

# CREATIVE

## Wealth Maximization Strategies

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## Is Someone Serving as Your “Financial Co-Pilot?”

Richard H. Thaler and Cass R. Sunstein are co-authors of the 2008 book “Nudge,” a best-seller about how behavioral science research can be used to improve “decisions about health, wealth and happiness.” One of the central philosophies in this improved decision-making process is encouraging governments to use their regulatory authority to “nudge” individuals toward making the “right” decisions. Thaler and Sunstein characterize this philosophy as “libertarian paternalism,” i.e., you can still do what you want, but the “easier” choice is to do what’s best for you.

A great example of this philosophy is the 2006 law that permits the automatic enrollment of new employees in the company’s 401(k) plan. Instead of asking new hires if they want to defer a portion of their earnings in a retirement plan, participation is the *default option* – all new employees are automatically enrolled unless they specifically initiate a request to opt out.

In the five years since this provision was enacted, 401(k) participation has increased significantly. According to Rebecca Lewis in a July 11, 2011, article for *AOL Daily Finance*, 57% of large companies now have automatic enrollment, the participation rate is 85%, and overall retirement saving is up. Based on those numbers, it seems the “nudge” of automatic enrollment has been a rousing success.

But there’s also an economic adage known as the Law of Unintended Consequences, which states that “intervention in a complex system always creates unanticipated and often undesirable outcomes.” So, even something that seems as simple as automatic enrollment in a retirement plan may trigger some unusual responses. Still, it would have been hard to imagine this July 7, 2011, headline and opening sentence in the *Wall Street Journal*:

### 401(k) Law Suppresses Saving for Retirement

**“A 2006 law designed to boost employees’ retirement savings is having the opposite effect for some people.”**

What? How can a “nudge” to save more end up suppressing it?

Here’s the scoop: According to research on the retirement saving patterns of over 20 million 401(k) participants compiled by the Employee Benefit Research Institute (EBRI), **“Forty percent of new hires at companies with automatic enrollments are socking away less money than they would if left to enroll voluntarily.”** Approximately two-thirds of companies with automatic enrollment set the contribution amount at 3% of salary or less. While many individuals might be able to save a higher percentage, the “nudge” to contribute 3% makes it easier to accept the default amount. The EBRI survey information is confirmed by data from several large mutual fund companies who report more 401(k) participants, but smaller average contributions. In the *WSJ* article, one of the companies, Vanguard, estimated that half of the decline in contributions “was attributable to increased adoption of auto-enrollment.”

From a paternalist perspective, this unintended consequence of automatic enrollment appears easy to solve: just raise the default contribution rate, right? But as Lewis notes in

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her *Daily Finance* article, “if the assigned rate is too high, the propensity to opt out increases.” The auto-enrollment nudge is actually a Catch-22 proposition. Set the automatic enrollment rate too low, and some people will under-contribute. Set the rate too high, and a greater number of people won’t even participate – a definite nudge in the wrong direction.

Ultimately, the underlying lesson here is that while government-authorized “nudges” may help some people save more money, there is no simple formula to ensure universally positive financial outcomes for everyone. Referring to the Law of Unintended Consequences, personal finances are a “complex system.” Each person has a unique set of interconnected financial issues and opportunities. The only way for an individual to maximize their unique financial potential is by taking personal responsibility. This means establishing a comprehensive financial program that is geared to their unique circumstances and aspirations, then monitoring progress and making adjustments. No matter how many well-intentioned external nudges are in place, financial success can never come from a simplistic “automatic” process.

### Three Steps in the Right Direction

Suppose you want your financial program to be more than a series of knee-jerk responses to institutional nudges and external events. Here are three practical observations about taking charge of your financial future.

**1. You can never “set-it-and-forget-it.”** While many strategies and guidelines may be useful, there are no “auto-pilot” programs. A successful financial future isn’t the result of a one-time planning session that never needs to be monitored or changed. For your individual financial program to deliver the results you want, regular reviews and adjustments are a necessity. For many individuals, devoting regular attention to reviews and adjustments is their greatest financial management challenge. Momentary crises keep them from assessing their progress or setbacks.

Furthermore, many aspects of your personal finances cannot be solved with simple approaches. “Insider secrets” and “fail-proof” strategies touted in mass mailers are marketing ploys, not real solutions. It makes no sense to believe that an investment strategy that apportions stocks and bonds based on your age is going to succeed, or that the best predictor of the stock market’s future direction can be determined by which team wins the Super Bowl – even if there is statistical evidence to “prove” it. These “simple” solutions just don’t reflect the complexity of your financial system. The reality is that sometimes the only true solutions are complex, and this may require you to learn new things.

**2. You need professional assistance.** Make a short list of the typical components in personal finance: just to start, there’s taxation, insurance, investment allocation, borrowing, legal documents. Each of those categories is so diverse and detailed it has its own professional field. Is it reasonable to expect that one person can serve as an

accountant, insurance agent, investment adviser, loan officer and attorney – in his/her spare time? No. **While some individuals may have the time and aptitude to make managing their money a full-time occupation, most people who make personal finance a do-it-yourself project will find it does them in.**

If you intend to maximize your financial potential, it is essential to obtain the expert services of competent financial professionals. Unfortunately, many individuals assemble their team of financial professionals by accident, often as a result of crises. While the people you find in an emergency may be more than capable, looking for a good accountant after you’ve received an audit notice is far from ideal. It’s better to get referrals and establish

relationships in advance.

**3. You can have a big crew, but only one co-pilot.** In ways large and small, the expertise and business interests of the team of financial professionals you work with will overlap. The attorney may also prepare tax returns, the life insurance agent might recommend a trust format, the loan officer could offer mortgage life insurance, etc. In order for your financial programs to perform maximally, it helps to determine if one of these financial professionals can serve as a coordinator for the diverse pieces of your finances.

Obviously, this individual should have a broad knowledge of the various financial instruments and issues that comprise your unique circumstances. But even more, this professional should also understand and be able to articulate the *philosophies* that inform your financial priorities. If your primary financial objective is leaving an inheritance to children and grandchildren, your co-pilot should be capable of assisting you in ensuring that all your professionals are working toward that goal.



Think about the three recommendations listed above. After some self-examination, answer these three questions.

- **Do you regularly review and adjust your financial assets?**
- **Have you selected a team of financial professionals to help you?**
- **Is someone serving as your “Financial Co-Pilot?”**

**IF YOUR FINANCIAL PROGRAMS NEED A REASSESSMENT OR A TUNE-UP, CONSIDER THIS YOUR “NUDGE” TO TAKE ACTION!**

**Most people who make personal finance a do-it-yourself project will find it “does them in.”**

## ACCREDITED INVESTOR STATUS: The Opportunity to Make (or Lose) a Lot of Money

A captivating aspect of capitalism is the variety of paths people take to make big money. The opportunities are endless, and the success stories are the stuff of legend. Here's a template that illustrates a typical up-from-nowhere American business success story:



**The American Dream, Part I:** Two friends hatch a great idea for a new business product. After fiddling in their home workshops for several years, they finally develop a working model, which confirms their initial hopes: This product works, and it works well enough to be “The Next Big Thing.” All that’s needed is to get their product out of their basement, and into the marketplace.

The partners agree to pool their savings, but their personal capital is just a drop in the bucket compared to what’s needed to acquire a factory, establish a distribution system, start a national ad campaign and hire professionals to manage the employees, money and legal requirements. As a start-up with no sales and no assets, lenders either refuse to extend credit or charge exorbitant interest. Without funding, their Next Big Thing remains just a great idea.

**The American Dream, Part II:** The partners realize they may need to take on some **financial partners**, people who will invest in the company in exchange for a share in ownership. In a carefully constructed agreement, the partners contract with an investment company broker to sell shares of the company to a select group of private investors, while retaining a controlling interest in the company.

Given life by this infusion of capital, The Next Big Thing hits the market. It is a resounding success. Two years later, the partners decide to go public, making some additional shares of the company available through an Initial Public Offering (IPO). The partners are instant millionaires. And the early investors, the ones who risked their money when no one else would, reap huge profits, either from dividends distributed to shareholders, or from the sale of their shares, at a substantial premium, after the IPO.

### Becoming Part of the Dream

Even in the anything-is-possible world of free enterprise, true innovation is pretty rare. Only a select few products or ideas really achieve breakthrough success. The majority of great ideas never make it. But what about being one of those plucky investors? How does someone have the chance to invest in The Next Big Thing when it is still just a great idea? Typically, you need to be an **accredited investor**.

An accredited investor is either an individual or organization permitted by United States securities law to invest in certain types of higher-risk investments, often broadly referred to as “private placements” or “private offerings.” These private offerings include investments such as seed money investments in start-up companies, limited partnerships, hedge funds, and angel investor networks. Accredited investors are typically wealthy individuals and

organizations (such as corporations, endowments, or retirement plans) that supposedly have the business savvy and financial resources to manage the high-risk nature of private placements (see the full definition of accredited investors in the box at the end of this article).

For every private offering investment that pays off with large profits, several others will never pan out. This is the nature of high-risk/high-opportunity investments. But the challenge of private offerings isn’t just the investment risk. Most private offerings are illiquid – once you’re invested, it can be almost impossible to sell your position and get your money out. In addition, some private offerings charge substantially higher management fees. Accredited investors are deemed wealthy enough to endure the potentially long holding periods, high fees, and/or absorb heavy investment losses.

By some estimates, almost half of all investment capital raised in the United States comes from private offerings. That’s a lot of financial opportunity concentrated in a relatively small number of investors. Recently, some thriving young companies made news by deciding to put off an IPO, and instead issue another round of shares through private offerings. This resulted in criticism that the “little guys,” such as middle-class investors and participants in employee retirement plans, were effectively being shut out of some of the most promising investments. Which prompts the question: should more people aspire to accredited investor status?

### Opportunity or Status Symbol?

While the prospect of out-sized returns is a definite attraction for accredited investors, a certain vanity factor is also in play. In a January 14, 2011, *New York Times* article by Paul Sullivan, “Private Stock Deals Are That Way for a Reason,” professor Meir Statman says being an accredited investor has the “attraction of status” similar to “hanging a Picasso in your house.” For some people, owning exclusive private placement investments is an indication of financial sophistication. And in a twisted way, declaring that you can afford large investment losses is an indication of how wealthy you are. For anyone eligible for private offerings, some self-examination is prudent, because risking a lot of money for a status upgrade rarely makes sense.

We are not recommending anything, and this is purely a mathematical exercise. That said, there are some reasonable financial arguments for private offerings in an accredited investor’s financial program. Suppose one investor attempts to achieve a total annual return of 8% on a \$1 million portfolio by investing 100% of his assets in a mixed basket of conservative, but non-guaranteed securities. Suppose another investor strives for the same result by allocating 96% of assets to a guaranteed account, then places the remaining 4% in a private offering. Some interesting comparisons might follow. For example...

**Which plan entails greater investment risk?** With a portfolio fully invested in non-guaranteed financial assets, 100% is at risk, and the balance at the end of the year could be higher or lower than \$1 million. In contrast, if the 96% placed in a guaranteed account earned 3% for the year, the minimum year-end balance would be at least \$988,800 –

even if the private placement proved to be a complete loss. From a potential loss perspective, some individuals might prefer the comfort of knowing the overwhelming portion of their portfolio is secure.

**How much does the private placement allocation have to earn to equal the results of a fully-invested portfolio?** Jbv.com, a web site for entrepreneurs and start-up companies, relates the perspectives and profit metrics of private offering investors: "They look for promising opportunities where they can purchase stock for a low price now (\$5-\$10 per share is considered optimal at opening) and sell for a high price (like \$50, \$75, or even \$100 a share) in two or three years when the company goes public or is bought out." If a \$5-to-\$50 profit occurred after three years, the value of the \$40,000 invested in the private offering balloons to \$400,000. Add the remaining 96%, earning 3% each year, and the total accumulation is almost \$1.5 million. By comparison, if the fully invested portfolio were to achieve the target of 8% each year, the 3-year accumulation would be \$1.15 million.

**One of the mistakes consumers often make is acquiring diverse financial pieces without having anyone see the big picture.**

### **Integrating Private Offerings into Your Big Picture**

**The above example is a purely hypothetical math exercise.** Private offerings for accredited investors are so varied that it is impossible to make general recommendations about their suitability for individuals. And just because you might qualify as an accredited investor doesn't mean you must include private offerings among your assets.

However, beyond the due diligence that is the responsibility of every potential investor, there is also the issue of determining how a private offering might affect other portions of your existing financial program. One of the mistakes consumers often make is acquiring diverse financial pieces without having anyone see the big picture. The 401(k) representative doesn't know about the life insurance policy, the insurance agent doesn't know about the private offering, and the broker doesn't know about the bank accounts.

If you are presented with an accredited investor opportunity, you may want to contact your financial professionals (especially your "Financial Co-Pilot"), just to assess how your participation may impact your existing plans.

- **ARE YOU AN ACCREDITED INVESTOR?**
- **ARE YOU CONSIDERING THE PURCHASE OF A PRIVATE PLACEMENT?**
- **ARE YOUR OTHER FINANCIAL PROFESSIONALS AWARE OF THIS DECISION?**

## **Do You Qualify as an Accredited Investor?**

From the Securities and Exchange Commission's web site ([www.sec.gov](http://www.sec.gov)):

Under the Securities Act of 1933, a company that offers or sells its securities must register the securities with the SEC or find an exemption from the registration requirements. The Act provides companies with a number of exemptions. For some of the exemptions, such as rules 505 and 506 of Regulation D, a company may sell its securities to what are known as "accredited investors."

The federal securities laws define the term accredited investor in Rule 501 of Regulation D as:

1. a bank, insurance company, registered investment company, business development company, or small business investment company;
2. an employee benefit plan, within the meaning of the Employee Retirement Income Security Act, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of \$5 million;
3. a charitable organization, corporation, or partnership with assets exceeding \$5 million;
4. a director, executive officer, or general partner of the company selling the securities;
5. a business in which all the equity owners are accredited investors;
6. a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds \$1 million at the time of the purchase;
7. a natural person with income exceeding \$200,000 in each of the two most recent years or joint income with a spouse exceeding \$300,000 for those years and a reasonable expectation of the same income level in the current year; or
8. a trust with assets in excess of \$5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.

## **Life Insurance is not a Disposable Product**

**"Don't worry about it. We can always get another one." (Or maybe not...)**



We live in an increasingly disposable consumer culture. Many products, from razors to writing instruments, are designed to be used and thrown out – refills and maintenance are too much of a hassle. If something breaks, it's often cheaper to buy a new one rather than fix it.



**Some things don't work well when they are treated as disposable items.**

**Life insurance is a future-oriented product.**

In the financial services world, more and more products have been adjusted in response to this trend toward disposal and replacement. Where many financial instruments once included either significant up-front fees or surrender charges that encouraged consumers to keep these investments for long holding periods, many financial institutions have altered their products to lower or eliminate these fees. Now you can change your investment allocations as easily as changing your shirt, and sometimes the “substantial interest penalty for early withdrawal” from a Certificate of Deposit isn't really that significant. If it appears the old product is no longer performing, it's easy to dispose of what you don't like, then get what you think you want.

But there are some things that don't work as well when they are treated as disposable items (marriage comes to mind, as does nuclear waste). In the financial products arena, life insurance is a financial instrument that doesn't perform well when considered a disposable commodity. This is primarily because of the unique nature of life insurance.

First and foremost, the ability to obtain personally owned life insurance is conditional on your health. For many financial products, the only barrier to acquisition is money; if you have the cash, you can buy it. But obtaining life insurance requires the prospective insured to meet the company's underwriting standards as well as pay the premiums.

As long as you are in good health, insurability may not seem like a major impediment. But life insurance is a future-oriented product. Both the insurance company and the policyholder expect the life insurance benefit will not be used today, but sometime later (hopefully, much later). If you decide – for whatever reason – to terminate a life insurance policy, **you have forfeited the certainty of your insurable status**. Any attempt to obtain life insurance in the future will require another underwriting assessment. Who knows what your health status will be in five, ten or twenty years? Since future insurability cannot be guaranteed, disposing of life insurance – for any reason – could be detrimental to your financial well-being because you may not be able to obtain replacement coverage.

Life insurance is unique in another way: It is the only type of insurance where the covered event – one's death – is 100% certain to occur. And unlike many other types of insurance, the covered event isn't subject to changeable definitions or adjustable benefit periods. Disability can be defined in many ways, auto insurance can limit exposure through deductibles, and a homeowner's policy can differentiate between assessed value and replacement costs. But with life insurance, there is no wiggle room for defining what is or isn't covered – you are either dead or alive.

The only adjustments to a life insurance policy's terms come during underwriting (when the insurance company may

accept, decline or charge a higher-than-normal premium to insure an individual life), or in the premium structure (this applies particularly to term insurance). For the most part, the terms you receive on the day the policy is put in effect will remain for the duration of the policy. If you are a healthy, slim, athletic non-smoker when you obtain the insurance at age 35, your premiums will reflect that status even if 10 years later finds you an overweight, cigarette-smoking diabetic. Since the general trend for everyone is declining health over time, it doesn't make sense to dispose of a favorable insurability status. If anything, you want to keep it for as long as possible.

This awareness, that life insurance is not a disposable financial product, should prompt you to carefully consider the long-term disposition of your life insurance policies, whether they are cash value policies or level term insurance. If you have obtained a favorable rating classification from a life insurance company, you should consider how this asset (your insurability) can be enhanced or preserved.



## **MEDICAL EXPENSE CREDIT CARDS Using Plastic for Plastic Surgery?**

As medical costs keep escalating, both insurance companies and consumers are pushed to accommodate these rising expenses. For insurance companies, the challenge is how to provide coverage that is both meaningful and affordable. For consumers, the challenge is how to pay both increased premiums and higher out-of-pocket medical expenses. A report from McKinney & Co. cited in a July 16, 2011, *Wall Street Journal* article estimates that out-of-pocket health-care expenses for Americans will approach \$150 billion by 2015 – a 200 percent increase over the estimated \$45 billion Americans paid in 2010.

For the past few generations, the default consumer response to a shortage of funds has been to use plastic – to charge it now and pay for it later. So it should be no surprise that credit card issuers have begun marketing health-care credit cards.

Health-care credit cards are similar to specialty cards issued by individual retailers in that they are available only for the payment of services from a particular health-care provider. Often these cards are offered in the context of helping consumers pay for costly elective medical procedures that typically are not covered by basic medical insurance. This includes items such as hearing aids and dental implants, and surgical procedures for vision and cosmetic enhancements. Some cards are even offered by veterinarians to allow pet owners to afford high-cost procedures for their pets!

These cards typically offer initial interest rates of 0%, usually for a period of six months to a year, with fairly high limits, often as high as \$40,000. For those who do pay the entire balance in the zero-interest period, the cards can represent a convenient and somewhat economical installment plan. But there are some potential downsides.

For balances outstanding after the initial zero-interest period, the interest charges are usually quite high, many over 20 percent. Further, the interest may be applied retroactively. For example, if \$1,000 is still unpaid at the end of a one-year zero-interest period, a full year's interest will be added to the account in the 13<sup>th</sup> month. Considering the out-of-pocket cost on some procedures could easily surpass \$10,000 there is a strong likelihood of a hefty unpaid balance at the end of one year – made even larger by a retro-active interest assessment.

Consumer advocates identify another potential issue. It is customary for medical providers to charge patients for the full cost of a procedure at the first visit, even before multistage medical work is completed. This can put patients at a disadvantage. In the *WSJ* article, Marv Rukavina, head of the Boston-based Access Project health-care advocacy organization, says that patients who are dissatisfied with their care may find it difficult to dispute or refuse the charges since they have already been paid by the credit card company. In a July 22, 2008, piece by Connie Prater (“Health care credit cards rise to fill insurance gap”) posted on

[www.creditcards.com](http://www.creditcards.com), Dr. Steffie Woolhandler, a co-author of a 2005 Harvard University study on medical bankruptcy, said that using a medical credit card, even with zero-interest, may actually result in higher overall medical expenses. “If you have medical debt with a hospital, you may be able to negotiate with the hospital for a discount. Once it's been turned over to a credit card, there's no incentive to negotiate.”

If it seems additional consumer debt is the only feasible approach to paying out-of-pocket medical expenses, some commentators recommend using one of your existing credit card accounts. You may or may not get a zero-interest period, but at least the additional payments will add points to your rewards program – and you may also be able to negotiate a discount.

Beyond the question of which credit card to use, there should be recognition of the need for individuals to increase their liquid reserves. Health Savings Accounts and other liquid cash reserve vehicles aren't glamorous – until you realize that maintaining a healthy cash cushion can keep you from paying 20 percent or more in interest charges.

### **ARE YOU PREPARED FOR A 200-PERCENT INCREASE IN OUT-OF-POCKET MEDICAL EXPENSES?**

**Here is another reason for individuals to increase their liquid reserves.**

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