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The Ripple Effects Of Prosperity

On occasion, it is helpful to take a big-picture look at the issues of personal finance. Instead of discussing the pros and cons of different accumulation strategies, or the tax implications of new legislation, let's consider a different aspect on personal finance:

When you have your financial stuff together, you make the world a better place.

It's true, the primary marketing messages from the mainstream financial media are designed to appeal to your personal well-being – it's about *your* security, *your* retirement, *your* dreams. While that narrow focus on your self-interests may be useful in motivating you to take action, it often ignores or downplays the positive ripple effects for society that come from personal prosperity. In general, history shows that widespread individual wealth produces a positive impact on society as a whole.

Defining Prosperity.

A definition of prosperity isn't derived from a numerical calculation. Rather, prosperity is a state of financial health. It is consistent income, minimal and manageable obligations, accumulated financial assets. Going forward, it's also the expectation of growth in these areas – the opportunity for more income, fewer obligations, greater accumulations.

The magnitude of one's prosperity will be affected by a vast range of factors, from natural abilities and interests to geographical location and a thousand other things. But a common component in all personal prosperity is good financial management. Prosperous people pay attention to their financial resources and maximize their value.

In a free-market society, prosperity is a result of individual ambition, skill, and effort. But these individual efforts to prosper also produce a "greater good" for society.

Prosperous people create wealth. At the beginning of the 20th century, Henry Ford's mass-produced automobiles changed the world. And it wasn't just Henry Ford Motors that became prosperous. The proliferation of the automobile spawned all sorts of prosperity for other people as well. Workers in Ford plants made more money than working on the farm. Resourceful individuals used automobiles to create new businesses and deliver new products and services. As more people traveled, more land became accessible for development and recreation. In retrospect, some might argue that not every change wrought by the automobile was for the good, but most would say the overall impact is undeniable. Directly or indirectly, people enjoy a higher standard of living because of the automobile.

Not every prosperous person succeeds at the level of Henry Ford, but when prosperous people create wealth, even at a modest level, they also create opportunities for others as well.

Prosperous people cost less. When someone defaults on a loan, the lender adjusts the cost of borrowing upward to compensate for the loss. A higher percentage of defaults mean higher borrowing costs – for everybody. Guess what? Well-managed individuals don't default as often. Prosperous individuals lower the financial costs for everyone.

But the ripple effect of prosperity goes beyond lower borrowing costs. When prosperous individuals make smart, prudent, future-oriented management decisions like planning for retirement, buying insurance or saving for their children's education, they indirectly decrease the burden on government social programs that often are used to assist those who haven't planned or don't have the resources. In general, the more that people can take care of themselves, the less they need to be taken care of by government, whether it's retirement income, education loans, or special subsidy programs. In one way or another, every government subsidy is a result of a wealth transfer in the form of taxes. It is not wealth creation. Although politicians have historically shown little

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restraint in spending, an increase in individual prosperity could ultimately result in a lower tax burden for everyone.

Further, when all other lifestyle and genetic factors are equal, prosperous people tend to be healthier. They live longer, and are productive longer as well. These individuals are more likely to add to family wealth than consume it.

Prosperous people give more. You can't give it if you don't have it. This is true not only for making charitable donations, but also in the context of larger issues. Ecological concerns are not issues in developing countries – the challenge of daily survival precludes any thought of protecting the rainforest, decreasing carbon emissions, or building homeless shelters for others. It is the prosperous individuals who have the time and resources to consider issues that affect the long term well-being of the world. And it is because of their prosperity that American commentator Michael Novak has concluded:

"We are going to see a revival in this country, and it's going to be led by rich people."

Novak's comments have strong historical support. Many significant charitable foundations in operation today had their beginnings as a result of great prosperity created years earlier. In ways great and small, the donations from industrialists from the late 19th and early 20th century were often the sole source of funding for museums, libraries, parks and schools. Entire communities enjoy recreational and cultural benefits today because of the generosity of previous prosperous generations.

Today, prosperous individuals are often the driving force behind various social causes, as they are able to give both time and money to further research, aid or education. Just recently, America's two richest individuals, Bill Gates and Warren Buffett, received considerable press for their combined charitable efforts.

Your prosperity isn't all about you.

Most of us have an affinity for connecting ourselves with purposes and institutions that are greater than our own self interests. We commit to raising families, joining religious communities, serving on volunteer associations, giving to special causes. Our connection with these "greater things" gives us a sense of belonging and satisfaction that cannot be realized by the purchase of a 48-inch flat-screen television.

Prospering, i.e., getting our financial world in order and maximizing our resources, allows us to participate in these "greater things" in a bigger way. And not only is this good for us, it's good for those around us.

There are many motivations that strongly influence human action. In the context of finances, fear and greed often get major air time. Fear may compel you to do what's necessary (buy insurance, start saving for retirement), and greed may drive you to satisfy your own desires (a flashy new car, a lavish vacation). But when the fear is gone, and the desire is satisfied, what happens next? A new fear? Another desire?

Achieving prosperity and enjoying the stability and satisfaction that comes with it is a lifelong project. In order to diligently pursue prosperity, you may need some long term motivation. Even though your finances are an individual project, it's worth remembering that your positive financial actions have a corresponding positive ripple effect. Some of the effects may be visible, such as the benefits to your family or heirs, but many others will never be fully seen. Still, the fact is:

Prosperous people make the world a better place.

We wish you a prosperous 2008.

OUTSIDE-THE-BOX THOUGHT:

"OVER-PAY" YOUR WHOLE LIFE INSURANCE

For all the benefits of whole life insurance (and there are many), one of the sticking points for some prospective buyers is the concept of paying premiums for one's whole life. (*"You mean when I'm 75 years old, I'm still going to be paying premiums? How am I going to be able to afford that on a limited income?"*) But if you have an understanding of the fundamental components of a whole life insurance policy, paying premiums for a lifetime isn't a deal-breaker.

While a typical illustration provided by the insurance company usually shows premiums paid for one's entire lifetime, most insurance contracts have provisions for alternatives other than life-long premium payments. Understanding – and using – these options can make it possible to design a premium payment program that adapts to ongoing changes in your financial life, yet allows you to preserve the benefits.

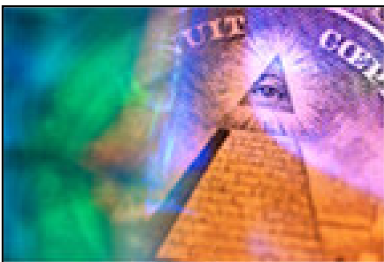
The mortgage analogy for whole life insurance

It's not a perfect analogy, but in many ways, a whole life insurance policy is structured similarly to a mortgage. When you purchase a whole life policy, the insurance amount represents a sum of money you are "borrowing" from the insurance company to provide financial security (for heirs, business partners, creditors, etc.) in the event of your untimely death. By making regular premium payments, you "own" this lump sum now, even though you have not fully paid for it. This corresponds to a typical home purchase; you are able to "own" a home by borrowing from a bank.

As you make regular payments on your mortgage, you gradually increase your equity position in the house. In an insurance policy, this gradual increase is called cash value. When you make the last payment on your mortgage, you own the house free and clear. Similarly, when (or if) you make the last payment on a whole life policy (usually at age 95 or 100), the policy is paid-up, and you own the insurance benefit free and clear.

Since many whole life contracts are calculated under the assumption that age 100 represents one's "whole life," you might say a whole life policy's mortgage term is 100 minus the age at issue. For example, a whole life policy issued at age 35 has a 65-year term of payment (100 – 35 = 65).

A home mortgage holder usually has the option of paying additional amounts over and above the required monthly payment. These additional payments serve to increase equity and reduce the term of the mortgage. Likewise, many whole life contracts (as well as other cash value policies) offer ways for policyholders to increase their cash values and reduce the length of time that premiums will be required. These additional payments are often classified as Paid-Up Additions (PUAs) to the policy.



More cash value = more options

The equity or cash value in a whole life policy can be used in several ways. Besides being withdrawn or loaned from a policy, cash values can be used internally as well. Depending on the structure of the policy, these internal applications may allow great flexibility in premium payments.

Cash values consist not only of a portion of premiums paid, but also the profits or dividends on the cash values. The rate of the dividend will vary from year to year but over time strong dividend payouts, and the subsequent increases in cash value, may result in paying up the policy before age 100. Dividends are not guaranteed, so it's impossible to project the exact point when the policy will reach paid-up status. Still, the paid-up status could be reached well before 100.

Additionally, annual dividends may grow large enough to exceed the annual premiums. At this point, the policyholder may elect to use the dividends to pay future premiums rather than allowing the dividends to accumulate. This decision will slow the accumulation of cash value, but it may free the policyholder from making ongoing out-of-pocket premium payments.

Loans may also be taken against cash values to pay current premiums (although outstanding loans will reduce future cash surrender values and death benefits). Depending on the premium amount, the cash value available, and the interest rate charged for borrowing the equity, the policyholder may not have to begin repayment immediately. In fact, depending on the variables, they may not have to make repayment at all; the interest cost will also be paid from existing cash values. This option can be particularly beneficial in situations where you experience short-term financial distress, such as a job change, unemployment, excessive medical expenses, etc.

The above discussion provides a brief overview of alternative forms of premium payment. Some policies may offer additional options as well, but most are variations on these basic strategies. In all of these scenarios, the policyholder keeps the essential benefits of the insurance policy, but has ways to restructure the payments.

Here's the important point: A key component for practical use of each option (or others like it) is **sufficient cash value.** If there isn't sufficient cash value, there aren't choices.

Like a mortgage, a typical whole life contract on a regular payment schedule usually has limited equity accumulation in the early years. But if you want flexibility early in your life insurance policy, it may require some extra "unscheduled" premiums. That's where Paid-Up Additions come in. PUAs accelerate the cash value accumulations, which in turn allow for flexibility in maintaining the policy in the future.

The amount of PUAs that can be added to a policy is limited by contractual and IRS guidelines, and not every policy offers the PUA option, so the devil is in the details when it comes to formulating an "over-payment" plan to increase the cash value balance. The best way to develop and implement a PUA strategy is by working with a financial professional at the time of application. Used properly, a judicious over-payment plan for the early years of a whole life policy can result in greater flexibility in maintaining the policy for the rest of your life.

Does your insurance have an "over-payment plan?" This is one of the areas we specialize in. Ask us for information if you are interested in learning more about your specific situation.

SUB-PRIME SUB-PLOTS

The sub-prime mortgage crisis has become the biggest financial story of 2007. Every day, there's another article, editorial or special report delivering more bad news. It's not only the bad news about foreclosures and defaults, but also the ripple effects on the rest of the economy; in some way, eventually, almost everyone will be affected by this situation.

There are obvious financial lessons to be gleaned from the sub-prime crisis. Lessons like:

- Making loans to people who can't afford them isn't good business.
- If your housing strategy requires betting on rising incomes, appreciating housing values, interest-only payments and low interest rates, you have no chance.

But as the sub-prime mess continues to unwind, there are interesting secondary plots that merit comment. For example…

Whenever a story gets big enough, politicians will insert themselves. It might be to "investigate," or perhaps to "fix it" through legislation, or simply to affix blame or take credit. And the story doesn't have to be financial (think of the steroids-in-baseball scandal, Hurricane Katrina, or lead paint on toys from China). But once a topic registers on the national consciousness, politicians inevitably appear.

During the past six months of the sub-prime story, legislation has been introduced to better regulate the mortgage industry; governors and mayors have participated in "summit meetings" to pursue alternatives to foreclosure, and activist organizations have announced lawsuits against "predatory lenders." Unfortunately, whether it's because of partisan politics or philosophical disagreements, the people who believe "something has to be done" will not agree on either the problem, or the solution. Check out this headline from an article posted November 16, 2007 on consumeraffairs.com:

Consumer, Poverty Groups Oppose Predatory Mortgage Bill
Measure Leaves Homeowners Worse Off, They Charge

Which leads to a second observation: **If you're going to take a financial risk, it may be to your advantage to take one everyone else is taking.** If you were the only one who defaulted on a sub-prime mortgage, it's unlikely that any politician would propose new legislation. Instead, you'd be scolded ("*What* were you thinking?") and left to suffer the consequences of your ill-advised choices.

However, if a lot of people make the same mistake and default on their mortgages as well, it's possible that the problem wasn't your faulty judgment, but that the "system" was flawed. In that case, a default may not be your fault.

When a number of people have the same problem, it changes the psychological, political and economic realities.

- Instead of being a foolish individual, maybe you are part of a victimized group – you are not stupid and you are not alone.
- Instead of enduring the legal consequences of your mistake, maybe the law can be changed.
- Instead of suffering financial loss, perhaps it's possible to stop your monetary and material losses, and maybe even reward you for your suffering.

It's true that many stories of individual financial success feature a strong theme of independent action, of rejecting the status quo and running apart from the herd. But when it comes to surviving failure, running with the herd may be the best way to cushion the consequences. (Intriguing spin-off thought: If you thought the stock market might crash, would the best place to hold investments be in a 401(k)? Imagine the size of the "herd" of aggrieved investors, and what might be done on their behalf.)

A concluding observation: **In spite of all the drama and dire forecasts, things may not turn out as bad as predicted.** Just recently, Wells Fargo CEO John Stumpf opined that the mortgage crisis, brought on by massive defaults of subprime mortgages is the worst since the Great Depression. That sounds bad.

But remember Y2K? As Jusin Lahart noted in his "Ahead of the Tape" column in the November 19, 2007 *Wall Street Journal*, "when the new millennium came, there was nary a problem, because people spent a lot of time ensuring there wouldn't be." Someone sounded an alarm, and people paid attention.

The sub-prime problem certainly has people's attention, and Lahart notes that banks are responding promptly. They are tightening lending standards, looking for ways to increase their capital reserves. These timely responses may negate greater economic fallout.

SPEND-DOWN MATH

The eventual goal of all asset accumulation is distribution. And now that the first members of the Baby Boom generation turn 62 in January, 2008, you can be sure that an increasing volume of financial commentary will begin focusing on the issue of distribution in retirement. Here's a short mathematical discussion that shows how challenging it can be to spend your savings:

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Living on the earnings: The Classic Approach

Until the middle of the 20th century, retirement was only for the very well-off. "Retirement planning" didn't exist. But the advent of corporate pensions and Social Security, combined with the demographic explosion caused by increased life expectancies and the baby boomers, meant that retirement was a possibility for almost everyone.

People were going to live longer, but they didn't have to work until they died, in part because there were so many young, eager replacements. In the space of two generations, retirement became a fixture in America.

From the beginning, the classic individual retirement model has been building a large enough accumulation so that you can live on the earnings (from interest, dividends, capital gains, etc.). With the living on earnings strategy, one never has to worry about running out of money no matter how long they live, because the principal will always be there to take care of you.

Living on interest is easily illustrated mathematically (Fig 1). The hypothetical account starts with $1,000,000, and withdraws the earnings each year. Assuming a stable rate of return, once you calculate the first year, all the rest are the same. (For purposes of this illustration, a conservative estimate of 5% was chosen. Higher or lower earnings estimates will generate correspondingly higher or lower annual withdrawals.)

FIG. 1 – LIVING ON EARNINGS

ASSUMES: $50,000 ANNUAL WITHDRAWALS
5.00% EARNINGS PER YEAR

YR	BEGINNING BALANCE	ANNUAL EARNINGS	AMOUNT WITHDRAWN	REMAINING BALANCE
1	$1,000,000	$50,000	$50,000	$1,000,000
2	$1,000,000	$50,000	$50,000	$1,000,000
3	$1,000,000	$50,000	$50,000	$1,000,000
4	$1,000,000	$50,000	$50,000	$1,000,000
5	$1,000,000	$50,000	$50,000	$1,000,000
(continues on the same way for 30 years…)				
30	$1,000,000	$50,000	$50,000	$1,000,000

A Simple Spend-Down:
More money to spend each year, nothing left over (maybe)

It's true that living on earnings provides security against outliving your assets, but it does so by assuming you will live forever, and that's not going to happen. If your goal is to maximize the spending value of your accumulation during your lifetime, the best distribution plan would be one that allows you to spend down to your last dime as you take your last breath.

No one can calculate quite that accurately, so spend-down strategies make a guess on life expectancy, and construct a distribution plan based on that guess. For example, Fig. 2 shows the same $1 million earning 5% annually as in Fig. 1. However, instead of withdrawing just the annual earnings, an additional $15,000 is withdrawn each year, for an annual total of $65,000.

FIG. 2 – 30-YEAR SPEND DOWN

ASSUMES: $65,000 ANNUAL WITHDRAWALS
5.00% EARNINGS PER YEAR

YR	BEGINNING BALANCE	ANNUAL EARNINGS	AMOUNT WITHDRAWN	REMAINING BALANCE
1	$1,000,000	$50,000	$65,000	$985,000
2	$ 985,000	$49,250	$65,000	$969,250
3	$ 969,250	$48,463	$65,000	$952,713
4	$ 952,713	$47,636	$65,000	$935,348
5	$ 935,348	$46,767	$65,000	$917,116
6	$ 917,116	$45,856	$65,000	$897,971
7	$ 897,971	$44,899	$65,000	$877,870
8	$ 877,870	$43,893	$65,000	$856,763
9	$ 856,763	$42,838	$65,000	$834,602
10	$ 834,602	$41,730	$65,000	$811,332
11	$ 811,332	$40,567	$65,000	$786,898
12	$ 786,898	$39,345	$65,000	$761,243
13	$ 761,243	$38,062	$65,000	$734,305
14	$ 734,305	$36,715	$65,000	$706,021
15	$ 706,021	$35,301	$65,000	$676,322
16	$ 676,322	$33,816	$65,000	$645,138
17	$ 645,138	$32,257	$65,000	$612,395
18	$ 612,395	$30,620	$65,000	$578,014
19	$ 578,014	$28,901	$65,000	$541,915
20	$ 541,915	$27,096	$65,000	$504,011
21	$ 504,011	$25,201	$65,000	$464,211
22	$ 464,211	$23,211	$65,000	$422,422
23	$ 422,422	$21,121	$65,000	$378,543
24	$ 378,543	$18,927	$65,000	$332,470
25	$ 332,470	$16,624	$65,000	$284,094
26	$ 284,094	$14,205	$65,000	$233,298
27	$ 233,298	$11,665	$65,000	$179,963
28	$ 179,963	$ 8,998	$65,000	$123,961
29	$ 123,961	$ 6,198	$65,000	$ 65,159
30	$ 65,159	$ 3,258	$65,000	$ 3,417

A 30-year spend-down would last until age 95 for someone who begins distribution at 65. For most people, that would seem likely to be enough. Yet even though no other factor in the calculation has changed, the distribution is 30% greater! (Surprisingly, if the earning rates are higher, the difference between a living-on-earnings and a 30-year-spend-down is smaller. At 8% per year, the spend-down approach yields only 11% more per year.)

The Inflation-Adjusted Spend-Down.
Growing distributions vs. a steady rate of earnings

Both of the above examples featured static distributions; the amount withdrawn each year stayed the same. In real life, inflation eats at the purchasing power of future distributions, making a $50,000 distribution in the 30th year worth far less than the first year. To reflect this reality, another distribution model features annual

incomes that increase each year. Fig. 3 shows the calculations and the long-term impact of this approach.

Sometime during the 29th year, the money is gone.

However, in terms of total payments, the inflation-adjusted example pays out a little more than $2 million in 29 years, while the simple-spend down distributes $1.88 million in 29 years.

The Possibilities (and complexities) are endless

Moving from these basic calculations, it's easy to see that additional variables and historical data can be merged to form an infinite number of spending models. Are any of them accurate? Probably not. Using past history to predict future performance is an inherently speculative exercise. While some certainty can be injected into real-life scenarios by using guaranteed financial vehicles, such as fixed annuities, it's more likely that your spending plans will have to be adjusted on a regular basis.

FIG. 3 – INCREASING ANNUAL WITHDRAWALS

ASSUMES: $50,000 WITHDRAWALS
5.00% EARNINGS PER YEAR
2.50% ANNUAL WITHDRAWAL INCREASE

YR	BEGINNING BALANCE	ANNUAL EARNINGS	AMOUNT WITHDRAWN	REMAINING BALANCE
1	$1,000,000	$50,000	$ 50,000	$1,000,000
2	$1,000,000	$50,000	$ 51,250	$ 998,750
3	$ 998,750	$49,938	$ 52,531	$ 996,156
4	$ 996,156	$49,808	$ 53,845	$ 992,120
5	$ 992,120	$49,606	$ 55,191	$ 986,535
6	$ 986,535	$49,327	$ 56,570	$ 979,291
7	$ 979,291	$48,965	$ 57,985	$ 970,271
8	$ 970,271	$48,514	$ 59,434	$ 959,350
9	$ 959,350	$47,968	$ 60,920	$ 946,398
10	$ 946,398	$47,320	$ 62,443	$ 931,274
11	$ 931,274	$46,564	$ 64,004	$ 913,834
12	$ 913,834	$45,692	$ 65,604	$ 893,921
13	$ 893,921	$44,696	$ 67,244	$ 871,373
14	$ 871,373	$43,569	$ 68,926	$ 846,016
15	$ 846,016	$42,301	$ 70,649	$ 817,668
16	$ 817,668	$40,883	$ 72,415	$ 786,137
17	$ 786,137	$39,307	$ 74,225	$ 751,218
18	$ 751,218	$37,561	$ 76,081	$ 712,698
19	$ 712,698	$35,635	$ 77,983	$ 670,350
20	$ 670,350	$33,518	$ 79,933	$ 623,935
21	$ 623,935	$31,197	$ 81,931	$ 573,201
22	$ 573,201	$28,660	$ 83,979	$ 517,882
23	$ 517,882	$25,894	$ 86,079	$ 457,698
24	$ 457,698	$22,885	$ 88,231	$ 392,352
25	$ 392,352	$19,618	$ 90,436	$ 321,533
26	$ 321,533	$16,077	$ 92,697	$ 244,913
27	$ 244,913	$12,246	$ 95,015	$ 162,144
28	$ 162,144	$ 8,107	$ 97,390	$ 72,861
29	$ 72,861	$ 3,643	$ 99,825	$ -23,321
30	$ -23,321	$ -1,166	$102,320	$ -126,807

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