

January 2015

To Buy a Toaster, or to Save: Why the choice is harder than you might think

It's an ongoing challenge for American households to delay gratification and save for the future. And it's even harder when it seems like macro-economic conditions are stacked against them. Right now, saving might be good for you, but no one is making it easy. Among the principal obstacles: [inflation](#) and [interest rates](#).

Two Kinds of Inflation

Economists have a variety of ways to explain inflation, but the simplest is that prices go up – it takes more money to buy the same goods or services. Inflation may be the result of a number of factors, but the principal causes are changing market conditions and government monetary policies.

Market-driven inflation is typically the result of technological change or unforeseen events. The Industrial Revolution exponentially increased the demand for steel. The destruction from the 1871 Chicago Fire led to a spike in lumber prices as the city rebuilt. Most, if not all market-driven inflation is temporary. Demand increases and prices go up – until competitors enter the market, after which prices usually go down. Current examples in the electronics and computer industry reflect this pattern. Early versions of personal computers were expensive, yet today's tablets have far greater capabilities at significantly lower prices.

In contrast, government-initiated inflation is the result of a deliberate manipulation of the money supply. A country's central bank implements measures to increase the amount of money in circulation. When more money is available to compete for the same goods and services, prices rise, i.e., inflation occurs. Most consumers do not react favorably to higher prices. So why would a government intentionally cause inflation?

In the short term, inflation tends to stimulate economic activity. Businesses and consumers see an advantage to buying today, rather than risk paying a higher price in the future. Increased economic activity usually has a spillover effect of more employment, meaning more people have more money – to buy things now, before those things rise in price.

But the only way to maintain the incentive to buy now is to make inflation a permanent condition. Consumers and businesses must believe prices will continue to rise – through more inflation – in the future. Yet too much inflation, at too fast a rate (hyperinflation), can collapse an economy. This happened in several countries in the 20th century, including Germany in the 1920s, Chile in the mid-1970s, and Zimbabwe in 2008-09. Thus financial policy makers seek to keep inflation in a “manageable” range. In a November 10, 2014, commentary, analyst John Mauldin observes “In the developed world, 2% inflation seems to be the common goal.”

The Toaster Analogy

The expectation of steady incremental price increases creates a dilemma for savers. Jim McMahan, in a 2010 post for [inflationdata.com](#), illustrates the challenge with the following hypothetical example:

Suppose you earn \$20/hour, which is enough money to buy a new 2-slice toaster. However, you already own an aging but fully functional toaster. So what could compel you to buy a new toaster? Here's the explanation:

To Buy a Toaster,
or to Save.



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The primary risk of inflation is that the longer you hold those dollars the less they will buy. So after a year, that money that used to buy a toaster will now only buy 90% of a toaster or 50% of a toaster... **Better to buy the toaster now, even though you don't need it at the moment, (emphasis added) rather than wait and have to spend more money later.** This causes people to spend money faster and faster the higher the inflation rate goes. The speed at which people unload their money is called the velocity of money.

“Managed inflation” discourages saving because dollars not spent are almost certain to lose their purchasing power. And since inflation also impacts wages, it may be better to wait for higher earnings before you start saving. But wage increases usually lag price increases. Consequently, perpetual inflation can become an economic hamster wheel for consumers. They earn a bit more, yet are compelled to spend it, continually running through money but never getting ahead.



Perpetual inflation: an economic hamster wheel, where consumers earn more, yet are compelled to spend it, continually running through money but never getting ahead.

How Much Inflation is There?

Like much of economics, measuring inflation is an inexact science. Officially, the U.S. government calculates inflation on a monthly and annual basis by its Consumer Price Index. In September 2014, the CPI indicated a 1.7% annual inflation rate. But the products and services in the CPI, and the measurement standards, have changed significantly over the last 40 years. If the same measurement methodology from the 1980s and early 1990s was applied, inflation would be almost 4 percentage points higher than the current “official” rate (see Fig. 1).

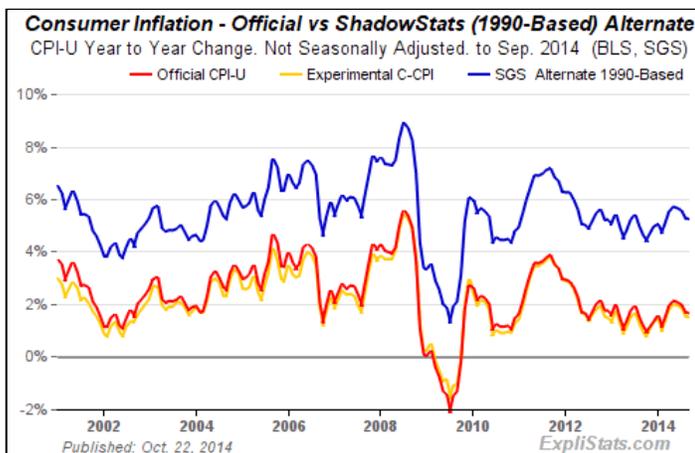


FIG. 1 (See definitions below)

Definitions from Graph :

Experimental CPI, per an April 2013 Washington Post article: "An alternate, experimental inflation measure developed by the Bureau of Labor Statistics (BLI) to track consumption among the elderly. If CPI-E were in effect today, it would result in \$56 more a year in payments to some who retired in 2001 to maximum benefits." This explains why it tracks very closely to the "official" CPI.

CPI-U: The CPI calculated for Urban consumers, i.e., those who live in cities.

SGS Alternate 1990-based: SGS stands for "Shadow Government Statistics." As mentioned in the article, this format calculates current inflation using the methodology the BLI used in 1990.

An accurate assessment of inflation is important, because there is a “savings antidote” for inflation. If the rate of return on savings equals or exceeds inflation, savers can maintain their purchasing power, and the incentive to spend today can be

curbed. Using the toaster example, an annual inflation rate of 5% would increase the price of a \$20 toaster by one dollar, to \$21. If \$20 saved for a year could return more than 5%, one’s purchasing power is preserved, and there is no advantage to buying something you don’t need just to avoid paying more in the future.

Unfortunately, current interest rates for most saving instruments (i.e., those with stated rates of return and principal guarantees) don’t come close to matching inflation – either the government’s number or the shadow one.

Interest Rates, Inflation Rates and the Spread between Them

In November 2014, a large, nationwide, multi-service financial institution listed current interest rates for a variety of its savings accounts. The standard rate for a no-frills savings account was .01%. That’s right, **one-tenth of one percent**. At that rate, \$20 set aside for next year’s toaster would yield an additional **two cents**.

Rates for alternatives with longer terms or higher deposit limits ranged from .03 to 1 percent. If savers are willing to forgo liquidity for up to 60 months, some institutions are offering annual rates close to 2 percent, which exceeds the published current inflation rate. But if inflation increases or the funds are needed before the five-year term has expired, the inflation-protection value is negated. In the current environment, savings vehicles do not keep pace with inflation. In fact, rates have been depressed to historically low levels for several years, and even though they are close to zero, many observers don’t see them rising anytime soon. Here’s why:

Banks’ principal sources of revenue come from lending. A prerequisite for lending is having money to lend. Banks have two avenues for lending capital: money deposited by savers, and money lent to them by other banks. In exchange for the use of other people’s money to make loans, banks pay interest – to savers or other banks. The interest rate for the bank-to-bank transactions is established by the Federal Reserve, the U.S. central bank, and is commonly known as the Fed Funds rate.

In December 2008, in an attempt to spur lending and boost the economy, the Fed Funds rate was essentially lowered to zero (Fig.2). As Casey Bond explains in a July 25, 2014, article at gobankingrates.com, “by providing commercial banks with an almost limitless supply of free money, the Fed ensured they no longer needed our money, and savings rates went into a four-year tailspin.”

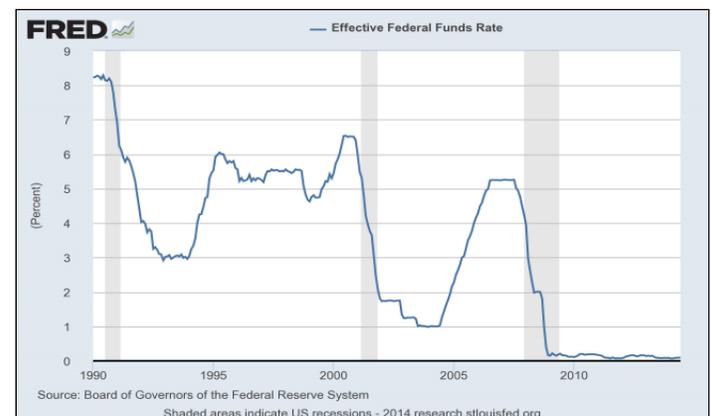


FIG. 2

Because of decreased business activity and tighter lending standards, lenders aren't making as many loans – and they have more than enough capital. If financial institutions don't need your money, there isn't much incentive for them to compete for your savings dollars. And it's not just savings accounts that have low yields. Even rates for longer-term saving instruments, like Certificates of Deposit, declined steadily in the past five years. (Fig.3). Right now, macro-economic policy decisions by governments regarding inflation and interest rates do not favor savers.

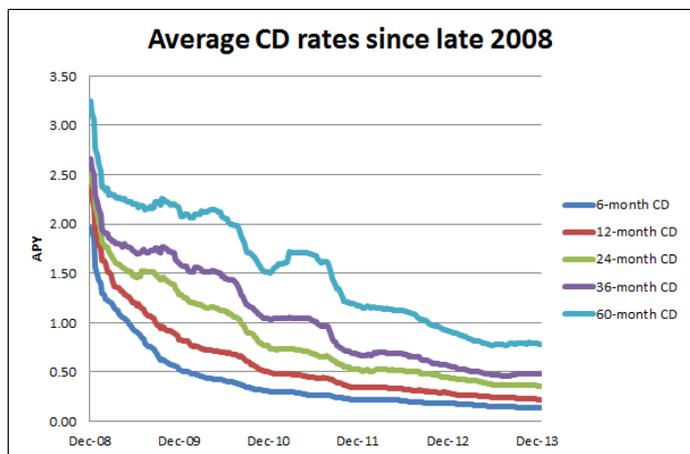


FIG. 3

Go Long and/or Go in Debt?

The combination of steady inflation and low interest rates has prompted two responses from many consumers.

1. Move savings from guaranteed liquid assets into long-term non-guaranteed instruments that, over time, offer the opportunity for inflation-beating returns. This move entails greater investment risk, in that savings may no longer really be safe.
2. Since the best chance for positive results from many non-guaranteed assets involves longer holding periods, short-term cash needs previously addressed by savings are now resolved with *borrowing*. Inflation encourages borrowing, not only because assets can be acquired now, but also because future debt payments are paid with diminished dollars. A \$200/mo. payment 10 years from now will “cost” as much.

Thus, the stereotypical American household carries substantial credit card balances and uses a 401(k) for saving – then borrows against it for emergencies. While these decisions may seem logical in light of inflation and low interest rates, they also make it harder for households to achieve financial stability and make steady progress. The ability to save is diminished by debt payments. And with fewer guarantees, what is saved is at risk; investment losses can leave savers with less than they started.

Seeing Past Inflation and Low Interest Rates

Even when guaranteed returns run well below inflation, there remains a persuasive argument for building and maintaining safe, liquid reserves. Cash decreases the need for future borrowing, and this improves finances in two ways. Decreasing debt increases the percentage of dollars available for saving. Further, not borrowing for future expenditures results in an “opportunity gain” equal to the money that doesn't have to be paid as interest on loans. Saving at below inflation rates does

result in a loss of purchasing power, but not borrowing avoids accelerating this loss of economic value.

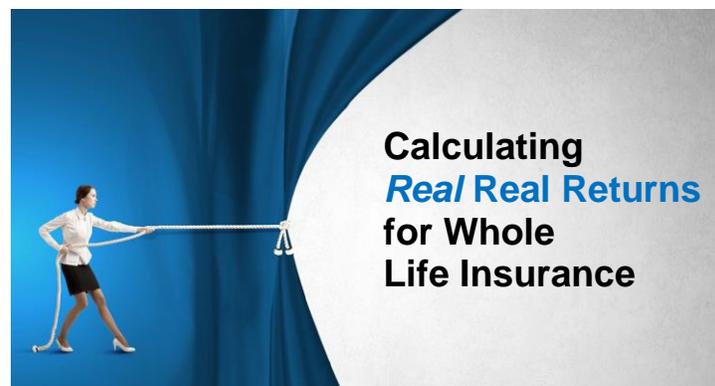
Additionally, households may find efficient financial decisions can boost their total savings, resulting in returns that effectively surpass inflation. If a family budget can add an additional savings of \$200/mo. through better management to an existing allocation of \$1000/mo., the result is a 20 % increase in savings. When overall saving allocations increase, it also allows for higher-yielding guaranteed accounts (like life insurance cash values) to be gradually blended into the mix of liquid assets.

Getting Off the Hamster Wheel, One Toaster at a Time

An ongoing debate among economists is whether the combination of inflation and low interest rates can be perpetuated. Currently, wages are not keeping pace with inflation, even on a delayed basis. When businesses and individuals can't maintain spending and service their debt, they have to jump off the hamster wheel, and economic activity slows down. This is bad for those depending on inflation and low rates to maintain their financial well-being. It may, however, offer opportunities for those who have liquidity. When an economy cools off, many assets may be had at discounted prices. In effect, waiting for a discount washes inflation out of the transaction.

There is an eternal tension between spending today or saving for tomorrow, and the manipulations of inflation and interest rates can skew the balance away from saving. Inflation and interest rates may try to convince you otherwise, but buying a toaster you don't need isn't the path to lasting financial success. Even when macro-economic headwinds make it difficult, those who are savers make better progress in the long run. ❖

Have you considered how better management and allocations might improve your saving? It's a great topic to address with your financial professionals during your next review.



Every year, Thornburg Investment Management publishes a report entitled “A Study of *Real Real Returns*,” in which the performance of various financial assets are evaluated after taking into account the diminishing factors of management expenses, dividend taxes, capital gains taxes and inflation. Recognizing that individual circumstances may vary significantly, this calculation still provides a broad approximation of the *real real* return, i.e., the gain (or loss) an investor realizes after all investment costs have been considered.

In its 2013 summary (issued October 2014), the report assessed the performance of 10 asset classes over periods of 1, 5,

10, 15, 20, and 30 years. While the shorter periods showed significant return fluctuations due to market factors, the long-term numbers were impacted primarily by the previously mentioned expenses. Even the best-performing asset class over 30 years registered a real annualized return of just 5.97%, as expenses wiped off 46% of nominal investment gains. While several asset classes registered small losses over shorter periods, two of the 10 categories showed negative *real* returns over 30-year periods.

What About Whole Life Insurance?

Using the same methodology, a major U.S. insurance company published a *real* real return assessment based on the historical performance of a “previously sold participating whole life policy, bought in 1985, for which full premiums were paid for 25 years.”

Whole life insurance is unique in that it can be considered two assets with two returns. One is the income-tax-free death benefit, with its return calculated by considering the benefit received against premiums paid. The other return is a “living benefit” – an assessment of accumulated cash values in relation to premiums. In calculating *real* real returns, for both the insurance benefit and cash values, the nominal return for these two assets is diminished only by inflation – taxes and investment expenses are essentially non-issues under most circumstances.

Given the actuarial paradigm of insurance, the real returns on the death benefit are inverted over time. If an insured individual died in the year a policy was purchased, the “return” to beneficiaries would be extremely high. But the longer the individual lives (and pays premiums), the lower the return on the eventual death benefit. While a whole life policy is expressly designed to be in force at death, the *real* real return can only be assessed when the individual passes; i.e., you can’t assign a rate of return at any time period unless you assume the period ends with the investor’s passing. Cash values, however, can be assessed for time periods similar to the other asset classes in the Thornburg report.

Regarding the living benefits (the cash value accumulation) the assessment yielded the following 30-year results:

Nominal Return: **5.19%**
Real Real Return: **1.68%**

Since cash value accumulations reported for the whole life policy used were already net of taxes and expenses for the policyholder, the only factor diminishing returns was inflation – which impacted all asset classes equally. On a *real* real return basis, this performance placed whole life squarely in the middle of the asset classes Thornburg evaluated – 5 were higher, 5 lower. And the results were **comparable to other high-quality, fixed return assets.**

A Unique Asset – with Unique Applications

The long-term returns from cash values are primarily from dividends which a participating (mutual) insurance company credits to accumulation values. Dividends are not guaranteed,¹ but most insurers have a long history of consistent annual distributions. And because dividends may result from less-than-projected mortality costs and efficient management, as well as returns from the insurance company’s General Account, the insurance company’s report notes that cash values are “not impacted by market volatility like other assets.”

While these factors can make cash values attractive, it is necessary to keep the **dual asset character** of a whole life insurance policy in mind, as well as the structural limitations imposed by law. You can’t have a cash value accumulation without also paying for a life insurance benefit. The cost of the insurance portion of a policy is amortized over a policy’s life, in that a larger percentage of premiums is applied to insurance costs in the early years. This means the 30-year returns for cash values cannot be achieved in shorter time periods, such as 5 or ten years.

In addition, tax law changes in 1988 restricted the ability of policy owners to accelerate the amortization schedule and increase cash value accumulations. Policies “paid up” with either a single premium or in too short a time period are designated Modified Endowment Contracts (MECs), and lose many of their tax advantages, significantly diminishing *real* real returns.²

More financial experts are beginning to recognize whole life as a unique asset class, and appreciate its benefits. But **maximizing the “dual-asset” values of whole life insurance requires an understanding of strategies for integrating it with the rest of one’s financial transactions.** Achieving *real* real returns from whole life means working with a *real* real life insurance specialist. ❖

¹ Dividends are not guaranteed and are declared annually by the 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 may also be subject to a 10% federal tax penalty on the gain portion of the policy if the owner is under age 59½. The death benefit is generally income tax free.

New Year’s Resolution:

Ask Someone Else to Get You in Shape

*Congratulations!
Today is your day.
You’re off to Great Places!
You’re off and away!*

– Dr. Seuss,
Oh, The Places You’ll Go!



The biggest challenge to keeping a resolution is: the change is up to us. *We* have to stop smoking, start exercising, and change our habits. Yet the reason *we* are making a resolution in the first place is that *we* haven’t been able to get ourselves to perform according to our own aspirations. It would be so much easier if *someone else* could affect the changes we want for ourselves.

If you think this sounds lazy, self-indulgent, or unrealistic, maybe it’s time to reconsider your assumptions about behavior modification. Having someone else get you in shape is arguably the most effective way to make lasting changes.

In fitness, consider the value of a personal trainer. The trainer designs the program, demonstrates the exercises, monitors your progress, and becomes your accountability partner. If you just eat what you’re supposed to, show up for workouts, and go through the motions of embracing a fitter lifestyle, the odds are pretty high you’ll see some success. In the process, you become

immersed in a supportive culture, and eventually some of the details that probably would have overwhelmed you had you done them on your own become habits, acquired through osmosis. American culture idolizes independence and self-reliance, but positive change is often more successful when it's a group effort.

They're Just Dying to Show You What They Can Do

When it comes to personal finance, the Information Age has given rise to a veritable cornucopia of programs and applications. It's not an exaggeration to say your smartphone can probably access, analyze and monitor your financial information better than the Chief Financial Officer of a major corporation could a decade ago.

The challenge for consumers with a get-my-finances-in-shape resolution is sifting through the myriad options and implementing a program that works for them. Sure, you can make this a do-it-yourself project. But if you know your history with other go-it-alone resolutions, why not have someone else do the heavy lifting? Especially since most practitioners in the personal finance industry would love to show what they can do.

Almost every business in the financial services industry has proprietary financial organization programs for use with their customers, and most are complementary – you don't even have to pay a user fee. These programs can aggregate your various accounts, and often provide real-time updates. A click of a button can generate monthly reports, and produce year-over-year comparisons. The projected performance of alternative strategies can be assessed under all sorts of scenarios, summarized in charts and graphs, and notated with great precision. And once you figure out what's going on and what you want to accomplish, action steps can be pre-programmed – monthly withdrawals, rebalancing, account transfers, etc.

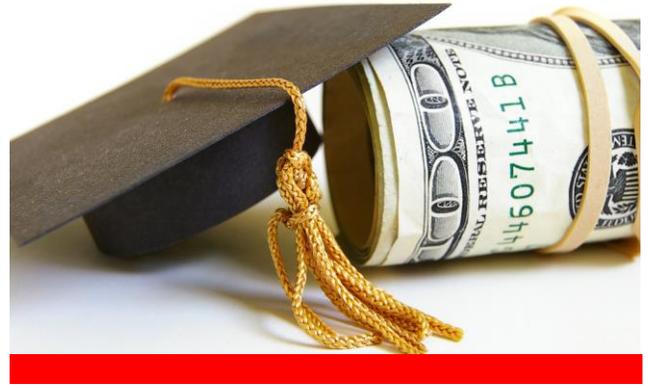
In most cases, the only “work” consumers have to do is provide documentation for input and formatting, and show up for planning discussions and regular reviews. You decide the changes you want to implement, and then put the professional in charge of the execution. Personal passwords and cloud storage give you 24/7 access, monitoring capability, and final authorization over every transaction.

Oh, The Places You'll Go!, is Dr. Seuss' last book. Published in 1990, it's an upbeat, inspirational rhyme encouraging people to see a world full of wonderful opportunities. It may seem like hype, but that Seussian optimism certainly reflects the potential impact of technology in personal finance.

Most Americans simply have no idea how thoroughly organized and ship-shape their finances could be if they decided to ask a financial professional to do the job for them. And in many cases, the out-of-pocket costs are negligible – a little record-gathering, some listening, and consideration of the possibilities. As the process becomes ingrained in daily life, benefits from staying on top of your financial condition will inevitably follow: improved financial literacy, informed spending decisions, increased saving, greater awareness of opportunities. And all because your New Year's resolution was to let someone else get you in (financial) shape. In the words of Dr. Seuss... **“TODAY IS YOUR DAY!”**

FOLLOW THROUGH ON ASKING SOMEONE ELSE TO GET YOUR FINANCES IN SHAPE. ❖

The Economics of Today's College Education



If you are a parent of a child anticipating college, the financial logistics of obtaining a college education can be summarized in two questions: ***How will we pay for it? And will it be worth the cost?***

Recent data hints at some nuanced answers, and some surprises.

Too Many College Graduates, or Too Many Contestable Careers?

According to Volume #1, 2014 of *Current Issues of Economics and Finance*, published by the New York Federal Reserve Board, the number of recent college graduates (between the ages of 22 and 27) who are underemployed (i.e., working in jobs that typically do not require a bachelor's degree) has risen from 34% in 2001 to 44% in 2012. Combined with the 6% of recent college graduates who are unemployed, half of all recent degree holders have not seen their diploma result in a better job. What's wrong? Are there too many graduates and not enough jobs?

The Fed report speculates at an interesting alternative explanation:

(U)employment and underemployment rates differ markedly across majors. In particular, those who choose majors that provide technical training, such as engineering or math and computers, or majors that are geared toward growing parts of the economy, such as education and health, have tended to do relatively well. At the other end of the spectrum, those with majors that provide less technical and more general training, such as leisure and hospitality, communications, the liberal arts, and even the social sciences and business, have not tended to fare particularly well in recent years.

The Fed report concluded, “It appears that a college major plays a role in determining whether a college graduate will find a good job.” Simply obtaining a degree is not enough to ensure stable employment or a lifetime of higher earnings. The degree must confer entry into a high-value industry or profession.

Economist Samuel Rines expands on why some college degrees have lesser economic value. In a commentary published October 22, 2014, in the *National Interest*, he talks about “contestable” jobs, ones that can either be outsourced overseas or replaced by technology (robotics or other automated processes). “(W)hen a US job is contestable internationally, then US workers are competing with cheap labor around the world.” In contestable job sectors, Rines believes “wages could be pressured or even decrease toward internationally competitive

levels,” drastically diminishing the long-term earning potential for some US college graduates.

Education Debt Exacerbates Underemployment

The Fed report distinguished between “good” non-college jobs and “low-wage” non-college jobs. A good non-college job paid an average annual wage of around \$45,000, while the low-wage job paid below \$25,000. Since 2000, the Fed also found a clear trend: “The share of underemployed college graduates in good non-college jobs has fallen sharply, while the share working in low-wage jobs has risen.”

The challenge of making financial progress for underemployed college graduates in low-wage jobs is made harder by the debt they accrued to get their degree. For many, this combination puts their lives on hold; they can’t earn enough to service their education debt *and* save. Some numbers Rines cites for recent graduates and education debt:

- 45% put off buying a house
- 55% delayed saving for retirement
- 14% put off marriage
- 28% put off having children

If You Find the Right Career, You May Work a Long Time (and Like It)

In an April 17, 2014, article for *ThinkAdviser*, James Green relates that studies indicate Baby Boomers who remain in the workforce appear to do so because their higher levels of education result in “more meaningful jobs that can be performed

into older ages.” While a much larger percentage of non-college-educated Boomers have already left the work force, higher levels of education are strongly correlative to increased job satisfaction, greater earnings and longer careers. Obviously, the ability and desire to work longer and more profitably greatly improves all the metrics for retirement.

Getting College Right Is a Big Deal

In an August 15, 2014, commentary for *Forbes*, Chris Bowyer observed that “it’s been the unofficial policy of many leaders, political and otherwise, to champion higher education as a universal good,” regardless of the field of study and how much one borrowed. But current data suggests one’s choice of major and plan for education financing has significant long-term ramifications. The economic gap between a good college decision (one that results in enjoyable, profitable, life-long work) and simply getting a degree (leading to underemployment and burdensome debt) is becoming a chasm.

Besides seeking competent career guidance for their children (probably more than “What are your interests?”), parents should also consider how to best arrange their financial assets to minimize education debt and, if possible, maximize eligibility for financial assistance. Delaying college, working and attending part-time, starting at a community college – every possibility should be on the table. Because whatever career path they pursue, your child’s ship will sail lighter if it isn’t dragging an anchor of debt. ❖



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