RASKINGLOBAL
SMART STRATEGIES FOR YOUR WHOLE LIFE

February 2015

A Unified Theory to Save the MIDDLE CLASS

The middle class in America is shrinking. A result of The Great Recession is a pullback in prosperity for all Americans, and the subsequent recovery, such as it is, has been unevenly experienced. The lower-income segments of the population have seen a slow return to pre-recession incomes and stability, while the upper-income class has not only recovered, but advanced. Meanwhile, the middle class, once the dominant economic strata in the US, has declined or diminished - the majority of migration moving downward. The result is a more polarized economy comprised of haves and have-nots, with greater barriers for those at the bottom to move up. This condition is both socially and economically damaging for the country.

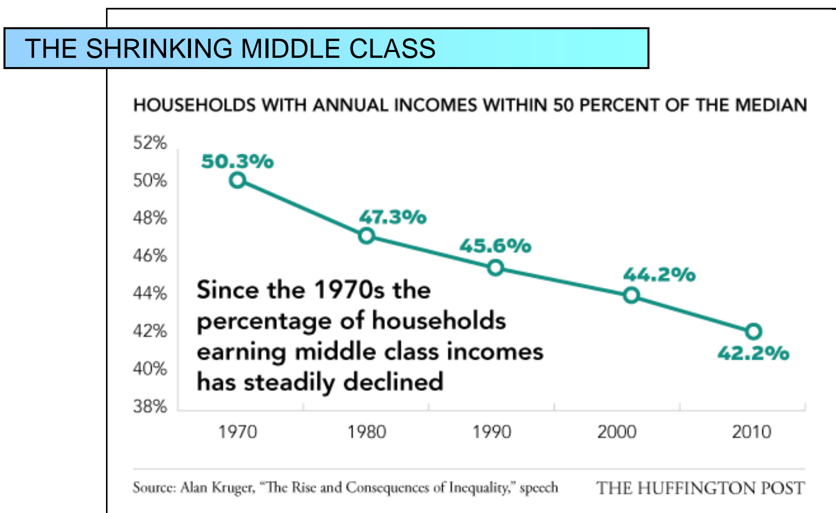
The shrinking middle class narrative has prompted a lot of academic study, attempting to define the participants, verify the decline, and determine the causes. When you dig into the data, it provides interesting nuance to the bigger story.

Defining the Middle Class

What characteristics define the middle class? Some assessments offer numerical definitions; others connect it to economic activities or self-evaluations.

A January 12, 2012, speech by Alan Krueger, the chairman of the President's Council of Economic Advisers, defined the middle class as "households with annual incomes within 50 percent of the median." With a national median annual income of approximately $55,000 in 2012, Krueger's middle class was roughly those Americans earning between $30,000 and $80,000. Adjusted for inflation, this metric produced the following 40-year graph, which received broad media circulation.

THE SHRINKING MIDDLE CLASS



> "Cautious optimism is generally the most rewarding path. But you have to have a large dose of reality." - John Mauldin

In This Issue…

A UNIFIED THEORY TO SAVE THE MIDDLE CLASS — Page 1

THE WHOLE STORY ON LIFE INSURANCE PERSISTENCY — Page 3

FAMILY LOANS: JUST BETWEEN US and the IRS — Page 4

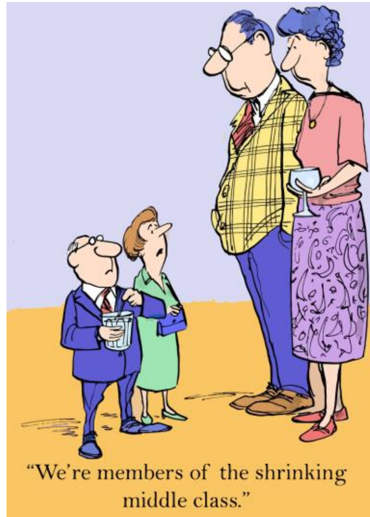
THE CHALLENGE OF PROVIDING COMPETENCY, PROTECTING ASSETS — Page 5

* The title of this newsletter should in no way be construed that the strategies/information in these articles are guaranteed to be successful. The reader should discuss any financial strategies presented in this newsletter with a licensed financial professional.

Similarly, a 2012 Pew Foundation report titled “The Lost Decade of the Middle Class,” considered the middle class to be “those living in households with an annual income that is 67% to 200% of the national median,” which translates to those with incomes between $37,000 and $110,000 for 2012. But income isn’t the only way to define the American middle class.

An October 25, 2014, *Cheat Sheet* commentary in *USA Today* referenced a definition provided by Diana Farrell, a former member of America's National Economic Council:

“(M)iddle class income begins at the point where a person (or family) has one-third of their income left over for discretionary purposes after they've provided themselves with food and shelter. In other words, someone who earns $3,000 per month would have $1,000 left after they've paid their mortgage or rent, utilities, and grocery bills.”



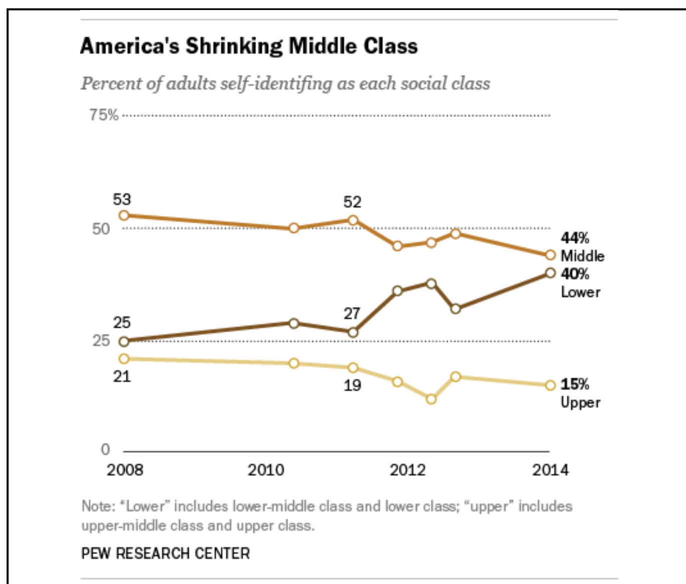
“We’re members of the shrinking middle class.”

The middle class is further defined by how they use their discretionary income: to take vacations, purchase new vehicles, pay off debt, accumulate emergency and retirement savings, and meet medical expenses. Following the recession, fewer middle-class households by income can afford these items.

Instead of income measurements or defining activities, other research focuses on how people *perceive* their financial condition. A January 28, 2014, article in *Time* titled, “Americans Are Painfully Aware of How Broke They Are,” declared,

“[I]t’s not absolute, but relative wealth which makes people happy. In other words, the average person is not made happy by how much he has, but how much he perceives himself to have in relation to those around him.”

A Pew Research survey provided a graphic for this assessment, showing a substantial perception shift downward by both those who self-identified as either upper or middle class.



If you consolidate these studies, American middle class households have annual incomes nearing $100,000, yet struggle to save and pay off debt, can’t afford a vacation, and feel like they’re losing ground.

The Unifying Theory: Moving from a Laborer to a Capitalist

At the beginning of his 2010 book *Your Money Ratios*, financial columnist Charles Farrell puts forward a Unifying Theory of Personal Finance, a fundamental statement that clarifies objectives and informs all actions. It is:

All decisions you make should help move you from being a laborer to being a capitalist.

This statement succinctly summarizes the financial aspirations of the middle class: to progress from working for money to having money work for you. So how does one move from laborer to capitalist? **The essential activity is accumulating assets** – savings, property, investments, etc.

But some historically successful templates for asset accumulation no longer deliver. Since World War II, a dominant laborer-to-capitalist model uses debt as a catalyst for upward mobility. You borrow to get an education, which leads to a higher-paying job, which makes it possible to borrow for a home, automobile and other creature comforts. As income rises, you retire your “start-up debts” and begin accumulating assets. One problem: If entry-level incomes don’t move upward, start-up debts (like student loans) take too long to retire, and accumulation is deferred. And right now, middle-class incomes aren’t increasing. Citing a 2014 monologue from comedian/social critic Bill Maher, the *Cheat Sheet* article noted that “50 years ago, the largest employer was General Motors, where workers earned an equivalent of $50 per hour (in today's money). Today, the largest employer – Wal-Mart – pays around $8 per hour.”

Not everyone in today’s middle class works in retail, but global competition for manufacturing jobs has caused a steep decline in high-paying “laborer” employment - the type of work where a high school diploma and a willingness to work are the only pre-qualifications. Unless innovation creates a new class of high-paid laborers, today’s American middle class is going to have to adjust its financial strategies.

A Return to Real Saving – and an Aversion to Debt

Some economists and politicians still cling to the debt-as-a-catalyst model because it can produce easy savings. When you can buy a home for no money down at $150,000 and five years later it’s worth $200,000, you’ve accumulated $50,000 in equity just by paying your mortgage. But as the housing crisis that precipitated the last recession showed, those “savings” can be erased just as quickly. Accumulations from leverage are often unstable and artificial.

This is not a screed against all debt. But expanding credit is like caffeine for an economy: a little provides a burst of energy, too much leads to the jitters. By almost every account, the middle class has too much debt. Taking on more isn’t going to solve their economic problems.

The reality is most middleclass households would realize great benefits from saving a larger percentage of their income and minimizing their debt (either by refusing to borrow more, or re-structuring existing obligations). It’s not a sexy, sophisticated, or clever approach. It just works. And in the end, it makes you happier. In her 2013 book *Happy Money*, author Elisabeth Dunn cites several studies that conclude “Savings are

good for happiness; debt is bad for happiness. But debt is more potently bad than savings are good."

When the prescription is saving more and minimizing debt, many Americans envision an austerity program, forgoing current luxuries and delaying purchases. To effect a quick turnaround, those actions may be necessary. But the first place to start is to "find savings" by cleaning up the inefficiencies in your financial life; lower interest costs, eliminate overlapping insurances, or re-structure existing allocations. You might think there's nothing to clean up, but changed priorities often reveal new ways to make progress toward new objectives.

It's possible that future economic conditions might usher in a new era of high incomes and easy credit, once again allowing middleclass Americans to make debt-fueled transitions from laborers to capitalists. But, in the meantime, the practical alternative is to increase savings and reduce debt. The next time you meet with financial professionals, ask them for strategies to improve your financial efficiency and accelerate your asset accumulation, one deposit or payment at a time.

Are your decisions based on a Unified Theory for your personal finances? …and take a vacation!

An on-going challenge to saving and avoiding debt is the conflict between present and delayed gratification. Saving can be de-motivating; there is a psychic opportunity cost when we forgo immediate pleasures, and give up everything just to save for some ill-defined possibility 20 or 30 years into the future.

Referencing *Happy Money* by Elisabeth Dunn, **behavioral studies repeatedly find that experiences deliver more happiness than things.** To that end, regularly scheduled vacations can be a great counter-balance to the pangs of delayed gratification. Purchasing a new car may give us a rush of well-being, but because of a phenomenon called "hedonic adaptation," enjoyment declines as we become used to owning the car. Conversely, many experiences (like vacations) have a long shelf-life for evoking happiness; and in some cases, the enjoyment even increases over time. Regular vacations not only create a storehouse of memories, but the anticipation of the next one can also lift spirits. While a stronger emphasis on *saving* may mean denying some immediate luxuries, keep vacations (or similar rewarding experiences) in your financial plans. ❖

THE WHOLE STORY ON LIFE INSURANCE PERSISTENCY

(Did the *Wall Street Journal* miss something?)

What if someone told you that the problem with having an automobile is the engine may seize up if you neglect to change the oil? Would this stop you from using a car? Would it convince you that cars are a substandard means of transportation and you'd be better off riding a bike?

Probably not. It's pretty clear the "problem" lies with the user, not the vehicle.

Occasionally, well-meaning reporters make similarly skewed assessments of financial products. They dismiss the value of a financial instrument because they believe some consumers, through misuse, could lose money. Life insurance, particularly whole life insurance, seems to regularly incur this type of criticism. An example:

A June 18, 2012, *Wall Street Journal* article titled "Life Policies: The Whole Truth," concluded that whole life insurance – with its flexibility, guarantees, and tax advantages – could "make sense" for some consumers. This acknowledgement was immediately followed by…

> But many buyers underestimate how difficult it can be to pay the premiums year after year, and they end up canceling their policy before they break even.
>
> In a study released in December [2011], the Society of Actuaries found that 20% of whole-life policies are terminated in the first three years, and 39% within the first 10 years.

What is it about whole life premiums that buyers "underestimate?" How is it harder than making monthly mortgage or car payments "year after year"? And people default on home and car loans all the time to their financial detriment, but there isn't a cry against houses or cars. Why hate on whole life?

A misreading of the numbers?

Some might say that the *WSJ* article's qualifying statement is akin to warning prospective homebuyers not to buy more house than they can afford, and then using statistics to imply this often happens with life insurance. However, an investigation of the Society of Actuaries' (SOA) study referenced in the article *doesn't* indicate that consumers tend to miscalculate the affordability of whole life. If anything, the opposite is true.

Titled "US Individual Life Insurance Persistency," the SOA has published this report on a regular basis since the mid-1990s. "Persistency" refers to how long policies remain in force, while policies which are terminated by nonpayment of premium, insufficient cash values or full surrenders are considered "lapsed." The 2011 report used data provided by 30 insurers from as far back as 1910 through 2009 for term life, whole life, universal life, and variable life policies, and was updated in 2012. Some of the findings:

- Overall, approximately 4 percent of all in-force life insurance policies lapse in a particular year. This rate has remained fairly static over the past two decades.
- The annual lapse rate for all in-force whole life policies was ***3.0 percent***. For term life policies, it was ***6.4 percent***. Long term, **individuals who purchase whole life policies are less likely to surrender them compared to other versions of life insurance**.
- The greatest lapse percentage – for all types of life insurance – occurs in the first year. The 2011 report found that 11.2% of all life insurance policies lapsed in the first year. For whole life, the first-year lapse rate was 13.8%, while term life matched the overall average at 11.2 percent.

Some of these numbers might seem to support the *WSJ* implication that "year after year" premiums are problematic – but for ***all*** life types of life insurance, not just whole life. And there are some other quirks in the stats.

The SOA study breaks down lapses in several ways, including the size of the insurance benefit and the age of the policyowners. Two consistent findings: smaller insurance death benefits (under $5,000 up to $50,000), and younger buyers (between ages 20 and 30) have much higher lapse rates, especially in early policy years. These factors distort assessments of consumer behavior, particularly for whole life.

Whole life policies under $5,000 had a 24.6 percent lapse rate in the first year, a significant outlier compared to the first-year rates for other types of life insurance. In contrast, larger whole life policies (like the ones consumers reading the WSJ article might use for cash accumulation, estate planning, or supplemental retirement income) have first-year lapse rates well ***below*** the overall average.

The lapse rate for new whole life policies between $200,000 and $500,000 was 8.2 percent, 27% below the first-year average for all types. For policies above $500,000, the first-year lapse rate was 6.4 percent – 43% below the overall average. As time goes by, the annual lapse rate drops to 1-2 percent, and stays there. These numbers suggest that individuals who purchase larger whole life policies – which come with larger premiums – are ***less likely*** to lapse them. Compared to other types of life insurance, whole life buyers are not underestimating their ability to pay premiums.

Individual consumer decisions about life insurance can be hard to quantify at a macro level, but multiple studies suggest financial setbacks and policy replacement are the most common reasons for lapses. A July 2012 white paper titled "Life Insurance Lapse Behavior," by University of Mississippi researchers Stephen Fier and Andre Liebenberg concluded that "voluntary lapses are related to large income shocks" such as unemployment or an unexpected expense. This was found to be particularly true for policy owners under 30. The authors also cited a 2011 LIMRA study that found "13 percent of survey respondents indicated they purchased life insurance to replace another life insurance policy."

Some practical observations

The SOA's persistency report and Fier and Liebenberg's lapse study provide several insights about successfully funding a whole life insurance program.

1. The importance of emergency reserves. Whether it's avoiding foreclosure or keeping life insurance in force, emergency reserves are critical to withstanding financial shocks from a job loss or unexpected expense.

2. Paying premiums monthly improves persistency. The SOA study found that lapse rates varied significantly by the mode of premium payment. Policy owners who paid premiums monthly by automatic withdrawal from a checking or savings account had significantly lower lapse rates; the premium was part of the monthly budget, not an irregular chunk that caught them by surprise.

3. Over time, whole life policies become easier to keep in force. Once the routine of regular premiums is established, the steady increase in cash values tends to reinforce the benefit of on-going deposits. Additionally, accumulated cash values and/or dividends* may be used to reduce or even replace premiums for periods of time. This can be a great benefit if income suddenly declines, or an opportunity requires a higher percentage of current cash flow.

* Dividends are not guaranteed. They are declared annually by the company's board of directors.

Whole life insurance is a complex financial product, and one that is frequently misrepresented, even by some so-called financial experts. But in well-managed, integrated financial programs, on-going premiums for whole life insurance are not fraught with peril. In fact, the numbers show that informed, mature whole life policyowners are more likely to maintain their policies and realize their various benefits. Used appropriately, whole life works. Haters need to chill. ❖

FAMILY LOANS:

Just Between Us – and the IRS

"Hey Dad, could I borrow some money?"

Providing financial assistance for children (or other family members) is a common practice, one that many households gladly consider because the benefits often extend far beyond financial outcomes. Especially when traditional lenders are unwilling or unable to extend credit, family loans can be a creative solution to financial dilemmas or opportunities.

As private transactions, these arrangements offer great flexibility. Children, as the borrowers, may incur lower interest costs and/or negotiate a favorable payment schedule. Parents not only have the satisfaction of helping someone they love, but the interest from the loan might exceed what the funds would earn if they remained in a savings account or other low-risk financial instrument.

Interest: Knowing the Ceiling and the Floor

These transactions may be all in the family, but family loans – even interest-free ones – are subject to state laws and Internal Revenue Service regulations. From the government's perspective, lending money doesn't make you a bank, and personal loans are not the same as institutional loans. There are limits – both maximums and minimums – to the interest that can be charged, as well as some unique tax issues that do not apply to loans involving traditional lenders.

Many states have Usury Limits which set the maximum interest rates for personal loans. In part, usury limits serve to define and deter loan-sharking, the practice of lending at exorbitant rates, often to poor and desperate borrowers. These limits vary widely from state to state. Some have a fixed rate (such as 10%), others tie the rate to a fluctuating number, such as the Federal Reserve Discount Rate (e.g., "5% above current FRDR"), while a few states have no restrictions at all. In some states the usury limit applies to all personal loans, while others

may exempt, relax or expand the usury provisions for larger loans, or those for special purposes, such as real estate. And while it is not uncommon for unsecured loans and credit cards from banks to exceed 10%, several states have usury limits between 7 and 9% annually for personal loans – with no exceptions. If the lender and borrower live in different states, the parties may have the option to decide the state in which the loan is being made, and which usury limit applies.

If Usury Limits place a ceiling on personal loans, IRS regulations mandate a floor. Personal loans must include a ***minimum*** interest equal to the IRS' Applicable Federal Rate (AFR). These rates are published monthly, and vary by the length of the loan (less than 3 years, 3-9 years, longer than 9 years). In December 2014, the AFR for long-term loans was 2.74 percent.

If a personal loan has an interest rate below the AFR, the lender may be required to report imputed interest income, which is the difference between the actual interest income received and what would have been earned at the AFR rate. The reporting of imputed interest is dependent on several factors, including the size of the loan, and whether the borrower's annual net investment income exceeded $1,000.

Interest-free loans

Michigan estate planning attorney Randall Denha notes in an October 2011 commentary that "as a general rule, the IRS presumes that intra-family loans are, from the beginning, actually disguised gifts. As such, the burden falls on the lender to convince the agency otherwise." This is especially true of no-interest personal loans.

No-interest lenders must not only consider imputed interest but also annual gift tax limits. Since the borrower did not pay the imputed interest based on the AFR, the lender is considered to have "gifted" the forgone interest to the borrower. If gifts to one person exceed the annual exclusion (currently $14,000/yr.), the lender may incur a gift tax assessment. The gift tax calculation also applies to below-market or no-interest loans in default, where the IRS may consider an uncollected balance a gift (instead of a non-business bad debt that could be deducted on the lender's tax return).

These personal loan regulations, and the accompanying tax costs, usually have minimal or no financial impact on small intra-family lending arrangements. While most tax and legal sources strongly recommend charging the AFR for family loans under all circumstances, they also acknowledge the imputed interest and gift tax issues are negligible if the aggregate amount of loans between the lender and borrower is less than $10,000.

But for larger transactions, such as those involving real estate purchases, no-interest or below-AFR loans penalize the lender twice, first by imputing interest and then by applying the borrower's unpaid interest towards the lender's annual per person tax-free gift limit.

Thoughtful structuring of the loan agreement may slightly alter some of the tax issues. A long-term loan written as a demand note that can be called for full payment at any time may be considered a short-term loan for AFR purposes, resulting in lower rates of imputed interest. For family loans used to purchase or refinance a home, the borrower and lender should consider securing the loan through a properly registered Mortgage, Deed of Trust, or Security Deed, as doing so may allow the borrower to deduct mortgage interest from his/her income taxes.

Do It Right, and Get It in Writing!

It is obvious, but worth repeating: The particulars of a family loan agreement need to be in writing, and conform to appropriate contractual standards. Working from a few scratches on a napkin and handshake is asking for trouble. There are many templates available on-line to use as a starting point, but the specific details should be completed or reviewed by a professional.

Family financing can be an integral part of multi-generational financial alliances, but the terms must comply with the laws for usury, income and gift taxes. ❖

THE CHALLENGE OF PROVIDING COMPETENCY, PROTECTING ASSETS

It's not here yet, but don't be surprised if future conversations with a financial professional include a note from your doctor.

Longevity and the decline of pension plans have not only reshaped the math of retirement, but also introduced another dilemma: Retirees have greater individual responsibility for managing their financial assets – for a longer time. There may be no cognitive issues at 65 or 70 when someone retires and establishes an income plan, but time and circumstances will almost certainly require adjustments. What if the individual is no longer mentally capable of making good decisions?

Spurred in part by several high-profile legal cases where the mental capacity of an elderly customer was a critical issue, the financial services industry is pro-actively moving to improve due diligence protocols. Scores of trade publication articles, seminars, and commentaries are suggesting processes and documentation for financial representatives to use in all customer interactions. These items attempt to address two areas of mental competency, comprehension and memory.

Among the more common recommendations:

1. Having the client certify in writing that he or she "has never had an issue concerning lack of mental capacity." Some even recommend having this statement co-signed by a medical professional.

2. Asking questions to determine the client's competency with financial technology, such as…

- Do you use an ATM?
- Do you have credit cards?
- Do you pay any bills online?

3. Compiling a history of recent financial transactions, for example…

- When was your last automobile purchase?
- Have you bought or sold a home in the past five years?
- Have you re-financed existing debt obligations?

Involving others

While helpful, these self-verifications of mental competence aren't fool-proof. Many debilitating mental conditions are gradual in their manifestation; it's possible for individuals to exhibit competency in many aspects of daily living even after diagnosis. And for various reasons, some people aware of their cognitive decline may attempt to hide it. Prudence dictates that outside verification might also be requested.

Consequently, a family member or trusted friend may be asked to confirm the "competency information" provided by a prospective client. In addition, the financial institution may stipulate that future financial decisions contemplated by the individual will be communicated to these family members or trusted friends before any action is taken.

Every new protective measure has potential downsides. If the verifying parties are geographically separated from the elderly client, the logistics of verifying mental competency and communicating possible changes might delay or negate necessary decisions. And even though it is for their protection, some elderly individuals may not want to disclose their finances to family members or trusted friends. They may fear a loss of financial autonomy or feel vulnerable to undue influence or manipulation.

A DPOA: The Sooner the Better?

Most of the above mentioned safeguards are intended to verify continued mental competency. But what happens if these procedures reveal cognitive decline? At some point, other parties will be called in to act in place of the individual. A Durable Power of Attorney for Finances is a document specifying the parties authorized to act on your behalf if illness, dementia, or other circumstances impair your ability to make decisions. DPOAs give designees (called agents) the ability to sign legal documents and manage the finances of the individual in the event of their incapacitation.

Like insurance, the best time to establish a DPOA is when you don't need it. If an individual is already in a diminished state, the appointment of designees may entail legal proceedings, and the resulting decisions may not reflect the individual's wishes. Unfortunately, DPOAs are often like wills and trusts, things people know they should have, but somehow can't find the time to establish.

Is this something you need to address – either for a family member or yourself? ❖

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