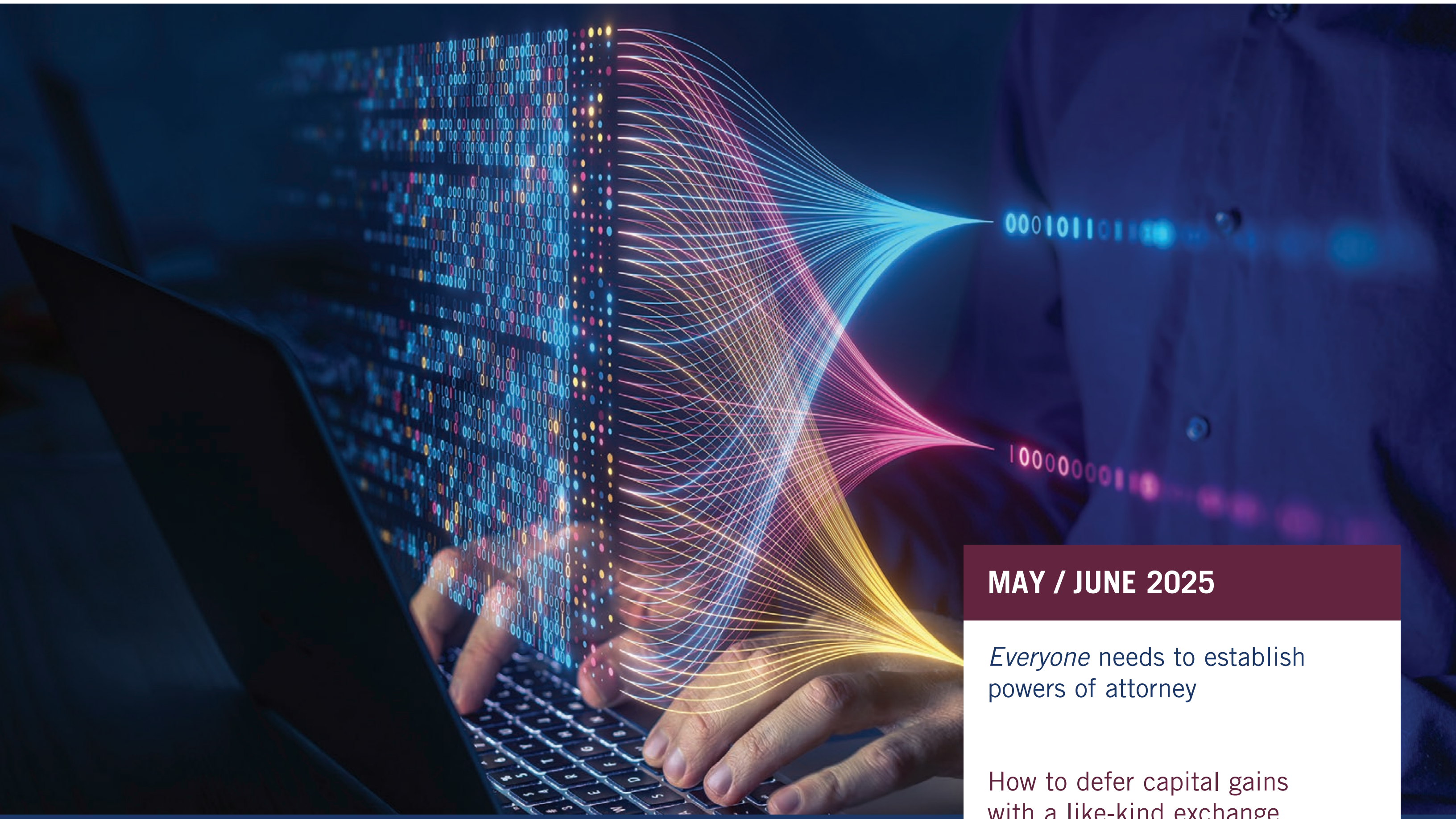
WEALTH MANAGEMENT **ADVISOR**



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AI AND WEALTH MANAGEMENT: PROCEED WITH CAUTION

AI and wealth management: Proceed with caution

When it comes to investment management, artificial intelligence (AI) is nothing new. After all, robo-advisors — online platforms that offer automated investment management and financial planning services — have been around for more than 15 years. As AI has become increasingly sophisticated, it has gained more power as a wealth management tool. But like other tools, these solutions are only as good as the people who design and use them. And while AI offers significant benefits, you should understand its limitations.

Quick and objective

According to a 2024 Mercer Investments survey of global investment managers, 91% either currently use (54%) or plan to use (37%) AI for investment strategy or asset class research. The advantages of employing such technology stem from AI's ability to quickly comb through vast amounts of data and make it actionable. Other benefits include:

Efficiency. AI's ability to automate many tasks means it can offer lower costs, making sophisticated investment and retirement planning advice available to more people.

Powerful data analysis. AI's ability to process and analyze data — including financial statements, market information and news articles — allows it to spot patterns and trends quickly, leading to better investment decisions.

Personalized advice. By analyzing large amounts of client data (financial history, investment goals, risk tolerance, demographics), AI can develop highly personalized investment plans and portfolios.

DANGER OF HALLUCINATIONS AND BIAS

Artificial intelligence (AI) is improving all the time, but it's far from perfect. For example, it can sometimes generate inaccurate or even fictitious results. These "hallucinations" may seem true and reliable but are, in fact, wrong, fabricated or even nonsensical. They can be caused by insufficient training data, poor model design and other factors.

Bias is another potential pitfall. It can occur when data used to train an AI system is incomplete or unrepresentative or when the algorithm or underlying data reflects existing human biases. Gender bias is particularly common. Suppose, for example, that a man and a woman are the same age and have comparable income, savings and risk tolerances. The AI model might assume all women earn less and have a longer life expectancy. Based on this assumption, the model might recommend that the woman allocate more of her portfolio, compared with the man's, to conservative investments (which tend to be less volatile but historically have had lower returns over the long term). Such allocations can make for huge earnings discrepancies.

To avoid making biased recommendations, wealth management advisors must give greater weight to AI systems whose recommendations are driven by individual client data, including a client's risk tolerance.

Objectivity. AI can help mitigate the emotional component of investment decision-making. For example, it might automate trade execution based on preset rules and criteria, thus helping investors maintain discipline and avoid impulsive decisions that can derail their long-term strategies.

Risk management. AI can monitor portfolios in real-time, detecting fraud and other potential threats, and recommend asset-allocation changes and other adjustments to maintain desired risk levels.

Error-prone and vulnerable to attack

AI isn't mistake-proof. The quality of its algorithms and the data used to train it are critical to its ability to enhance wealth-management advice. And it can't replace human judgment — at least not now. AI systems are trained using historical data, and while they perform well under stable conditions, they may lack the ability to deal with unforeseen developments. AI systems may also struggle with issues that require human evaluation, such as those involving investor emotions, subtle market characteristics or nuanced decisions, such as balancing current quality of life against saving for the future.

Other potential disadvantages include a lack of transparency. For example, some AI models are "black boxes," meaning users may not know much about their underlying algorithms or decision-making processes. This can make it difficult for investors to understand and manage risks.

AI may also be unable to handle complex planning. These models generally aren't well suited for complicated scenarios that go beyond investment decision-making, such as estate, retirement or tax planning. Such scenarios generally demand human expertise and experience.

Then there are data security issues. Robo-advisors and other online investment platforms are attractive targets for cyberattacks. So it's important for investors to become comfortable with an AI system's data security practices.

Finally, overreliance on AI can be risky. Although AI offers significant benefits, it can't handle every investment scenario, which sometimes leads to bad output (see "Danger of hallucinations and bias" on page 2). Experienced financial professionals need to provide close oversight of AI systems to help ensure their recommendations make sense in the real world.

The human touch

AI can be a powerful tool, but it's just that — a tool. It generally enables financial advisors to process huge amounts of data efficiently, automate much of the investment management process and respond to investors' questions and requests more quickly. However, given its limitations, AI should be viewed as a *complement* rather than a replacement for human beings. Humans will likely continue to oversee AI activities, direct big-picture wealth management plans, troubleshoot unforeseen events and provide clients with emotional support for some time. ■

Everyone needs to establish powers of attorney

The U.S. Social Security Administration reports that about one in four people between ages 20 and 67 becomes disabled. Many more people older than 67 can't manage basic life functions, including making financial and medical decisions for themselves. Indeed, you could be just a heart attack, stroke or early onset of dementia away from incapacity.

For these reasons, everyone — even young and healthy adults — needs to appoint trusted individuals to assume powers of attorney. In general, powers of attorney can be addressed in your estate plan.

2 types

Many elements of a typical estate plan focus on actions that take place upon or after death. But it's equally important to have a plan for making financial and medical decisions should you be unable to make them for yourself. Legally, a power of attorney is a document authorizing another person to act on your behalf. This person may be referred to as the "agent," "attorney-in-fact," or "power of attorney."

Agents usually are assigned one of two types of power of attorney:

1. **General.** This type is broad in scope. People commonly use these if they frequently take extended trips out of the country and need someone to authorize business and investment transactions while they're gone. A general power of attorney becomes invalid if you're incapacitated.
2. **Durable.** Unlike the general form, a durable power of attorney remains in effect if you become incapacitated and only terminates on your death. Therefore, you'll likely want to establish this type. Just know that this document must include certain language required under your state's laws to be effective.

Note: Some people choose a "springing" power of attorney. This document takes effect when someone is incapacitated but is only available in certain states. Talk to your estate planning advisor to see if it's an option for you.

Health care directives

Powers of attorney can provide authorization to make both financial and health care decisions. With a health care power of attorney, you can establish the terms for determining if you're incapacitated. For example, it may only be in effect temporarily if you're unconscious and then become ineffective if you regain consciousness. Whatever you decide, discuss your document's terms and your reasoning with your appointed agent.

Also, don't confuse a power of attorney with a living will. A durable power of attorney allows another person to make decisions in your best interests. A living will provides specific end-of-life directions for terminally ill patients.

Putting — and keeping — it in place

Powers of attorney can only be established for someone who's currently competent. However, even if you've been diagnosed with a specific disease, it doesn't make you "incompetent" to establish powers of attorney. Even an elderly person in the beginning stages of Alzheimer's may be able to do so.

Once you've established powers of attorney, review them periodically and consider executing new ones if your wishes have changed. Another reason to review and renew: Some financial institutions and health care providers may be reluctant to honor powers of attorney that are more than a few years old. And you should definitely review these documents if:

- An appointee has died or become unavailable,
- You've divorced the spouse you initially appointed, or
- You've moved to another state.

Certain terms have different meanings in different states, and states don't all have the same procedural requirements. Some states, for example, require durable powers of attorney to be filed with the local county recorder or some other government agency.

Revocable documents

Finally, powers of attorney usually continue until death but are revocable. This means you can revise or discontinue them anytime and for any reason. Just make sure you notify your estate planner, the agent you appointed and any family members who need to know. ■

How to defer capital gains with a like-kind exchange

If you're looking to dispose of highly appreciated real estate without triggering a substantial tax bill, you might want to consider a like-kind exchange. Section 1031 of the tax code allows you to defer tax on business property exchanged for other property of "like-kind" until the replacement property is sold. Such deferrals can even be permanent if you hold the replacement property for life. This makes the like-kind exchange a powerful estate and income tax planning tool.

Here are answers to common like-kind exchange questions.

How much can you defer?

An outright sale of appreciated property can generate a variety of taxes on the capital gain. These include federal income taxes (15% or 20%, depending on your tax bracket, or 25% on any "recapture" of previous depreciation deductions); the 3.8% federal tax on net investment income (if applicable); and in many cases, state capital gains taxes as well.

What property qualifies?

Like-kind property is defined broadly as any real property interest held for investment or business purposes. It can even include vacation homes owned primarily to rent. However, it doesn't include land under development or property held for sale.

Personal residences also don't typically qualify. But if the sale of a personal residence would trigger a large capital gains tax — for example, because the home sale exclusion doesn't apply or the property's appreciation exceeds the exclusion amount — it may be possible to convert the residence into a business (rental) property. Then you might later be able to execute a like-kind exchange. To qualify, you'd generally need to use the property for rental or other business purposes for at least two years.

How does it work?

To enjoy the tax-deferral benefits of a like-kind exchange, you must comply with several timing and technical requirements. Actual exchanges of one property for another are rare. Usually, property owners do a "deferred exchange," which gives an owner 45 days after the sale of "relinquished property" to identify one or more replacement properties. Replacement property must then be purchased and the transaction closed by the *earlier* of:

1. 180 days after the relinquished property is sold, or
2. The due date — including any extensions — of the owner's tax return for the year of sale.

To avoid immediate taxation, an independent "qualified intermediary" must hold sale proceeds and use them to acquire the replacement property.

It's also possible to acquire replacement property first and then sell the relinquished property in what's known as a reverse exchange. These transactions are more complicated than traditional deferred exchanges and you should ask your financial advisor for more information and help.

What are the estate planning benefits?

Leaving appreciated property to your children or other heirs can be an effective estate planning strategy. Your heirs generally would receive a stepped-up tax basis in the property, equal to its fair market value on the date of your death. If they were to sell the property, they would avoid capital gains tax on all appreciation occurring before that date.

But what if you've identified other property that would provide greater investment returns for your family? You could sell your existing property, lose a big chunk of the proceeds to various taxes, and reinvest what's left. However, a like-kind exchange would allow you to trade for a more attractive property without losing any of the relinquished property's value to taxes.

Seek professional help

Like-kind exchanges potentially offer significant tax benefits, but they're subject to strict technical Sec. 1031 exchange requirements that must be followed to the letter. If you're considering an exchange, consult an experienced professional to plan the transaction and help minimize risk. ■

Climbing the Roth IRA ladder to an early retirement

Federal Reserve Bank of New York research has found significant changes in Americans' "retirement expectations." Fewer than 50% of workers say they're likely to keep a full-time job past age 62. Of course, some respondents expect to become "involuntary" retirees who lose their jobs and can't find suitable new employment — not necessarily independently wealthy retirees.

But you may be able to make an early and comfortable retirement possible with a Roth IRA ladder.

Multiple transfers

Here's how the process works: You transfer funds from a traditional IRA, 401(k) plan or similar tax-deferred account to a Roth IRA. You must pay tax on any amount you transfer.

But once the transfer is in your Roth IRA account, you may be able to withdraw transferred funds, original contributions and any earnings tax-free. The "ladder" part of the process involves several transfers into the Roth IRA account staggered over a period of years. You stagger the transfers because each converted amount must meet certain timing rules before you can withdraw it and any earnings.

Tax-free withdrawals and more

With Roth IRAs, you can make tax-free withdrawals of your contributions anytime (because they've already been taxed). However, for withdrawals of your earnings to be tax-free and penalty-free, they generally must meet the following requirements (with some exceptions):

1. You must first reach the age of 59½, and
2. At least five tax years must have passed from the beginning of the year you first set up and contributed to the Roth IRA.

The big advantage of Roth IRA ladders is that they can enable significant tax-free withdrawals after only five years. Depending on the size of your accounts and planned retirement lifestyle, this strategy could make it possible for you to retire early.

Other advantages? You don't have to take required minimum distributions (RMDs) from Roth IRA accounts and may, therefore, be able to leave more to your heirs. Also, converting funds in installments and creating multiple income streams can provide greater tax and retirement planning flexibility.

Potential risks

There are drawbacks that may make a Roth IRA ladder risky or less tax-efficient for some individuals. Discuss your specific situation with financial professionals. They can help you determine whether the Roth IRA ladder strategy might work for you. ■