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HOW WILL THE 'GREAT RECESSION' CHANGE YOUR PERCEPTION?

When it comes to money, the financial climate in which you grew up can have a life-long impact on your financial perceptions and behavior. The influence appears to be particularly strong if the financial events are extreme, such as those occurring in a boom or bust period and especially impactful for people who are between the ages of 18 and 25 when the major event occurs. A research paper published in September 2009 by Paola Guilano and Antonio Spolombergo (*Growing up in a Recession: Beliefs and the Macro-Economy*) reported that "recessions do alter perceptions," and that these changes in perspective tend to persist throughout one's life.

Looking back on 20th century American experiences, it is possible to see how significant financial events shaped the behavior of different generations. The generation that came of age in the Great Depression placed a high priority on frugality, steady employment, and saving. They had strong aversions to almost all debt (and unsecured credit in particular), and were reluctant to take risks in the stock market. Guilano and Spolombergo concluded that because "recession-influenced respondents…tended to believe that success in life was more a matter of luck than hard work," they also displayed a greater preference for government intervention, in the form of entitlement programs and progressive tax rates.

In contrast, the authors found that "birth cohorts that experienced high stock market returns throughout their life report lower risk aversion." They are "more likely to be stock market participants, and, if they participate, invest a higher fraction of liquid wealth in stocks." This observation describes the Baby Boom generation that was born following World War II, as well as the Boomers' children. In addition to taking greater investment risk, these generations embraced easy credit, longer mortgages, and became comfortable using financial leverage (credit) for almost every transaction.

Will there be prominent perception shifts as a result of the Great Recession (or as economist Paul Krugman likes to say, the "Lesser Depression")? Based on previous experience, the past few years qualify as an extreme period in financial history, so it seems likely that major attitude shifts might follow. From a broad survey of current financial commentary, here are some possible perception changes that are in the making:

Eighty (80) is the new 65. For the generation that grew up during the Depression, the magic number for retirement was age 65, when fully vested pension payments and maximum Social Security benefits began. For awhile during the 1980s and 1990s, that magic number dropped into the 50s as a high-flying stock market led many to believe they could accumulate enough to retire early.

But today, age 65 has "become irrelevant," according to a November 17, 2011, wire report from Moneynews.com. Longer life spans, rising healthcare costs, falling stock market values, and heavy debt loads have led many Americans to conclude that continuing to work as long as possible is their only retirement option. A November, 2011, Wells Fargo study showed almost one fourth of middle class Americans now see age 80 as "a good age to shoot for when it comes to retirement."

A trend toward prolonged working lifetimes could result in a fundamental change to many financial dynamics, from accumulation and distribution strategies to the cost of employee benefits, required minimum distributions, tax credits, and eligibility for government programs like Social Security and Medicare.

"Sure things" aren't sure things. Two financial clichés that were popularized in the late 20th century and persisted up to 2007: (1) "Stock markets may fluctuate, but the long-term trend is always up," and (2) "Buying a home is the best long-term investment a person can make."

In This Issue…

For awhile, the numbers seemed to support these assertions.

And then the sub-prime bubble burst. The market for housing dried up, foreclosures skyrocketed, and prices plummeted. Now, as the November 10, 2011, headline from the *Wall Street Journal* states: “Home Prices Keep Dropping.” The actual numbers vary with the location, but a 30-40% decline in home prices since their 2007 peak is not uncommon. What’s worse, says Paul Dales, an economist for Capital Economics, it will take “years rather than days for a proper recovery to get going.”

Americans find themselves living on a thin financial margin where one unforeseen incident can unravel everything.

Meanwhile, the past decade has not been good for stocks. While there have been significant ups and downs during this period, the net result over 10 years from most market indexes is slightly better than break-even. Even though many financial professionals continue to remind consumers that stock market investing is a long-term project, a 10-year period with almost no return (or a loss) is hardly reflective of an upward trend. What’s worse, markets have become more volatile – even if the overall return is flat, fluctuations are higher and more frequent.

Insurance *matters*. With fewer assets and lower returns, more Americans find themselves living on a thin financial margin where one unforeseen incident can unravel everything. Suddenly, it seems financial discussions – in the media and around the dinner table – are as much about protecting oneself from poverty as getting rich. People know they need insurance.

Right now, health insurance is the front-and-center topic, one that will apparently require a Supreme Court ruling to determine how the nation will address both affordability and protection. But other insurance issues need to be resolved as well. And much like health insurance, it will be interesting to see whether private or government programs will win the day.

As defined benefit pensions have been replaced by 401(k) accounts, retirees face the challenge of turning their accumulation into a steady income stream. In the marketplace, this concern has meant the revival of immediate annuity purchases, allowing individuals to exchange a lump-sum for a guaranteed stream of payments. From the government side, public policy advocates have floated several ideas to reshape Social Security or establish national retirement accounts.

Where once a popular strategy for life insurance was to buy cheap term insurance to cover one’s working years, increased life expectancies and a lack of retirement assets have prompted many Americans to take a second look at life insurance designed to stay in force for their whole lives. Additionally, hybrid financial products that combine either life insurance or an annuity with long-term care insurance are also attracting consumer interest. Going forward, insurance will play a larger role in individual finances.

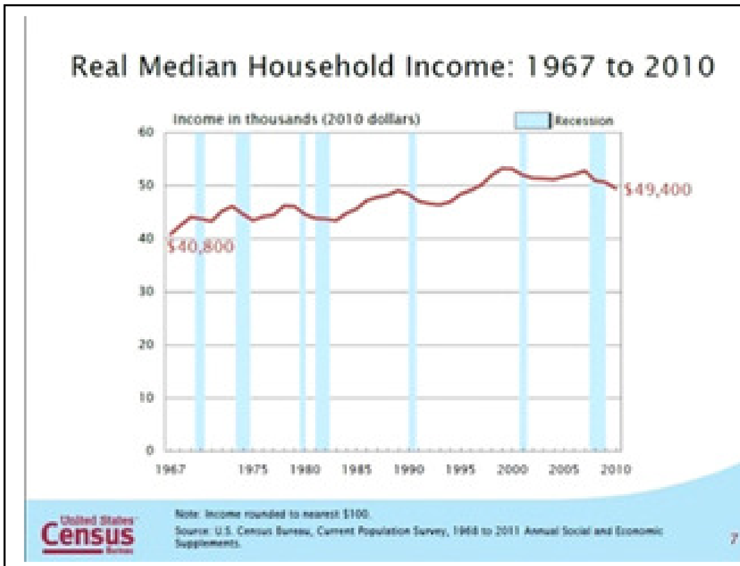
Employment is a fluid condition. Once upon a time, the average American graduated from high school or college and settled into a lifetime of steady employment, often staying with the same employer until retirement. At least, that’s how we imagined the story went. The reality is much different, both then and now.

“For the great majority of American workers, so-called ‘career jobs’ never existed, and they certainly do not exist today,” says Craig Copeland, an Employee Benefit Research Institute senior research associate and author of the study “Job Tenure Trends, 1983-2010.” “A distinct minority of workers have ever spent their entire working career at just one employer.” The median job tenure for Americans is slightly more than five years, and considerably less for younger Americans, but this number hasn’t changed much over the past 20 years. What is different today are the reasons for job change.

In periods of high employment and prosperity, people changed jobs to pursue better opportunities. Today, job change is more likely the result of layoffs or downsizing. People aren’t moving from job to job, they are moving from employment to periods of unemployment. Furthermore, due to the high ancillary costs that come with hiring full-time employees, more businesses are meeting their labor needs with contract and temporary workers. As a result of the Recession and the subsequent changes in employment, census data released in September 2011 showed US households earned less in 2010 than they did 13 years ago (see chart).

Obviously, this on-again-off-again work format has the potential to disrupt or complicate efforts to achieve financial security.

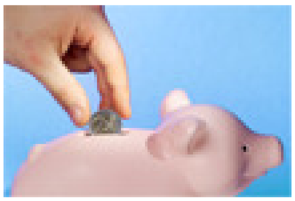
Adjusted for inflation, real household income has dropped to 1997 levels. Outstanding debts must eventually be repaid. One of the reasons economic recovery has been so slow to take hold is because there has not been a bounce-back in consumer spending. Shaken by the events of the past few years, many Americans are coming to the conclusion that they can’t always outgrow, out-earn, defer or restructure their debts. Instead of borrowing for a new car, or refinancing the mortgage to add an addition, more Americans are paying off credit card balances, cleaning up their student loans, and trying to build cash reserves as a hedge against employment and investment uncertainties. Some observers wonder if those who have grown up in a culture of leverage – always borrowing today, and hoping to pay tomorrow – can



truly embrace a new paradigm, but as was mentioned at the beginning of this article, recessions alter perceptions. And it appears many Americans have embraced an austerity program as a way to stabilize their financial status.

If only governments were so responsible. Whether it's Greece or the United States, deficit spending cannot continue indefinitely. The optimists may still believe it is possible for a national economy to outgrow its obligations, but when debts get too large, a tipping point is reached, and the only solutions are decreased spending, higher taxes, or bankruptcy. None of these options are good ones. But somehow, the debts must be resolved.

Adjusting to Changing Perceptions: Recapitalize and Restructure. In the business cycle economic model, bust follows boom, which precipitates a recapitalization and restructuring that lays the foundation for the next boom. The events of the Great Recession certainly have the characteristics of a bust. The question is how best to recapitalize and restructure.



In the Great Depression, much of the restructuring came from government initiative. Employment programs like the Civilian Conservation Corps and the Works Progress Administration stepped in to put Americans to work. Social Security was established to assist with retirement. The funding for these programs came from higher taxes and deficit spending (i.e., borrowing). Today, it is an open question as to whether voters will accept either higher taxes or deficit spending as a way to facilitate government solutions to these financial issues.

There is a second problem with government intervention: Even if the electorate approves these steps, lenders may not. Look at Greece. While the Greek population seems strongly in favor of maintaining the country's entitlement programs, the government is finding it can no longer borrow to pay for the programs. In effect, outside creditors are determining national economic policy; while the Greek government may want to provide for its citizens, its credit card is maxed out. When governments reach their spending limits, the only recourse is individual initiative to develop and implement individual solutions.

In any phase of the business cycle, people who are paying down debt and rebuilding their savings are recapitalizing, and better prepared to prosper in the future. But what is often overlooked is how efficiently this recapitalization is taking place. New perceptions may require changes in strategies as well. For example:

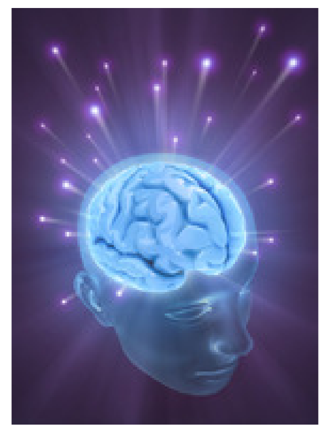
- If your future employment may be characterized by periods of unemployment, should you adjust how you contribute to a qualified retirement plan, such as a 401(k)?
- If your house isn't the best investment you've ever made, are you sure you want to make extra principal payments to pay off the mortgage earlier?
- If you are ready to retire, should some of your accumulation be used to purchase a guaranteed stream of income?
- If it is likely your current employer will not be your employer 10 years from now, should you consider portable, personally-owned disability and/or life insurance benefits?

This discussion is a bare-bones overview of some projected long-term effects of a significant financial event. The challenge for individuals is determining how best to respond to these changing financial perceptions. Effective financial management has never been a set-it-and-forget-it program; even if you are well-positioned right now, some changes may be necessary in the future.

IN LIGHT OF RECENT EVENTS, COULD YOUR FINANCIAL PROGRAMS BENEFIT FROM RECAPITALIZING AND RESTRUCTURING?

ARE YOUR FINANCIAL PERCEPTIONS IN LINE WITH THE AFTERMATH OF THE GREAT RECESSION?

RESEARCH SHOWS FINANCIAL I.Q. DECLINES – JUST WHEN YOU'LL NEED IT MOST



We are not older and wiser. Rather, we are older, less smart and over-confident.

For many Americans, their most important financial decisions come at the end of their lives. They must decide when to retire, when to take Social Security, how to make retirement distributions, which Medicare supplemental insurance to buy, to keep the house or downsize, which investments to choose, how to update the will or establish a trust. These decisions not only involve large dollars, some of them are irrevocable. Yet a new study shows that, regardless of gender or education level, Americans' financial literacy diminishes rapidly after age 60.

On a 16-question test measuring knowledge of investments, insurance, credit and money basics, scores fell about 2% each year starting after age 60, according to Michael Finke, an associate professor at Texas Tech University and a co-author of the study. For those 80 and older, this decline represented a 50% decrease in financial understanding compared to 60-year-olds.

This information has an additional twist: Finke found that peoples' confidence in their financial decision-making abilities rises with age. As MarketWatch's Robert Powell noted in an October 27, 2011, article, this means…

We are not older and wiser. Rather, we are older, less smart and over-confident.

Finke's research is confirmed by other studies. Experts say the process of making financial decisions relies heavily on two forms of intelligence. The first is crystallized intelligence, which involves both memory and problem-solving skills. The second is fluid intelligence, which is the capacity to think logically and solve problems in novel situations, independent of acquired knowledge. Applied to financial decision-making, one must have fundamental knowledge of basic financial concepts and products, then be able to adapt this knowledge to match one's unique circumstances.

In 2009, Harvard's David Laibson reported that cognitive performance improves from youth to middle age, at which point it peaks before beginning a steady decline. Finke confirmed this finding, but added "the decline in cognition is due to a decline in financial literacy." In other words, as people got older, they had a harder time deciphering financial information.

Given their combination of life experience and mental acuity, middle-aged adults are in their decision-making prime. But what if your big financial decisions are still a few years away? Are there steps you can take ***today*** to minimize the likelihood of making a poor decision in the future? Here are several suggestions.

1. **Admit your weakness.** First and foremost, acknowledge that your ability to make financial decisions will decline after age 60. Don't think, "This won't happen to me!" At some point, it will. Just like you won't be able to run as fast, or jump as high, it's reasonable – and responsible – to anticipate a decline in your mental capabilities.
2. **Educate early and often.** Most financial concepts and products are detailed applications of basic ideas. Life insurance, estate planning, retirement and the like can be understood by the average consumer – it isn't rocket science. The more you are exposed to both the concepts and the details, the easier it is for you to maintain understanding. It sounds simplistic, but most people would dramatically increase their financial literacy if they just read a personal finance publication on a regular basis. Even better would be scheduling regular meetings with your financial advisors, not every week, but perhaps once a quarter. Regular discussion conversation keeps you sharp.
3. **Prepare a plan today – and put it in writing.** No one says you have to wait until the event is upon you before making a decision. For example, since you know the likelihood of diminished capacity in old age, it makes sense to develop a retirement-income plan that won't require ongoing complex decision-making in the future. Putting these plans in writing serves as an ongoing reference for you, and can instruct others who may offer help or advice.
4. **Find help.** Cultivate relationships today with those you might consider delegating some decisions to in the future. If you know your decision-making may slip in later years, begin working with someone who will be 60 when you're 80. Meet with a family member, knowledgeable friend, or financial expert who has your trust and understands your priorities. Ideally, you want an individual who is younger than you working at a firm that's older than you – it's a combination of youth and experience that can stay with you over time.
5. **Annuitize.** Like many other economists and financial behaviorists, Finke recommends planning to annuitize a portion of your assets, preferably in a straightforward immediate annuity, or perhaps using a mix of annuity and investment products (but don't make it too complicated, right?). This "pre-set" strategy takes pressure off you *and* your financial advisers.

Whether the topic is saving for retirement, executing a will, applying for life insurance, or some other aspect of personal finance, an accompanying statement is often "Do it now!" because procrastinating may result in a missed opportunity. But the value of acting today is more than simply completing a task and crossing it off the list.

One of the major themes from the *Millionaire Next Door*, a 1996 book that studied the habits and priorities of prodigious accumulators of wealth (PAWs), was that wealthy Americans invested considerably more time and energy discussing, executing and reviewing their financial plans – long before retirement. The comparative success of PAWs was due to a solid foundation of knowledge and preparation. They knew more, and had more successful experience to draw on.

Acting today, when you are most lucid and capable of making a good decision, is the best way to secure your financial future. You don't want to delegate your financial decision-making to the 80-year-old version of yourself, who may not be as capable as the 60-year-old version. And in order for the 60-year-old you to make the best decisions, the time to prepare is now.

TO BE AT YOUR DECISION-MAKING BEST, WHAT NEEDS TO IMPROVE?

- **YOUR BASIC PHILOSOPHIES OF WEALTH AND MONEY?**
- **A CLARIFICATION OF YOUR GOALS?**
- **KNOWLEDGE OF FINANCIAL CONCEPTS AND PRODUCTS?**
- **REVIEWS OF YOUR CURRENT POSITIONS?**
- **THE RELATIONSHIP WITH YOUR FINANCIAL PROFESSIONALS?**

APPLES & ORANGES: The Chance to Get Rich vs. The Guarantee of Avoiding Poverty

"The more things change, the more they stay the same."

Every now and then, a look backward can be enlightening. That's the case with the on-going debate about how whole life insurance fits into individual financial programs. Because whole life insurance is a unique financial asset, the challenge for professionals and consumers has always been to properly evaluate its value in relation to other alternatives.

Life Insurance Selling is a professional trade publication with a long history of reporting on issues and trends relating to life insurance. In its November 2011 issue, *LIS* published an excerpt from a November 1967 article titled *"Apples or Oranges – A Meaningful Comparison?"* by R. Earl Denman. Although Mr. Denman's commentary was written 44 years ago, his words remain relevant today; the same issues are still being discussed, and the same distinctions still apply. Here's the excerpt:

> There is such a to-do these days about life insurance versus mutual funds, common stocks, etc., that unless an agent is careful, he finds himself comparing life insurance as an investment with a lot of other things or becoming involved in a long discussion of the history of the stock market, mutual funds, and investment trusts, in which people have put surplus cash in years past, only to find that age did not fulfill the promises of youth.
>
> It has been helpful to me in the past year or so, when the [individual] wanted to compare life insurance with these other things, to remind him that he is comparing apples with oranges.
>
> **Life insurance is a guarantee that he and his dependents will not be poor. All the other institutions offer is a chance to get rich. After 45 years of observing people and reading financial results obtained by my friends and acquaintances, I'm convinced that 99 out of 100 need the guarantee that they won't be poor more than they need the chance to get rich.**

Denman's last paragraph neatly summarizes the apples-and-oranges issue in evaluating whole life insurance: Which objective is more valuable, the guarantee of avoiding poverty or having the opportunity to get rich? Both paths offer the prospect of greater financial security, but address the objective in markedly different ways. And in spite of the many changes in products over the past five decades, consumers today face the same decisions about saving and accumulating: Should I take the risk or play it safe?

Mathematically, the determination of which approach to follow depends on how the variables are manipulated. The results of any mathematical analysis between whole life insurance and another investment and/or combination of investments and term insurance will hinge largely on the projected rate of return, tax assumptions and length of time used for comparison. Of course, the math isn't the whole story; there are also the intangible aspects of the risk-vs.-guarantee issue.

Historically, Americans' response to investment risk has hinged on their perceptions. When double-digit annual returns were an every-year expectation, money flowed into all sorts of equity products. Sure, it was possible to lose money, but it seemed so many people were profiting that the risk of loss seemed minimal. Conversely, the performance of many equity products in the past decade has driven many investors to re-evaluate their risk tolerance, and guess what? Whole life is back in the discussion again. Insurance companies run television ads during football games promoting whole life insurance, and the *Wall Street Journal* features articles like "Honestly, What's the Best Policy?" explaining why Baby Boomers and their children may want to invest in whole life insurance.

Psst!... It's not an either-or decision

In real life, no one insists that you decide between apples or oranges; you can have both. Likewise, although there is a tendency for experts to make an exclusive declaration in favor of one option over another, many American consumers would benefit from a financial approach that included both the guarantee of avoiding poverty and the chance to get rich. In fact, having the guarantees against poverty might make it easier to take advantage of chances to get rich.

Whole life insurance is a unique financial product, but one with a proven track record in the market place. Just because comparing whole life to almost everything else may be an apple-and-oranges endeavor, shouldn't mean you don't want whole life. The key to a successful whole life program is properly positioning it among your other financial assets, - i.e., finding a place where the apples and oranges can grow together.

WANT TO LEARN HOW TO MAKE WHOLE LIFE FIT IN YOUR FINANCIAL PICTURE? CONTACT US TODAY FOR IDEAS AND DETAILS

INFLATION DISTORTIONS

A bit of financial trivia that received a lot of attention in November was the increased cost of Thanksgiving dinner this year. According to the American Farm Bureau Federations' survey, a turkey dinner for five with all the fixings cost about $49.20 this year, a 13% increase over last year. This price jump seems significant until it's compared with the cost of the same meal during the Great Depression.

In a November 26, 2011, article for the *Salt Lake City History Examiner,* Rachel Quist did some research and calculated the cost of a similar turkey dinner in 1934. The amount: a mere $4.38 – until you adjust for inflation. In today's dollars, the 1934 meal cost $72.73 – a difference of $23.53. Put another way, a 2011 Thanksgiving dinner cost 32% *less* than it did in 1934. Who would have expected that?

We all know inflation exists. In fact, we expect it and accept it as part of our financial lives. Some of us can remember when gas was $1.00/gallon and hamburgers were 50 cents, and recognize it's unlikely we will see those prices again. But over time, inflation makes it hard to determine where we stand. Here's another example:

According to the Internal Revenue Service, Americans filing a joint tax return in 1953 paid a top marginal tax rate of 92% on taxable income in excess of $400,000. A 92% tax rate is steep in any time period, but it's the $400,000 threshold that might be worrisome to many people – until you adjust for inflation. According to Department of Labor statistics, $400,000 of taxable income is equivalent to $3.4 million in today's dollars. So while the top-end tax rates were obviously high in 1953, a very small percentage of Americans reached that level of taxable income.

Inflation's greatest distortions of perceived value occur when longer time periods are involved. This is one of the reasons calculating a "retirement number" is a dicey proposition. Suppose you are age 45, and want to retire at age 65, with an accumulation that can provide 75% of your annual pre-retirement income. What's the inflation factor for 20 years? In short order, you find that if inflation averages 3%, $1 million in today's dollars must increase to almost $2 million to maintain purchasing power. Suddenly, it occurs to you that $1 million is no longer a big number. And the task of reaching your financial goals may suddenly seem overwhelming. But don't despair. It's helpful to remember that inflation also tends to bump up incomes as well as costs – although not always to the same degree.

Given the capricious history of inflation, you can't really "plan" for it, even though you are aware of its financial impact. **The only psychologically healthy and rational strategy is to guard against risks, consistently maximize your present transactions, and adjust as you are able.** Meanwhile, enjoy the things that are less expensive today, even if inflation makes the price higher.

HAVE YOU SCHEDULED YOUR CHECK-UP?

December 31, 2011 represents the fiscal year-end for individuals and many businesses. In short order, this means collecting financial information, preparing tax returns, and compiling other accounting summaries, such as profit/loss and net worth statements. With this information fresh in your mind and readily accessible, now might also be a good time to schedule a review with your financial professionals.

Besides the advantage of starting the year with a renewed understanding of your financial condition, scheduling a review also gives you time to make deliberate decisions about any financial transactions that may need to be executed before April 15th (such as IRA contributions or catch-up deposits to an employer-sponsored retirement plan).

Start the year right. Get the knowledge you need, update your plans, and give yourself the best opportunity to prosper in the coming year. Sounds like a resolution!

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