A life event such as divorce also tends to shorten people's horizon as their outlook in life often lacks clarity.

The implications from an investment standpoint are primarily a temporarily diminished desire to take on portfolio risk and a shortening of time horizons. In English this translates to searching for greater certainty and not looking too far out.

As wealth managers our first goal is to first understand the client's circumstances and needs once the divorce is finalized. Our P.R.O.AC.T.I.V.E process serves as the framework for initiating and exploring client concerns and issues.

Once we have a full understanding of the client situation we move on to the implementation phase of our process. This is where properly constructing portfolios customized to the goals and situation of the client comes in.

At Insight Financial Strategists we employ a “bucket” approach to portfolio construction. A client’s overall portfolio is composed of three buckets:

- A **Safe Bucket** geared at providing the cash flow necessary to fund your lifestyle over the near term (usually 1-4 years)
- A **Purchasing Power Bucket** designed to outperform the loss of purchasing power due to inflation over the next decade with a reasonable margin of safety
- A **Growth Bucket** built to capture the long-term out-performance of equity securities around the world

All three buckets are designed to work with each other and are rebalanced periodically to take advantage of evolving capital market views, changing life circumstances and comfort with investment fluctuations as well as to account for any required cash flow needs of the client.

Our P.R.O.A.C.T.I.V.E approach at Insight Financial Strategists is designed to make your money work for what you deem important. Divorce is difficult and transitioning to a new beginning takes time. As you adjust to your post-divorce life your financial assets will also need to be managed consistent with the new you.

At Insight Financial we are experts at guiding you through this difficult adjustment period and transition into a new beginning.