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December 2013

All-Weather Risk Management

There are Storm Clouds on the Financial Horizon…

Assessing the current financial landscape, one writer, a "renowned financial expert, a *New York Times* best-selling author, and pioneering online commentator" declared on October 26, 2013:

> **"(T)he world has far too much debt that it can't pay back. Sadly, debt can only go away via: 1) defaults, 2) paying down debt through economic growth, or 3) eroding the burden of debt through inflation or devaluations."**

The author elaborates, explaining that previous eras would likely have experienced defaults by businesses and financial institutions as the economy corrected for its excesses. Defaults are painful, but often are considered necessary to clear the way for new economic growth.

But after the collapse in real estate values, the shrinking of the economy, and a significant increase in unemployment, a return to prosperity has been sluggish. Instead, some economists worried about a death spiral of cascading financial and business failures. To forestall further meltdowns, central bankers of many countries have attempted to engineer "soft landings" for their economies with various types of financial stimulus, such as lowering interest rates and allowing individuals and governments to take on more debt.

These monetary manipulations may buy time for recovery, but historically, their end result is inflation. When extra money is pumped into the economy, prices go up because more money is chasing the same basket of goods and services. And because a dollar (or euro, or yuan) doesn't buy what it used to, everyone's standard of living goes down. In addition, the value of previously accumulated wealth, particularly savings, can be dramatically diminished.

The hope for financial policy makers is that their attempts to stimulate the economy take effect before inflation hits. Because if inflation gets out of control, an economy doesn't just go bad, it can collapse. In the opinion of this particular expert, many economies across the globe are teetering precariously; even though inflation has not ignited, it is inevitable. And when it happens…

> **"…we are left with no good choices, only choices that range from the merely very difficult to the downright disastrous. The choice now left to some countries is only between Disaster A and Disaster B."**

This view of the near financial future is decidedly bleak. If this expert is correct, the economy is in for a rough patch, one that may last for the next decade. Of course, not everyone arrives at the same conclusion, even when they are looking at the same circumstances.

…Just Ahead of a Bright Future

Here's another slant on the economic outlook, released August 27, 2013, by a columnist twice recognized as "Wall Street's top economist."

> **"Beyond what I believe are bright prospects for a return to rapid U.S. economic growth and the resulting decline in federal debt-to-GDP, Americans in the future will enjoy six major advantages over developed and developing country competitors in the globalized world."**

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* 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.

The author goes on to give six reasons the United State will "dominate" the global economy in the near future. Here is a brief summary:

1. **The U.S. has favorable demographics.** Unlike most of Europe, Japan, and China, the U.S. has maintained a birthrate at or slightly above replacement, and is relatively open to immigration.

2. A cultural value of independence and individuality leads to **an entrepreneurial spirit**. Job creation and economic growth are not as reliant on government subsidies or regulations.

3. Because it has a lower percentage of higher-priced unionized labor, and the lifetime employment arrangements typically found in Europe or Japan, the **U.S. has a flexible labor force** that can easily re-allocate to opportunities in new technologies and industries.

4. As Americans begin to "de-leverage" from previous debt, and increase their personal saving, there is a **declining need for foreign financing** of the U.S. economy.

5. **The U.S. has a strong dollar**, i.e., there is a world-wide acceptance of the dollar as the currency of choice in most financial transactions. This means profits from around the globe spill into the U.S. economy, and also at times of crisis or opportunity, money flows into the U.S.

6. New drilling and fracking technologies, which are unlocking vast reserves of natural gas and petroleum from shale, mean **energy independence for the US**.

The columnist acknowledges that the country's debt and inflation issues are concerns, but firmly states:

> **"I disagree with the long-term pessimists who, in this age of deleveraging and persistent slow growth, find increasing acceptance. I lean toward a return to rapid U.S. economic growth in the longer run…"**

This is certainly a happier take on what the future holds. If given a preference, most would probably want this projection to come true. Unfortunately, economic futures aren't decided by vote or popular opinion.

Who is correct?

Either one could be. Both opinions – each commentary is longer than 10 pages, and accompanied by charts and statistics – are logical and supportable; these two commentators are smart people. But at this point, no one can be certain which event – debt, innovation, or some other unexpected occurrence – will tip the balance one direction or another. And really, that's the point.

An essential ingredient in a comprehensive financial program is risk management. Most often, we associate risk management with the threat of financial loss. But there is also an aspect of risk management that considers the financial consequences of missed *profits*. (Economists have a term for it: "opportunity cost," i.e., what you "lose" if you cannot allocate resources to a specific opportunity.) A good risk management plan for personal finance addresses both types of risk, because...

There are financial risks in bad times. Declining values – for investments, real estate, businesses – get the most attention in the financial press. But there are other risks associated with a tough economy, such as depleted savings, limited access to credit, and decreasing or interrupted incomes. All of these events can jeopardize economic health.

In addition, there are individual financial challenges which must be addressed, even when an economy is booming. An illness, accident, sudden death, or family crisis can quickly undermine financial progress and stability.

There are financial risks in good times. Economic growth is often driven by new industries, new technologies, new markets. Yet even in good times, many would-be entrepreneurs or investors cannot afford the loss of time or money that a new opportunity requires. Over-confidence is another risk during boom periods. The longer things go well, the greater the tendency to see profitability as a permanent condition. This sometimes leads to financial recklessness – borrowing too much, over-spending, etc. Business history is replete with stories of companies or industries that grew too fast, couldn't handle success, then flamed out.

Since you can't predict the future financial "weather," are you situated to thrive in all conditions?

These "good-time" risks are paralleled in household finance. Some individuals are not prepared for opportunities; they either have no savings or they are illiquid. Their current situation isn't bad, but doesn't have the flexibility to get better. Perhaps past debt takes all their disposable income, or their access to cash is limited by the loan provisions in their retirement plan. And hubris is always a possible pitfall: If income is up, if the business is thriving, if the investments are throwing off great returns, there is the temptation to "double down," take on more debt, and increase spending, because "we can't lose."

All-Weather Risk Management

Some risk management strategies, especially those for bad times, are obvious: Insurance of all kinds is great protection against the threat of financial loss. Financial instruments which provide guarantees, either for principal or earnings, may also mitigate accumulation loss. Liquidity, i.e., having cash readily accessible, is an all-purpose risk management tool, for both good and bad times.

In the context of risk management, other products and strategies merit careful evaluation. Reducing debt is usually desirable, but a program to accelerate repayment should be weighed against the opportunity costs of reduced savings or cash flow. Conversely, borrowing to acquire income-producing assets (such as commercial real estate) is often considered "good debt" – there might be times to borrow more, instead of less, to leverage your financial opportunity. **In some instances, insurance, usually thought of as loss protection, may serve as a "permission slip" to pursue other opportunities.**

The All-Weather Plan

Remember, just like the local TV weatherman, economists are notorious for errant forecasts, so you shouldn't structure your financial program based exclusively on sunny predictions or doom and gloom. Prudence dictates a balanced risk management approach, one that not only

protects against loss, but permits participation in opportunities for gain. Here's an interesting list of questions to illustrate an all-weather risk management perspective.

If times are good (or bad), can you…

- Afford to change jobs or careers?
- Sell your home or relocate?
- Forgo employer-sponsored benefits?
- Withstand a period of reduced or no income?

Momentous times lie ahead. What will they be like? You can't know for sure. Regardless, are you financially positioned to thrive – under all circumstances? ❖

Now or Later? Maximizing Social Security*

*Contact the Social Security Administration for complete details regarding eligibility for benefits.

The bad thing about complexity is people get confused by it. The good thing about complexity is people who understand it often gain an advantage. This axiom applies to deciding when to start Social Security retirement benefits. Since its inception in the 1930s, Social Security has seen numerous modifications and adjustments, and in almost every instance, these tweaks have made it more challenging to understand and evaluate the program's benefits. It's not that the general concepts are hard to comprehend, it's that the details, and the scenarios that result, are so, well…complex.

The Basic Parameters

American workers participate in Social Security by paying taxes into the program based on their annual income. These taxes, collected during their working lifetimes, entitle them to receive a monthly income from the Social Security Administration in retirement. The retirement income received is based on two factors: your lifetime earnings, and the age at which you begin receiving benefits.

Age 62 is the earliest one can begin receiving Social Security retirement benefits. This is referred to by the Social Security Administration (SSA) as an "early retirement age." If a retiree selects an early retirement, the monthly lifetime income will be less than if the retiree waits until his/her "full retirement age." In the beginning, full retirement age for Social Security was 65, but this number has been gradually adjusted upward (see chart) so that those born after 1960 have a full retirement age of 67. Thus, someone born in 1953 (who is now 60) has a full retirement age of 66, while a person born in 1957 is eligible for full retirement benefits at age 66 years, 6 months. However, both individuals may begin receiving benefits when they reach 62. If workers elect to delay receiving retirement benefits beyond full retirement age, they will receive a higher monthly benefit. These increases are accrued on a monthly basis, but once the retiree reaches age 70, increases stop.

Year of Birth	Full Retirement Age
1937 or earlier	65
1938	65 years, 2 months
1939	65 years, 4 months
1940	65 years, 6 months
1941	65 years, 8 months
1942	65 years, 10 months
1943-54	66
1955	66 years, 2 months
1956	66 years, 4 months
1957	66 years, 6 months
1958	66 years, 8 months
1959	66 years, 10 months
1960 and later	67

This decision, to receive benefits early or wait until age 70, is a simple benefit analysis. Is a lesser monthly benefit received for a longer time more valuable than a larger benefit received over a shorter period? The concept is simple, but the devil is in the details.

For example, here's the SSA explanation for the reduction that comes from taking early retirement:

> In the case of *early retirement*, a benefit is reduced 5/9 of one percent for each month before normal (full) retirement age, up to 36 months. If the number of months exceeds 36, then the benefit is further reduced 5/12 of one percent per month.

Thus, someone with a full retirement age of 66 who elects to receive benefits at age 62 is looking at 48 months of reduction, resulting in a 25 percent decrease in monthly income. (According to the formula: 36 months at 5/9 of one percent, totaling 20 percent, plus 12 months at 5/12 of one percent for an additional 5 percent.) If one's projected monthly benefit at age 66 is $1,600/mo., electing to receive Social Security at 62 reduces the amount to $1,200/mo.

Conversely, Social Security adds 2/3 of one percent each month to the full retirement benefit for those who delay benefits beyond full retirement age. Using the previous example, waiting until 70 would result in a 32 percent increase in monthly benefit, or $2,112/mo.

While $2,112/mo. is 76 percent more income than the $1,200/mo. received at age 62, the person who elects early retirement collects $115,200 during the 96 months between 62 and 70. To equal the total benefits received, the retiree in this example would have to live until age 79½ for his benefits to exceed those received by starting at 62. (And this number doesn't include a calculation of what the $115,200 might have been worth if it was profitably invested.)

Wait, there's more…

Social Security also extends retirement benefits to spouses of workers, even those who didn't work or pay taxes into the program. This benefit may be collected as long as the spouse is at least 62, and the primary worker is at full

retirement age – even if the worker is not yet receiving benefits. Quoting the SSA website:

> “If you are full retirement age, you can apply for retirement benefits and then request to have payments suspended. That way, your spouse can receive a spouse's benefit and you can continue to earn delayed retirement credits until age 70.”

Sometimes referred to as a switching strategy, this maneuver allows a couple to begin receiving benefits now, then switch to a higher monthly income later.

Start with the age 62-70 calculations, add the spousal options, throw in some life expectancy projections and you have the ingredients for a very complex financial decision, one where improper timing can cost you “$100,000 to $150,000 over a lifetime,” according to an October 21, 2013, *USAToday* article. Yet, financial author Jack Tatar says this decision is “probably the least-evaluated decision for retirees.”

However, as more Baby Boomers cross the full retirement age threshold, the market for evaluating Social Security is increasing, and several financial institutions have developed online calculators to help retirees plan their SSA benefits. This ability to quickly assess your options is obviously a positive. There’s only one problem: Many retirees don’t have outside assets to maximize their Social Security.

To Maximize Social Security, You Need Other Assets

Because both the annual increase for delaying benefits past full retirement (8%) and the annual decrease for taking early retirement (6.6%) are higher than current interest rates, the consensus among Social Security specialists is that many retirees would benefit from delaying their payments to age 70. However, according to the Social Security Administration, 41.4% of Americans elect to begin receiving monthly retirement benefits at soon as they become eligible at age 62. Why? Most Americans can’t wait; they need the money now. AARP’s Public Policy Institute found that “half of Americans 65 and older rely on Social Security for at least 50% of their family income; 23% rely on Social Security for 90% or more of their family income.”

For prospective Social Security recipients, waiting until 70 for benefits may require income distributions from other sources for the years between age 62 and 70. Assets used to provide income need to be liquid, with stable values and dependable returns. If these payments are scheduled for several years, the amounts required in lieu of Social Security may compel a restructuring of one’s portfolio.

These re-allocation and benefit decisions may also impact your income taxes. Considering all the variables for Social Security and how outside assets may be integrated in the process, most prospective retirees should consider professional input regarding their decision.

For those in the middle class approaching retirement, maximizing your Social Security benefits can represent a substantial long-term upgrade in retirement income. For those with high earnings histories who have also accumulated substantial assets, the current maximum Social Security payment of approximately $2,500/mo. may not impress. But if you paid into the plan, you are entitled to benefits. Even if you don’t “need it,” the financially efficient response is to maximize your benefits. ❖

ROI (Return on Investment) and Financing for…

Let’s say your son is a senior in high school, and while reasonably intelligent, he has not expressed a definitive interest in a career path. “I just don’t know what I want to do when I grow up,” he says with a shrug. One day, a brochure comes in the mail, addressed to him. The glossy fold-out has a simple, bold message on the front:

Explore the world.
And in the process, find yourself!

“Hey,” he says, flipping you the brochure, “I think I might be interested in this. What do you think?”

The item is from an “adventure travel company.” The trip: a four-year “tour of the world,” one that promises to “expose you to new cultures, introduce you to new friends, provide new experiences, uncover new passions, and shape your future.”

“A four-year vacation?” you ask, slightly puzzled.

“Hey, I did a little more research online. It’s not a “vacation” vacation – it’s an ***adventure***. You don’t just relax and take pictures. You do stuff, you learn things. They call it a journey of self-discovery, a way to give you a broader perspective on the world, to maybe help you figure out what you want to do with the rest of your life. You know that’s sort of something I need right now – a way to figure out what I want to do.”

“I guess I was hoping the school’s guidance counselor might be able to provide some input,” you respond, with just a touch of sarcasm. “But, you never know. So tell me, how much does this great adventure cost?”

“Well, depending on where you go, it’s between $80,000 and $160,000. Understand, that’s for the full four years. You don’t have to pay it all upfront, you can go year-by-year. And that price covers everything – living accommodations, food, the events, everything.”

Trying to stay calm, and not show sticker shock, you ask the follow-up question: “And how did you think you would pay for this great adventure?”

Your son gets a little sheepish. “Ah, you know, I wasn’t sure. I mean, from what I read, it seems like a lot of the kids

that go on these adventures have their parents pay for it, y'know, sort of a graduation present instead of a car. And for others, they borrow to pay for the trip."

"What?" This conversation is taking a surreal twist. "You mean to tell me people borrow $80,000 to $160,000 ***to go on vacation?***"

"Dad, like I said before, it's not a vacation. It's an adventure."

If you haven't yet been able to read between the lines, simply substitute "college" for "adventure." Get the idea?

For the last half-century, the standard thinking was that a college education would quickly pay for itself, in both higher starting incomes and lifetime earnings. But in today's sluggish job market, attaining a college degree is not a sure ticket to a lifelong career, or even steady employment. So while four (or more) years of higher education may significantly expand your child's knowledge and mature their character, the financial costs of a four-year "adventure in self-discovery" can be pretty steep. Which leads to the question: What is the main objective of a college education – higher earning potential or greater self-enlightenment?

However you answer the first question, others follow: Should return on investment be the deciding factor in pursuing a field of study? And if the prospects for employment in one's field are slim, what is the justification for borrowing to obtain a degree?

Beginning November 2013, *Wall Street Journal* readers were asked in an online survey:

How should a potential salary factor into choosing a college major?

As of November 12, 2013, the results were as follows:

20.4% said "college is about finding your passion."

28.1% said "get a degree with big earnings potential."

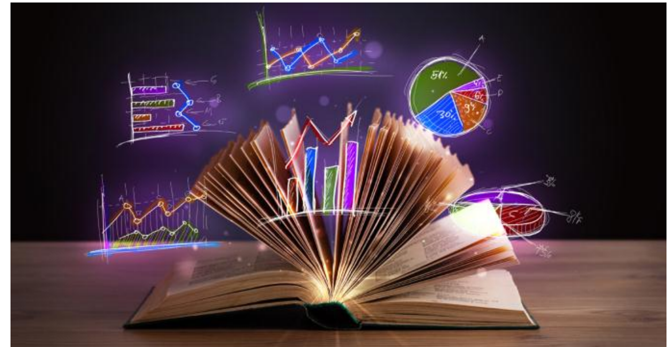
51.6% said "plays a role, but not a deciding factor."

Based on these results, over 70 percent say pursuing a college degree is not primarily about future earnings. And that's okay. There is no rule that requires every financial decision to deliver a tangible return on investment. Intangible benefits, while they may not be quantifiable, are very real. A home of one's own, a special car, a work of art, a luxury item, all can provide great personal satisfaction. It's also understandable that parents might willingly spend their own assets to give their children some of these intangible benefits.

But what about borrowing (a lot of money) to obtain an intangible benefit? If the "adventure travel" analogy is valid, how many people would choose to begin their financial lives by borrowing almost $100,000 for an adventure? Further, how many financial institutions would lend this amount to an 18-year-old with no employment, no proven skills or collateral assets?

A college education has undeniable value. But prospective students and their parents should carefully weigh the financial dynamics of borrowing to obtain a degree. Skim the headlines and read how many recent graduates are struggling to stay afloat while dragging anchors of student loan debt. It may take longer, but a save-and-pay-as-you-go plan might be the financially efficient way to pay for your educational "adventure." And parents…

IF YOU WANT TO GIVE YOUR CHILDREN THE ADVENTURE OF A GREAT EDUCATION, NOW IS THE TIME TO BEGIN THE FUNDING PROCESS. ❖



Designs, Dividends and Mutuals, *Oh My!*

In an article on developing a financial foundation for one's children and grandchildren, Tom Dyson, the publisher of a financial newsletter, spoke first of instructing one's heirs in order to make them financially literate. This is essential, because according to Dyson, ***"there will be no mercy for the financially illiterate in the future."***

Beyond educating them in financial fundamentals, Dyson then encouraged parents or grandparents to establish investment accounts for their offspring, referencing the stock market as a great place to experience the magic of compounding.

Then, after these generalities, Dyson made a shift to a very specific recommendation for long-term compounding: "a uniquely designed, dividend-paying, whole life insurance policy from a mutual insurance company."[1]

So…are you among the financially literate who know what these terms mean? And, why might someone consider them important?

On further reading, it is apparent that Dyson is structuring these whole life insurance policies to maximize their potential for cash value accumulation. Building significant amounts of cash in a whole life insurance policy is not a new or radical idea, and depending on their circumstances, some consumers may find many of the features of a cash value-rich policy attractive. However, since whole life policies are far from generic, the terms mentioned above can impact the performance of a contract geared toward cash value accumulation.

Speaking to the unique design issue, the consumer must remember that even if accumulation is a stated objective, this financial instrument is first and foremost a life insurance contract. To this end, in 1988, Congress and the IRS established limits on how much cash may be accumulated inside a contract and still be considered a life insurance policy. If a contract holder exceeds these limits, the policy

becomes a Modified Endowment Contract (MEC)[2], and the cash values lose much of their tax-favored characteristics.

Through the use of **paid-up additions** and other agreements that allow for additional premium deposits, many whole life policies can accelerate their cash value growth schedules. However, improper utilization of these options can result in a policy becoming a MEC. If this happens, the policy's status cannot be reversed.

A **dividend-paying policy** is one where the policy owner is entitled to receive a portion of the insurance company's profits, usually on an annual basis. These policies are also sometimes called **participating policies**, and the amount of the dividend will vary depending on the company's expenses (including claims paid), and investment returns. Although many participating policies have a long history of regular payments, dividends are not guaranteed. In contrast, some insurance policies are **non-participating;** the policy owner does not share in the company's profits, and there are no dividends. But there is also no concern about fluctuating cash values, as the accumulation over the life of the policy is pre-determined. Non-participating policies may result in lower premiums, while participating policies may justify higher premiums with the potential for greater cash value accumulation.

When considering dividend-paying insurance contracts, consumers may be inclined to look for **mutual life insurance companies.** In a mutual insurance company, each policy owner is also a fractional shareholder in the company. In contrast to a stock-owned insurance company, the mutual arrangement is thought to best align the interests of the policy owners with the company, theoretically leading to higher dividend distributions. In a June 10, 2013, article by The Insurance Pro Blog (insuranceproblog.com) titled "Top Whole Life Insurance Companies for Building Cash Value," six of the seven insurers listed operated under the mutual format.

There is a growing awareness in the financial marketplace of life insurance as a unique asset, and the benefits of a cash value policy in coordination with other assets. ❖

If your financial circumstances are such that accumulating cash value is an attractive option, a rudimentary knowledge of policy design, dividend payments and the mutual structure should help your evaluation.

[1] Whole Life Insurance is intended to provide death benefit protection for an individual's entire life. With payment of the guaranteed premium you receive a guaranteed death benefit and guaranteed cash values inside the policy. Guarantees are based on the timely payment of required premiums and the claims paying ability of the company. Cash values may not appear and dividends may not be paid until the third policy year. Whole life cash accumulation should be considered for its long term values.

Dividends are not guaranteed. They are declared annually by the insurance company's Board of Directors.

[2] A Modified Endowment Contract (MEC) is a type of life insurance contract that is subject to first-in-first-out (FIFO) ordinary income tax treatment, similar to distributions from an annuity. The distribution is also subject to a 10% tax penalty on the gain portion of the policy if the owner is under age 59 1/2. The death benefit is generally income tax free.

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