CREATIVE
Wealth Maximization Strategies

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AMERICANS NEED TO GET THEIR FINANCES IN ORDER.
(Will Making a Budget Help?)

"No matter what you hear from the politicians, the media and 'the street', keep in mind that the combination of the household debt, low savings rates and tepid increases in income has been the reason for the deep recession and subsequent below average growth, and will continue to be the reason why economic growth will likely be slow for some time to come."

*- May 3, 2013 commentary from Comstock Partners, Inc.

Considering the dramatic financial impact of institutional and governmental decisions in the past few years (such as the sub-prime mortgage bubble, financial bailouts, and Federal Reserve monetary policies), it seems a bit harsh to say the key to economic recovery is getting American households to clean up their personal finances. But there is also some truth in this perspective; on the whole, American households don't manage their finances very well.

Between 1951 and 1992 U.S. household savings rates as a percent of disposable income were consistently between 7% and 11%. When income growth slowed in the mid-90s due to global competition and down-sizing, American households maintained their spending habits by increasing debt and decreasing saving. By 2005, the savings rate was below 2%, and personal debt ratios were at an all-time high. Since the recession, there has been some improvement, both in debt reduction and saving. But compared to other countries, U.S. households are underachiever savers.*

The Organization for Economic Co-operation and Development (OECD) is a global think tank sponsored by democratic nations with free-market economies. According to the OECD, the estimated savings rate for the United States in 2013 is 4%, which ranks 18th among the 26 countries listed in the report. Yet citizens with greater economic challenges – higher unemployment, lower economic activity, heavier taxation – save significantly more than Americans. The French save 15.8% of disposable income, while Germans save 10.6%. In Spain, where unemployment is approaching 20%, the national savings rate is estimated to be 13.6%! Belgians have a higher tax burden, yet save 9.5%. In light of these numbers, you can't lay all the blame for a poor U.S. savings rate on governmental or institutional policies. There's more to Americans *not saving* than difficult economic conditions.

Enter the Financial Behaviorists

In simplistic theoretical models of economics, consumers make rational financial decisions based on their self-interest. But in the real world, people make irrational financial decisions based on their frailties and ignorance. This is where financial behaviorists enter the picture.

Financial behaviorists attempt to explain irrational financial behaviors by understanding how our attitudes and habits regarding money influence our decisions. From this insight, they develop strategies to make it easier for us to do what is best, or at least avoid mistakes. Behind the scenes, financial behaviorists exert considerable influence in the marketplace, attempting to encourage "paternal libertarianism," i.e., allowing us to do what we want, but "nudging" us to the "right" decision. Default enrollment in retirement savings

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plans, automatic deposits, electronic payments, and lifestyle funds all have the imprint of behavioral engineering.

Spurred by a proliferation of free on-line programs and the ability to integrate data from multiple financial institutions, a trending "new idea" from financial behaviorists to encourage saving is…are you ready?...

ESTABLISHING AND MAINTAINING A PERSONAL BUDGET.

Why a budget? (And can you make one?)

The dictionary says a budget is "an itemized summary of estimated or intended expenditures for a given period along with proposals for financing them." In theory, establishing a budget will help you see the reality of your financial circumstances, understand where your money is going, leading to an "Aha! moment" that motivates you to better decisions.

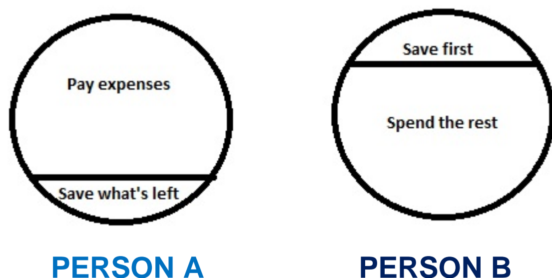
The concept seems plausible. An April 2013 Gallup survey of households with annual incomes of $75,000 or more found that 39% of respondents "prepare a detailed written or computerized household budget each month that tracks income and expenditures." The $75,000 income level is a pretty accurate marker for middle class households that typically have the financial resources to save and invest, so **6 of 10 households that could be saving are operating without a monthly budget**. Seems like budgeting would be a beneficial activity. Except…

Assembling and maintaining a budget can be a data-heavy, time-intensive activity – the devil is most certainly in the details. That's why most businesses rely on professional assistance. In theory, technology promises to make similar budgeting assistance affordable for individuals. But no matter how "easy" technology makes the process, financial behaviorists admit some people aren't going to prepare a monthly report – written or computerized. Their personality type just can't handle details, even for "important" issues. A budgeting process can't make people change if it never gets done.

Two Circles

Instead of starting with the daunting task of monthly reports, a little simplification may be in order. John Savage, a well-known late-20th-century financial counselor, distilled budgeting down to a simple two-circle illustration:

Fig. 1

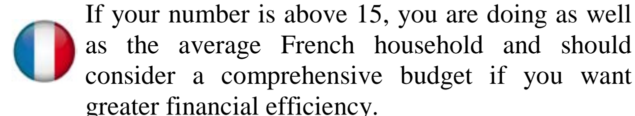


Person A added up monthly expenses and saved what was left over. **Person B** saved a specific amount each month, then spent what was left over. Savage asked a simple question: ***Which person will save the most money?***

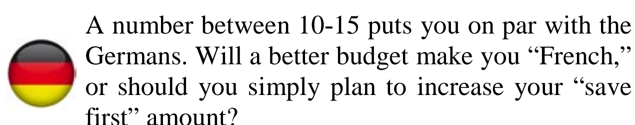
Do You Need a Budget?

The Tax Return Evaluation.

Here's a simple way to assess your need for a budget, bare-bones or in-depth: Divide your annual saving allocations by the adjusted gross income on your most recent tax return, then multiply by 100. This will give you a personal savings rate.



If your number is above 15, you are doing as well as the average French household and should consider a comprehensive budget if you want greater financial efficiency.



A number between 10-15 puts you on par with the Germans. Will a better budget make you "French," or should you simply plan to increase your "save first" amount?

Any number below 10: Before undertaking a budget, you probably need to answer this question: Is "saving first" a priority? If the answer is "yes," use a budget to find additional savings in your finances.

In theory, the pictures represent equal amounts of saving. But people intuitively understand Person B will save more, because **saving is declared a financial priority** – it happens first. Yet Person A is more likely to be preparing a budget!

Savage's illustration is financial behaviorism at its finest. In one simple illustration, it clarifies and connects priorities with behavior. If saving is important to you, you will save first and spend the rest – **no details required.**

Is budgeting really that easy? Maybe.

People who commit to saving first tend to adjust their spending to accommodate their priorities. Any household that works toward consistently saving 15% or more of annual income will almost certainly achieve long-term financial stability. If this minimal budgeting process achieves these results, what else is needed?

There are reasons to consider a full-fledged, detailed budget – at least once. Some households need a detailed budget **to find the money to save.** For others, a budget can discover inefficiencies and "turbo-charge" existing allocations. As a one-time project instead of an ongoing process, even individuals with an aversion to details should be able to get through the task, especially since making a budget doesn't have to be a do-it-yourself project; financial professionals who want your business should be available to help you.

In this format, a "budget" need not be comprehensive, just focused on the critical elements of your financial life (saving more, eliminating debt, etc.). If necessary, a select number of important financial accounts can be connected in

an on-line financial program to provide simplified updates when needed.

The value of a budget is measured by its results. If two circles work, fine. If it takes a monthly written or computer-generated statement, do it. If you need expert assistance, get it. But the process only works if the priorities are clear: You must be a "save first" household for a budget to improve your financial condition. By extension, American households, particularly those earning more than $75,000, must establish a "save first" priority. After all, U.S. economic growth depends on it. ❖

Indexed Insurance Products: Fad, Trend, or New Standard?

Today's saver/investor has a vast assortment of financial products for accumulation. However, this array of options can be distilled to three categories. Fig. 1 provides a proportional representation of potential annual returns from these choices. **Option 1*** products present the greatest opportunity for gain, but also include the risk of loss. Potential returns from **Option 2** offerings, while less than Option 1, never incur a loss. **Option 3** is a guaranteed return; the upside is limited compared to Options 1 and 2, but an annual increase is assured.

Twenty years ago, most retail investors had only two options, 1 and 3, and allocation strategies consisted of blending market-based (Option 1) and fixed-interest (Option 3) financial products according to one's objectives and risk tolerance. The range of potential gain and loss might vary depending on the market-based instrument selected, but the proportional spread between the two options remained fairly stable. As investors got older, they typically shifted to fixed products, both to preserve capital and provide an income stream.

However, as annual rates of return on many fixed-interest products have dropped to 1% (or less), many savers find Option 3 instruments unattractive; the return is just too low. Yet the same savers are typically disinclined to add more risk, leaving them to ask **"Isn't there anything else?"**

A response from the financial marketplace has been the introduction of indexed insurance products, primarily annuities. Instead of declaring a guaranteed annual return based on earnings from the insurance company's investments, the annuity's crediting rate is tied to the performance of a selected market index, such as the S&P 500 (thus the term "indexed" annuity). If the index shows a gain, the annuity owner receives a percentage of the increase, based on a pre-determined formula. If the index experiences a loss, the annuity owner has no return but preserves principal. This concept is illustrated by Option 2: lower potential positive returns, with a guarantee of no negative returns.

How does this Work? Hedging and Caps

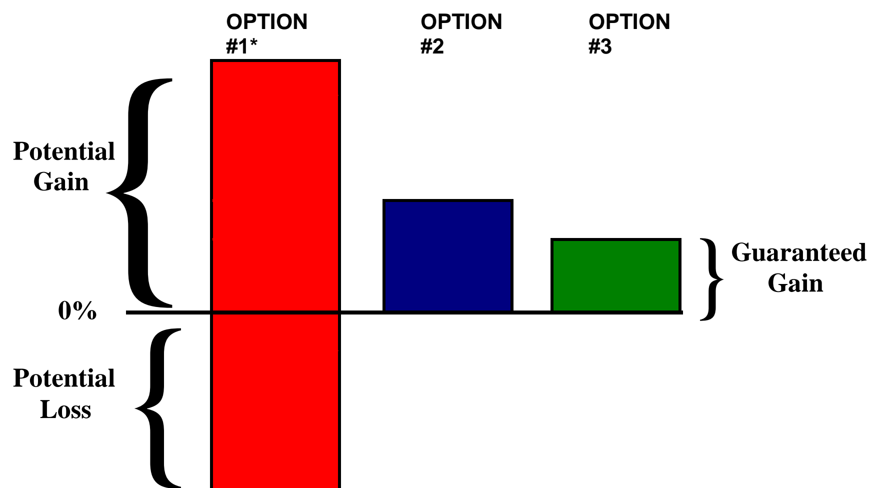
Insurance companies achieve this potential-gain/no-loss result through the use of hedging strategies, "typically in the form of purchasing index call options," according to Marla G. Lacey, general counsel for a prominent indexed annuity company. If the selected index goes up, the call option gives the insurance company the privilege of "buying the gain." If the index goes down, the insurance company does not exercise the option; it pays the price of the call, but lets the option expire.

To help fund the no-loss features, the insurance company also imposes a limit on gains. How these "caps" on gains are calculated varies with the annuity contract, but the general effect is that gains from an indexed annuity will be less than gains reported by the index itself. Some examples of these calculations are listed here. *(see next page)*

An annual point-to-point crediting formula based on the S&P 500 with a 5% cap means the crediting is based on the difference between the S&P 500 index today and a year from now. If the result is negative, the account value remains the same. If the return is between 0-5%, the account is credited the actual gain. If the gain is more than 5%, the account receives 5%, which is the capped maximum.

Sometimes the cap is expressed as a "participation rate." An annual point-to-point based on the S&P with a 50% participation rate means the account will receive 50% of any positive returns. If the actual S&P return is 4%, the account receives 2%; if 18%, the account is credited 9%. (But for any negative index results, the annuity owner incurs no losses.)

Consider how these two crediting methods, based on the same index, deliver different results. If the actual S&P return for the policy year was 6%, the first method would credit 5%, while the second would add 3% (50% of 6%). Yet for any return higher than 10%, the second option would credit more



to the annuity account.

The determination of caps and crediting calculations for indexed annuities is closely tied to interest rates; higher interest rates will typically result in higher caps, or greater participation rates. Since interest rates are constantly changing, and most indexed annuities are designed to be held for at least 5 years or longer, many indexed annuity contracts allow the owner to reallocate the account to a different crediting strategy each policy anniversary. A typical indexed annuity may offer 5-8 crediting choices, including a guaranteed interest option.

Indexed Accumulation vs. Indexed Income

While much of the discussion regarding indexed annuities involves their accumulation potential, one of the principal reasons for purchasing an annuity is the ability to receive a lifetime stream of income. Annuity income is determined by age, gender, and the insurance company's projection of interest rates at the point income begins. In a traditional fixed annuity, the terms set at the start of the income stream remain in effect for the lifetime of the annuitant. If rates are low when payments commence, income will not change – even if rates go up.

In contrast, some indexed annuities permit their indexed crediting options to be applied not only during the accumulation phase, but also when receiving income. This allows the annuitant to receive a guaranteed lifetime income that may increase; if the index shows a negative return, the payment remains the same, if it goes up, so does monthly income. This feature means favorable market performance in the future can be reflected as higher payments – for a lifetime.

The combination of multiple crediting formats in indexed annuities and the ability to reallocate annually – including using several different strategies at once – exponentially increases the complexity for consumers. And while the opportunities for gain are higher than fixed-interest products, it is also possible that returns might not match those from guaranteed accounts. Backward-looking studies of historical returns for indexed annuities show mixed results, primarily because so much is dependent on the cap and crediting formulas. In general, when market-value returns are trending upward, indexed accounts deliver returns above guaranteed rates. In prolonged downturns indexed accounts may lag fixed-interest products, but again, no indexed account incurs a loss.

And consumers apparently like the indexed concept, at least while interest rates are low. LIMRA, a life insurance marketing and research company, noted that purchases of indexed annuities have set records each year since 2009, and in a Fall 2012 report, the research firm Moore Market Intelligence projected that indexed annuity sales would exceed fixed annuity sales by 2015. Institutional investors, including private-equity firms, are also entering the market, either as buyers or providers of indexed products.

Is there an indexed insurance product in your future?

The demise of company pensions, coupled with the surge of Baby Boomers into retirement, is prompting many Americans to consider guaranteed insurance products to provide retirement benefits. Conceptually, indexed insurance instruments seem to occupy an attractive middle ground: potential for gain, no risk of loss, flexibility in allocation, and lifetime income. However, these multi-faceted characteristics also add complexity to consumers' financial lives – and the potential for error or less-than-optimal results.

The no-loss feature in indexed products is attractive, particularly for retirees seeking income. However, time-tested accumulation strategies using a blend of market-based and fixed-interest vehicles should be considered as well, since they have historically delivered positive long-term results. Stronger industry oversight encourages potential purchasers of indexed insurance products to carefully consider their unique features and costs. But given the range of features and numbers of companies entering the market, consultation with trusted professionals is prudent. Indexed insurance products have passed the fad stage, and are definitely a hot trend in the financial services marketplace. But they are not one-size-fits-all products; effective use requires careful consideration of your unique circumstances.

*Variable Annuities and their underlying variable investment options are sold by prospectus only. Prospectuses contain important information, including fees and expenses. You should read the prospectus carefully before investing or sending money. Clients should consider the investment objectives, risks, fees and charges of the investment company carefully before investing. The prospectus contains this and other important information. A prospectus may be obtained by contacting your financial professional.

Annuity contracts contain exclusions, limitations, reductions of benefits and terms for keeping them in force. Your licensed financial professional can provide you with complete details.

Variable annuities are long-term investment vehicles that involve certain risks, including possible loss of the principal amount invested. The investment return and principal value may fluctuate so that the investment, when redeemed, may be worth more or less than the original cost. Withdrawals of taxable amounts will be subject to ordinary income tax and possible mandatory federal income tax withholding. If withdrawals are taken prior to age 59½, a 10% IRS penalty may also apply. Withdrawals affect the variable annuity's death benefit, cash surrender value and any living benefits and may also be subject to a contingent deferred sales charge.

All guarantees associated with an annuity are backed by the claims-paying ability of the issuing insurance company.

Multi-Generational Legacies with Life Insurance

The formal definition of a **legacy** is either:

"a gift by will, especially of money or other personal property" or

"something transmitted by or received from an ancestor or predecessor or from the past."

Informally, a legacy is often defined as "whatever I want to be remembered for."

In the torrent of financial information that rains constantly on consumers, the topic of legacy planning doesn't get much front-page attention, but well-executed legacy plans are powerful financial events. They not only enhance the memory of the providers, but can be catalysts for generations of future prosperity. American culture may idealize the virtues of the self-made men or women who start with nothing and accumulate great fortunes, but all things being equal, recipients of financial legacies have a decided long-term advantage when it comes to stability and prosperity.

When exposed to the idea, most people respond favorably to the legacy concept; we can readily see the value and satisfaction that comes from giving to loved ones or charities. The real challenge in legacy planning is not convincing individuals to *give*, rather the issue is *making sure there is something left to pass on.*

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Although some legacy transfers may take place while the owner of the assets is still alive, most legacies are transacted at the death of the giver – because the owner is done using them! Yet so many things can happen from the time someone declares an intention to leave a legacy to when the transfer is scheduled to occur. The assets might lose value or be destroyed. If the donor experiences financial difficulties, assets designated to a legacy may have to be liquidated. When expenses from one's final illness or medical condition consume a lifetime of savings, it is all too easy for heirs and charity to receive nothing. Legacies with no assets become disappointments; they are hopes that die – for the giver and recipient.

Considering these challenges to taking a legacy from idea to reality, life insurance can be a very effective financial tool. For a proportionally minimal fixed cost, a specific benefit will be delivered at precisely the right time. These features, inherent in life insurance, provide a much higher level of financial certainty for both legacy donors and recipients. The giver knows the legacy is funded, freeing him/her to spend other assets if necessary – there is no concern that spending today is shortchanging a future gift. For recipients, the certainty of a future asset provides immediate benefits, in that today's financial decisions can be integrated with specific expectations for the future (i.e., "because we know there is a legacy on the horizon, we can confidently take this action today").

The next step: Insuring future generations

If one understands the power of life insurance to fund financial legacies, ambitious future-oriented donors may want to multiply the benefits by purchasing life insurance for successor generations. Financially secure parents can not only obtain life insurance on themselves, but also on children and grandchildren, extending financial certainty across several generations. Not only will there be a legacy transfer when the first generation passes, but also when children and grandchildren are gone.

The financial ripple effect of this approach is mind-bending. A decision today can conceivably deliver returns seventy or eighty years into the future. If the current generation is constantly securing life insurance for future generations, the result is a perpetual legacy machine, providing future generations with valuable financial capital.

Successful execution of this type of life insurance program requires considerable planning. Policies may need shortened premium schedules, in which all premiums are paid in a 10- or 20-year period. Proper titling of the policies for ownership, beneficiary and tax purposes may require the establishment of trusts or other legal agreements. And, because the benefits are staggered over a long period, review and ongoing adjustment should be expected.

While attempting a multi-generational legacy plan is an ambitious undertaking, it is certainly doable – even for families with modest financial resources. Premiums and policy benefits can be adjusted to match circumstances; even policies with modest death benefits can have a big legacy impact. And when it comes to selecting a financial vehicle that can last long enough to deliver these far-in-the-future benefits, life insurance companies have a strong track record; many modern-day insurers have been in existence for more than a century.

The majority of financial commentary regarding life insurance focuses on providing benefits to immediate family members – a surviving spouse, children – and rightly so. In that context, life insurance provides essential financial protection. But when it comes to delivering material blessings to future generations, life insurance can also be a powerful financial vehicle.

Interested in establishing a legacy that extends over several generations? If you want to expand your financial reach, consult with your life insurance professional. ❖

"What we do in life echoes in eternity."
– Maximus in *Gladiator*

TOP RETIREMENT STRATEGY:

STAY HEALTHY

What's the biggest threat to your retirement? Inflation? A stock market crash? Taxes?

It's probably your health.

More than any other issue, poor physical health (and the medical costs that come with it), can wreak financial havoc in your life. In many ways, poor health has a financial impact similar to rust or other corrosive agents on a water conduit. For a long time, the functional capacity of the pipe may not be impaired, but once a rupture occurs, there's no chance of

restoring the pipe – it is broken beyond repair. Likewise, you may be able to get away with being physically negligent during your early working years, but over time the strain catches up with you. And when it does, there may not be a remedy.

A Double Whammy on Retirement

Poor health adversely affects retirement in two big ways: It shortens one's working years and increases expenses. A Spring 2013 MetLife Mature Market Study found that 37% of 65-year-old Baby Boomers who are "fully retired" stopped working earlier than planned because of health-related reasons. Recent commentary about the dramatic rise in applications for Social Security Disability benefits attributes the increase to aging Baby Boomers whose health is faltering before they reach retirement age. Fewer years in the workplace means lower lifetime earnings and smaller retirement accumulations.

The increased medical expenses that come from poor health only compound the problem. A report from Fidelity Benefits Consulting released May 15, 2013, estimated that a 65-year-old couple retiring this year will need $220,000 to cover medical expenses in retirement. With limited savings and a dependence on government assistance, those with poor health may find their retirement decisions focused entirely on paying for healthcare.

In contrast, healthy workers have more employment options, work longer, earn more money and have greater potential to save. Good health not only enhances earnings but can substantially reduce healthcare costs. Steve Vernon, author of *Live Long and Prosper,* estimates that pre-retirees and retirees "can reduce the odds of having high medical costs in retirement, and especially those associated with long-term care, such as nursing homes, by 75% simply by eating right, exercising and reducing stress." Vernon also states that "Most of the diseases and illnesses associated with long-term care are due to lifestyle decisions."

Opportunity costs are elusive calculations, but very real; neglecting your health will inevitably have financial consequences. If you want your future to include travel, leisure pursuits, and trips to visit the grandkids, you might want to buy a treadmill, skip the super-sized fast food meals, and sign up for yoga classes. Not only will you look and feel better, but indirectly, you'll be saving for retirement. ❖

**"He who has health, has hope;
and he who has hope,
has everything."**
– Thomas Carlyle

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