CREATIVE
Wealth Maximization
Strategies

Certified Financial Services
600 Parsippany Road, Suite 200
Parsippany, NJ 07054

Richard Aronwald
raronwald@cfsllc.com

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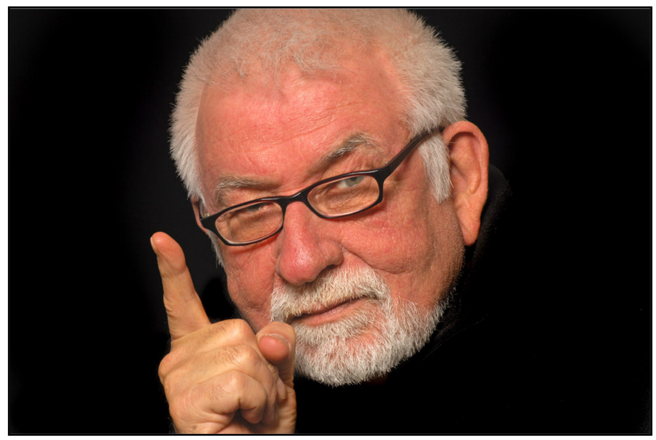
THE PATERNAL 401(k):
IS AUTOMATIC ENROLLMENT "*FOR YOUR OWN GOOD*?"

"Ask a 5-year-old if he wants zucchini with his dinner, and he'll probably produce retching sounds loud enough to startle the neighbors and scare the dog. But quietly put some zucchini on his plate, and he may take a bite or two.

It appears the same approach works with grown-ups who are eligible for their employers' 401(k) plan. When asked if they'd like to enroll in a plan, many workers say they're not interested. But when companies sign them up automatically, most stick with the program."

Sandra Block, *USA Today*, June 20, 2005.



"It's for your own good."

(Uh oh.)

When you were a kid, that phrase meant you were about to be forced to do something you didn't really want to do. But being adults, your parents (or grandparents, or teachers or coaches) knew better than you, and usually they had your best interest at heart. It was their job to look out for you, and sometimes that meant making decisions for you, because you weren't responsible enough to make the right choice on your own.

Concerned about the abysmal saving habits of the average American, a group of well-intentioned "financial parents" has decided to pursue "benevolent" legislation for American employees. Since so few seem to do so of their own initiative, this new approach aims to gently tell American workers to save.

In a move long advocated by some financial experts (those "financial parents" who know more than you), Congress appears poised to present new pension and retirement plan regulations that would mandate automatic enrollment for employees in their company's 401(k). The details (including the start date for implementation) aren't finalized -- since the House and Senate versions of the bill also either attach or delete some tax deductions -- but here's an overview of the "auto enrollment" features that have been proposed as part of H.R. 2830:

- <u>Automatic Deferral and Increase</u>. Unless an employee opts out, the employee is treated as having elected to defer at least 3% of compensation in the first year, increasing by one percent per year until total annual contributions reach a minimum of 6%. Contributions would be capped at 10% of annual income.
- <u>Matching Contribution.</u> Under the plan, an employer must match 50% of each employee's contribution up to 7% of total compensation. Alternatively, employers may contribute 3% of pay for all employees regardless of whether 401(k) contributions were made on the employee's behalf. All employer contributions must vest completely within two years.
- <u>Notice Requirement.</u> Employers are required to provide a notice to employees informing them of the right not to participate in the plan or to elect to have contributions made in a different amount. The notice must also explain how employee contributions will be invested in the event the employee does not make an investment election.

In the words of Jim O'Connell, a vice president at Ceridian Corporation, H.R. 2830 "would dramatically alter America's defined contribution retirement plan system by shifting participation and savings from employee *opt-in* to employee *opt-out.* (It) would change the 'default setting' for America's 401(k) system from employee nonparticipation to employee participation."

(continued...)

Why automatic enrollment? Because it works -- especially with "children"

Automatic enrollment is already in existence for many employees. Citing a 2006 Hewitt Associates study, Mary Brandel, writing for Veritude Strategic Human Resources, notes that "23% of large 401(k) plans have adopted auto enrollment, and 20% of large employers say they are very likely to add automatic features to their plans by year's end."

Does automatic enrollment boost 401(k) participation? According to a June 2006 update from Ceridian Corporation, one fourth of eligible employees do not participate in their employer's 401(k), and of those that do participate, only 8% contribute the maximum amount allowed. In contrast, Fidelity (a strong advocate of auto enrollment) reports 80% participation in plans where default enrollment is the rule.

Some research seems to indicate that automatic enrollment is especially helpful for low-income employees. A survey conducted by the Employee Benefits Research Institute (EBRI) found that only 23% of low-income employees participate in their retirement plan when they have to enroll themselves, but with auto-enrollment the number jumps to 52%.

"If you don't start them in the plan immediately, they don't think they have enough money, but if you start them right away, they tend to stay in," says Jack VanDerhei, a Temple University professor who serves as a consultant for EBRI.

In fact, VanDerhei, (who is apparently a very influential "financial parent" when it comes to advocating automatic enrollment) would make the automatic features of a 401(k) even broader. In a May 2006 interview for PBS's *Frontline*, VanDerhei opined that plans should provide age-appropriate default investment options, mandate that a portion of the retirement distribution be annuitized to guarantee the participants a monthly income for life, and impose stricter penalties for pulling monies out of the plan (because even after they put money in the plan, "kids" are immature, and are inclined to break into the piggy bank early). "Increased tax penalties, maybe even restrictions on pulling the money out, I think would go a long way to curbing the leakage problem" with 401(k)s, says VanDerhei.

<u>Question:</u> Is automatic 401(k) enrollment a good thing?

How you answer depends on the perspective from which you view the question.

<u>Answer #1:</u> Yes! Automatic enrollment addresses a natural tendency in human nature to procrastinate. Given the option, most people will avoid the stress and hassle of implementing change. For many, even the simplest paperwork procedures – to save for retirement, receive a consumer rebate, register for a warranty, etc. – aren't completed unless there's a serious loss at stake. Otherwise, it's "I'm too busy right now," or "I'll get to that next week." And nothing happens. Life goes on, and one day there's the awareness of "Gee, I should have taken care of that. Oh well."

Automatic enrollment turns the human tendency toward inertia into something positive. Instead of not starting something, automatic enrollment means you are less likely to stop what has been started for you.

<u>Answer #2:</u> No! In theory, the net (after-tax) wages you receive from employment belongs to you, for you to use as you see fit in "life, liberty, and the pursuit of happiness." Any arrangement, no matter how well-intentioned, that makes it harder for you to receive those funds could be construed as an unnecessary restriction on your individual freedom.

Most automatic enrollment advocates dismiss the personal freedom issue by saying the problem of under-saving Americans is so dire that individual liberties must be sacrificed. As Clark Howard, a nationally syndicated talk show host says, "some may see (automatic enrollment) as an infringement on personal liberties, but something needs to change if we want to prevent people from ending up in poverty in an old age." The title of the October 2, 2005 entry in the BrothersJudd blog about auto enrollment reads "The Key to Choice Is Not Letting Folks Make Many." In other words, it's for our own good.

But if one of the arguments for automatic enrollment is that too many Americans are childish financially, it's hard to see how this regulation is going to make people "grow up." Restricting personal freedoms has a tendency to also inhibit any development of personal responsibility, not encourage it. It is true that given greater freedom some people will make mistakes, but in the long run, experience proves to be a great teacher, and most people don't make the same mistakes over and over, they learn from them.

Additionally, automatic enrollment puts greater financial and reporting obligations on the employer. Certain provisions in the proposed legislation do provide greater liability protection for companies, but Edward Hayes, in a May 30, 2006 *CCH Wall Street* article, writes the new regulations "would likely mean new headaches for compliance officers at financial services firms who have to handle the automatic transfer of funds and keep records of those transfers." During the recent economic downturn, many employers decreased or eliminated their matching contributions, but kept the plan open for employee contributions. Under the new legislation, employer contributions would be mandatory. Automatic enrollment puts employers in a position of financial babysitters.

<u>Answer #3:</u> Maybe, well…not really sure! Even if automatic enrollment works, and even if you don't see this as an infringement on individual choice, what makes the 401(k) the best program?

In reality, many of the financial problems experienced by the average American are inter-related. The issue isn't just saving for retirement. It's paying for college, affording a home, dealing with debt – most people just don't have enough money to handle all their obligations or meet all their desires.

But governmental responses, while well-intentioned, tend to make it harder to develop an integrated response to these financial challenges. Each issue has its own government-mandated solution, and the only way to cover everything is to put money in every program. Struggling with retirement? Here's a 401(k)/IRA/SEP. College funding? Try an UGMA/UTMA, 529 or Coverdell. Medical costs? Don't forget FSAs and HSAs.

Michael Burrill, of Burrill Insurance and Financial Services of Auburn, Ca. likens this financial approach to a series of boxes. There's a box for cars, another for retirement/401(k)s, and others for credit cards, equity loans, college saving, etc. The problem? According to Burrill, "the economic law of scarcity dictates that money supply runs out before all the boxes can be filled. This forces impossible guesses. Which 'box' is most important? That can only be known *after* things happen."

Following that line of reasoning, is it reasonable to assume the 401(k) box the most important one? Some experts may declare "contributing to your company 401(k) is universally considered a good investment" (BrothersJudd, October 2005); others have their doubts.

In the same PBS *Frontline* interview with Jack VanDerhei, Brooks Hamilton, a benefits consultant with Brooks Hamilton & Partners, was less enthusiastic about 401(k)s as the solution to American saving problems:

"I regret the fact that our retirement income strategy in major companies is the 401(k), because I think it may be fatally flawed. I know it's flawed; it's either fixable or it's not, and I won't pass judgment on that. I know there's a growing number of people who feel it's not fixable…I look back and think, how many people are going to be worse off because their pension benefit is gone and they now have a 401(k)?"

The *Frontline* panel expressed concern over the way management/regulatory costs and investment fees erode returns. Elizabeth Warren, a Harvard Law School professor, also noted that the 401(k) is a "best-case" scenario program "that can be good news in a rising stock market. That can be good news if you don't get really sick when you get old. That can be good news if you don't live very long after you retire. But all of those risks (rest) on each individual worker."

Considering all the other financial risks that may be left uncovered, is it really good policy to make retirement saving the default option in every employee's financial life?

<u>Answer #4:</u> If I'm an "Adult," what difference does it make? Do "financial adults" still need to be treated like children? After all, if you're one of the people who has taken the time to develop a financial program, coordinated your saving, borrowing and benefits, and determined you have better alternatives than automatic enrollment in a 401(k), you've probably already taken the initiative to pick up the paperwork to opt out. For you, the automatic enrollment discussion is moot, because you aren't someone who needs the "it's-for-your-own-good" discipline.

However, there may be a nugget of wisdom for the financial adults as well: Combined with the appropriate financial program, automatic enrollment is a great way to make your financial life easier. When a percentage of every paycheck is directly deposited to a separate "wealth account," that's automatic enrollment. When you authorize insurance premiums to be withdrawn from your bank account each month, it's a form of automatic enrollment. The difference is ***you*** have selected the program (and the advisory team to help you with it), instead of the government or an employer placing you in a default program.

The automatic enrollment issue might get a lot of play in the financial press, but for readers of this newsletter, it may be background noise – something to be aware of, but not something to act on. As long as you are taking responsibility for your financial well-being – i.e., you are a financial adult – you don't need a bureaucratic financial parent pushing you to make saving in a 401(k) a priority.

THINGS THAT MAKE YOU GO "HMMM…"

A Solution for Social Security, Medicare and Medicaid:

Everyone gets an annual check, but no one gets any benefits

You might get one or two people to disagree (just because it's almost impossible to get everyone to agree on anything), but most Americans know Social Security, Medicare and Medicaid programs face a troubled financial future. Without massive tax increases, there just isn't going to be enough money to support the promised benefits. And while the prospect of financial catastrophe has induced a lot of hand-wringing, there hasn't been a fundamental change in the system. Not having a workable plan, Congress just sits, reluctant to antagonize its senior citizen constituents, hoping for a silver bullet.

Well, Charles Murray just might be the Lone Ranger.

Charles Murray is the current W.B. Brady scholar at the American Enterprise Institute, a conservative private, non-partisan, not-for-profit institution. He is also the author of the book "*In Our Hands: A Plan to Replace the Welfare State,*" published in March, 2006. In his book, Murray offers a unique, way-outside-the-box solution for avoiding the financial train wreck that looms for Social Security, Medicare and other government-sponsored entitlement programs.

Here's an overview of Murray's solution, currently nicknamed "the Plan:"

> Everyone over the age of 21 (who is not incarcerated) would get a $10,000/year grant from the government – for life. A government agency would authorize electronic deposits, made on a monthly basis, to approved bank accounts. Once a person's annual income reaches $25,000/year, a surtax would be levied to reduce the amount of the grant.
>
> To pay for the grants, the Plan would eliminate all other government transfer payments (i.e., programs benefiting some citizens but not others). Social Security, Medicare, Medicaid, welfare programs, social service programs, agricultural programs, "corporate welfare," – the works – would all be terminated.
>
> In Murray's vision, a portion of the $10,000 must be used by recipients to buy health insurance and establish a retirement fund. After that, the remainder of the grant can be used at the individual's discretion.

That's it.

Murray insists this scheme is possible. The $10,000 number is an estimate, but after thorough study, he's convinced the math works. The initial cost to change might be steep, but eventually the savings would far exceed the costs of continuing with the current system. "We're rich enough to do it," he says.

For some critics, the problem isn't the math. It's the freedom; the fear of irresponsible people wasting the grant money, then left without a safety net. But Murray believes a different dynamic will take hold when government steps out of the picture. In a March 22, *Wall Street Journal* Opinion essay, Murray stated:

> *Throughout history until a few decades ago, the meaning of life for almost everyone was linked to the*

challenge of simple survival. Staying alive required being a contributing part of a community. Staying alive required forming a family and having children to care for you in your old age. The knowledge that sudden death could happen at any moment required attention to spiritual things. Doing all those things provided deep satisfactions that went beyond survival.

It is Murray's position that putting the money back in our hands, instead of government's, will help re-affirm human communities by making each person individually responsible, yet also more reliant on other individuals with whom he/she has a personal connection. "Some will see this as a step backward," he writes, "thinking it is better to pay one's taxes, give responsibility to the government and be done with it." But if we want our children to "embrace social virtues, we need to give them practical opportunities." This happens when "human needs are not consigned to bureaucracies downtown, but are part of life around us, met by people around us."

Most of Murray's book is devoted to explaining how these no-strings-attached grants could effectively address social issues such as poverty, education, family stability and childcare and community development by encouraging people to work together.

*Hmmm…*Murray says the Plan poses this question: "assuming the technical questions have answers, do we want a system in which the government divests itself of responsibility for the human needs that gave rise to the welfare state in the first place?" In other words, do we want to take care of ourselves?

News Digest

(Snippets from stuff we've read, including differing points of view, not all of which we agree with. Want to know more? Give us a call and we can provide you with the complete article.)

SQUEEZED BY RISING PRICES, MANY CONSUMERS FIND 'HOUSE BANK' IS EMPTY

Rising interest rates and higher gasoline prices are putting the squeeze on consumers' budgets, and many are finding it harder to keep up with their bills.

An important measure of consumer financial distress, late payments on credit cards, ticked up in the first quarter, according to figures from the American Bankers Association. The Washington, D.C. based trade group said the percentage of bank cards 30 days or more past due increased to 4.40% in the January-March quarter from 4.27% in the final quarter of 2005.

Catherine Williams, a credit expert with Money Management International, a Houston-based financial counseling and education agency, said rising costs for gasoline and utilities were only part of the explanation for rising credit card delinquencies and increased consumer financial stress.

"People refinanced (their mortgages) six months or a year ago, so the 'house bank' is empty," Williams said. "Most can't go back and tap their home equity again."

Associated Press, July 3, 2006.

SURVEY SAYS RETIREMENT IS JUST A DREAM

While many Americans have dreams of retiring as millionaires, many are on a path that stops well short of that goal. According to USAA's recent "Money Snapshot" survey, conducted by Harris Interactive, 51% of employed U.S. adults who are not retired say they want to save $1 million or more for retirement, but close to one-third (30%) haven't set aside anything for their golden years. Only about one-fourth (26%) have saved more than $50,000.

"Americans are living the 'dream" – literally they're dreaming," said June Walbert a Certified Financial Planner with USAA. "They hope to save a lot of money for retirement, but many haven't saved even one dollar yet. The survey suggests Americans of all ages aren't making the right money management decisions that will help them save for retirement."

Business Wire, June 15, 2006.

OBESITY AMONG YOUNGER AMERICANS PUTS MORE ON DISABILITY

While older Americans are remaining fit longer, their children and grandchildren are becoming disabled sooner because of health problems related to obesity.

Researchers are already seeing an increase in the percentage of disabled young workers. If current trends continue, the numbers are expected to rise significantly, especially as these individuals reach their fifties and sixties.

"Even though the elderly are getting healthy, the young are getting more disabled," said Darius Lakdawalia, an economist at Rand Corp., a public- and private-sector think tank based in Santa Monica, Calif. He found that disability rates for people ages 30 to 59 have increased, especially among 30- to 39-year olds. That rate more than doubled between 1984 and 1996 across all demographic and economic groups.

Julian Mincer, *Wall Street Journal*, May 24, 2006.

RETIREES NEED $295K JUST FOR MEDICAL EXPENSES

A couple aged 65 retiring today and living to average life expectancy would need $295,000 to cover premiums for health insurance and out-of-pocket expenses during retirement, according to a study published today by the nonpartisan Employee Benefit Research Institute (EBRI).

The $295,000 estimate assumes average life expectancy of 82 for men and 85 for women. But for those living longer than the average, a lot more money is needed: If the couple lives to age 95, they would need $550,000 to cover premiums and out-of-pocket expenses. Both estimates are for retirees who have access to retiree health benefits from a former employer but pay the full premium.

"As high as they are, these projections are probably underestimating the amount of money needed in retirement for health care expenses," writes Paul Fronstin, director of the EBRI health research and education program. "If health care costs increase faster than projected, or if individuals live beyond average life expectancy, retirees will need more money."

U.S. Newswire, July 20, 2006.

BUY AND HOLD: GOOD STRATEGY FOR ACCUMULATION, NOT SO GOOD FOR DISTRIBUTION

Many Americans, especially those with retirement accounts, invest a portion of their long-term savings in the stock market, usually in the form of mutual funds. Statistically, this strategy has made sense for the past two decades, because the stock market has generally out-performed most other investment options.

Of course, these returns aren't guaranteed. Looking at the past five years, it's not uncommon to find some funds whose investment performance includes one or two down years. But the prevailing conventional wisdom states that it's not what happens in one year that makes or breaks your results. Rather, the idea is that staying invested in the market over the long-term tends to neutralize most of the risk, and in the end, provide higher returns. This is the essence of the "buy and hold" strategy. As long as the long-term average rate of annual return is acceptable, it's not necessary to fret so much over the performance in one particular year.

A simple mathematical example illustrates this approach:

Starting with $100,000 in a mutual fund, watch what happens when the investment results are mixed over a ten-year period (Figures 1 and 2). In the first example, the mutual-fund owner experiences three consecutive down years (a bear market) losing 5% each year. But the market rebounds, with years 4 through 7 earning 12% annually, and the return rising to 15% for the last three years.

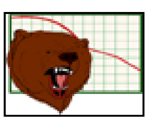


FIGURE 1*
"THE BEAR COMES FIRST"

YR	STARTING BALANCE	ANNUAL RETURN	ENDING BALANCE
1	$100,000	–5%	$ 95,000
2	95,000	– 5%	90,250
3	90,250	– 5%	85,738
4	85,738	+ 12%	96,026
5	96,026	+ 12%	107,549
6	107,549	+ 12%	120,455
7	120,455	+ 12%	134,910
8	134,910	+ 15%	155,146
9	155,146	+ 15%	178,418
10	178,418	+ 15%	**$205,181**

The result? The $100,000 has more than doubled, growing to over $205,000. This represents an average annual rate of return of approximately 7.5%.

The second example is just the reverse of the first. The bull market years come first, starting with three years of 15% annual returns, followed by four years at 12%, and the negative years come at the end. Check out Figure 2…

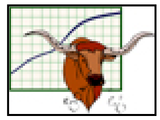


FIGURE 2*
"THE BULL LEADS OFF"

YR	STARTING BALANCE	ANNUAL RETURN	ENDING BALANCE
1	$100,000	+15%	$115,000
2	115,000	+ 15%	132,250
3	132,250	+15%	152,088
4	152,088	+ 12%	170,388
5	170,388	+ 12%	190,779
6	190,779	+ 12%	213,672
7	213,672	+ 12%	239,313
8	239,313	– 5%	227,347
9	227,347	– 5%	215,980
10	215,980	– 5%	**$205,181**

The accumulation results are the same for both situations. This is a key concept: While you are accumulating, the timing of the downturns in the market isn't critical. It's the long-term average return that counts.

But it's a different story when you decide to start withdrawing the money. Suppose you decide to withdraw $10,000 each year from the $100,000 starting amount. Now whether you retire into a bear or bull stock market makes a big difference! Here's the math:

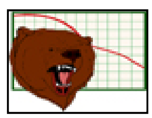


FIGURE 3*
RETIRING INTO THE BEAR

YR	STARTING BALANCE *	ANNUAL RETURN	ENDING BALANCE
1	$100,000	–5%	$85,500
2	85,500	– 5%	71,725
3	71,725	– 5%	58,639
4	58,639	+ 12%	54,475
5	54,475	+ 12%	49,812
6	49,812	+ 12%	44,950
7	44,950	+ 12%	38,741
8	38,741	+ 15%	33,052
9	33,052	+ 15%	26,510
10	26,510	+ 15%	**$18,986**

**includes withdrawing $10,000 a year at the beginning of each year.*

Ow! At this rate, you are two years away from going broke. Now compare the results of withdrawing at the start of a series of good years:

(continued…)

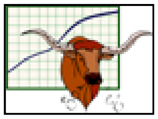


FIGURE 4*
DRAWING FROM THE BULL

YR	STARTING BALANCE *	ANNUAL RETURN	ENDING BALANCE
1	$100,000	+ 15%	$103,500
2	103,500	+ 15%	107,525
3	107,525	+ 15%	112,154
4	112,154	+ 12%	114,412
5	114,412	+ 12%	116,942
6	116,942	+ 12%	119,775
7	119,775	+ 12%	122,948
8	122,948	– 5%	107,300
9	107,300	– 5%	92,435
10	92,435	– 5%	**$78,313**

**includes withdrawing $10,000 a year at the beginning of each year.*

With a little more than $78,000 left, you would probably have to adjust your financial plans, but the remaining balance is four times greater than the $18,000 left in Figure 3!

This is a mathematical exercise. It doesn't take into account real-world factors that could make the results different than those generated by simple math. But there are some conclusions that can be drawn from the math, even if it's simple.

1. ***Accumulation and spending are not the same***, and probably shouldn't use the same strategy. Buy and hold may not work in retirement.
2. ***Avoiding loss has greater significance in retirement***. Each losing year hurts, because you don't have the time to catch up for the loss.
3. ***Mathematically projecting future returns from past performance is a risky proposition***, especially if the projection uses a flat rate of return each year. It makes a difference in retirement if the bad years come first.

The financial planning industry has responded to this accumulation-vs.-distribution issue with more sophisticated computer models that create historical "probability scenarios" that reflect the possibility of retiring into a bear market. Now, instead of providing a retirement income projection based on an average annual rate of return, the computer delivers a probability percentage – i.e., if the retiree withdraws a certain amount, the probability of still having money at a date in the future is 40%, while the probability of going broke is 12%, etc.

But while the probability approach is "less wrong" than projecting with a simple number, it's still not right. The probability assessment comes from past numbers. Future performance may be outside the range of previous performance, both positively and negatively. If that happens, the probabilities will be wrong.

In light of these realities, there are several practical alternatives:

a. Make year-by-year assessments regarding withdrawals.
b. Guarantee withdrawals by annuitizing some of the funds.
c. Emphasize capital preservation, since losses hurt more in the distribution phase.

*Figures quoted are for illustrative purposes only and are not indicative of a specific result that may be obtained on any particular investment. They do not include consideration of the time value of money, inflation, and fluctuation in principal or in many instances, taxes.

"The majority of men meet with failure because of their lack of persistence in creating new plans to take the place of those which fail."

- - Napoleon Hill

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Richard Aronwald

raronwald@cfsllc.com

600 Parsippany Road, Suite 200
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