Ruminations on Sudden Wealth

The possibility of suddenly coming in to a large sum of money may be pleasant in our daydreams, but in reality, sudden wealth can cause a great deal of stress. The source of sudden wealth doesn't necessarily have to be winning a lottery or receiving an unexpected inheritance. Many people face adjustment issues even from the sale of a business or the rollover of a large 401(k) upon retirement. In these cases, even though net worth is unchanged, having the wealth more accessible and liquid somehow makes it seem more real. Following, in no particular order, are some instructive comments for those contemplating the use of a large sum of money:

1. People who are prudent with small amounts of money tend to be prudent with large amounts of money. People who are profligate before an unexpected inflow will be profligate with that inflow. In other words, more income or wealth won't solve what is fundamentally a spending problem. This is undoubtedly the reason that studies have found that between one third and one half of lottery winners eventually declare bankruptcy.

2. Far too often, people who come into sudden wealth seem almost to be *trying* to lose the money. Most people become comfortable with a certain lifestyle, self-image, etc., and when something happens to change that, they may try (perhaps subconsciously) to get back to where they were previously. This is the financial equivalent of the biological process of homeostasis.

3. People think that lump sums will go further than they actually will. If you have made $50,000 per year all your life, you may see the $500,000 in your 401(k) at retirement as an incredible amount of money, when it really isn't. The most extreme example of this that I have seen is that of a very successful attorney approaching retirement. His main assets were about $1,000,000 in his 401(k) and the value of his partnership share which his partners would buy from him for about $500,000. I asked the couple how much they needed to live on in retirement, and his wife replied, "We have a fairly modest lifestyle. If we continue to get what he makes now, we should be just fine." I asked the obvious follow-up question, "What do you make now?" To which he responded, "About $500,000." I wanted to ask what they planned to live on in year four (but I didn't). I also didn't get them as clients. My guess is they went with an advisor who said they were in fine shape.

4. People sometimes try to "prove something" to someone such as a spouse or a parent (even if the parent is deceased). It is not uncommon for someone to lose a great deal of sudden wealth in investments or businesses trying to demonstrate how skilled they are at investing or business.

5. Sometimes people don't know what to do, so they ignore the funds completely. I once did a financial plan for a school teacher who lived very frugally on her salary. Her primary concern was whether she could afford to buy a condo to live in rather than continuing to rent an apartment. Her father had left her some stocks when he died more than 20 years previously, and she not only didn't spend any of the money, she had never bought or sold anything in the account. It had been untouched for more than 20 years, and her net worth was just under $1,000,000.

6. The receipt of sudden wealth can also strain relationships with existing friends and family members. Many wealthy people are treated differently and not uncommonly feel taken advantage of. Of course, new "friends" and "advisors" become prevalent as well.

So, what is the solution? The main thing is to proceed slowly. It is perfectly fine to leave the wealth in cash while becoming acclimated to the new situation. It may not be prudent to immediately move to a nicer area, a bigger house, etc. As a first step, paying off all debt and committing to remain debt free is probably advisable. In addition, thinking of the wealth as an income stream rather than a lump sum may be helpful. The sustainable withdrawal rate from a portfolio is about 4% per year. Thinking of a million-dollar windfall as being able to pay off a $500,000 mortgage and then having $20,000 per year from the remaining portfolio to spend may lead to vastly different decisions than thinking about what to do with a million dollars.

Notes:

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