

# CREATIVE

## Wealth Maximization Strategies

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**“For 200 years pessimists have had all the headlines, even though the optimists have far more often been right. Arch-pessimists are feted, showered with honors and rarely challenged with their past mistakes.”**

- Matt Ridley, *The Rational Optimist*

## The Case for Rational Optimism

Currently, much of the conversation about the economy is pessimistic, and with some justification. The last several years have been the setting for a wide swath of bad economic news, from the real estate bubble, to declining stock market values, bailouts for industry giants, rising unemployment and a ballooning national deficit. And right now, there aren't many encouraging signs of a rebound either. With little good news to stop the negative momentum, the tendency is to project even more dire conditions in the future. In the words of one commentator, “The signs of the sinking system are coming on furiously now.”

Whoa. When so-called experts proclaim “the end is near!” what are we to do?

Maybe it's time for a little rational optimism.

Matt Ridley is a scientist, journalist, national newspaper columnist, and author whose most recent book is *The Rational Optimist: How Prosperity Evolves*. The main conclusion of the *Rational Optimist* is simple: “life is getting better.” As the blurb on the book jacket says,

**Food availability, income, and life span are up; disease, child mortality, and violence are down — all across the globe. Though the world is far from perfect, necessities and luxuries alike are getting cheaper; population growth is slowing; Africa is following Asia out of poverty; the Internet, the mobile phone, and container shipping are enriching people's lives as never before. The pessimists who dominate public discourse insist that we will soon reach a turning point and things will start to get worse. But they have been saying this for 200 years.**



Ridley's observation that life is getting better is not new or unique; other contemporaries have made similar conclusions. In general, things have never been better for more people – ever. And despite some ebbs and flows in personal circumstances, the trend is strongly upward. It is highly unlikely we will regress to another Dark Ages or live as the Classical Greeks did. So when one hears the wailings of the financial doom-and-gloomers, it is perhaps advisable to see if there are other more optimistic perspectives.

### Prosperity: Everybody Working For Everybody Else

One of Ridley's strongest arguments for optimism is the long history of exchange and specialization. While it is theoretically possible for each individual to be self-sufficient, mankind has always found interdependent relationships to be the more efficient and profitable. Instead of catching our own food, making our own shelter, etc., humans have created social and economic systems where everyone can specialize and trade with others who specialize in other things. This means that those best at making houses make houses, those best at making food make food, and by trading, we can each benefit from that which others do and vice versa. Self-reliance equals subsistence; interdependence through trade equals ingenuity and a boom in living standards. As Ridley puts it, “Prosperity comes from everybody working for everybody else.” Not only does exchange and specialization result in greater prosperity, it also can create society-strengthening virtues like “mutual dependence, trust and sharing.”

Of course, the evolution of prosperity has not always been a steady ascent. Not everyone wants mutual dependence, trust or sharing. So while the trend toward a

better life for all has been upward, there have been times when progress has been stymied by bad behavior: war, oppression, theft or conquest. People and governments, in their quest for power, have occasionally destroyed generations of prosperity. For some, this is the fear: that centuries of progress can be irretrievably undone due to the incompetent or malicious actions of bad people, bad leaders, bad governments.

However, recent evidence suggests that the benefits of exchange and specialization not only make life better, but may also mitigate against destructive behavior in the future. When almost everyone has a cell phone that can transmit video images to the outside world, and Internet connections to anywhere, tyrants find it much harder to cover their misdeeds or suppress dissent, and elected governments cannot control their constituents by stifling opposing views. When the economy is truly global, it is harder for countries to impose restrictive tariffs or maintain artificial trade advantages. Progress has not only resulted in more wealth, but also made it harder for wealth to be destroyed.



Yet public sentiment about the economy is often bipolar. When things are going well, there is, in the words of ex-Federal Reserve chairman Alan Greenspan, an abundance of over-exuberance. And when conditions turn negative, each new bit of information seems to reinforce the sense that the economy is stuck in an uncontrollable death spiral. On reflection, it is possible to see that these collective mood swings are usually over-reactions; while there are ups and downs, things are usually neither as great – or as terrible – as they seem. So, with an awareness of our tendency to overreact, how should one realistically view today's economic storm clouds, and respond to those who forecast an even darker future?

**Economic history says bad times may disrupt trade and slow innovation, but not destroy them.** And as soon as things improve, even a little bit, prosperity surges forward once again. The Great Depression of the 1930s represents the worst economic period of the modern age; for developed nations it was the first global meltdown. The previous two decades had introduced many innovations to everyday life, from automobiles and radios to indoor plumbing and electricity. The Great Depression didn't drive these innovations from the marketplace. People struggled financially, but they did not return to pit toilets and horse-drawn carriages. Even in the worst of the Depression, most people in Western civilization enjoyed a safer, healthier, and more prosperous standard of living than the previous generation.

In the midst of the worst economic disasters, the capacity for trade and innovation has always resurfaced.

Contrary to prevailing commentary, there are rational reasons to be optimistic about your financial future. If this is true, shouldn't you be making plans to survive and thrive in the days ahead?

## **LOOKING FOR OPTIMISTIC STRATEGIES TO TODAY'S FINANCIAL CHALLENGES?**

**CALL US AND FIND OUT HOW THINGS ARE LOOKING UP FOR THOSE WHO WANT AN OPTIMISTIC APPROACH**

## **Applying Rational Optimism to the Threat of Inflation**

The recent financial recession has made many Americans more aware of how government financial policies can have a direct impact on their daily economic lives. Suddenly, words like "bailout," "deficit spending" and "quantitative easing" have become part of dinner table conversations. Among the concerns: the risk of inflation, where prices rise faster than incomes, and dollars lose their purchasing power. Instead of a "manageable" inflation of 1-2% annually, some worry that prices might rise 10% or even 20% annually. High inflation discourages saving and decreases accumulated wealth. In worst-case scenarios, inflation can destroy financial systems and bring a nation's economy to a standstill. The most pessimistic will point to the hyperinflation that occurred in 2007-08 in Zimbabwe,

## Hyperinflation throughout history...



Ancient Rome



American Revolutionary War



American Civil War



World War II

where, according to Steve H. Hanky, professor of Applied Economics, Johns Hopkins University, the inflation rate rose to **79.6 billion percent a month**.

In the past, governments have regularly financed their budget shortages by putting more money into circulation. In ancient times, governments did this by minting coins with mixtures of base metals and silver or gold, yet declaring they were worth the same as coins that were pure silver or gold. In modern times, governments have simply printed more paper currency.

In a November, 2010 article in *The Freeman* titled, "Government's Diminishing Benefits from Inflation", Jeffrey Rogers Hummel states that when money supply increases, but the supply of goods and services remain the same, prices go up. But since governments are the first to have the "extra money," they use it to buy goods and services (or pay off debts) at the lower prices before the new money begins its inflationary effects on everyone else. Economists have a term for the economic benefits governments

acquire through inflation: *seigniorage*. For governments struggling to meet their obligations (often because of costly wars or burdensome entitlements), seigniorage is a tempting strategy, even though the populace eventually ends up poorer.

Throughout history, some incidents of seigniorage have led to hyperinflation. Ancient Rome experienced it, as did the United States during both the Revolution and Civil War. Germany's hyperinflation in the 1930s, and the subsequent economic collapse, paved the way for Hitler's rise to power. There is no doubt that hyperinflation is bad stuff.

But here's an interesting counter to the threat of inflation: New technology makes seigniorage less profitable for governments. Hummel argues that "sophisticated financial systems now prevent governments from gaining much revenue from severe inflation." Because information flows faster and is available to more people, and because money can exchange hands with the click of a computer key, the government doesn't have as much time before the new money raises prices for everyone, including the government.

Two hundred years ago, when inflated US paper money wasn't "worth a Continental," citizens didn't

have many alternatives. In many places, the only "good money" was a gold Spanish doubloon, but these were in short supply. Today, many individuals and companies operate in a global economy, where it is often possible to transact business in another currency – the local money isn't the only game in town. Further, the global economy means countries often cannot pursue seigniorage without incurring some criticism from other countries. Some of the most vociferous protests against the Federal Reserve's proposed "quantitative easing" have come from China and Germany, because these countries recognize that inflation in the United States will affect their economies as well. In November, 2010, China and Russia announced they would no longer use US dollars to transact business between their two countries, as US currency was no longer considered a stable vehicle for trade.

The technological advances that tend to nullify some of the advantages of government-induced inflation may also prompt better fiscal responsibility, both from individuals and countries. A November report from the Federal Reserve noted that outstanding credit card debt has declined for 25 consecutive months (through September 2010). In short, banks aren't inclined to make risky loans and consumers aren't eager to take on more debt. Borrowing-to-buy behavior appears to be replaced by frugality as everyone tries to re-establish some financial sanity. Indeed, *The Art of Deleveraging*, a new book by Dr. A. Gary Schilling makes the argument that deflation is "far more likely and a far greater threat to investors than inflation." Among Schilling's expectations: developed countries will begin to practice financial restraint because "these are difficult conditions to offset with monetary and fiscal policies."

Thus, while it is possible that deliberate inflationary action by a government could destroy a nation's currency, it will not destroy money. If the US dollar loses its position as the world's currency, people will learn to use whatever replaces it, from Chinese yuan to local scrip. Two hundred years ago, changing to a new currency may have been problematic. Today, it's incredibly easy to find better forms of money when existing ones prove inadequate.

This is not to say inflation is a financial non-issue; even moderate levels of government-induced inflation result in a wealth loss for most individuals. This is why prudent financial strategies have always advocated a mix of real and paper assets, even some hard money assets like gold and silver. But a rationally optimistic approach suggests that inflation no longer has the destructive power of previous centuries, because technological progress and increased global trade make it possible for individuals and countries to dodge inflation bullets if they are fired.

## Private Loans

### THE BANK OF MOM AND DAD

A November 9, 2010 article from the Reuters news service reported that the average rate of return for all Certificates of Deposit dipped below 1% for the first time since 1952. At the same time, banks have tightened their lending standards, making it harder for people to obtain loans. How can these two parties resolve their financial dilemmas? One answer may be private loans, particularly those between family members.

As reported by Anne Tergesen in a November 27/28, 2010 *Wall Street Journal* ("Mom, Dad, Can I Borrow \$140,000?"), "business is booming at the Bank of Mom and Dad." For parents lending the money, there is the opportunity for returns greater than what they are getting from money placed in CDs or savings accounts. And while these returns are not guaranteed, parents are likely to know the trustworthiness of their borrowers – after all, they raised them. For children, the advantages to borrowing from parents may be lower-than-market interest rates, and favorable payment terms.

Even though family loans are often executed with nothing more than a handshake and an informal verbal agreement, it is strongly recommended that any family loan agreement be documented in a written contract, for several reasons. A document provides a written record for both parties and clarifies the terms of the agreement, including whether any property is pledged as collateral for the loan. In the event of missed payments or other unexpected circumstances, this information makes settling disputes easier. A contract also provides the heirs and estates of both parties with proof of the existence of the agreement. Since interest received from loans may result in taxable income, this recordkeeping is valuable confirmation in the event of an audit.

Further, according to this article, IRS regulations require a nominal interest rate that must be charged on loans to relatives in order to avoid incurring either gift or income taxes. This rate is known as the Applicable Federal Rate (AFR). Currently, loans with terms of three years or less have a minimum AFR of .35%, while loans of 3-9 years in duration have an AFR of 1.59%, and those longer than nine years must have a minimum annual interest rate of 3.35%.

### PEER-TO-PEER LENDING

Similar to intra-family loans are peer-to-peer (P2P) lending companies that attempt to match individual borrowers and lenders. Most of the companies are Internet-based. In a typical arrangement, a prospective

borrower provides financial information which results in an assessment of their credit-worthiness. The borrower then submits a request for funds and waits to see if borrowers are interested. The interest rate is usually determined by the peer-to-peer service, with high-risk borrowers being charged the highest rates. For a modest fee, the company takes care of the contractual issues, and serves as the custodian for payments from the borrower and disbursements to the lender(s). Lenders can take a fractional position in a loan, and some P2P lending services allow lenders to participate in loans with investments of as little as \$1,000.

In theory, using this peer-to-peer lending format could allow an individual to hold a diversified portfolio of loans made up of differing levels of risks, length of maturity and rate of return. But just like a parent making a loan to a child, the lender needs to evaluate the creditworthiness of the borrowers and weigh the risks of default against anticipated returns. You probably won't know the borrower personally, and will have to rely on the financial information provided by the borrower (although some P2P lenders have become very thorough evaluators of those to whom they lend, but that can become a full-time job). According to one of the leading P2P

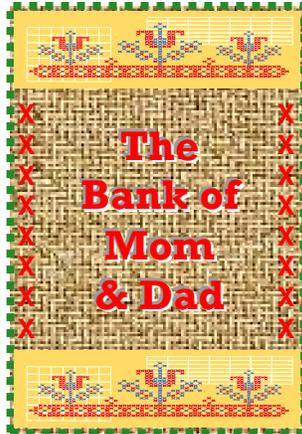
websites, current rates charged for unsecured loans to the highest-rated borrowers is between 8-9%, while the default rate for this group is around 7%. For high-risk borrowers, the interest rate charged is much higher, but the default rate is closer to 20%. When the odds are 1 in 5 that a loan will end in default, this transaction cannot be considered "guaranteed," even if the terms of the contract are clearly specified.

Because of their economies of scale, expertise and network connections, banks have many advantages over individual lenders. But P2P lending companies represent another way that innovation and cooperation provide new opportunities for individuals to prosper.

### BTW: If You Own a Cash Value Life Insurance Policy...

Many cash value life insurance policies have a paid-up additions feature (or something **similar**) **that allow for additional premiums to be credited** to the cash value account. Since these accounts typically pay annual dividends\* at a competitive rate, and accumulate tax-favored basis, policyholders may realize a substantial earning advantage by placing some of their savings in cash values – without the worry about the creditworthiness of an individual borrower.

One caution: Paid-up addition deposits are subject to annual limits according to Modified Endowment Contract (MEC) rules established by the IRS. Since



exceeding these limits may result in the loss of tax advantages, and because each policy has a unique MEC limit based on the annual premium, the policy's face amount and the history of previous paid-up addition and premium payments, you should always consult with the insurance company before making additional deposits.

*\* Dividends are not guaranteed.*

## **YOUR NEXT CAR: BUY OR LEASE, NEW OR USED?**

For most Americans, personal transportation is a necessity. They need a car to work, to get the groceries, to drop the kids at school, and to access entertainment. This means most Americans will face a significant financial transaction every three to five years when it becomes necessary to replace a vehicle. Each time, the two biggest financial questions are:



1. Should I buy or lease the vehicle?
2. Should I buy a new or used vehicle?

While some financial experts may hold to hard-and-fast answers to both questions (comment from one financial website: "never, ever buy a new car!"), other information

suggests that the "right" decision is dependent on a number of constantly changing market factors, as well as your own priorities regarding automobiles.

### **Your car: A monthly expense or a capital investment?**

There are two ways to evaluate the purchase of a vehicle. One is to consider a car as part of one's monthly transportation costs, the other is to see an automobile as a piece of equipment with capital value. The transportation cost model includes fuel, garage or parking space fees, repairs and maintenance, insurance, licenses, tolls, as well as monthly payments on a lease or loan. The total of these expenses represent your transportation costs, and the relevant financial issue is the size of this number. Any discussion of the residual value of the vehicle after three to five years is inconsequential; the main concern in having reliable transportation and keeping the costs affordable.

In contrast, when the vehicle is considered as a separate capital investment, a new set of metrics apply. There is a projection of how long the vehicle can be

driven before its transportation value is completely exhausted, i.e., how long will it take to "use up" the car? Is it 100,000 miles? 200,000? Is the intent to drive it until it stops running, or to sell it at some point and buy a newer vehicle? If this is the case, at what point does the vehicle have its optimum resale value? How does this optimum number compare with other vehicles?

Consider how these different perspectives affect the decision-making process:

If you sample a range of sources in the auto industry, they will tell you a new car loses between 15 and 40% of its value the minute it leaves the dealership. This means a new car with a \$25,000 showroom price purchased Monday would likely be resold for \$20,000 or less on Tuesday. From the perspective of capital expenditure, it makes a lot of sense to purchase the used car on Tuesday instead of the new car on Monday. Provided the vehicle is competitively priced and in good condition, buying a pre-owned vehicle is usually better than buying new. Except...

The reason for having a vehicle is transportation, not investment. The more you drive a car, the less it is worth. Older vehicles with higher mileage tend to incur more maintenance costs. In contrast, most new vehicles are less likely to require major repairs in the early years of use, and many of the most costly repairs will be covered by warranties. So while the cost of buying a used vehicle might be significantly lower, the accompanying maintenance costs could be much higher.

This same thought process, that transportation is an ongoing cost rather than an investment, leads to another conclusion: it doesn't make sense to finance a depreciating asset. A lease agreement allows you to "rent" transportation for a known period at a fixed cost. When the term expires, you return the used vehicle and negotiate a new lease. In a sense, there is no investment risk with a lease – but there also is no opportunity for gain, either.

Given your assessment of the issues, it is possible to make financial arguments for leasing a new car as well as buying a used one. The decision hangs on how you assess the purchase of the vehicle; is it a monthly expense or a capital investment?

### **Outside factors that scramble the decision**

Even if you have clarified your financial perspectives regarding automobiles, market conditions can make these parameters meaningless. A November 10, 2010 *Wall Street Journal* article titled "When Used Costs More Than New" highlighted a rare recent development: The current monthly payment for some new cars is **lower** than the payments for similar 1-year-old vehicles. How did this happen?

A combination of financing options, unexpected demand for used vehicles, and dealer incentives have

made it possible for some consumers to buy a new car at a lower monthly payment than a one-year old version of the same model. New-car dealers are offering end-of-model-year rebates and special in-house financing terms to clear inventories. The result is a car with a higher sticker price but a lower monthly payment. For someone who doesn't intend to keep the vehicle for its usable life, but replace it in three years, and plans to finance the purchase, buying a new vehicle may now seem like a smart move.

This example summarizes the external market forces that require you to constantly reevaluate your transportation decisions. The price relationship between new and used vehicles is constantly changing for reasons that are hard to predict. When gas prices were high, fewer gas-guzzling pick-up trucks and SUVs were sold, and fewer entered the re-sale market. As gas prices eased, the demand returned, which combined with limited availability, drove prices up. If you buy, what will the vehicle you are driving today be worth when you replace it? If you lease, how will the predetermined resale price match the market? What will it cost to replace this vehicle, whether bought or leased, three years from now? You can't know the answers to any of those questions.

Most leased vehicles are financed and resold through the auto companies. Most used car loans are made by local banks. The cost of borrowing, whether to lease or buy, may be higher or lower, depending on the financial institution. Sometimes the financing costs are lower with the auto dealer, at other times the local bank has the advantage. Each time you're ready to obtain a new vehicle, you must reassess the financing landscape.

The *WSJ* article mentions another factor: everything is different if you pay cash. If you can afford this option, it means you must also consider the opportunity costs. What would that chunk of money used to buy a car be worth if it remained invested instead of exchanged for a car? At the end of five years, a car owned free and clear will be worth a fraction of its original value, while money that remained invested could grow have grown significantly. Are the transportation benefits from owning a depreciating asset really worth sacrificing money that perhaps could be allocated somewhere else?

**LOOKING TO BUY A NEW CAR THIS YEAR?  
WHY NOT HAVE US HELP YOU CALCULATE  
THE TRUE FINANCIAL COSTS OF  
TRANSPORTATION?**

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