CREATIVE
Wealth Maximization Strategies

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

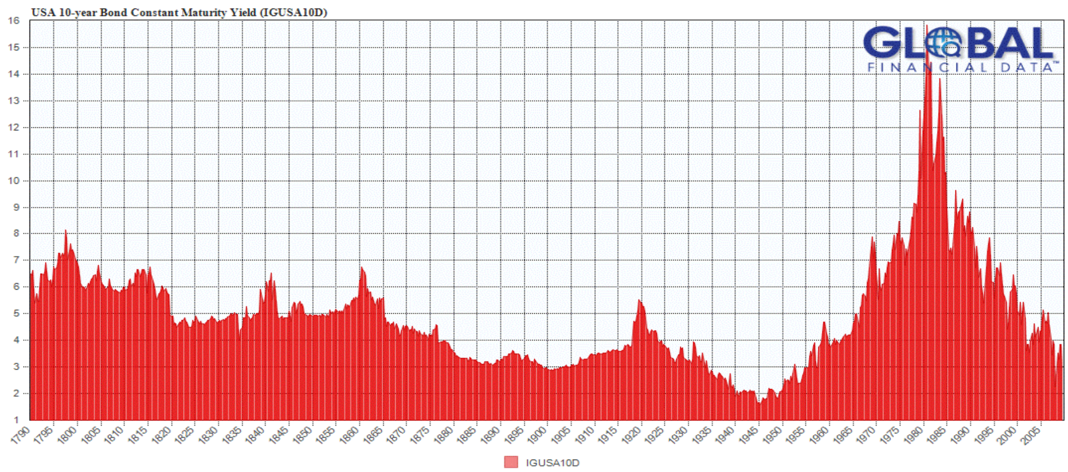
Richard Aronwald
Financial Specialist

August 2012

A LACK OF INTEREST – BUT NO APATHY

How low can they go? Interest rates, that is.

In June, the yield on the 10-year US Treasury bond reached a new low of 1.47%, breaking the previous low of 1.48% in 1947. Then on July 16, the yield went even ***lower***, dropping to 1.44% during the day before closing at 1.46%. And when financial commentators speak of record lows for the US economy, the time frame stretches all the way back to **1790**, the beginning of the nation! *(see chart)*



The 10-year US government security yield, which is often cited as a key indicator of the national economy, also reflects the costs for borrowers, and returns for lenders, in a variety of other financial instruments. That same day, mortgage lender Freddie Mac reported the average mortgage rate also hit a record low, at 3.56%. The U.S. Prime Rate, which is the interest rate at which banks lend money to their most creditworthy business customers, stood at 3.25%. The U.S. Prime Rate serves as a benchmark for other interest-based financial instruments, including savings accounts. Here are some annual interest rates for different savings vehicles as of July 16, 2012:

6-mo. Certificate of Deposit…	**0.46%**
1-year CD ……………………	**0.69%**
5-year CD ………………..	**1.42%**
Money Market Account…	**0.49%**

So…this means a 1-year CD of $10,000 will generate $69 in interest. Seeing these numbers, is easy to see why some financial commentators have called current savings account offerings the "land of no return."

But while the returns from many guaranteed accumulation options are historically small, there are also some advantages for consumers in this low interest rate environment.

The Good and Bad of Low Interest Rates

Low interest rates can be considered a reflection of the relative strength and stability of the American economy. As Marc Gongloff wrote in a May 30, 2012, *HuffPost* article, "The U.S. and Germany are having an easy time borrowing right now mainly because they are seen as safe havens in a world where every other investment suddenly looks horrible." Gongloff goes on to mention the financial crises plaguing several European countries, as well as the economic slowdown in China, and concludes that, right now, higher yields and borrowing costs coincide with much higher risk and uncertainty. Even with low yields, global investors prefer American debt because of its perceived safety; in short, the assurance of return of investment here beats the prospects of return on investment almost anywhere else.

In This Issue…

A challenge for all prospective borrowers is meeting the tougher lending requirements that have come in the wake of the recent financial crisis. But, if they qualify, today's lower interest rates have made it possible for many businesses and individuals to reduce the costs of their current obligations. For businesses, lower borrowing costs improve a company's financial health, and can allow for expansion opportunities. Individuals may find significant savings by refinancing their mortgages, switching credit cards and restructuring other loan arrangements. This combination of tighter lending standards and low rates has helped businesses and households with solid financial footing become even stronger.

Interest rates are driven by two factors: The policy decisions of a government's central bank (such as the Federal Reserve in the United States), and market conditions. In theory, a decision by a central bank to raise or lower interest rates can be used to "manage" the economy – i.e., to stimulate growth, manage inflation, etc. But market conditions – political events, natural disasters, new technologies, shifts in public opinion – often undo management decisions and render unintended consequences.

In "normal" circumstances, lower borrowing costs could be expected to increase lending; businesses and consumers could use the "easy money" to expand operations, hire more people, buy more stuff. But with the fallout from the recent financial downturn still fresh in their minds, many Americans have been hesitant to take on more debt, even at lower rates. Restructure existing debt, yes – but not borrow more. A January 31, 2012, *Wall Street Journal* summarized Commerce Department data for 2011: "Consumers are choosing to put more of their income into savings rather than spend it." A collective change in attitude about debt has blunted the management efforts of government economists.

This save-not-spend behavior reflects the dilemma of one of America's biggest cohort of savers: retirees. Retirees who rely on their safe, conservative, yield-bearing, financial instruments to provide a secure income stream are severely impacted by low interest rates. Lower rates may mean choosing between living on a reduced income, or dipping into principal to maintain lifestyle. Concerned about running out of money, the prudent decision of many retirees is to reduce spending. The *WSJ* article found that, adjusted for inflation, personal spending was down in 2011. Again, we see unintended consequences in play: Even though lower rates were intended to stimulate growth, a segment of the population with the greatest amount of cash isn't spending it.

Will interest rates eventually go up?

The simple answer: They almost have to. When something is at an historic low, the only logical place to go is up. According to data published by fedprimerate.com, the average U.S. Prime Rate since 1947 is 9.842%, and the most frequent Prime Rate value has been 7.5%. Compared to today's Prime Rate of 3.25%, those numbers may be hard to imagine, for both lenders and borrowers. Then consider that in January 1981, the Prime Rate hit 21.5% – and people were still borrowing! In the past 65 years, interest rates have fluctuated quite a bit. Based on history and the statistical theory of regression to the mean, interest rates should be expected to increase. The next question is: how soon?

That's hard to say. Remember the unknown impacts of other market conditions. In the 1990s, the financial managers of the Japanese economy lowered interest rates to almost zero following a recession – and rates have remained low for more than a decade and Japan's economy has stagnated. Then again, some other factor – war, new technology, a change in tax policy – could result in a dramatic change in a very short period of time.

From the perspective of savers, low yields are a definite downer; a change of strategy may be in order. But for borrowers, low interest rates also present some unique opportunities to dramatically improve their financial conditions. In a twist of the phrase, low interest deserves close attention.

- **ARE YOU TAKING ADVANTAGE OF THIS LOW INTEREST ENVIRONMENT?**
- **LOOKING FOR WAYS TO LEAVE THE "LAND OF NO RETURN" WITHOUT TAKING EXCESSIVE RISK?**
- **NOW MAY BE AN OPPORTUNE TIME TO REVIEW YOUR OPTIONS, RECALIBRATE YOUR OBJECTIVES, OR SET A NEW COURSE FOR ACCUMULATION.**

GENERAL MOTORS "DE-RISKS" WITH AN ANNUITY

On June 1, 2012, 118,000 white-collar retirees from General Motors received notification that their former employer would be transferring the management and payment of their pension to a third party, Prudential Insurance Company of America. As part of this change, GM also presented 42,000 of these retirees with the option of receiving a one-time, lump-sum payment in lieu of a monthly pension. In a letter to the affected retirees, GM explained that these changes would "maintain the value of your pension benefits…while significantly reducing GM's ongoing pension liabilities." *Reuters*, in an article released the same day, noted the transaction would relieve GM of approximately one-fourth of its "legacy costs," which have represented a significant operating expense for the company and been a concern for investors. The details of the transaction provide some interesting insights into the costs of providing retirement income, both at corporate and individual levels.

From the corporate perspective, GM will transfer its pension obligations to Prudential through the purchase of a group annuity. The cost of this transaction is steep, and not just because of the number of retirees involved. GM will transfer $26 billion from its $109 billion pension fund, and also pay another $3-4 billion as a special charge, to fully fund the annuity contract. The additional amount required to complete the transaction indicated two things: One, GM's pension was underfunded, and two, the company was willing to pay Prudential a substantial premium to take over its payment obligations. Still, many observers viewed the transaction favorably. Quoted in a June 1, 2012, *Reuters* article, analyst Itay Michaeli said, "Although the transaction doesn't come cheap, it serves a very important purpose of permanently de-risking 25 percent of GM's U.S. pension obligation." So even with the additional payment, GM obviously considered this transaction a good business decision.

But what about the retirees? Is the transfer good for them?

Several factors would seem to indicate the answer is "yes." First, this group is segregated from all other GM retirees, both now and in the future. They do not have to be concerned about their pensions being undone by a large number of future retirees, poor investment performance of the pension portfolio, or a company bankruptcy. The GM pension is currently underfunded, but GM in theory made up this deficit for the retiree group by adding other funds.

It can also be argued that, as an insurance company, Prudential is better suited to deliver the promised benefits. With a known group of recipients and a specific dollar amount to fund the benefits, insurance actuaries have a much easier predictive task than pension managers who must constantly recalculate their program's assets and obligations. Additionally, the financial requirements of state insurance departments are typically more stringent than those for pension plans (hence, the additional payment made by GM). As Laura Stern, a financial advice columnist for *Reuters* notes in a June 5, 2012, article, "Prudential has never defaulted – or even been late – on an annuity payment in almost 85 years of doing these kinds of deals."

Lump-Sum or Annuity Payments?

Higher Payout or Survivor Benefits?

An Individual Example

Looking at the specifics of GM's offer to an individual retiree sheds even more light on the financial factors behind this transaction. All retirees received at least two options in the transfer:

1. To continue receiving their benefits as originally scheduled. For retirees under age 62, this included a supplemental monthly income that would decrease once the retiree became eligible for Social Security. The pension survivorship benefit was set at 65% of the retiree's amount.

2. To receive a new level benefit, with no supplemental income prior to receiving Social Security. This new payment also allowed for adjusting the survivorship benefit percentage, either down to 50%, or up to 75%.

A select group also had the option of taking a lump sum, which could be received immediately, with all taxes due, or transferred to an IRA to be managed and disbursed at the retiree's discretion.

A real-life example:
A 60-year-old male retiree with a 47-year-old spouse received the following offer:

1. Lump sum offer: $517,749.87

2. Maintain current benefit:

a. **$3,485.03**/month to age 62, then dropping to
b. **$2,526.76**/mo. after becoming eligible for Social Security. The benefit to a surviving spouse: $1,642.61/mo.

3. New lifetime benefit from Prudential:

a. **$2,854.93**/mo., with a 50% survivorship benefit ($1,427.47/mo) or…
b. **$2,721.66**/mo., with a 75% survivorship benefit ($2,041.25/mo.)

What jumps out immediately is the offer of a higher lifetime monthly benefit from Prudential in exchange for foregoing the supplemental benefit until the retiree becomes eligible for Social Security. If the retiree can live without the Social Security supplement for the next two years, his long-term monthly income from Prudential will be almost 8% higher ($2,721/mo v. $2,526/mo.) – even while increasing the survivorship benefit to 75%.

Then dig a little deeper: The retiree was offered $517,749 as a lump sum. Suppose the retiree shopped other insurance companies for a comparable monthly annuity payment, using the lump sum as funding. Could he equal the Prudential offer? Not even close. A typical lifetime income proposal (with a 50% survivorship benefit) was $1,972.80/mo., 30% less than the group offer from Prudential. When asked how large a lump sum would be required to guarantee $2,854.93/mo., the same insurance company calculated $755,272, or 45% more than the lump sum offer made by GM.

If the lump sum offer represented the retiree's actuarial share of the pension fund, the implication is that GM added another $238,000 to induce Prudential to take on this particular obligation. Forty-five percent seems like a steep premium to unload the obligation, which makes it all the more interesting to realize GM thinks the transaction is worthwhile. Already, some rumors are circulating that a similar buyout will eventually be offered to GM's hourly retirees.

What would you do?

Besides calculating retirement income options, the lump-sum option presents some other issues. If the individual in the example above chooses an annuity option, he forfeits the opportunity to pass on some or all of the lump-sum pension value to his heirs (other than his spouse receiving survivor benefits if she/he outlives him). In a worst-case scenario, such as if the retiree and spouse were killed in an auto accident next week, the financial loss of this irrevocable decision would be $500,000. Of course, when the pension was managed by GM, this decision had already been made – a retiree received a monthly income for his/her lifetime, and there was no option to leave "unspent" portions to heirs.

Placing a lump-sum value on the pension prompts some retirees to wonder, **"Can I do better than an annuity?"** Doing so means the individual will assume both investment risk and the responsibility for providing an income. Stern's article noted that several money managers working with GM retirees projected a 5% annual return would be required to out-perform the group annuity's benefits. For retirees willing to gamble, the potential exists for greater benefits, such as increasing payments over time, larger monthly amounts, as well as an inheritance that can be left to children, grandchildren, or charities.

The lump-sum might also allow some retirees to save by paying off mortgages or other debts (thus reducing monthly expenses), or invest in a business that generates a "second career," creating another income stream. Of course, the viability of all these options is partially dependent on other factors, including age, health, existing savings, etc. But simply offering a lump sum provides new opportunities, and decisions, for retirees who before had none.

Is this the future of retirement planning?

The decisions facing this group of GM retirees mirror the decisions many other retirees will face in the coming years. Defined Benefit pensions are rapidly being replaced by Defined Contribution plans like 401(k)s, which means retirees will face many of the same decisions:

- Should I place all the money in an annuity to guarantee a lifetime income?
- What about survivorship benefits?
- How much investment risk is practical, and how important are guarantees?
- Do I want to leave an inheritance from my 401(k)?
- How long will I have to manage these assets?

IF YOU ARE NEARING RETIREMENT, IS IT TIME TO LOOK AT SOME PERSONAL "DE-RISKING" STRATEGIES?

MAKING SENSE OF LIFE INSURANCE COMPANY REPORT CARDS

With the steady move away from employer pensions to Defined Contribution retirement plans, such as 401(k)s, more retirees are faced with the question, "How do I make my savings last as long as I live?" One of the possible responses may be to purchase an individual annuity from a life insurance company.

While the features of an individual annuity may be tailored to the retiree's unique circumstances, every annuity is in essence a long-term contract to provide retirement benefits. Given the steady increase in life expectancies, the benefit period of a typical retiree could easily be 30 years or longer. This long time frame means an insurance company's financial strength is a very relevant factor; you want to know the insurance company will be able to deliver on its promises, both now and in the future. **How can the average consumer evaluate the financial strength of life insurance companies?**

Every insurance company files comprehensive financial reports with state insurance agencies on a regular basis, detailing their assets and obligations, so it is possible for individuals to obtain and personally evaluate a company's data. But unless you're a business analyst with some familiarity of the life insurance business, that's not going to happen. Instead, most consumers will rely on the assessments of several ratings services. And while these rating organizations provide consumers with definitive evaluations of insurance companies' financial fitness, they each grade on a different scale, which can be confusing. Here's an example, from an insurance company brochure for one of its annuities:

Organization	Rating	Rank
A.M. Best	A (Excellent)	3 of 15
Standard & Poor's	AA+ (Very strong)	2 of 20
Moody's	A2 (Good)	6 of 21

Are these good grades? On one hand, there are a lot of "A's." But how does an "A"grade merit an "Excellent" from one assessor when an "A2" is only "Good" from another? And if your rank is 6 of 21, does it mean the company is barely in the top third of the class? It's apparent that more information is needed to understand these.

While there are similarities in terms, each rating organization has its own list of grades and definitions. But none of the rating organizations use an academic grade model of A to E/F. In general, most rating organizations are top-heavy; they have a lot of A and B grade distinctions (like A++, AA, or Aaa), with lowest grades of C or D (some raters mark low grades with an R or S). This grading scale in part reflects grades in the bond market, where an S&P grade below BBB is considered a "junk bond."

The descriptive word or phrase after the rating also varies, but helps defines the grade. A.M. Best designates companies with A++ or A+ grades as "Superior," while A and A- are "Excellent." Other A.M. Best phrases include Good, Fair, Marginal and Weak. The S&P categories have labels like "Extremely strong, very strong, adequate" and "vulnerable." Moody's uses the words "exceptional, good, adequate, questionable."

"Rank" refers to where the grade fits on the rating company's scale. On the A.M. Best scale, an "A" is the third highest grade (A+ and A++ are higher) of 15. Fitch and Moody's both have 21 grades in their scale. S&P has 20 marks on their grading scale.

Confused? Let's go to the Comdex.

Since rating agencies do not use a universal scale, and have different assessment terms, comparing company ratings can be a challenge for the consumer. In an effort to bring clarity to the process, the Comdex was developed.

Instead of deciphering the letter grade, the Comdex concludes that the grade is not as important as the rank of the insurance company relative to other insurance companies. A company whose grades place it in the top 20% is stronger than one in the top 40% – regardless of letter designation or description. The Comdex percentile ranks the companies on a scale of 1 to 100 – with "1" being the weakest and "100" the strongest – in relation to other companies that have been evaluated by at least two of the four independent ratings services (A.M. Best, Standard & Poor's, Moody's Investors Service and Fitch). The result is a number that is self-explanatory, and can be used to gauge the financial strength of an insurance company relative to its peers. Many experts consider Comdex scores in the mid-90s to represent "the best of the best."

As an example, here are the evaluations from the four major ratings agencies for The Guardian Life Insurance Company, and their translation as a Comdex score:

Organization	Rating	Rank
A.M. Best	A++ (Superior)	1 of 15
Standard & Poor's	AA+ (Very strong)	2 of 20
Moody's	Aa2 (Excellent)	3 of 21
Fitch	AA+ (Very strong)	2 of 21

Comdex: 99

Although Guardian received the highest evaluation from only one ratings company (A.M. Best), its overall ranking puts it in the 99th percentile, literally one of the top few of the class.

As more older Americans and retirees seek to secure their financial future apart from pensions, they will inevitably be faced with making long-term transactions with life insurance companies, for both life insurance and annuity payments. These are often one-time decisions with decades of consequences. **Getting an assessment of the insurance company's financial strength should be a critical part of the evaluation.**

21st-CENTURY TREND: Will Single-Family Homes Become Multi-Generational?

"Junior's living in the basement. Mom and Dad put a tenant in the garage. And now Grandma's moving in."

- "Multiple Families, One Roof," *Wall Street Journal*, July 19, 2012

According to Harvard's Joint Center for Housing Studies, more than half of America's detached single-family homes are located in the suburbs. Designed for baby boomers, these subdivision properties offered each family its own 20th-century manor: a ranch or two-story colonial "castle," with an attached garage, and landscaping to maintain.

Of course, the baby boomers are now approaching retirement, and some are beginning to agree with the observations of Glenn Ruffenbach in a September 19, 2009, article "Making Suburbia More Livable":

> **The nation's sprawling suburbs may have been a good place to grow up. But they are proving a tough place to grow old. Indeed, as the country ages, suburbia's widely assumed benefits—privacy, elbow room, affordability—tend to vanish. Maintaining yards and homes requires more effort; driving everywhere, and for everything, becomes expensive and, eventually, impossible. (Research shows that men and women who reach their 70s, on average, outlive their ability to drive by six and 10 years, respectively.)**

In regard to living arrangements, a predominant social paradigm for the generation that preceded the baby boomers was to "downsize," often moving from the family residence to a condominium or apartment, then perhaps to a senior-citizen community, and eventually, some form of assisted living. In anticipation of this trend expanding as boomers hit retirement, this type of housing increased, even during the economic downturn. But, in an ironic twist, it now looks as though many boomers may not want, or be able to afford this scenario. Instead, there may be a transformation of the single-family residence into something more fluid in definition and use.

Across the nation, suburban homeowners are looking to modify their existing living spaces – basements, garages, even bedrooms – to accommodate parents, adult children and even tenants, living on the same property. This sometimes means adding kitchens and bathrooms, creating separate entries, adding parking. And often these changes in building structure and living arrangements are bumping up against homeowner association by-laws and community zoning codes, which must decide how to resolve the issue of "accessory units."

The rise of homeowners seeking to reshape their suburban castles is associated with three factors. First, many older homeowners don't want to move. In a 2009 AARP survey, 85% of surveyed individuals age 50-plus said they wished to remain in their communities for as long as possible. Second, because of depressed housing values, many homeowners couldn't leave if they wanted to. They either don't have enough equity in their present property or would not receive enough cash from a sale to make a move financially feasible. And third, their children may need a place to live. One of five college graduates, ages 25 to 34, is living with his or her parents, according to the Pew Research Center.

In general, economic planners find it desirable for communities to consist of a healthy demographic mix – such as singles, young families, established professionals, seniors. Allowing for accessory units in single-family homes may help preserve these demographics, but can also introduce other challenges, such as taxing the capacity of local utilities, inadequate parking, and upsetting the child-friendly dynamic many suburbs were intended to provide.

In previous generations, the "exit strategy" for the single-family home in the suburbs was to sell it. As new economic and social realities may make this option less likely or desirable, households may be compelled to adjust their financial plans as well. Instead of paying off the mortgage, it might be time to take a home equity loan. Having a tenant could impact cash flow and taxation. Instead of something to shed, the single-family residence could end up being a big part of someone's inheritance. In fact, some builders are already responding to this developing trend. One company mentioned in the June 19, 2012, WSJ article is offering new models featuring "a home within a home" comprised of separate living units attached to a main house.

If your residence has an "accessory unit" in its future, it may impact your larger financial picture – meaning your retirement, your estate plans, even long-term care. **This is a trend worth watching.**

CREATIVE
Wealth Maximization Strategies

Certified Financial Services, LLC
Richard Aronwald
Financial Specialist
raronwald@cfsllc.com

600 Parsippany Road Suite 200
Parsippany, NJ 07054
973 263-0622
Richardaronwald.com