Overcoming Financial Literacy Insecurity

In Divorce Financial Analysis

By Jacqueline B. Roessler, CDFA®

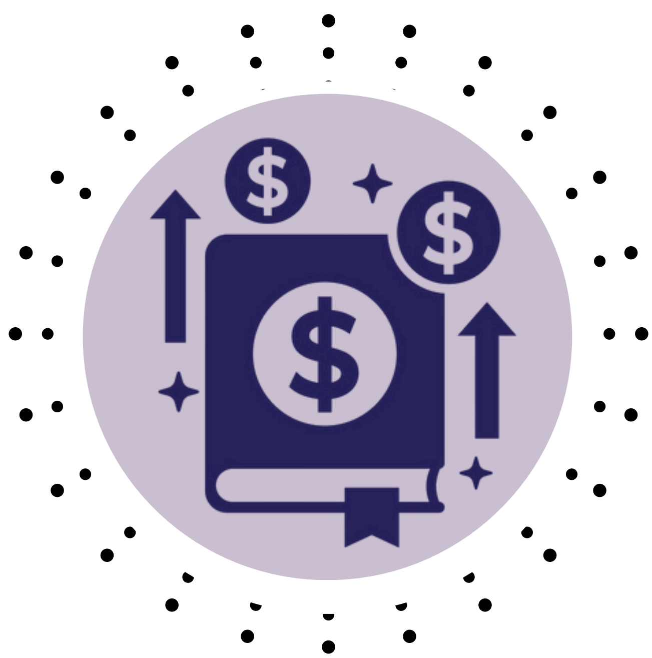
As a divorce financial planner with nearly three decades of experience, one of the most frequent questions I encounter is regarding the most significant financial mistake I've observed among clients. Common responses often include concerns about maintaining the marital home when it is unaffordable, overlooking the tax implications of their share of the marital estate, or treating retirement assets as if they hold the same value as post-tax dollars.

However, the most substantial financial mistake typically occurs much earlier in the process, long before such decisions are made. It is rooted in mindset—a mindset that, while often more prevalent among women, can also affect men. This mindset is characterized by a belief expressed by many clients: "I'm bad with money." This statement is often followed by expressions of uncertainty about investments and financial matters, such as, "My spouse handled our money" or, "My spouse works in finance," or even, "My spouse understands this better than I do."

This mentality represents one of the greatest obstacles to achieving a favorable settlement, and overcoming it is often the most challenging aspect of my work.

Financial literacy, in its simplest terms, refers to the ability to manage personal finances

This includes budgeting, cash flow management, making informed investment decisions. and overseeing asset allocation. It also encompasses retirement planning and effectively managing risk through insurance. None of these skills are determined by an individual's intelligence. Rather, financial literacy is directly tied to exposure—specifically, the degree to which an individual has been educated or introduced to these concepts.



As a divorce financial analyst, what key topics should be prioritized to ensure clients are exposed to the essential concepts needed to make informed and sound financial decisions during and after divorce?

In this article, I aim to provide a basic overview of financial principles tailored to individuals navigating divorce. This content is applicable not only to those currently going through a divorce but also to individuals considering divorce, newly divorced individuals, or those simply seeking to improve their financial literacy. The concepts I will cover are foundational and accessible, yet they are areas of knowledge that many individuals lack.

Cash flow management as a means to financial literacy.

In my experience, the first concept clients must grasp is cash flow management. A strong understanding of cash flow enables clients to make informed decisions regarding the marital home, plans to re-enter the workforce, and setting an anticipated retirement date, among other financial matters. While cash flow encompasses both income and expenses, the income side may be uncertain at the outset of divorce. However, the most illuminating aspect of this "lesson" for many clients is understanding their expenditures, particularly in terms of budgeting. For many, creating and maintaining a budget is viewed as a tedious and unpleasant task.

Despite this, it remains a fundamental component of financial literacy. As divorce financial professionals, it is essential that we guide our clients through this crucial process.

Many financial advisors provide clients with budget templates to help track their expenses. In my experience, clients typically complete the housing and other fixed expense sections with relative ease. However, they often overlook or minimize discretionary expenses.

In such instances, the advisor may need to arrange a more in-depth conversation to gain a clearer understanding of the client's actual financial outflows.

Even when clients feel uneasy discussing discretionary spending, it remains essential to document an accurate account of the family’s expenses during the marriage. To facilitate this process, it can be helpful to recommend that clients review several months’ worth of credit card and bank account statements as a way to ensure a more realistic assessment.

This comprehensive understanding of cash flow will inform more effective and realistic financial planning. As I often emphasize to clients, creating a budget is empowering, not restrictive. When clients establish a budget for their future, they are actively making decisions about what is most important to them and what can be deprioritized. For some, a monthly massage might take precedence over frequent takeout meals. A well-crafted budget serves as a tool for focusing on priorities and ensuring that financial resources are allocated in alignment with one's values and goals.

The Importance of Basic Investment Literacy

Once priorities are established through a detailed budget, the next critical step is helping clients understand which investment vehicles are most suited to achieving their short-term and long-term financial goals. For instance, let's consider a client who has a well-defined budget and recognizes that maintaining the marital home long-term is not financially feasible. The next phase involves educating them about the remaining assets in the marital estate. As divorce financial planners, we should not assume that clients fully understand the types of investment assets they hold or the reasons for owning them. It is never too early in your engagement with a client to inquire whether they have a clear understanding of all the assets listed in their marital balance sheet.

In fact, one of the most effective ways to build trust is by thoroughly educating clients, enabling them to actively and confidently participate in negotiations to divide their assets.

I often start by coaching my clients through the basic reasons for owning different investment types. In order to do that, we have to start at the beginning-the four main reasons people invest their money; to achieve Safety, Liquidity, Income and Growth from their portfolio.

1. Safety

The first concept clients often seek is safety. After the uncertainty of divorce, many clients are understandably concerned about protecting their assets. They want to know that their money is secure, much like how they would expect it to be in a bank. Our job is to educate them that while no investment is 100% risk-free, there are options that offer a higher degree of safety—cash equivalents, for example, like savings accounts or money market accounts, are low-risk. However, we must also explain that perfect safety comes at the cost of low returns. It's important that clients understand this trade-off.

2. Liquidity

Next, clients need to understand liquidity—the ability to access their money quickly. Many people think of investments like gold or real estate as safe, but these types of assets are not liquid. If an emergency arises, such as needing money for a home repair, selling gold or other non-liquid assets could take time and may not provide the immediate cash needed. Educate your clients that cash equivalents—like money market funds or CDs—are liquid. If they need their money quickly, these types of investments allow easy access without penalty.

3. Income

Another key factor clients often look for is income. This is especially important for clients nearing retirement who need reliable, ongoing income to supplement Social Security or pension benefits. Fixed-income investments like bonds, or dividend-paying stocks, can provide a consistent income stream. It's important that clients know the difference between investments that appreciate in value (growth) and those that offer steady income. By explaining these options, you can help clients choose investments that meet their needs for income during retirement or other life stages.

4. Growth

Clients also want their money to grow. Growth—achieving a high return on investment—is often the primary reason clients are interested in investing at all. While stocks are the typical go-to for growth, they come with a higher level of risk. It's crucial to explain that growth investments are not guaranteed and can fluctuate in value. As financial planners, we need to guide clients in understanding the relationship between risk and reward, and help them find a balance that works for their situation.

Understanding the Trade-offs:

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Key Investment Types:

To explain how to achieve these objectives, introduce clients to the three main investment categories:

- **Cash Equivalents:** These are low-risk, liquid investments, such as savings accounts, money market accounts, and certificates of deposit (CDs). While they offer safety and liquidity, the trade-off is typically lower returns.
- **Bonds:** Bonds provide a steady income through interest payments, making them a good option for clients seeking income. They come with a moderate level of risk.
- **Stocks:** Stocks offer growth potential but are more volatile. These are best suited for clients willing to take on higher risk in exchange for the possibility of higher returns.

In a well-balanced investment portfolio, clients should include a combination of these types of assets. By ensuring they understand the role each investment plays—whether for safety, liquidity, income, or growth—we can help them make more informed decisions. Our goal as divorce financial planners is to guide clients toward building a diversified portfolio that aligns with their financial goals and risk tolerance, providing them with the tools they need to manage their finances with confidence after divorce.

Tax-Deferred versus Taxable Investments

An essential concept to convey to clients is the distinction between assets designated for retirement through tax-deferred vehicles and those growing outside of a tax-deferred structure. Many clients are willing to relinquish their portion of retirement assets to retain the family home, often without fully understanding the long-term financial consequences. It is crucial not to assume that all clients are aware of the purpose and mechanics of their tax-deferred assets.

We must begin by explaining that retirement assets are specifically intended for retirement and can be either employer-sponsored (such as a 401(k)) or individually held (such as an IRA).

These assets grow tax-deferred until distributions are taken in retirement, at which point withdrawals are taxed as ordinary income.

The strategy behind tax-deferred accounts is based on the assumption that individuals will be in a lower tax bracket during retirement. This allows clients to reduce their taxable income during their high-earning years and defer taxes on earnings until retirement when they are presumably in a lower tax bracket.

I always emphasize to clients that $100,000 in a retirement account is not equivalent to $100,000 in a bank account, as withdrawals from retirement accounts are subject to taxes—and potentially a 10% penalty, depending on the client's age and the withdrawal terms. Divorce financial planners must be mindful that even the most financially knowledgeable clients often struggle to grasp this concept. In many cases, I've engaged in lengthy discussions with clients who don't view retirement accounts this way, which is also true for some state Domestic Relations Laws. However, to enhance clients' financial literacy, it's important to help them understand that we must evaluate all assets on a like-for-like basis. Just as we subtract the outstanding mortgage from the appraised value of the marital home, we must also account for future taxes when calculating the value of tax-deferred investments in the marital balance sheet.

Conclusion

Helping your clients see the need for them to understand basic financial literacy and showing them it's easy to achieve that will change the way your client engagements work-from beginning to end. Instead of contributing to the continued co-dependency of clients, you will empower them with confidence to ask the right questions, a skill they'll need to rely on once the divorce is final.

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Jacki has been assisting clients and their attorneys as a Certified Divorce Financial Analyst® since 1996. She is passionate about helping individuals, couples and attorneys navigate the complex financial decisions and issues in divorce. Whether it's assisting clients in understanding their assets, cash flow, retirement account divisions and tax issues or helping their attorneys understand how to divide RSUs, Stock Options and complex retirement plans, Jacki's experience, in-depth expertise and empathy make her an invaluable resource in your case.