

Dan Moericke

# Wealth Maximization Strategies

## Empowering People With Sound Financial Strategies

***“The ultimate effect of shielding men from the effects of folly is to fill the world with fools.”***

*- Herbert Spencer (1820-1903)*

**To move forward, you must re-establish some positive perspectives and plans of action.**

## Move Forward

Here’s a summary of financial commentary for the past twelve months:



**In a cool, reserved voice:** “Well, the economy appears to be moving in a general downward trend.”



**With a raised eyebrow:** “Hmm. The decline is steeper than expected, which may mean it will take longer for a full recovery.”



**Startled:** “Whoa! The economy just went off the cliff!”



**Wide-eyed, hand over mouth:** “Oh my! What are we going to do?”

### So what *are* you going to do?

A few months ago, there was concern. Now the perspective is a little more desperate. Media headlines feature words like “panic” and “Great Depression.” And no one is saying, “Ah, it’s just a blip on the screen. Don’t worry.” No one is immune to the ripple effects of this economic crisis.

Among the masses, one of the popular responses is to

blame somebody. Blame the people who bought more house than they could afford, then defaulted. Blame the banks for authorizing the risky loans. Or blame the financial wizards who thought they could cover any risk if it was divided and packaged the right way. Blame legislators who, because of the perceived social benefits, encouraged these risky behaviors by promising the government would provide financial backup should losses occur. If there’s a need to place blame, there are plenty of options.

Another common reaction to the current financial situation is to commiserate with all of your fellow sufferers. You might have lost money in the stock market, or been whipsawed by an adjustable rate mortgage, but somehow the personal trauma isn’t as devastating when you realize you’re not the only one experiencing these problems (“I’m in a bad spot, but at least a lot of other people are too”). If it’s true that misery loves company, then there’s plenty of financial distress in which people can share their sorrows: There’s foreclosure misery, real estate depreciation misery, investment loss misery, job-loss misery, inflation misery.

Wanting to find someone (or something) to blame, and wanting to share your disappointment with others who have experienced a similar loss are understandable human behaviors. In fact, much like the grief-counseling

### Financial Literacy Question

(See page 6 for the answer.)

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

For those Americans currently over age 90 and in good health, who has a higher life expectancy?

- A. Men
- B. Women
- C. They are about the same

paradigm (denial-anger-bargaining-depression-acceptance), people may need to go through several stages of emotions before they can begin making positive plans for the future. But assigning blame and commiserating are not actions that will get your financial life on track again. To move forward, you must re-establish some positive perspectives and plans of action.

### **Understand financial risk – it means “you can lose money”.**

It's important to acknowledge the true nature of financial risk. Over the past two or three decades, the popular financial media has subtly cultivated the idea that most financial losses can be avoided or greatly minimized through better statistical analyses and strategies. The belief that it was possible to “outsmart” financial fundamentals resulted in overconfident individuals and institutions who believed they could take greater financial risks or repeat previous mistakes, yet avoid the historical consequences. But recent events indicate that risky strategies are still risky, and losses – sometimes big losses – still occur. And even financial wise guys can't avoid the fallout.

At the end of 2007, *Barron's* asked equity strategists from 12 major Wall Street firms to forecast where the S & P 500 index would be at one year later, on December 31, 2008. The index began this year at 1468. All the experts' predicted gains, ranging from a high of 1750 to a low of 1525, and no one predicted a loss. As of October 24, 2008, the S&P 500 closed at 876. This represents a 40% loss in value – in just 10 months. But the “experts” couldn't see it coming. And if the experts couldn't avoid getting blind-sided, do you think you're any smarter?

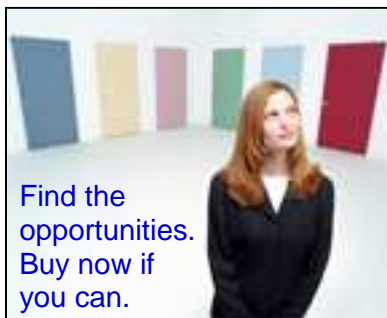
It's true that risky financial bets sometimes pay off. But where there is risk there is always the risk of loss, and history proves there is no strategy or formula that can turn risky financial moves into sure things. If you can't handle the fall-out from a financial loss, you shouldn't take it on. Too many people made financial bets they couldn't cover. That's not bold and daring behavior... it's foolish and irresponsible.

### **Find the opportunities. Buy now if you can.**

The price some individuals and institutions pay for their mistakes in a severe downturn can be severe. But economic downturns can also be moments of great financial opportunity. This was true in the Great Depression, and there's ample evidence to indicate similar opportunities are available today. In the bust that typically follows an economic boom, items that were once over priced often become seriously under-valued,

in part because people are so shocked by what has just happened. In the midst of the Great Depression, value investor Benjamin Graham, who became Warren Buffet's mentor, summarized the situation this way: “Those with enterprise haven't the money, and those with money haven't the enterprise to buy when things are cheap.”

Both then and now, the key component that allows one to act on opportunities is **liquidity**. The prices are down, but so is the ability to buy by borrowing; you need to bring cash to the table. Here's Steve Kroening, editor of *Wisdom's Edge*, a weekly financial newsletter, on how fortunes were made during the Great Depression:



**“So how did they do it? They had cash on hand and used it to buy up anything of value at bargain-basement prices. Because these things were so cheap, they could buy many times more than they could have prior to the Depression. And, when prices went back up, they were able to sell and make millions. Those who bought companies were the most successful, as they bought an asset that continued to produce a saleable product.”**

There are already signs that some bargain-buying is taking place. On October 1, 2008, Warren Buffet's investment company secured a large preferred stock position in General Electric. While real estate values are down, sales are beginning to tick up in many parts of the country as those with strong financial positions swoop in to pick up bargain properties.

### **Unprepared to buy opportunities? Start saving. It's not too late.**

What if you don't have the liquidity right now to take advantage of these opportunities? Don't fret. If you start saving right now, there's a good chance opportunities will still be there.

Not only do experts miss the economic downturns, they often miss the mark on when the recovery will arrive. In 2001, Colin J. Seymour issued the “1927-1933 Chart of Pompous Prognosticators.” The chart is a list of quotes from prominent economists and financial analysts during the Great Depression, and shows the magnitude of misunderstanding among the experts. The first quote on the chart is from John Maynard Keynes, who confidently stated in 1927, “We will not have any more crashes in our time.”

*But...*

From a record high on September 3, 1929, the stock market declined almost 40% by the end of “Black Tuesday” on October 29, 1929. As the dust settled, the experts weighed in. On November 2, 1929, the Harvard

Economic Society said “we believe the slump in stock prices will prove an intermediate movement and not the precursor of a business depression.”

*But...*

The stock market proceeded to drop another 13% in the next 10 days. This prompted Irving Fisher, Professor of Economics at Yale to state “the end of the decline of the Stock Market will probably not be long, only a few more days at most.”

*So...*

After a short-lived rally early in 1930, the decline continued – for another **three years**. At its July 8, 1932 bottom, the United States stock market had lost almost 90% of its 1929 value. And it wasn't until 1954 that the market again reached its 1929 level.

Typically, the “lesson” from this information is that the fallout from the Great Depression lasted a long time. But there's more to it. If economic downturns open the way to new possibilities, the window of opportunity after the Great Depression stayed open for a long time. No one knows at this point how long it will take for the current situation to ease. But who's to say the current downturn/recession/crisis might not last for awhile longer?

Furthermore, when the economy goes bad, many Americans stop saving. Faced with having to cut back, saving is often the first item to be suspended. A September, 2008 AARP report indicates that within the past 12 months, 20% of Americans have stopped funding their retirement accounts. Not only is there likely time to re-establish your financial footing, choosing to refocus your energies on saving today probably gives you an even better chance to separate yourself from the herd. But get going because it appears some other people are starting to re-establish the saving habit as well (see graph). Notice that after a five-year

downward trend, saving jumps back up in mid-2008.

### Moving forward isn't just positive thinking.

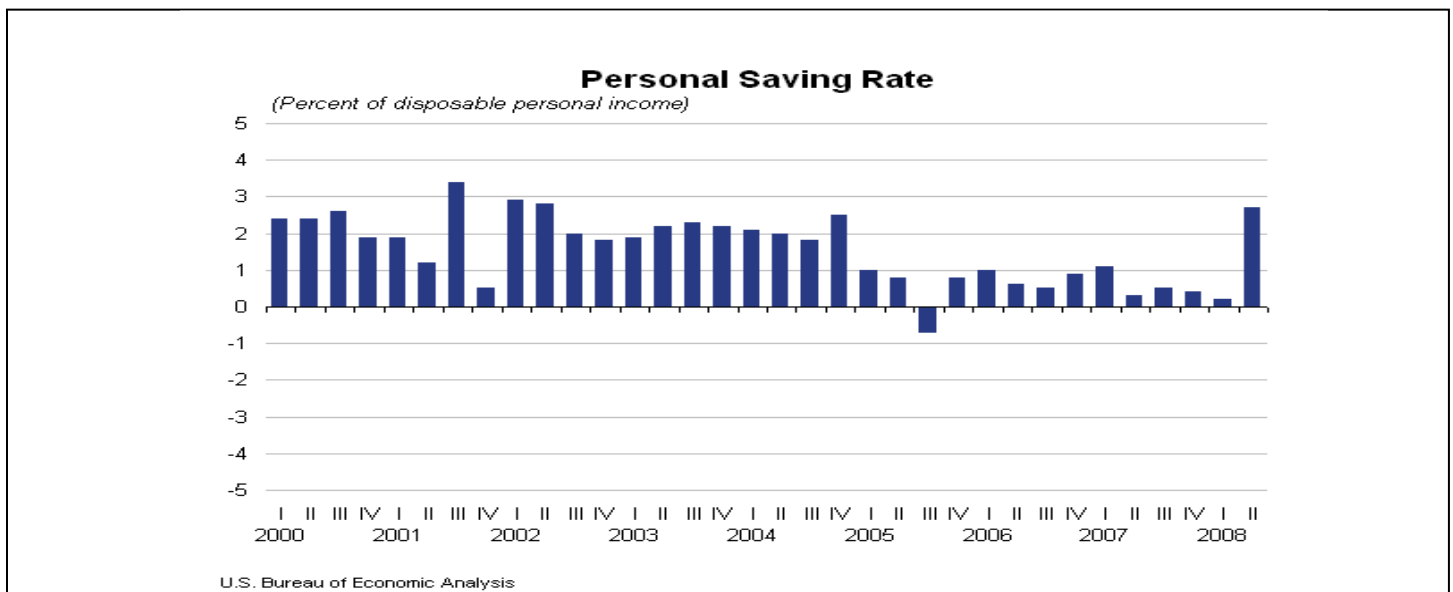


Some of this commentary may strike you as nothing more than positive thinking, the “every cloud has a silver lining” outlook. While it's true your mindset can greatly impact your outcomes in life, there's more to it than having a good attitude in the face of bad events.

In recent years, the priority of building cash reserves has been devalued because of the perception that liquidity and safety were no longer critical to financial stability. It was considered a better use of funds to pursue other, more risky or long-term financial strategies because of the prospect of higher returns. For example, typical personal finance articles declared the primary financial priority was to fully fund a retirement account. But the current economic crisis should cause most people to reconsider that position. Liquidity and safety today matter just as much as a fat retirement account tomorrow.

Wealth always gravitates toward productive economic behavior. Saving money is a productive economic action, because liquidity and safety always have their place in a financial program – for times like now and for other times as well.

### HOW HEALTHY IS YOUR LIQUID CASH POSITION? ARE THESE FUNDS LIQUID AND STABLE? IS IT TIME TO REFOCUS YOUR SAVING EFFORTS?

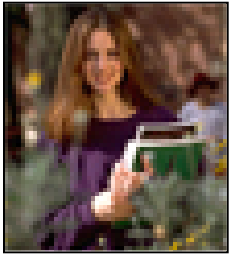


**After a five-year downward trend, saving jumps back up in mid-2008**

## CONTROL ISSUES

A recurring theme in this newsletter is the importance of **having control over the financial instruments you use to achieve your objectives**. Control is an intangible quality – you can't quantify it on a spreadsheet – but it is nonetheless an important consideration. The following articles highlight some control issues that can have a significant impact on the bottom-line results of a particular approach.

### 529 PLANS: Once-a-year changes, and required expenses



529 college-savings plans allow participants to establish an account in a child's name for the specific purpose of providing funds for college expenses. The 529 format (named after the section of the Internal Revenue Service that regulates the accounts) allows

participants to put after-tax dollars into accounts that typically offer a wide range of mutual funds and other investments. Earnings and distributions in 529 plans accumulate tax-free, as long as they're used for higher education. Many plans are state-sponsored, and some offer the additional attraction of being exempt from state taxes as well.

In order to qualify for the above-mentioned tax advantages, 529 plans must conform to very specific IRS rules. For example, the IRS limits participants to one investment change per calendar year. The rule is intended to keep people from making knee-jerk reactions to market moves, but an unintended side effect is that it may prevent some account holders from shifting to more conservative investments when the stock market drops precipitously, as has happened this year. For those who made 529 portfolio changes early in 2008, they have two options:

1. Between now and January 1, 2009, watch their account's performance and hope for the best.
2. Cash out of the account, and incur income tax on any earnings, plus a 10% penalty.

In an October 16, 2008 *Wall Street Journal* article, writer Jane J. Kim notes that when faced with the possibility of losing a large portion of their account because they cannot change their investment allocation until next year, some account holders are electing to cash out, simply to preserve the savings they have accumulated. And in light of current events, some 529 advocates are petitioning the IRS to change the one-change-a-year rule to allow four transactions.

Another example of how the specific details of 529 plans can be problematic is the definition of qualified

higher education expenses. The standard definition provided by much of the financial media typically states "The earnings on the investments in a 529 savings plan will not be taxed by the federal government as long as they are used for qualified higher education expenses (which include tuition, books, and room and board)."

This definition is generally accurate. However, one word is left out of the above definition, and it can make a big difference as to which expenses are considered qualified, and which are not. According to Section 529(e)(3) of the Internal Revenue Code, "qualified education expenses are the tuition, fees, books, supplies, and equipment that are *required* for enrollment or attendance at an eligible educational institution." In a 2007 web post, Martin Krikorian, president of Capital Wealth Management in Chelmsford, MA, highlighted the potential difficulties of following the distribution rules to the letter:

During an audit in 2001, the IRS challenged the tax-free status of a 529 account withdrawal by a family, claiming money used to pay their daughter's college tuition, books, a computer, and room and board furnishings were not "required qualified higher educational expenses".

In August of 2006, a U.S tax court ruled that the savings the parents used to pay for their daughter's tuition met the definition of a "required" qualified expense. But when it came to the portion of the distribution that was used to purchase a computer, books, and furnishings for their daughter's dorm room, the court sided with the IRS and upheld the taxes and 10% penalty imposed on the earnings.

The logic behind the split decision: According to the court, the school did not "require" students to have a computer, since it provided a limited number of computers for students to use in the library, and the daughter was not enrolled in any classes that required her to have her own computer. Similarly, the purchase of appliances, furniture, and bedding to furnish their daughter's dorm room was not a requirement of the university and, therefore, was disallowed. The money spent on books was disallowed because the parents didn't have all of the receipts to prove the money withdrawn was used to purchase the books. In addition, none of the books were "required" for their daughter's enrollment or for any specific class.

Tax-free accumulation is certainly an attractive feature, especially when the funds may remain in the 529 account for a long time before being used. However, the control issues that come as part of the tax advantages should not be overlooked. Upon further review, you may find other options more suitable for your particular situation.

**It is important for you to have control over the financial instruments you use to achieve your objectives.**

## MUTUAL FUNDS: Taking a loss – and paying tax on the gain



According to an October 22, 2008 article by *WSJ Tax Report* writer Tom Herman, Morningstar Inc.'s research showed the average U.S. diversified stock fund had a year-to-date loss of 33%. And yet, says Herman, mutual-fund shareholders “may have to pay hefty tax bills on their losing funds anyway.”

Huh? How can you sustain a 30+% loss, and still have to pay tax on “profits?” The answer is year-end capital gains distributions. When a fund decides to liquidate a position it has in a particular holding, it is required to report a capital gain if the stock is sold for more than its original purchase price. The “profit” from this sale is passed on to the fund shareholders in the form of a capital gain. These gains are generally taxable if the investments are held in a taxable account, rather than a 401(k) plan or other tax-favored retirement account.

There are a variety of reasons why mutual fund management may elect to liquidate a position and declare a capital gain. For example, the stock may have peaked in value, and management wants to lock in the gain before its value declines. Or, if the fund has a high number of shareholders liquidating their accounts, it may have to sell some stock to make the cash-out payments.

In 2007, mutual funds made their largest capital gains payouts in history, and while nobody knows the exact amount of gains that will be handed out this year, 2008 distributions are expected to be far below a year ago.

An additional twist to this situation is how the taxes that may result from capital gains distributions might be paid. Suppose a fund shareholder incurs an additional \$500 in income tax as a result of a capital gains distribution. Instead of reaching into his pocket for the additional \$500, suppose the shareholder instead chooses to liquidate some of the shares to pay the \$500.

If the share price at liquidation is lower than the price at purchase, the losses incurred by the sale can be used to offset capital gains, and can even be used as a deduction against other income in excess of \$3,000 per year. Capital losses not used in one year can be taken in subsequent years.

This sale-at-a-loss-to-negate-gains-tax strategy is commonly referred to as “tax-loss harvesting” or “tax selling” and is a legitimate way to reduce the tax costs that may be associated with mutual funds. (Of course, the requirements for correctly using this strategy are

somewhat detailed, so make sure you get expert assistance if you think tax-loss harvesting fits your circumstances.)

But when you think it through, selling at a loss for tax purposes, while workable, doesn't seem like an optimal financial strategy. You aren't increasing your wealth, but you are still paying taxes on gains. And if you solve this dilemma by liquidating, you lose the opportunity to benefit if the share values rebound.



The credit market crisis will shift the balance of power within the finance industry towards insurers and away from banks because insurance companies have a better business model. That's the assessment of Dr. Nikolaus von Bomhard, CEO of **Munich Re**, the world's biggest reinsurance company, in an October 15, 2008 *Reuters* article by Christian Kraemer.

Located in Germany, Munich Re has subsidiaries throughout Europe and North America. After observing the challenges affecting banks and mortgage institutions both at home and abroad, von Bomhard is confident Munich Re “is stable and well-capitalized – despite the market turmoil.” In fact, von Bomhard believes that most insurance companies “will emerge stronger from the crisis.”

According to von Bomhard, there are two reasons insurance companies should continue to survive – and thrive – in tough economic times. First, insurance companies have a superior track record when it comes to evaluating investment risk. In the *Reuters* article, Bomhard stated that many banks' business models were based on unrealistic profit expectations, and in an attempt to meet those expectations, some institutions took more risks. But because banks did not have appropriate risk management systems in place to accurately assess their investments, they “blindly relied on the judgment of outside credit agencies.”

A second factor that favors insurance companies is what Bomhard calls “sustainability.” The emphasis for insurance companies is long-term returns within the

context of being able to pay claims. “Insurance is a promise for the future,” says Bomhard. “Its business model is built on fulfilling obligations from insurance contracts on a durable – in other words, sustainable – basis.” In contrast, Bomhard sees banks as too often oriented toward short-term results.

In an October 8, 2008 press release following the fallout from the financial crisis, Bomhard said “major losses or crises like the present one are also a test for our business model. And we are passing this test.”

While Bomhard has an obvious interest in trumpeting the strength of insurance companies, his comments have some academic support as well. In his 2006 book *Money, Bank Credit, & Economic Cycles*, Spanish economist Jesús Huerta de Soto provides the following assessment of life insurance companies relative to banks:

**The institution of life insurance has gradually and spontaneously taken shape in the market over the last two hundred years. It is based on a series of technical, actuarial, financial and juridical principles of business behavior which have enabled it to perform its mission perfectly and survive economic crises and recessions which other institutions, especially banking, have been unable to overcome.**

By the way: As an example of the way things might be different if this financial shift occurs, Bomhard said, “In my view, life insurance is going to experience a renaissance because it is secure.” De Soto concurs, calling life insurance “a form of perfected savings.”

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## Dan Moericke

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

## FINANCIAL LITERACY QUESTION

Here's the answer to the question at the bottom of page #1.

Answer: C.

Overall, women in the United States have a longer life expectancy. But among those who live beyond normal life expectancy and are in good health, there is little difference between men and women. In fact, according to data gathered and reported in January 2008 by John M. Bragg, an actuarial consultant at Bragg Associates of Atlanta, healthy men over 90 may have a slightly higher life expectancy than women. Bragg's data showed healthy men aged 90 had a life expectancy of 3.64 years, while women had an expectancy of 3.62. And at 95, healthy men had a slightly greater advantage, 2.50 to 2.42 years to live.

Those individuals alive and healthy over age 90 are what some actuaries have informally titled “The Immortal Group.” And this demographic has some interesting characteristics.

First, it's helpful to define the group. In the Bragg study, those who were considered “healthy” were those who were living independently, did not have a disability or chronic illness, could qualify for standard life insurance, and did not require assisted living or skilled nursing care.

While people in the Immortal Group have typical old-age impairments, such as arthritis, hearing and eyesight problems, etc., most of these people reached age 90 by staying in the group all along, i.e., they never had a period of disability or chronic illness, never required assisted living, etc.

As the Immortal Group ages, survival rates decline – but only until 96. After that, survival rates remain steady or slightly improve! At age 101, the likelihood of living to 102 was 86%!

Non-smokers are 50% more likely to be represented in the Immortal Group.

From his data, Bragg postulates that making a distinction between “healthy” and “unhealthy” senior citizens can significantly improve the life expectancy component in retirement planning. For those whose health and history put them on track to enter the Immortal Group, prudence would suggest structuring assets so they will be available for a *very long time*.