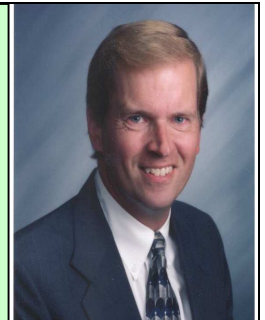


Wealth Maximization Strategies

Empowering People With Sound Financial Strategies



Dan Moericke

“The ignorant will not in general defer to the opinion of the informed.”

Economist Frank Knight, 1921

OBSERVATIONS ON A “ROLLERCOASTER” YEAR

For the majority of Americans, 2008 has been a wild financial ride, one that has run mostly downhill. As one year comes to a close, and another one begins, it's worth pondering what we've learned. Here are three items to consider.

1. “All I can say is, beware of geeks...bearing formulas.” - Warren Buffet

In 1921, University of Chicago economist Frank Knight made a famous distinction between *risk* and *uncertainty*. Knight said risk was characterized by randomness with knowable probabilities, while uncertainty was randomness with unknowable probabilities. According to Knight, in risky situations we don't know the specific outcome, but we do know what the overall distribution of outcomes looks like. For example, we don't know which number will result from rolling two dice in a craps game, but we do know the possibilities and probabilities: The possible combinations range between 2 and 12, with 2, 3, 11 and 12 the least likely combinations, while 7 occurs most often. Actuaries, through their detailed analysis of large amounts of data, can make similar risk calculations of the likelihood of having an accident, becoming disabled or dying. Actuaries don't know who will experience these events, but they have a good idea how many people will. Applied to economics, one of the characteristics of financial risk



is that there is some method to insure against it.

In contrast, economic uncertainty has no known range of outcomes, so you can't limit possible damage through preventive measures. So while history may reveal why something happened (like the Great Depression or the tech bubble), it doesn't provide any certainty that what happened before will happen again – even though there may appear to be some repeatable patterns. This is especially true when a particular issue is influenced by multiple variables. You can't tell which variable will have the greatest impact, and thus determine the course of events.

However, because many random, uncertain events *seem* to have patterns, people keep trying to find ways to change uncertainties into knowable risks. They develop formulas for profiting in the stock market, predicting elections, selling products, finding a spouse, etc. Now that computers can process infinite amounts of information, there is an accompanying belief that almost every activity can be quantified and predicted. But recent events would indicate this belief is wrong. Economic uncertainties cannot be changed to knowable risks.

One of the first “domino factors” that served as a catalyst for the recent meltdown in the financial markets was the credit-default swap (CDS). A CDS is a private contract similar to an insurance contract designed to pay investors when a bond or company defaults. CDSs, often purchased by investors for speculation, hedging, and arbitrage, are described in an October 31, 2008 *Wall*

Financial Literacy Question

(See page 6 for the answer.)

Here's a quick quiz on a basic financial concept. Do you know the answer?

What percentage of Americans provide unpaid care for another adult (usually a family member)?

- A. 10% B. 15% C. 20% D. 25%

Street Journal article as “devilish complicated deals”

But several large financial firms believed brokering CDSs could be an extremely lucrative business, provided they could accurately define the risk. To that end, these companies hired some of the brightest economic talent to devise computer models to determine which CDSs were good bets. For almost a decade, the formula seemed golden. Unfortunately, not all of the potential problems with CDSs were taken into consideration by the computer models. According to the *WSJ* article, the companies “didn’t anticipate how market forces and contract terms not weighed by the models would turn the swaps, over the short term, into huge financial liabilities.” As a result, many of these once-stalwart financial institutions have been brought to ruin.

The ability to process large volumes of information in complex ways may provide new financial insights about what happens, and why. But it is dangerous to believe that uncertain financial opportunities can become manageable risks just because there is more information available. When there are too many factors that can

impact the outcome, the end result is still uncertainty.

For Americans who bought the hype of “new formulas” for wealth and accumulation, the past year has been a wake-up call. Uncertainty – and the possibility of losing it all – is still an unfortunate financial fact of life.

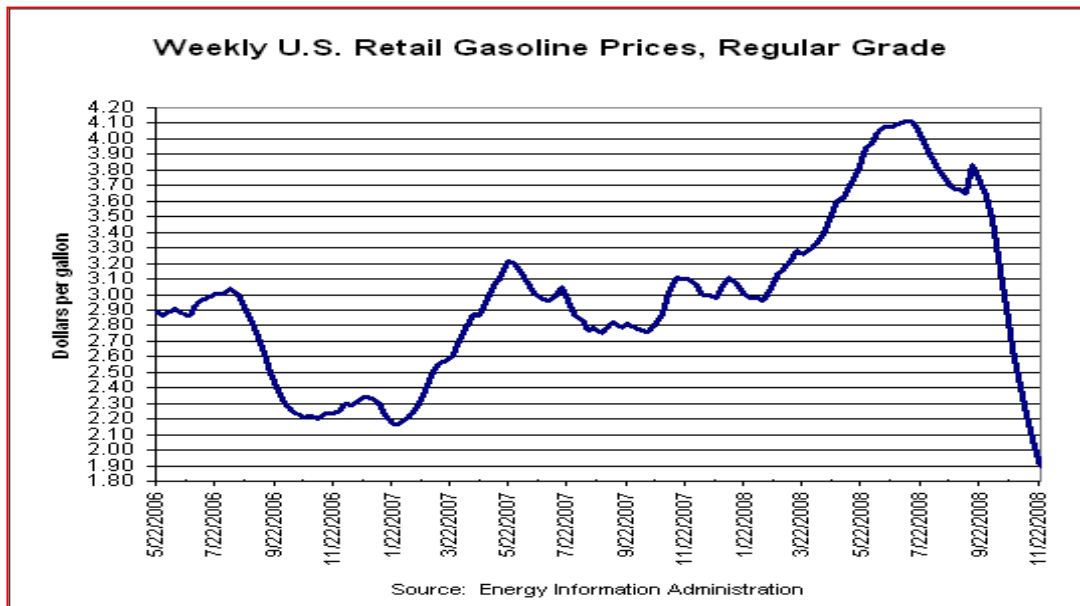
2. Things can change quickly – for better or for worse.

The average price of gasoline in the United States was over \$4.10/gallon on July 4, 2008. By November 17, 2008, the price had fallen to \$1.85/gallon (see graph below). That’s a decline of almost 60% – in less than five months! By late November, some areas reported prices below \$1.40/gallon, a price level lower than the late 1970s. Be honest: After this summer, did you ever think gas would be less than \$1.50/gallon? Did you ever think the drop in price would happen this fast?

On October 9, 2007, the S & P 500 index reached its all-time high of 1565. Just less than a year later, on October 1, 2008, the index stood at 1161, a decline of 26%. From October 1, 2008 to November 24, 2008 – just 55 days – the index fell another 26% to 851. The total decline from the October 2007 peak: 45%.

The values for several individual stocks have dropped even more – a 90% drop in share value has not been unusual, and some of the biggest names have fallen the hardest.

For the Baby Boom generation, the oft-repeated media mantra for the stock market has been: “Buy and hold. Look at the long-term perspective.” Thus, as the



S & P 500 June – November, 2008 (6 months)



market began its downward slide through early 2008, many pundits congratulated the behavior of small investors who stayed the course, even as losses reached 25%. After all, they said, it is not unusual for the stock market to fluctuate on a yearly basis.

However, it is historically atypical for the fluctuation to be so large, especially downward. When the steady 10-month slide finished with a steep drop in less than two months, the descent came so quickly many didn't have time to respond, or even know if they should. Conditioned to stay in the market, many now feel they have no choice but to stay in, hoping that a new upward trend will quickly recover the losses.

Most good financial decisions are predicated on taking long-term perspectives as opposed to constantly changing plans in response to each daily turn of events. You don't refinance your mortgage every time interest rates drop, you don't trade in the SUV for a fuel-efficient sedan when gas prices move up a few cents, and you don't buy or sell a home based on the price your neighbors paid (or received) last week for their home. Big decisions made in haste usually turn out poorly.

But since circumstances can sometimes change quickly, it is prudent to have an idea of how you might want to respond. For example, some investors give themselves pre-determined limits. If an investment rises to a certain level, they sell and secure the gain; if it drops, they sell and stop the loss. Being aware of dramatic changes – and having a contingency plan for them – may not only minimize losses, but also open the door to financial opportunities as well.

3. The mixed economy is not a controlled economy



Government Involvement

The phrase **mixed economy** describes an economy in which both public and private enterprises participate in the production and supply of goods and services. Typically, a mixed economy is one that combines elements of capitalism and socialism, of free enterprise and government regulation, of privately owned and centralized, government-run businesses. Given this definition, almost all countries from Cuba to the United States have mixed economies;

the difference is the proportion of private or public influence.

In the United States, one of the rationales for government involvement in the economy is that it promotes the public good.

- The Federal Reserve System exists to provide a stable and standardized money supply.
- The missions of Fannie Mae and Freddie Mac are to make home ownership possible for a wider range of citizens.

- The Interstate Highway system facilitates commerce and national defense.

Another rationale for government involvement is that it can act as a stabilizing force against the excesses and fluctuations inherent in capitalism. Free-market competition not only produces great wealth and prosperity, but it also drives less productive businesses out of the market, and this “creative destruction” catches some people and businesses financially unprepared to cope with the changes. In consideration of the public good, the government may step in by protecting pensions, extending bailouts, increasing the money supply, providing subsidies, lowering interest rates, etc.

In theory, these government measures are meant to harness the positive benefits of capitalism and minimize the negative aspects of free-market change, providing greater opportunity in good times and a “soft landing” for the economy in downturns.

In practice, governmental involvement can also distort productive activity and incur unintended consequences. And in some cases, whatever is happening in the private marketplace will override any governmental intervention, no matter how well-intentioned.

During the Great Depression, unprecedented steps were taken by the U.S. government in an attempt to right an economy staggered by the stock market crash of 1929. The Roosevelt administration created massive public works projects, reorganized the financial system, provided an extensive welfare security net – *yet the economy remained mired in a depression that didn't let go until the country entered World War II*. While government intervention could influence free market activity, it couldn't control it.

It is impossible to tell whether today's economic situation will rival the Great Depression. But it is almost certain that any government involvement will have the same impact as it did 70 years ago. Contrary to the claims of earnest, well-meaning politicians, no amount of financial assistance/bailout or government oversight will be able to guarantee a stable and prosperous economy. Centrally controlled communist governments of the late 20th century attempted to regulate all aspects of their economies and failed miserably, so it is illogical to believe that a government operating in a mixed economy can exert greater control. It is impossible to legislate economic stability or prosperity.

With this in mind, individual citizens must carefully observe the ways in which governments will attempt to calm the current financial turmoil. The combination of financial distress and a new administration have spawned all sorts of rumors: minor changes to retirement plan distributions, higher estate tax levels, government-managed retirement accounts, mortgage relief programs for foreclosed homeowners, etc. Any number of government mandated changes could have significant

impact on your financial condition, so it is essential that you pay attention and adjust if necessary.

But paying attention to government involvement in your personal financial affairs is only half the story. You must also consider what's happening in the marketplace. An exquisitely crafted estate document or a stretch-IRA strategy isn't worth much if there's nothing available to spend or pass on because you have made poor decisions about where to save and invest.

From Knowledge to Action

If you've read this article carefully, several relevant questions should be bouncing around in your head. Questions like:

- **How much of my financial life is subject to uncertainty? Should I attempt to replace those uncertainties with knowable risks?**
- **Am I prepared for quick changes in my financial world? Do I have a plan for protecting myself against sudden change or seizing sudden opportunities?**
- **At a personal level, what is the impact of government involvement on my financial decisions? Are my financial decisions based on artificial government factors (like tax deductions) or is there a good economic reason as well?**

Looking for some answers? Maybe it's time to review these ideas with your financial advisors. And considering how quickly things can change, the sooner the better!

401(k)s to IRAs: The Rollover Opportunity

One of the ripple effects of the current financial slowdown is the decision facing terminated employees about their 401(k) balances. Whether the termination is due to retirement, early retirement/buyout, or layoff, the question is: What do I do with the money in my 401(k)?

Of course, before implementing any changes you will want to consult a tax professional; but in general, there are four options:

1. Leave the account under the administration of your previous employer. Depending on the size of the balance in your account and your vesting status, your former employer may allow you to leave the money in the company plan. While you cannot make additional contributions to this 401(k), the account will continue to grow (or decline) on a tax-free basis, according to the performance of the underlying investments.

2. Take a lump-sum distribution. You can instruct the administrator of the plan to issue a check for the balance. However, if you choose this option, the entire lump-sum amount is subject to a mandatory 20% withholding,

because all distributions from a qualified retirement plan are treated as taxable income in the year they are received. In addition, distributions prior to age 59½ may be subject to an additional 10% tax penalty.

3. Turn some or all of the account into a regular retirement income. Even if you are younger than 59½, IRS rules allow for individuals to receive a regular income from qualified retirement plans. If these payments are made according to IRS guidelines regarding both the amount and the duration of payment, the distributions are considered taxable income, but are not subject to an early withdrawal penalty.

4. Transfer the balance to an Individual Retirement Account (IRA). Terminated employees can authorize a direct transfer (or "rollover") of their 401(k) balance to investments in another financial institution, where the



money will be held as an IRA. In general, the IRA will have the same tax treatment as the 401(k): tax-free accumulation, with all distributions treated as taxable income.

Which option is best for you?

In unique circumstances, options 1-3 might apply, but for the majority of individuals, transferring the account to a rollover IRA is the default option. First, some employers will insist on liquidating your 401(k) balance within a specific number of days following termination – if you are no longer employed, you can't be part of the plan. Second, unless there is an immediate financial need, the up-front tax cost of receiving all the money now is a strong financial deterrent to taking a lump-sum. Third, if you choose an early retirement income, the income must continue until age 59½ or five years, whichever lasts longer.

Given the restrictions and punitive tax consequences of other options, the most likely response to a discontinued 401(k) account is to move the balance to a rollover IRA. While an IRA has some restrictions, there are several advantages as well.

IRA Differences and Restrictions

In considering how to position existing retirement account balances, there is one significant difference between 401(k)s and IRAs: While most 401(k) plans have loan provisions, no loans can be taken against IRAs. For people in the habit of buying cars or making home improvements through 401(k) loans, this restriction can change your financial habits.

The other major differences involve ongoing contributions. Because an IRA is an individual account

and not part of an employer-sponsored plan, there are no matching contributions from an employer to help boost the account's growth. Further, the annual contribution limit for an IRA in 2009 is \$5,000 for those under age 50, while the 2009 limit for a 401(k) is \$16,500.*

Another distinction is that a 401(k) plan can have life insurance, but an IRA, even an IRA from a 401(k) rollover can not.

For most people, these differences only matter if you want to make additional deposits to an IRA (because your new source of income is from self-employment, or your new employer does not offer a retirement plan). But for reasons that will be discussed later, it is prudent to keep any new IRA contributions separate from whatever amounts are transferred as a rollover from previous employer retirement accounts.

IRA Advantages

When retirement account funds are placed in an IRA, the selection of financial vehicles is very broad, and fully under your control. You can designate an account at your local bank as an IRA. You may select from any number of funds offered by investment institutions. Although an IRA account must be held under a custodian, you can establish your own self-directed account and hand-pick individual stocks or bonds, or you can retain an investment management service to manage your account.

In addition, transferring to an IRA doesn't exclude pursuing any of the above-mentioned options at a later date. For example:

Rollover IRAs can be used to pass tax-free accumulations from one employer plan to another. Depending on the regulations accompanying the qualified retirement plan of a new employer, it may be possible to transfer the balance from your rollover IRA into the new employer's retirement plan – **(NOTE: This is something you should discuss with a tax advisor.)** If you were born before 1936, and your IRA plan has only the rollover proceeds from previous employer plans, a later rollover to another employer plan protects your ability to enjoy the capital gains and ten year averaging on a lump sum distribution (which is no longer generally available). This is called a "conduit IRA".

If the new plan allows transfers, the amount transferred will not count against the annual contribution limit. In addition, transferring the IRA balance into a new employer's retirement plan may "re-activate" the ability to borrow against the account and to hold life insurance in it.

Unlike 401(k)s, lump-sum withdrawals can be taken from IRAs at any time. These withdrawals will be considered income and subject to tax, and withdrawals taken before age 59½ will most likely incur an additional 10% penalty. But the tax does not have to be withheld at

the time of distribution, only paid when the tax year is concluded. Thus, the tax on a lump-sum withdrawal taken in January 2009 does not have to be paid until April 15, 2010. Also, it is not necessary to liquidate the entire IRA – partial withdrawals may be made repeatedly. Especially for those over 59½ and not subject to the 10% penalty, this flexibility can be a very attractive feature.

Not only can partial withdrawals be taken from an IRA, but the account can be divided so that one portion of the balance provides a regular income – even prior to 59 ½ – while the remainder continues to accumulate tax-free.

Some Important Rollover Details

When a 401(k) account is closed, all outstanding loans become due in full. If not repaid, the outstanding balance will be treated as a withdrawal for the current tax year and be subject to income tax and penalties. **You should make every effort to resolve loans in your 401(k) before effecting a direct transfer to a new IRA.**

IRA account holders are allowed one 60-day transfer per year in which the individual can physically take receipt of the funds, then re-deposit the balance in another IRA account. Some financial commentators see this as a 60-day "interest-free loan" provision, but in order to avoid tax and penalties, the full amount received must be re-deposited in the new IRA within this 60-day period. (Note: It is a true 60 days; if the 60th day falls on a Saturday, Sunday or a holiday when no business is transacted, you must be sure the funds are deposited prior to the 60th day.)

Like other qualified retirement plans, IRAs allow you to designate a beneficiary. Each time a retirement account is established, you are required to name a beneficiary. This is a good time to be sure all your retirement accounts have the correct designation.

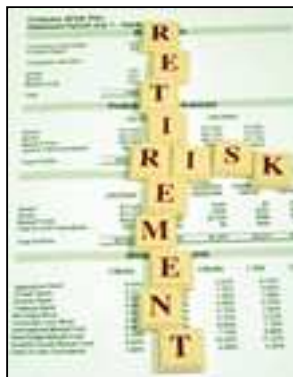


If you have a 401(k) balance that needs to be moved because of a change in your employer or working status, transferring the money to a rollover IRA is a prudent step for most situations. You retain many of the features of your 401(k), and have the flexibility to restructure the account according to your wants and future objectives.

However, for best results, consider reviewing your options with a knowledgeable financial professional.

*For more detailed information on IRAs please see irs.gov/publications/p590; for 401(k)s, please see irs.gov/publications/p525.

Please consult a tax advisor; we do not provide legal or tax advice.





Update: The Rooney's Dilemma Resolved

An article published a few months ago discussed the challenges of a prominent family business as it attempted to transition ownership to a third generation. Here is a follow-up to that story:

After receiving several offers from outside bidders, four brothers who own 64% of the Pittsburgh Steelers National Football League team formally agreed to sell their shares to their brother, allowing the business to remain in the family. On November 14, 2008, the Pittsburgh Tribune-Review reported that Arthur Jr., Patrick, Timothy and John Rooney had agreed to sell their interest in the team to chairman Dan Rooney and his son, Art, II.

The terms: After subtracting business debt, Dan Rooney will pay his four brothers approximately \$750 million dollars. The payments will be made over several years, and Dan Rooney says he will come up with the money for the purchase by arranging a \$280 million loan and bringing in some yet-to-be-named equity partners.

Some backstory: In September, Hedge fund manager Stanley Druckenmiller took an \$820 million cash offer off the table when the four brothers couldn't reach consensus on the terms of sale. Various Wall Street analysts had valued the team between \$800 million and \$1.2 billion, so it might appear the Rooneys sold at a discount to their brother.

Several sources indicate two motivating factors for the sale. First, NFL bylaws have demanded divestiture from lucrative horse and dog racing tracks owned by the four brothers, along with some casino gambling facilities in New York and Florida. Second, the Rooneys feel the newly-elected administration is planning to increase both capital gains and estate taxes. With this sense of urgency, all parties expect the terms of the deal to be finalized at the team's December 2008 board meeting.

FINANCIAL LITERACY QUESTION

Here are the answers to the question at the bottom of page 1.

Answer: C.

According to a report from the National Alliance for Caregiving cited in a November 15-16, 2008 *Wall Street Journal Report*, "one in five adults provides unpaid care for another adult." The adult receiving care may be an aging parent or grandparent, a disabled spouse, an adult child with special needs, or a relative who has no other source of assistance or protection. Whatever the situation, the *Journal Report* concludes:

"Caregiving, and the demands it places on families and household budgets, promises to be a defining issue in the U.S. for the next two decades. As baby boomers get older, and science and medicine extend our lives, more people will need more help to remain independent as they age."

Material discussed is meant for general illustration and/or informational purposes only and is not to be construed as tax, legal or investment advice. Although the information has been gathered from sources believe reliable, therefore the information should be relied upon when work needed with individual professional advice.

Dan Moericke

Financial Design Group
4006 Hummingbird Rd.
Wausau, WI 54401
(715) 359- 2300
(715) 359- 2228 fax

Dan Moericke, Registered Representative and Financial Advisor of Park Avenue Securities LLC (PAS). Securities products/services and advisory services are offered by PAS, 8010 Excelsior Drive, Suite 200, Madison, WI 53717, (608) 828-9800, a Registered Investment Advisor and broker-dealer.

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