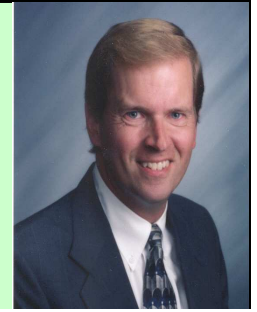


# Wealth Maximization Strategies

## Empowering People With Sound Financial Strategies



Dan Moericke

**“Perhaps the most valuable result of all education is the ability to make yourself do the thing you have to do, when it ought to be done, whether you like it or not; it is the first lesson that ought to be learned; and however early a man’s training begins, it is probably the last lesson that he learns thoroughly.”**

Thomas H. Huxley, *English biologist (1825 – 1895)*

## GET IT IN WRITING



Often the biggest challenges most people face in reaching their objectives, financial or otherwise, are not external, but internal. For reasons we can’t entirely comprehend, great plans and good intentions are undone by our poor behavior.

We may blame it on a lack of willpower, a character flaw, or even a psychological condition; regardless the explanation, we find we are our own worst enemy. And even the best among us feel the frustration. Paul the Apostle once wrote:

**“For what I am doing, I do not understand; for I am not practicing what I would like to do, but I am doing the very thing I hate.”**

At one time or another, we’ve all been there. **So if some of the biggest obstacles are internal and psychological, what can be done to fix them?**

Hey, this isn’t a Dr. Phil column. There are a bunch of ways to resolve your issues, and a bunch of people to help you. But when it comes to achieving your financial objectives, there is one simple, practical thing *anyone* can do to improve their chances for success:

### GET IT IN WRITING.

Seriously. Whether you use a pencil or a word processor, getting things out of your head and onto paper increases your chances of achieving your

objectives. As Will Farrell would say in *Anchorman*, “It’s science.”

First, the physical act of preparing a paper document requires a greater level of engagement. Thoughts and words are vapors that can easily dissipate when new distractions emerge. But getting things in writing usually focuses thought and encourages clarity. And the physical act of writing (or, to a lesser degree, typing) engenders another level of reinforcement – your thoughts take on a visual aspect, and even acquire some “muscle memory.”

Second, getting it in writing leaves a trail, including one that is visible to others. Getting it in writing provides you with a definitive reference point, for the past and the future. You’re saying “on this day, here’s where I was, and there’s where I wanted to be.” And when you put it in writing before a spouse, partner, or advisor, that document becomes a common point of reference. It can be used by others to understand you, help you, remind you, and challenge you.

### When it comes to my finances, what should I get in writing?

**1. Write (or type) your present financial condition.** Most people believe they have a general sense of their financial status. They can tell you if they’re current with their bills, if they’re saving money, and roughly how much they earn in a year. But move beyond the generalities, and you’ll find most people don’t have a good grip on what’s really going on – it’s all sort of fuzzy.

Consequently, it’s difficult to make new financial decisions with any degree of confidence. Are you sure you can afford a new car payment? What about re-financing? If you start a new life insurance program, will you be able to make the premium payments? When

you're not sure, you either make guesses or put off deciding, and neither of those options have a high success rate.

Imagine what could happen if you committed to preparing an accurate cash-flow statement every month. First, just attempting it would improve your financial organization. Checks would be written from the correct account, receipts would be kept – if nothing else, you would begin to have a paper trail.

For some, making an accurate monthly cash-flow statement might be a challenging task. It might take a lot of effort to set up the process and sort through your piles. If you find a cash flow statement requires too much work, start by picking one or two financial categories that need the most attention, like tracking your debt reduction progress, or monitoring the monthly accumulations in your savings and investments. Just collect some accurate information, and write it down.

**2. Write (or type) your financial objectives.** In general, everybody wants more money. But how much do you want, and for what purpose?

Everyone knows the job of sales and marketing departments is to convince consumers to buy their products. And most people understand that sales and marketing experts use a range of psychological ploys, both blunt and subtle, to compel people to buy. If you're not clear on what you really want, you are much more susceptible to being sold something else.

Writing down what you want to accomplish makes it easier to resist the daily bombardment of sales pitches. You've embedded your own financial values, which allows you to see which items align with your objectives and which ones don't. Clearly articulated objectives help you recognize that a flat-screen TV priced 50% off is a great deal – but only if you really want a flat-screen TV.

**3. Write (or type) your plan of action.** The default option for contemporary American culture is often the tyranny of the urgent; what's immediately in front of us demands our attention. We deal with one momentary crisis after another, then either collapse in exhaustion or seek some recreational escape. And then we do it all over again the next day.

At some point we may notice the track we *thought* we were on is really a treadmill, but those moments of recognition are fleeting; there are new items hitting our in-box, and each one seems to be stamped "urgent." Even if you decide to get off one treadmill – by changing careers, relocating, etc. – you may find yourself on another treadmill, running just as hard, yet still staying in the same place. Taking the time to write down a course of action in order to achieve your financial objectives gets you off the treadmill, first to reflect on, and then to redirect, your activities.

## Does getting it in writing really work?

Intuitively, most people know getting it in writing would help them make progress. Of course, there are caveats. Making a direct cause-and-effect connection between writing it down and success is difficult because so many other factors are involved. You may have some financial issues that aren't going to be resolved by simply writing them down (like back taxes to the IRS), but the very act of deciding to get your financial life in writing means you're giving it a higher priority and a higher likelihood of success.

Thomas Stanley and William Danko are the co-authors of the *Millionaire Next Door*. Released in 1996, the book was a comprehensive study of the character traits and actions of American millionaires, particularly those the authors classified as PAWs – prodigious accumulators of wealth. Stanley and Danko found that the most successful millionaires spent a significantly higher percentage of their time reviewing their financial condition and planning their next financial action. Both activities required them to obtain accurate information, and develop clear plans of action – in some fashion, you could say they were "getting it in writing".

You can find a lot of information about financial recording and goal-setting. Those details may help you, but the basic issue is this: When it comes to your finances, do you have it in writing? If you don't, you have a simple question to answer: Are you going to get it in writing?

- **HOW MUCH OF YOUR FINANCIAL LIFE IS IN WRITING?**
- **DO YOU HAVE A MONTHLY CASH FLOW STATEMENT?**
- **DO YOU HAVE A WRITTEN LIST OF FINANCIAL OBJECTIVES?**
- **DO THE FINANCIAL PROFESSIONALS YOU WORK WITH HAVE COPIES OF YOUR WRITTEN INFORMATION?**
- **OR... WOULD YOU LIKE TO HAVE A FINANCIAL PROFESSIONAL HELP YOU TO GET IT IN WRITING?**

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## 5-MINUTE FINANCIAL THOUGHT:

Suppose you could swap all your financial assets in exchange for a contract that guarantees you a risk-free return for the next 50 years. What is the minimal annual rate of return (after inflation, fees and taxes) you would accept in order to make this exchange? (5-minute answer is on the next page.)

# Total-Return Swaps, Unrealistic Expectations, And Why Experts Will Only Guarantee 1% Annual “Real” Returns (A 5-Minute Answer)

## Total-Return Swaps

The hypothetical trade in the 5-Minute Financial Thought is a simple form of a total-return swap. In a total-return swap, one party receives a guaranteed payment in exchange for surrendering all returns generated from their non-guaranteed assets. Sophisticated versions of total-return swaps are used by financial institutions, particularly hedge funds.

When they come to agreement, the terms of the total-return swap indicate the expectations and risk tolerance of both parties. For example, suppose you would accept a guaranteed 6% annual rate of return. This means you feel the risks required to achieve a return greater than 6% are not worth the value of the guarantee. In contrast, the institution or individual offering the 6% guarantee believes that the returns from your non-guaranteed assets will yield more than 6%. Researchers often use some form of total-return swap question when surveying investor expectations.

## Unrealistic Expectations

It's one thing to assess your risk tolerance within the framework of a total-return swap. It's a completely different question as to whether most investors' assessments of their risk tolerances and return expectations are **reasonable**. Consider the following:

The question asks for a minimal rate of return *after inflation, fees and taxes*. Historically, inflation has averaged 3% a year, and most experts would estimate that fees and taxes eat away another 2 to 4 percentage points. Thus, in any given year, these factors have the potential to reduce annual returns by 5 to 7%.

Ibbotson Associates calculates that, since 1926, U.S. stocks have averaged 9.8% on an annual basis. This means the average “real” return falls somewhere between 3 and 5%. (There are certainly other investment options beside U.S. stocks, but many financial analysts would say stocks have achieved the best long-term results of any asset class.)

With this background information, Jason Zweig, who writes a regular column in the *Wall Street Journal*, asked several prominent investment experts which guaranteed “real” return they would accept in a total-return swap. William Bernstein of Efficient Frontier

Advisors said he would accept 4%. Laurence Seigel, a consultant and former head of the Ford Foundation said 3%. For John Bogle, the founder of the Vanguard group of mutual funds, the number was 2.5%. Elroy Dimson, an expert on the history of market returns was even lower: 0.5%. In essence, the experts' understanding of the risks and rewards seems in line with actual performance.

But what about non-institutional, individual investors? From the research, most don't have a clue. A Vanguard survey from October 2009 found the median investor expects annual returns of 7.5%, but 15% of respondents expect annual returns of 15% or higher. Zweig cited another survey in which investors expected returns averaging 13.7% over the next 10 years.

## Just 1%? Why?

As president of the Investment Fund for Foundations, David Salem posed the total-return swap question to several institutional money managers, asking them what rate of real return they would be willing to guarantee in exchange for a mixed portfolio of assets (containing stocks, bonds, cash and a small amount of commodities and real estate). The answer: 1%. Considering the way stock markets have rebounded in the past year, why is the guarantee so low?

Remember, the guarantee is based on a net return after inflation, taxes and fees. An institutional manager may be able to manage the effect that fees and expenses would have on the net return, but who knows about inflation and taxes? Stimulus spending and record deficits have many analysts worried about inflation. If the rate of inflation were to rise to 8%, it might require gross returns of 12% just to realize a 1% real return. And increasing tax rates would only make the challenge greater.

Because inflation is an unknown (and sometimes subjective) variable, and because taxes vary with individual circumstances, most reports of annual returns are *not* after expenses – they are not “real” returns. When individuals combine unrealistic expectations about returns with an ignorance of the costs associated with investing, they are setting themselves up for disappointment.



## IDEAS THAT ENDURE

Ideas matter. The value of every statistic, every calculation, is determined by the ideas and philosophies to which the numbers are applied.

In the past several years, several trade publications have republished a short commentary on the essential elements of life insurance. Originally titled “Just a Life Insurance Policy,” this is a brief yet powerful statement of the timeless ideals that make life insurance a financially relevant product.

The article, probably written at least 50 years ago, was resurrected by Marvin Feldman, a prominent Ohio insurance agent and industry authority, in 2006. Feldman notes in an accompanying commentary that he was unable to identify the original author, and while the article can be found in a number of publications and websites, none of these sources cites an author either. Feldman also acknowledges he had to reword some of the article because the original syntax reflected a different era. Still, the financial and social concepts at the heart of life insurance remain relevant to the challenges and aspiration of today’s world.



More than 150 years after its emergence in “modern” form, life insurance continues to have a primary position in both individual and collective financial programs. In the financial service marketplace, where new products appear every day, the longevity of life insurance is a testament to its powerful ideas and unique structure.

*The policy pictured was purchased 90 years ago.*

### **I am a Life Insurance Policy.**

I am a piece of paper, a drop of ink and a few pennies of premium.  
I am a promise to pay.  
I help people see visions, dream dreams, and achieve economic immortality.  
I am savings.  
I am property that increases in value from year to year.  
I lend money when you need it most, with no questions asked.  
I pay off mortgages, so that the family can remain together in their own home.  
I assure people the daring to live and moral right to die.  
I create money where none existed before.  
I am the great emancipator from want.  
I guarantee the continuity of business.  
I conserve the employer’s investment.  
I am tangible evidence that a man is a good husband and father, and a woman a good wife and mother.  
I am a declaration of financial independence and economic freedom.  
I am the difference between an old man or woman and an elderly gentleman or lady.  
I provide cash if illness, injury, old age, or death cuts off the breadwinner’s income.  
I am the only thing that you can buy on the installment plan that your family doesn’t have to finish paying for.  
I am protected by laws that prevent creditors from assessing the money I give to your loved ones.  
I bring dignity, peace of mind and security to your family.  
I supply investment capital that makes the wheels turn and motors hum.  
I guarantee the financial ability to have happy holidays and the laughter of children – even though father or mother is not there.  
I am the guardian angel of the home.  
I am life insurance.

## Single-Premium Life Insurance and MECs

With most big-ticket items, such as a home or an automobile, there are typically two ways to complete the purchase: you pay cash, or you finance it. But did you know you have the same options when it comes to buying permanent life insurance?

Most people are familiar with paying regular premiums for life insurance, whether it is a term or permanent policy (such as whole life insurance). But although the option is infrequently discussed, it is possible to buy a life insurance policy with just one cash payment. The product is called Single-Premium Whole Life (SPWL).

### How SPWL works

Suppose a healthy non-smoking 45-year-old man wants to buy \$100,000 of whole life insurance. Most people would consider a policy with annual premiums, scheduled to be paid for one's entire life (hence, the term "whole life"). Although the premiums might vary slightly depending on the insurance company, a representative whole life policy from a reputable (mutual company) insurer would be \$1,970/yr. (This example assumes no additional features or riders, such as waiver of premium, are added to the policy.)

However, if the man happened to have significant savings, he could also consider making just one premium payment – of \$31,180 from a reputable company that offers such a product. That single payment would guarantee the insurance would remain in-force for the rest of his life, no matter how long he might live.

Paying just one premium not only secures the insurance benefit, but dramatically changes the cash value accumulation. Here are the hypothetical cash-value accumulations\* for the whole life and single-premium whole life. (These hypothetical values assume a certain level of dividends credited and that such dividends were assumed to be used to buy paid-up additions, Dividends are never guaranteed.)

As you can see, the cash value at the end of the second policy year exceeds the original premium. (The cash value of the whole life policy is not projected to

exceed premiums paid until the 13<sup>th</sup> year.)

In simplest terms, a single-premium whole life policy is an asset transfer. The buyer is exchanging one asset (bank savings, shares of stock, bonds, etc.) for the values and benefits of another (permanent cash-value life insurance).

### “Once upon a time...”

If you are familiar with the unique characteristics of permanent cash value life insurance, you might think, “hey, I could see some attractive advantages to purchasing a single-premium policy.” And before 1988, you would have been right. But that was before changes in the tax law introduced the Modified Endowment Contract.

Prior to 1988, a single premium policy was treated like any other life insurance contract that had cash value. The cash values accumulated on a tax-deferred basis, and at death the proceeds passed tax free to the beneficiary. If the cash value accumulation was needed, it was available to the policyowner through tax-free lifetime loans or withdrawals. With single-premium policies, it was possible to place large amounts of cash as a single deposit, and investors often used SPWLs in place of other investment vehicles in which the earnings or liquidation were subject to income or capital gains taxes.

As some cash value life insurance policies (such as SPWLs) started to appear more like tax-favored investments and less like insurance, lawmakers chose to limit or eliminate the tax advantages. New tax laws enacted in 1988 defined insurance policies that were funded too rapidly (generally in one large payment) as Modified Endowment Contracts (MECs), and eliminated the use of such policies as short-term savings vehicles by imposing stiff penalties.

SPWLs are still offered by life insurance companies, and these policies may still be a good fit for appropriate situations. But the MEC guidelines have greatly reduced the use of SPWL in most financial programs. And since MEC guidelines apply not only to SPWLs, but *all life insurance policies*, consumers need to be aware of the possible impact of MEC in their financial programs.



WHOLE LIFE			
Policy Year	Annual Premium	Net Cash Value	Net Death Benefit
1	1970	0	100000
2	1970	66	100066
3	1970	1612	100318
4	1970	3357	100694
...	...	...	...
20	1970	55271	136581

SINGLE PREMIUM WHOLE LIFE			
Policy Year	Annual Premium	Net Cash Value	Net Death Benefit
1	31180	30693	100000
2	0	32486	100769
3	0	34382	103245
4	0	36388	105798
...	...	...	...
20	0	88673	160595

### The MEC Rules

**First, there is taxation on cash values.** Under the current law, money taken from a MEC in the form of policy or premium loans, partial surrenders, assignments, pledges, withdrawals,

\*These are for comparison purposes and not necessarily representative of any particular company's policy.

or loans secured by the policy are subject to income tax and, in some instances, additional tax penalties (such as withdrawals or loans taken before age 59½). The tax is imposed on a last-in, first-out (LIFO) method. In a non-MEC policy, withdrawals are treated as a return of premium, so any tax is applied last, and only to amounts in excess of premiums paid.

**A policy that was not a MEC when issued can become one** if it becomes “over-funded” at a later date. The rule determining whether a life insurance policy has become a MEC is known as the “7-pay test.” According to Forefield.com, a company that provides information to financial professionals, the 7-pay test “is a limitation on the total amount you can pay into your policy in the first seven years of its existence. The test is designed to discourage premium schedules that would result in a paid-up policy before the end of a seven-year period.” But the 7-pay test is also a rolling calculation, so even policies that were non-MECs in the early years can become MECs later (possibly through extra premium payments or even greater-than-projected dividends).

However, while a non-MEC policy can become one at a later date, **once a policy is a MEC, it can never revert to non-MEC status** – even if the policy is changed, adjusted, or reconfigured so that it would not otherwise be considered a MEC if it was a new contract. Even a non-MEC policy received in exchange for a MEC is also considered a MEC.

### **Why You Should Care About the MEC Rules**

Because many investors have suffered substantial losses in various investments over the past two or three years, permanent life insurance has been “rediscovered”

by some financial commentators as a stable, attractive asset class. This has prompted greater interest in using permanent life insurance for accumulation, particularly in policies which offer options for depositing additional premiums, most of which are applied directly to the cash value accumulation.

In some ways, this approach is akin to making a regular whole life policy function like a pre-1988 single-premium policy. One commentator who advocates maximum cash value accumulation while retaining all the withdrawal features of a typical whole life policy puts it this way: the goal is to “snuggle up to the MEC line – but don’t cross it!”

This approach is legal, and may be suitable for individual situations. But it also requires attention and management! Insurance companies are aware of the potentially negative consequences of having a policy classified as a MEC, so they are scrupulous about monitoring the status of each policy. In addition, policyowners have 60 days to rescind transactions that would cause a MEC to occur. But the burden is on the policyowner to respond to the notifications.

### **What about Your Situation?**

If you have whole life insurance policies (or are considering adding them to your financial program), you may want to explore ways to maximize the cash value accumulation through additional premium payments and dividend options. But make sure your discussion includes an awareness of the MEC limits and the potential penalties.

Material discussed is meant for general illustration and/or informational purposes only and it is not to be construed as tax, legal or investment advice. Although the information has been gathered from sources believed reliable, please note that individual situations can vary, therefore the information should be relied upon when coordinated with individual professional advice.

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