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Simpler is Better

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An occasional discussion of financial issues of interest to physicians.

It is settled law that stipends paid to medical residents are taxable income. However, it is unclear whether such stipends are subject to 15% Social Security and Medicare taxes, half paid by the employer and half by the employee. If medical residents are “students,” their wages are exempt from these taxes.

A court recently ruled that stipends paid by the Mayo Foundation are exempt from Social Security and Medicare taxes. This ruling does not directly affect medical residents in California because we are subject to the jurisdiction of a different court. But it may indicate how the wind is blowing.

If residents’ stipends were tax-exempt and if the net received by residents were unchanged, hospital emergency rooms would save 15% of the compensation currently paid to medical residents. This is a drop in the bucket compared to operating deficits and to the financial threats routinely discussed in *Lifeline*. The student exemption from Social Security and Medicare taxes is therefore bad policy because it makes the rules more complex with no substantial benefit.

Some issues are inherently complex. Birthdays, for example. The young man in Gilbert and Sullivan’s *The Pirates of Penzance* was indentured for a lifetime because his mother did not consider the implications of his February 29th birth date. But it is not clear how we benefit from a complex tax code which uses age 14 to qualify the children who may report unearned income on a parent’s return and ages 13, 17, 18, 19 and 24 to qualify children in other circumstances.

Complexity increases the cost of compliance and breeds loopholes, mistakes and fraud. Problems are compounded when enforcement is less than vigorous. California is rumored to be laying off tax auditors in response to our budget crisis. We would have thought that good auditors would be profit centers!

The IRS is rumored to be about to rein-in certain egregious pension promotions.

Highly compensated small business owners (aka self-employed physicians) are entitled to extra large pension deductions if their pensions are funded with life insurance. Such pensions are known as 412(i) plans. The deductions are extra large because the return guaranteed by life insurance is less than the likely return of other investments.

Some pension promoters are promising highly compensated small business owners gargantuan deductions by super sizing the life insurance policy. A super sized insurance policy exceeds what is needed to fund the pension; any excess funding is taxed at retirement. To avoid this tax, the promoters transfer the life insurance out of the pension before retirement and they artificially lower the cash surrender value so that this transfer occurs at an attractive price, that

is for less than fair market value. The difficulty is that transferring life insurance for less than fair market value is a taxable transaction.

Unnecessary complexity is not limited to taxation. There is wide support for a Medicare drug benefit to help those seniors who are forced to choose between their food and their medication. The obvious solution would be a means-tested, catastrophic drug benefit. Yet our legislators seem intent on providing complex first dollar coverage for both rich and poor.

As health care consumes an increasing share of our national bounty, costs come under increasing governmental scrutiny. This trend means lower lifetime incomes, and less money to invest, for younger physicians.

There are good reasons to believe that investment returns will fall below historical averages in the coming decades. The implication of less money to invest and lower investment returns is that physicians need to pay more attention to their investment portfolios.

Physician William Bernstein writes “Unfortunately, when doctors put on their investing hats, they completely forget their scientific training. There is, in fact, a rich and informative scientific literature about what works and what doesn’t in finance; it is routinely ignored. Instead of depending on the *Journal of Finance* (the investing equivalent of *The New England Journal of Medicine*), they get their advice from *USA Today* or worse, from their stockbroker.” - Introduction, *The Four Pillars of Investing*, McGraw-Hill, 2002.

The investment literature teaches that simpler is often better. Although more complex strategies should provide slightly better returns, the reality is that passive portfolios outperform the majority of actively managed portfolios. See Bernstein, chapter 3, and books by Vanguard’s John Bogle and by Professors Burton Malkiel and Jeremy Siegel.

A passive strategy starts with a portfolio of low cost “index funds” and/or low cost “exchange traded funds.” These securities offer broad diversification within their respective asset classes but you still need to decide how much of your portfolio should be in bonds and how much in real estate and how much in foreign stocks. “Charlie Cringe” in Bernstein’s Chapter 4 is a reasonable allocation because it avoids big bets on specific asset categories.

The asset allocation can be improved by considering risk tolerance, financial acumen and the tax environment, as is illustrated by Bernstein in Chapter 13.

A passive strategy implicitly assumes that you are not trying to guess which stocks will outperform. You will make changes to maintain the target asset allocations and you may make changes as you become more experienced. But you will not buy simply because something is hot and you will not sell simply because something is experiencing a bad stretch.

If you are disciplined and able to invest some time to financial matters, a passive strategy is simple enough to implement on your own. A diversified portfolio of index funds and ETFs should cost less than 0.5% annually.

If you have other things to think about¹, your best bet is to hire an adviser. There are capable advisers who will implement a passive strategy for 1% annually, including fund expenses. You may have to search a bit but this cost is realistic because this is what Vanguard charges for their advisory services.

Investors pay more when their company pension is administered by a life insurance company. "Variable annuities" involve extra fees which add at least a half a percent to annual costs. If your only pension options are variable annuities, you could quit and roll your pension over to a low cost IRA. We'd suggest hiring an adviser to first investigate other possible solutions!

Costs matter. If the long term trend is 8% annually, saving a thousand dollars a month should produce a \$1.5 million portfolio after thirty years. If extra costs reduce the long term trend to 7%, your portfolio will be worth one fifth less.

Taxes are another investment cost. Next time, we will discuss how a simple passive strategy can be tweaked to benefit from the 2003 tax changes.

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¹ TIAA-CREF, "Managing money for people with other things to think about."