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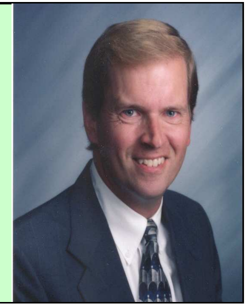
Wealth Maximization Strategies

Empowering People With Sound Financial Strategies



Dan Moericke

BLIPS ON THE FINANCIAL RADAR

Buzzwords, Trends, and Unintended Consequences

Here are a few financial particulars currently receiving a fair amount of attention in the financial press:

BUZZWORD: PHASED RETIREMENT

The combination of a struggling economy and declining asset values has affected a sea change on older American workers. Instead of anticipating an early retirement filled with leisure and travel, a new set of expectations have appeared. For some, the prospects for retirement have been postponed; for others, the only option appears to continue working as long as one is able.

But even these adjusted objectives face a daunting challenge: The realities of aging. Even if we are healthy and have employment, most of us face the prospect of declining capacity as we get older. As we age, we can't work as hard or as long as we could when we were age 30 or 40. This reality can put some people in a bind: In their current circumstances, they don't have enough time to "catch up" for retirement, and they don't have the physical capacity to earn more to make up the difference.

Enter the idea of "Phased Retirement." The term can refer to a broad range of scenarios, but all generally revolve around two ideas: (1) the individual continues working, but usually with a reduction in the number of hours on the job. (2) In concert with the decreased workload, the individual supplements his income with previously accumulated retirement assets.

Phased retirement could take many forms. In fact, many individuals that we might currently classify as "semi-retired" are actually implementing a phased retirement strategy. As an example, it could be a person who retires from 40-hour-a-week employment, takes a part-time job, and draws Social Security and/or a small amount from his/her retirement account. In this form, the possible configurations of phased retirement are endless: part-time work, independent consulting, or seasonal

employment combined with irregular withdrawals, or period certain annuity payments, etc.

However, some versions of phased retirement may actually require some restructuring of pension and retirement plans. Consider the situation of a long-term employee with a high level of technical skill and experience. The employer may find great benefit in retaining this employee, even on a part-time basis, so a plan where the employee works three days a week and draws a partial retirement might seem ideal for both parties.

But what if most of the employee's retirement assets are held in the company's 401(k), or are in the form of a company pension? Many retirement plan rules *prohibit active employees from receiving retirement plan distributions while still employed*. And if there is a pension plan, how will the employee's ongoing earnings affect payments they are receiving concurrently?

Even if you think your accumulation plans are on track, there may a phased retirement in your future. Numerous studies have shown that older workers are valued for their experience, knowledge, work habits, commitment to quality, and proven ability to work in a

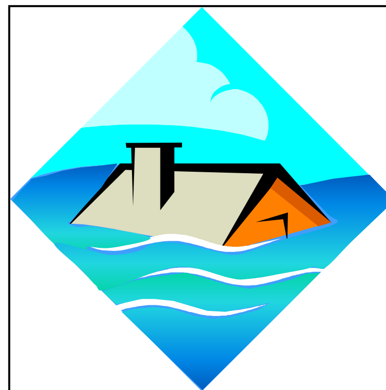
team environment. Regardless of age, good employees are worth retaining, and as the population glut from the baby boom generation recedes, it is becoming harder to find younger replacements. Especially if you are an employee with highly specialized skills and a long tenure with one employer, you might receive an offer that's too good to refuse.

The concepts contained in a phased retirement program also upend some paradigms of conventional retirement planning. It is possible, even likely, that a phased retirement program will experience income ebbs and flows. There may be periods when the need to supplement income from assets is quite high, but these times could be followed by stretches where the individual has excess income and is saving during retirement. This fluctuating state of affairs could greatly impact decisions about where funds should be allocated, and which ones should be distributed. **Given these changing dynamics, it may be time for you to consider phased retirement strategies and the types of financial products that meet these objectives.**

TREND: "STRATEGIC DEFAULTS"

> ***"Go ahead. Break the chains. Stop paying your mortgage if you owe more than the house is worth. And most important: Don't feel guilty about it. Don't think you're doing something that's morally wrong."***

As outrageous as it may sound, that's the lead sentence to Kenneth R. Harney's November 29, 2009 *LA Times* article titled "Professor advises underwater homeowners to walk away from mortgages." The professor in the article is Brent T. White, a law professor at the University of Arizona, and his comments were probably the first to articulate, and justify, a growing trend among homeowners. His opinion is, if the home you own is now worth a lot less than what you owe on your mortgage, walking away from your home and defaulting on the mortgage may look like a prudent financial decision – even if you still have the financial resources to make the payments. Say hello to the "strategic default."



Strategic default: the decision to stop making payments on a debt despite having the financial ability to make the payments.

A **strategic default** is the decision by a borrower to stop making payments on a debt despite having the financial ability to make the payments. While businesses may regularly implement strategic defaults (typically on mothballed facilities), only recently has the approach taken hold in the *personal* real estate arena.

Strategic defaults usually occur after a substantial drop in the house's price so that the debt owed is considerably greater than the value of the property. This results in a negative equity situation where the homeowner is significantly "underwater," so much so that the prospect of ever returning to a positive equity position is considered unlikely.

Borrowers who strategically default are often called "walkaways," and statistics indicate their number is increasing. A September, 2009 joint study from Experian and the Oliver Wyman consulting firm estimated that close to a fifth of troubled mortgages in the U.S. involved borrowers who were strategically defaulting. Google the term, and you'll even find web sites offering "strategic default calculators," supposedly helping you decide if it's time for you to walk away.

Ethical? Logical? Practical?

For most people, reneging on a financial obligation is seen as a last resort, something to consider only when all other options have been exhausted. After all, the only reason people and institutions extend credit is because they assume they will be repaid. Individuals who don't repay their loans ultimately increase the costs of borrowing for everyone. Brian Faith, a spokesperson for Fannie Mae, the government-sponsored mortgage lender, told Harney "there's a moral dimension to this as homeowners who simply abandon their homes contribute to the destabilization of their neighborhood and community."

But some commentators would argue there are unique factors at work in the residential marketplace that justify using a strategic default as a pre-emptive financial strike to minimize future financial distress. Some think the moral arguments for repayment go far beyond what is required. In the January 10, 2010 *NY Times Magazine*, Roger Lowenstein states the general terms of a mortgage, and the consequences of default:

> **Mortgage holders do sign a promissory note, which is a promise to pay. But the contract explicitly details the penalty for nonpayment – surrender of the property. The borrower isn't escaping consequences, he's suffering them.**
>
> **So you're not really breaking the contract. The contract remains valid, and the**

stipulation for nonpayment follows through according to contract.

For some homeowners, the size of their mortgage and the magnitude of decline in their home's value have resulted in an investment loss that can never be reversed. The only logical financial decision is to cut one's losses and start over. Feeling some guilt and shame over defaulting might be natural, but that doesn't mean it isn't a wise business decision. As Lowenstein says, "The average homeowner is allowed to take a cold business approach as much as anyone is."

Right now, the cold business approach seems to indicate owning a home doesn't have the value it used to, either as an investment or a financial priority. In a January 7, 2010 *Time.com* article, William Clark, a geography professor at UCLA, said the housing mania of the last decade led many buyers to see their homes as speculative investments — "high-flying stocks that happened to come with wine cellars and four-car garages." Today, "with the sudden run-up in foreclosures, you're starting to see people ask, is housing a good investment?" he said. "In fact, it probably never was." Lita Epstein, in a February 6, 2010 article for AOL's *Daily Finance,* cited a January 2010 Transunion trend study that found people were maintaining car payments as their first priority, credit cards second, and mortgages last.

Of course, a strategic default isn't as simple as simply sending your lender a good-bye note and the keys to your house. And the consequences of strategically defaulting aren't limited to just losing the house. Because of the variations in state laws and lending agreements, most "default experts" recommend obtaining legal representation. *Second* mortgages, especially those written as lines of credit, may *not* be released in a walkaway. Epstein's article notes that credit scores will average a decline of 100 to 125 points as a result of the mortgage default. If there are late payments prior to the default, Professor White cautions the hit to one's credit history could be as high as 300-400 points. Besides the services of an attorney, you may require tax counsel as well, because some states may assess taxes on forgiven debts after a short sale or foreclosure. And beyond all the financial and legal ramifications, there's also the issue of finding another place to live, moving one's belongings, and handling the increased stress that comes from a major lifestyle upheaval.

There are also alternatives to a strategic default, such as loan modifications and short sales. Cristine Gonzalez, an AP reporter writing an article posted January 8, 2010, on creditbloggers.com, notes that an increasingly prevalent form of loan modification is one in which the lender reduces the principal amount. Besides resulting in a lower balance and payment, a loan modification usually does not change one's credit score.

If nothing else, the surge in strategic mortgage defaults should reinforce the necessity to accurately assess the true financial benefits and costs associated with home ownership. As Professor Clark said, too many people perceived "buying up" (i.e., buying the most expensive home one could afford) as a great investment strategy that came with extra perks like a swimming pool and a great room.

But a strategic default isn't a wealth-building strategy; at best, it's a way to hit the financial re-set button – with a damaged credit history and a slim chance of getting a mortgage for the next three to seven years. So while an online calculator may indicate a strategic default may make financial sense, it's not easy, and not without wide-ranging financial consequences. Better to have made a good housing decision at the beginning rather than hoping to escape a bad one later.

UNINTENDED CONSEQUENCES:

ROTH IRA CONVERSIONS = TAX WINDFALL

In an ironic twist, the perception that the US government is about to do something undesirable in the future may reward that same government in the present.

A tax provision enacted in 2006 established that owners of IRA and other tax-deferred retirement accounts would be allowed in 2010 to convert these accounts to Roth IRAs, without limitation. (In previous years, the eligibility to convert to Roth IRAs was limited by income – the more you made, the less you were able to convert.)

Converting to a Roth IRA entails paying any previously deferred taxes now, on both the deposits and gains. In exchange, the Roth format means freedom from future taxes on principal, income and gains, whether distributed to you or your heirs. As Donald L. Luskin, CIO at Trend Macrolytics, stated in an April 15, 2010 *Wall Street Journal* Opinion essay, "the tax and estate planning benefits are so compelling that the wealthiest Americans are likely to convert in droves."

Since the middle of 2009, this expanded opportunity to convert to Roth accounts has been featured prominently in the financial media, and the expectation has been that many individuals will take advantage of the provision. But recent events have perhaps provided even more incentive for conversion.

With skyrocketing national deficits and the need to fund the new health-care provisions, the consensus expectation is higher taxes, particularly on America's

most wealthy households. Luskin say the strong possibility of higher tax rates in the future means "the very wealthiest Americans, who control most of the eligible assets, have utterly irresistible tax incentives" to convert in 2010.

Of course every account converted today in the hope of avoiding higher taxes tomorrow means more revenue now for Uncle Sam. How much more?

It's hard to say for sure. Combining data from several sources, Luskin estimates the total amount of funds eligible for conversion is somewhere in the range of $9 trillion. Approximately 60% of the $9 trillion, or $5.4 trillion, is in the hands of the wealthiest 10% of American households. If only 10% of those funds are converted ($540 billion), and taxed at 35%, the result is a "$189 billion revenue surprise for the U.S. Treasury."

But if the political momentum to increase taxes picks up, the conversion response could be larger. In Luskin's study of a USAA survey, he finds it conceivable that up to 35% of wealthy Americans could make the change to Roth accounts. The resulting tax bonanza would be $662 billion in "bonus" tax revenues, *nearly enough to cut the budget deficit in half*. That's big money!

Luskin's commentary provoked prompt and opposing responses from some financial experts. In a letter to the editor on April 20, 2010, Douglas Geig II, a CPA from Brecksville, Ohio wrote:

> **If you are young and beginning your career, you may not want to put any of your savings in a tax-deferred account. In other words, pay the taxes on your savings today at relatively small marginal rates. Sadly, if you defer this tax (and if you are successful and responsible), your future tax burden will be tremendous, as effective tax rates skyrocket to fund our nation's escalating deficits.**

Jack McManemin, CFP in Salt Lake City, begged to differ:

> **Although tax brackets in general may be higher in the future, what matters is a person's own tax bracket. Many people, after retiring, will find themselves in lower brackets as they live off their portfolio without income from a salary.**

Once again, the question of tax deferral comes down to whether it's best to pay tax on the "seed", or on the "harvest." And once again, the final answer will only be revealed at liquidation. You must make a deposit decision today, not knowing what tax consequences will be when it is time to make a withdrawal.

When dealing with tax law, economists regularly discuss the principle of unintended consequences: changes in tax law will almost certainly result in changes in taxpayer behavior, usually to minimize or avoid the tax. But the final twist in this guessing game is that the individual uncertainties about the future will most likely result in more people choosing to pay taxes today. How strange is that?

The government certainly didn't anticipate this outcome. Luskin says in 2006 the Congressional Budget Office projected only $8 billion in revenue from Roth conversions for 2010 – and never adjusted that number in successive years. That's a long way from Luskin's low estimate of $189 billion, and even further from $662 billion that is projected if a large contingent of Americans decide for conversion.

Are You Ready to be Converted?

For most IRA and qualified retirement account owners, the biggest challenge to conversion is determining how to pay the taxes. The ideal arrangement is usually transferring the IRA balance in full, while paying the resulting income taxes from other non-qualified accounts, such as bank savings, life insurance cash values, or investments held outside the retirement plan. Taxes could be paid from the IRA accumulation, but this will decrease the amount converted, and depending on your age and other issues involving your account, may also result in additional penalties for early distribution. With a Roth conversion, the devil is often in the details.

WANT TO REMOVE FUTURE TAX OBLIGATIONS FROM YOUR RETIREMENT ACCOUNTS? THIS YEAR MAY BE YOUR BEST CHANCE!

WANT TO DO IT RIGHT? THEN GET PROFESSIONAL HELP!

"The point to remember is that what the government gives it must first take away."
- John S. Coleman
20th-century American Industrialist

THE DIFFERENCE BETWEEN INVESTING AND GAMBLING

Right before the 2010 Super Bowl, a page 1 article in the February 5, 2010 *Wall Street Journal* opened with this sentence:

“Investors are sometimes accused of treating the stock market like a casino. Now, one Wall Street firm wants to treat casinos like the stock market.”

The article details the decision of a Wall Street bond-trading company to take over the management of sports betting at a new Las Vegas casino. Lee Amaitis, the company executive who runs the betting operation, says the firm got into sports gambling because “we wanted to turn gamblers into traders.” Using sophisticated financial-markets software, bettors can not only bet on the final outcome, but also make wagers on events during the game, such as whether the next pass might be completed, or who kicks next field goal.

On several occasions, the article noted similarities between investing and gambling. The article even featured a bond trader-turned-professional gambler who said “Wall Street is just a form of legalized gambling.”

Is investing just a form of gambling? For many investors, the answer may be “yes.” But it doesn’t have to be. And it probably shouldn’t be.

In July 2000, Tom Murkco, the CEO of Investor-Guide.com, published an essay titled ***“What is the difference between gambling and investing?”*** While Murkco noted that many aspects of gambling and investing might appear similar, there were several distinct and easily defined differences.

For either investing or gambling, the beginning of Murkco’s definition is the same:

An activity in which money is put at risk for the purpose of making a profit.

But while the purpose of gambling and investing is identical, the methods by which the purposes are achieved are drastically different. According to Murkco, Here are Murkco’s distinctions:

when someone **invests**…

- sufficient research has been conducted;
- the odds are favorable;
- the behavior is risk-averse;
- a systematic approach is being taken;
- emotions such as greed and fear play no role;
- the activity is ongoing and done as part of a long-term plan;
- the activity is not motivated solely by entertainment or compulsion;
- ownership of something tangible is involved;
- a net positive economic effect results.”

when someone **gambles**…

- little or no research has been conducted;
- the odds are unfavorable;
- the behavior is risk-seeking;
- an unsystematic approach is being taken;
- emotions such as greed and fear play a role;
- the activity is a discrete event or series of discrete events not done as part of a long-term plan;
- the activity is significantly motivated by entertainment or compulsion;
- ownership of something tangible is not involved;
- no net economic effect results.

When defined this way, it’s easy to see the differences between investing and gambling. It’s also easy to see that because of the methods some people use to invest, their behavior may more closely resemble gambling.

For example, industry studies have repeatedly shown that the behavior of mutual fund investors often accounts for poor investment performance. Because they don’t approach investing systematically, emotions like greed and fear may cause people to make impulsive decisions, with little or no research. Not surprisingly, the results from these methods more often resemble the returns from lottery tickets.

Not Gambling with Your Investments: Easier said than done?

In his book, *Snap Judgment: When to Trust Your Instincts, When to Ignore Them, and How to Avoid Making Big Mistakes With Your Money*, author David Adler says it’s the psychological component of investing that is the most difficult to manage. Adler contends that behavioral research shows many individuals have an almost over-whelming set of hard-wired dispositions to take gambles rather than make investments. Adler quotes Andrew Lo, an MIT professor of finance:

“The same neural circuitry that responds to cocaine, food, and sex has been shown to be activated by monetary gain as well.”

For some people, the thrill of investing/gambling can be addictive. But when the stakes are one’s financial future or retirement, or your children’s college education, the need for a thrill shouldn’t come by jeopardizing one’s investments.

This imperative to not compromise investing by gambling highlights one of the greatest benefits of working with a team of financial professionals: **Besides receiving informed advice, a financial professional can often serve as a protection against gambling with your investments, by encouraging you to make sound decisions based on good research that have a high likelihood of success.**

Take a moment to consider the last few major financial decisions you’ve made in the past year. Then look at the list above. Did you make an investment or take a gamble?

5-MINUTE FINANCIAL THOUGHT:

"I wish I had…" or "I'm glad I did…?"

Quickly, consider what's happened in your life in the past five years. Skim through the ups and downs, the major events and memories. If you have the opportunity, make a list. As you go through the list, sort those events and memories in two categories, "I wish I had…" or "I'm glad I did…" What do you find?

If you're like most of us, you probably have items in both categories. Like:

"I wish I had exercised more."
"I wish I had taken that job offer."

or

"I'm glad I saw the doctor."
"I'm glad we took that trip."

Here's another question: For those "I wish I had…" situations, would it have taken very much to change them to "I'm glad I did…"? Possibly quite a few could have been changed with a small action on our part.

Conversely, when it comes to "I'm glad I did…" events, how many great benefits and positive memories were triggered by small decisions, or modest actions that were never anticipated to deliver great results?

In retrospect, many of the major events of our lives may have tipped on small things. Five years from now, it's likely that many other small actions, either taken or left undone, will deliver the same impact.

The famous early 20-century American journalist H.L. Mencken, wrote **"Remorse is the regret that one waited so long to do it."**

Financially, we all know we have some things where we say "I wish I had…" made a will, bought that stock, taken that life insurance." We also know financial mistakes have ongoing opportunity costs; today's poor decisions often cost us much more in the future.

Life doesn't come with guarantees. But if you make a conscious decision to add another item to the "I'm glad I did…" category, you can't help but believe the future is going to be better. **The best financial program is one with no regrets. What needs to be done today so that five years from now, ten years from now, you will be able to say, "I'm glad I did…"?**

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

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