

# CREATIVE

## Wealth Maximization Strategies

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APRIL 2007

**"Tis far more noble to help create assets  
than simply move them around hoping to hit the jackpot."**

– Jack Bobo



### Are You "Tall Enough" To Ride The Stock Market?

Remember going to the amusement park, and standing in line for the signature ride, the one that strapped you in, flipped you over, took you to exhilarating heights, then plunged you so fast you had a moment where your life flashed before your eyes?

Usually, there was a sign right before the entrance that said "You must be \_\_\_ inches tall to go on this ride." The park's operators wanted to be sure you were big enough to take on the thrills and chills.

Hmmm...A roller-coaster experience with exhilarating heights and scary plunges. Yep, that's a possible description for investing in the stock market. Except there isn't a sign that says, "You must have \_\_\_ money before going on this ride." Today, with mutual funds and direct deposits from your paycheck into the company 401(k), everybody can invest in the stock market – there's no money down and no minimum requirements. Which means anyone could have the following experience:

#### **Good story about the stock market #1:**

In 1965, Warren Buffet takes control of Berkshire Hathaway, a former textile company whose stock price is selling at \$18/share.

In October, 2007, with Mr. Buffet still at the helm of what is now a holding company that oversees a conglomeration of investments, Berkshire Hathaway's

share price tops \$100,000 – for just one share. According to Karen Richardson in the October 24, 2006 *Wall Street Journal*, this represents a 5,555-fold increase over the 41-year period, while the Dow Jones Industrial Average is up only 13 times over the same time frame.

#### **Good story about the stock market #2:**

Written at the end of 2002, during the final stages of the tech-stock collapse, and reposted on numerous weblogs, this is an ironically sobering look at the perils of stock market investment investing:

"If you had bought \$1,000.00 worth of Nortel stock one year ago, it would now be worth \$49.00. With Enron, you have \$16.50 of the original \$1,000.00. With WorldCom, you have less than \$5.00 left.

On the other hand, if you bought \$1,000.00 worth of Budweiser (the beer, not the stock) one year ago, drank all the beer, then turned in the cans for the 10-cent deposit, you would have \$214.00.

Based on the above, our current investment advice is to drink heavily and recycle."

**How's that for exhilarating heights, and plunging depths? Which brings us to the real question:**

***Is there a minimum requirement for safely taking a ride in the stock market?  
And if there isn't, should there be?***

#### **A Bit of History**

In the "old days," (in this case the 1970s), the loosely-defined topic of "financial planning" usually considered stock market investing as one of the last steps up the financial pyramid. You laid a foundation by establishing a good life insurance program, preparing a will, and getting rid of high-interest debt. Then you began saving, often in guaranteed low-risk instruments like certificates of deposit or life insurance cash values. Only when you had accumulated an "emergency fund" of somewhere between six months and two years of income, did you entertain investing in more exotic financial vehicles like blue-chip stocks or corporate bonds, or consider opening a brokerage account. 35 years ago, a very small percentage of Americans had money in the stock market.

One of the reasons stock market investing was one of the last rungs on the financial planning ladder was the high cost of entry. As Katherine Wilson noted in *The Roots of Broadened Stock Ownership*, an April, 2000 report released by the Joint Economic Committee Study, investing in the stock market "...was kind of a rich person's discipline because, in order to be cost-effective, you had to buy in round lots (100-share increments of stock) or an individual bond. It was a very restricted market for this in many ways."

And while mutual funds had been in existence since after the Great Depression, it wasn't until the late 1970s that several factors combined to make them popular and available to the average middle-class American. The first factor was skyrocketing inflation, and the second was Regulation Q, a Depression-era banking law that limited passbook saving accounts to paying no more than 5¼ percent interest. As inflation began increasing at a double-digit rate annually, savers recognized leaving their money in bank accounts was a losing game. Increasingly, they turned to non-guaranteed money market fund accounts, which offered significantly higher interest rates.

Eventually, Regulation Q was overturned, and the spread between bank rates and money markets diminished. But in the interim a lot of money had left the banks. And the arrival of another factor meant most of it wasn't coming back.

Congress introduced the Individual Retirement Account (IRA) in 1974, offering tax deductions for deposits and tax-deferral on the growth in the accounts. As the report notes, "by eliminating some of the multiple taxation that exists on saving and investment, IRAs and 401(k)s became attractive relative to other retirement saving options. Americans looking for a way to protect their savings from the ravages of inflation began to look towards investing in stocks and mutual funds."

IRAs and their spin-offs (401(k)s, TSAs, SEPs and the like) created a new type of investor. Quoting Joseph Nocera, from his book *A Piece of the Action: How the Middle Class Joined the Money Class*, surveys found that a high percentage of money fund customers saw their investment in mutual funds as "'general savings.' These new customers were still not investors – or rather they didn't think of themselves as investors. They still thought of themselves as savers."

These changes resulted in many more Americans participating in the stock market. In 1983, the share of households that owned stock either outright or indirectly through mutual funds, trusts or pension accounts was about 24%. By 2001, over 50% of Americans were stock market investors in some fashion.

### **Is Broadened Stock Ownership a good thing? (If everybody can get in, should they?)**

Even though the barriers to entry in the stock market have been significantly diminished, if not completely

obliterated, establishing some self-imposed restrictions on stock market investing are worth consideration. (One of the reasons Berkshire Hathaway's stock price is \$100,000 a share is because Warren Buffet has refused to authorize a stock split to lower the price. It's his theory that the high price tends to discourage buying by short-term traders.)

All statistical evidence indicates that the most successful stock market investor is one who stays in the market long enough to realize the long-term gains that have been historically achieved since the 1930s. Unfortunately, the behavior of most mutual fund investors isn't conducive to a long-term approach. Studies show they tend to jump in and out of funds, most often buying high and selling low. (Details at [www.dalbarinc.com](http://www.dalbarinc.com).)

Maybe this counter-productive behavior is because they see their stock market investments as "general savings." Maybe it's because the median length of time workers have been with their current employer is only four years (according to a 2006 U.S. Bureau of Labor Statistics report); changing jobs every four years can make it hard to take a long-term perspective. Even if it was your intention to invest for the long-term in your company's 401(k), what happens when you change employers? There's usually either a rollover or a distribution, and both transactions might result in liquidation from a particular account, even if it's just to transfer to another one.

### **Setting Your Own "Height Limit"**

The appeal of the stock market is the possibility embodied in the Berkshire Hathaway story. Thus, when considering the opportunity for significant returns as a result of stock market investing, there's one line of thought that says, "if this is the place where you can realize the greatest return, it only makes sense to concentrate your assets there."

But the uncertainties of life make it impractical for anyone to put all their assets in the stock market. Something is going to come up, and the situation is going to require cash. If your only way to obtain the cash is by selling out of the market, it's almost certainly a bad time. If your shares are down, it's bad because you lost money at the very time you needed it. If your shares are up, you might be leaving the party just as it's getting good. There's an axiom that says, "The only good time to sell out of the stock market is when you want to, not when you have to."

Some people look at money in guaranteed accounts as "slow money;" it's not growing fast enough to suit their taste. But the old 70s rule about building an emergency fund equal to six months to two years of living expenses isn't a bad idea. When you have a cash cushion, you can ride the roller coaster. And if your money starts to take off, you won't have to slow it down. Establishing a "height limit" before you enter the stock market gives you the best opportunity to be a true investor, instead of a "saver with risk."



## No-Lapse Guarantee Universal Life: New model, but based on the same math

Founded in the late 17<sup>th</sup> century, Lloyd's of London is an insurance market providing specialized insurance services in over 200 countries and territories. Over the years, Lloyd's has gained the reputation of insuring unique assets. (For example, Fox Studios once insured the shapely legs of movie star Betty Grable for \$1 million.) But while the covered items might be unique, the basic concept is no different than auto, health, life, or any other insurance. Any risk that can be accurately evaluated by actuaries – no matter how unusual – can be priced for insurance.

Currently, a new version of life insurance, generically referred to as No-Lapse Guarantee Universal Life (NLG-UL), is gaining attention in the marketplace. And while the features may offer a new twist or two, the concept is still tied to the same risk evaluations that comprise any other life insurance policy.

### The same risks, with a new pricing model

*Warning:* The following is a very broad overview of the basic features of several different types of life insurance. You probably didn't wake up this morning saying, "Hey, that NLG-UL stuff intrigues me! I should Google it when I get home from work." And unless you're an actuary or an insurance aficionado, you might not be able to operate heavy machinery or drive while reading this next section. (If you want, we give you permission to skip the next five paragraphs, and go right to the summary comments.)

In a traditional whole life policy, an ongoing level premium provides either a guaranteed death benefit at any age, or a guaranteed accumulation should the insured live to a specified age (typically age 100, although this is changing). Should a mutual insurance company exceed its contractual guarantees, it results in the distribution of dividends, which may be applied to increase cash value accumulations and/or the policy death benefit. Depending on the terms of the policy, the greater-than-guaranteed results may allow the policy to be fully paid-up earlier than age 100.

Since actuaries are conservative in their pricing, it is not unusual for whole life policies to outperform their guarantees. Essentially, this means whole life policyholders "overpay" the actual cost of insurance, but the overpayment is compensated for by faster cash accumulation or a greater death benefit.

Universal life uses the same risk factors as whole life but offers the policyholder flexible premiums. Each year, the owner needs to pay just enough to keep the policy in force. Any additional premium may be added to the cash values, which may be used at a later date to cover the cost of insurance. As attorney John Bannen of Quarles & Brady LLP of Milwaukee notes, a universal life policy "becomes a checkbook with the cash value being the account balance; so long as there (is) a positive balance, the policy stays in effect; if there is no cash value, additional



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premiums have to be paid or the policy will lapse."

While offering flexibility and the prospect of lower out-of-pocket costs, universal life introduces some uncertainty, as many policyholders base their premiums on *projected* performance, instead of *guarantees*. When cash accumulations do not meet expectations, policyholders may risk lapsing the insurance because they cannot afford the subsequent higher minimum premiums.

NLG-UL is an attempt to provide the death benefit guarantees of whole life with the flexibility and lower premiums of universal life. NLG-UL does this by charging an additional fee to guarantee the insurance benefit will never lapse, regardless of the policy's "account balance." Even if there is no cash value, the insurance benefit remains – as long as minimum premiums put forth in the contract are paid in a timely manner. Late payment of even *one* premium, regardless of the current cash value balance, can void the no-lapse guarantee.

**The past five paragraphs can be summarized as follows:** Regardless of policy type, actuaries are working with the same mortality statistics, the same costs of operation, and the same investment opportunities for the premiums collected. The difference in pricing reflects the level of guarantees provided by the life insurance company, or the risks assumed by the policyholder.

Actuaries may be perceived by the general public as being boring, risk-averse, "bean counters". But in reality, they are ruthless business analysts. While the marketplace may clamor for the equivalent of an affordable guaranteed lifetime term insurance policy, actuaries cannot allow consumer sentiment to override their statistical evidence. If the math doesn't work, neither will the life insurance. Thus, Bannen notes that a NLG-UL policy may likely include higher mortality charges and expense loads, and less-favorable crediting rates for of interest. But these additional costs "are not evil or nefarious; they simply reflect the fact that the guarantee has value, and features with value cost money."

### The key is the guaranteed death benefit

The emergence of NLG-UL represents a growing acknowledgement of the financial value of **keeping life insurance in-force until death**. Where term life insurance emphasizes paying the lowest price for what is perceived as a temporary need, whole life insurance advocates often focus on the tax-favored accumulation advantages, and universal life straddles the difference. NLG-UL recognizes the financial value of securing a guaranteed financial transaction to be delivered **at the end of one's life**.

The reasons for keeping life insurance in force until death could be many and varied, from estate preservation and inheritance to long-term care supplementation or

pension maximization. But the key factor is obtaining insurance that will eventually result in the payment of a death claim. All three policy types (whole, universal and NLG-UL) offer the expectation that the life insurance will remain in force until death. And when factors such as the time value of money and true cost of insurance are calculated, it could be argued the costs and benefits are substantially the same for all three types of life insurance.

**But if the objective is guaranteeing that the policy will remain in-force for one's entire life, the strongest guarantees (albeit with the higher initial premiums) are found in a whole life contract. Further, if the whole life policy outperforms its guarantees, the payment options may become more flexible as time passes.**

## Outside-the-box IRA idea #1: SHOULD YOUR IRA TAKE AN "EARLY RETIREMENT?"

IRA, the acronym for Individual Retirement Account, is the most basic of all the tax-deferred retirement plans authorized by the U.S. Government. Similar to other tax-deferred plans, like 401(k)s and TSAs, deposits to an IRA account can be tax-deductible – no tax is incurred before the deposit is made. Deposits also grow tax-deferred; only when money is withdrawn from the account at a later date is tax due.

The government-authorized tax break on deposits is a direct incentive to encourage retirement saving.

However, along with the "carrot" of tax-deferral, there is also a "stick." If distributions are taken from an IRA or similar tax-favored account prior to the minimum retirement age (which the IRS has established as 59½), not only is income tax due on the distribution, but a 10% penalty tax is also applied. This restriction is designed to keep the money "on ice" until retirement, and not spent earlier. So while the tax-deferral may be a positive, changing your mind and deciding not to wait until retirement to use the money can be costly.

There are several exceptions to the 10% early distribution penalty. Most fall under the category of hardships or special circumstances, such as:

- ◆ Disability or death of the participant.
- ◆ Qualified first-time home purchase (\$10,000 per person).
- ◆ Qualified educational expenses.
- ◆ Medical expenses greater than 7.5% of adjusted gross income.
- ◆ Payment of health insurance premiums if collecting unemployment compensation for at least six weeks.

Under these conditions, withdrawals from the IRA prior to age 59 ½ are taxable, but not subject to a 10% penalty.

In addition, many individuals are not aware of another pre-59½ penalty-free distribution option. Authorized under Internal Revenue Code: IRC Section 72(t). This allows individuals to access their IRA accounts penalty-

free *at any time* if the withdrawals are taken as "a series of substantially equal periodic payments over the life of the participant."

In other words, if you begin drawing a regular retirement income from your IRA there is no penalty. You could be 25 years old and start drawing a retirement income from your IRA! And while the income received would be taxable, no additional penalty would be applied.

In order to be considered "substantially equal periodic payments," the distributions must meet the following criteria:

- ◆ Withdrawals must be on a regular basis, most often monthly, and at least annually.
- ◆ Withdrawals must conform to one of three IRS-approved calculation methods.
- ◆ Withdrawals must continue for at least five years or until you reach 59 ½, whichever is longer.

(Note: Because this is an IRS regulation, it's no surprise to learn that there are some convoluted calculations required to be sure this "early retirement income" conforms to the law. So please, do not attempt a distribution of this type unless you receive some expert assistance.)



### Why would anyone want to take an early retirement from an IRA?

An IRA is a legitimate method of saving for retirement; it encourages you NOT to touch the money, so it will still be there.

As certain types of manufacturing and service work have migrated overseas, a growing number of individuals are finding themselves in "temporary early retirement," (i.e., they are younger than 59½ and not working). For many, a large portion of their savings may be held in their ex-employer's retirement plan. Instead of taking a lump-sum distribution from this account (and incurring the above-mentioned 10% penalty), here's a possible scenario using the 72(t) rules.

After transferring the funds to an IRA from your ex-employer's retirement plan, you could begin taking a distribution from the IRA, if only to provide supplemental income while temporarily unemployed, or beginning new employment at a lower salary. Should your income level eventually return or exceed its previous level, you will still have to continue the IRA distributions, but you may also be able to redirect this income back into a retirement account with your new employer.

But beyond the economic necessity, there may be other creative and financially advantageous reasons to begin taking an early retirement income from an IRA. Here's a practical example:

Suppose you have \$25,000 in an IRA. You decide you'd like to buy a newer, larger home, but the newer, larger payment (\$200 more each month) would be a strain on your budget. To make the purchase possible, you could elect to receive \$200 each month from the IRA, or \$2,400

for the year (*this assumes the \$200 falls within the IRS' allowed formula for your age and situation*).

The payment from the IRA would allow you to live in a newer home, essentially with no change in your monthly expenses. At the end of the year, you will have \$2,400 more income to report as a result of taking the retirement income early. But...

For many individuals, the income may largely be offset by the tax deduction you would receive on the additional mortgage interest that was paid in the early years of the mortgage. Because the extra money was used for a tax-deductible item, the transaction is a wash from a tax standpoint – more taxable income, but also more tax deductions. Your advantage: You have a better home, both for your family right now, and as an investment for the future.

Or course, by spending some of the IRA now, you lose the growth that could have occurred if the money had stayed in the account. But in this example, the IRA distributions are being used to build equity in the new home, which can also be considered an asset. *The value is still accumulating, only it's in home equity instead of the IRA.*

Not only could your IRA be used to assist in buying a new house right now, but a variation on the same strategy could also be used to get additional equity out of the house. Let's assume you own your home, worth \$150,000, free and clear. Additionally, you have \$50,000 in an IRA.

You would like to pursue a business opportunity that requires a \$50,000 lump-sum investment. Drawing directly from the IRA would generate negative tax consequences, because \$50,000 of additional income would not only be taxable, but might even bump you into a higher marginal tax bracket. Plus the 10% penalty would apply. Depending on your financial circumstance, it is quite likely, the cost for using the \$50,000 from the IRA could easily be 40% in taxes, or \$20,000. That's a pretty steep price for access to your money. So let's consider a different approach.

Taking a new \$50,000 mortgage on the home for 30 years at 7% puts money in your hands on a tax-free basis, because the funds are received as a loan. To keep this loan from becoming an additional drain on cash flow, the mortgage payments will be made by taking a retirement income from the IRA. Again, the deduction on loan interest may offset some of the tax cost of this distribution.

At first, this might seem like a lot of maneuvering. But consider what is accomplished: The \$50,000 acquired by using a mortgage comes with no immediate cost, other than the fees to execute the loan. Unlike the IRA example, it won't cost \$20,000 in taxes to take receipt of \$50,000. There is an ongoing 7% cost for the loan, but if the interest is deductible (very likely) this cost is reduced further. By taking the IRA distributions as "substantially equal periodic payments" over the course of the mortgage, no tax penalty occurs. Even better, the amount of additional taxable income probably won't result in pushing you into a higher tax bracket. And the mortgage obligation is collateralized by the IRA, so there's no increase in

financial risk.

The two previous examples illustrate how repositioning assets can make them "spend better," that is, the cost of using the assets is either decreased or eliminated. In both cases, **coordinating other assets with the IRA** (in these examples, the asset is home equity) **creates an efficiency that is greater than using the assets separately.**

Again, the calculations and procedures for properly accessing an early retirement income are complex. Furthermore, the effectiveness of these "early distribution" strategies hinge on what other assets are available as well as your tax status. In the words of Evel Knievel, "Kids, don't try this at home!" Call our office to discuss this and other ideas, and check with your tax advisor. Get expert assistance.

## **Outside-the-box IRA idea #2: Give it to charity (at least until December 31, 2007)**

One of the ironies of investing in an IRA or similar plan is the tax format that induced you to make deposits for retirement may also discourage you from withdrawing the money in retirement.

For a variety of reasons (such as ongoing income, generous pension checks, other profitable investments, decreased deductions, etc.) some individuals may face substantial tax consequences when making a withdrawal from their IRA, even after age 59½. Especially if the money isn't needed, the thought of paying upwards of 30% in taxes is often motivation to simply forgo withdrawals and allow the IRA to continue accumulating tax-free.

Of course, distributions can't be delayed indefinitely. At age 70½, the law requires mandatory minimum distributions, and taxes must be paid.

But for the rest of 2007 (and perhaps longer, if proposed legislation is approved), there's another option: Rolling over some or all of the IRA to charity. Introduced as part of the Pension Protection Act of August 2006, the charitable IRA rollover allows people 70½ or older to transfer up to \$100,000 a year from their IRAs to charities.

According to an article, "*Charities Love IRA Rollover,*" by Arden Dale in the January 27/28, 2007 *Wall Street Journal*, at least \$25 million has been given through rollovers since the legislation became effective. Harvard University reports receiving 11 rollovers for the \$100,000 maximum amount. Based on the response, charitable organizations have been pushing Congress hard to make the rollovers permanent and expand or remove contribution limits.

The charitable rollover concept is attractive for several reasons. While many wealthy individuals may specify bequests to charities from their estate, the rollover allows the donor to give large amounts while they are still alive.

And while the money was initially intended to be for retirement, if the IRA holder doesn't need or want the money for personal consumption, a rollover provides a way for the accumulation to be applied at maximum value, because the charity incurs no tax when it taps the funds.



## Wealthiest Individuals - The Latest Forbes Rankings

Every year Forbes magazine publishes a list of the richest people in the world, based on estimations of their net worth. It's no surprise that Bill Gates continues to lead the list, as he has for the past 13 years. And Warren Buffet is once again listed as No. 2, but several other names are closing the gap between the two front runners. Here's a summary of the top 10.

Rank	Name	Citizenship	Source	Industry	Net Worth
1	William Gates III	United States	Microsoft	Software	\$56.0 bil
2	Warren Buffet	United States	Berkshire-Hathaway	Investments	52.0 bil
3	Carlos Slim Helu	Mexico	Telecom	Communications	49.0 bil
4	Ingvar Kamprad family	Sweden	Ikea	Retailing	33.0 bil
5	Lakshmi Mittal	India	Steel	Manufacturing	32.0 bil
6	Sheldon Adelson	United States	Casinos, hotels	Leisure	26.5 bil
7	Bernard Arnault	France	LVMH	Diversified	26.0 bil
8	Amancio Ortega	Spain	Zara	Apparel	24.0 bil
9	Li Ka-shing	Hong Kong	Diversified	Diversified	23.0 bil
10	David Thomson family	Canada	Inheritance	Media/entertainment	22.0 bil

Some other items of interest:

- Of the top 10 richest individuals, Forbes describes the fortunes of seven of them as "self-made" – they started from scratch, and their entire fortune has been accumulated in their lifetime.
- While most of those in the top 10 are in their 60s and 70s, Mr. Gates (whose fortune is self-made) is only 51, and has been the richest man in the world since his late 30s.
- Inherited wealth has staying power as well. If the net worth of each of retailer Sam Walton's five heirs were combined, it would exceed Mr. Gate's net worth by almost 60 percent.
- Besides Mr. Buffet, only six other individuals in the top 100 have made their fortune through stock market investment. The vast majority of those on the list are owners or large and diversified businesses.

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## Wealth Maximization Strategies

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