

CREATIVE

Wealth Maximization Strategies

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“Economists are gradually shifting away from the way we think about the determinants of economic well-being. Traditionally, the focus was on *resources*.

Increasingly, we appear to be moving toward a focus on *beliefs*.”

- Arnold Kling

TO SUCCEED, YOU MUST FIND THE RIGHT GROUP

Three Statements, Three Questions, One Decision

Statement 1: Group beliefs shape your financial destiny.

The desire to be part of the group, to be accepted, is a powerful psychological motivation. That's not a surprising statement; humans are social creatures. But what is surprising is that the group psychological factors at work in an individual's life may far outweigh any other variables when it comes to determining one's eventual financial success. More than income, education, vocation, or any other material factors, it makes a difference which group you are part of, and what the group's belief system is in regard to financial matters.

Arnold Kling, the author of the quote at the beginning of this article, is an economist, adjunct fellow for the Cato Institute, volunteer high school teacher, and contributing editor to online publication *TCSDaily*. In a series of articles written in January 2006, Kling presented some fascinating theories on the way ideas gain mass acceptance, and how these ideas, once adopted, exert a strong influence on group economic behavior.

Statement 2: Scholars may think up ideas, but it's what the group believes that matters.

Kling divides beliefs into two categories: *Scholarly Beliefs* and *Folk Beliefs*.

The Scholars are the originators of ideas that have influenced history, for good and for bad. From Socrates and Plato to Marx and Freud, the beliefs of philosophers and writers have been the catalyst for change.

But while the Scholars may be the sources of ideas, the impact of those ideas is decided not by scholars, but by the masses – the “folks.” According to Kling, it's important to understand that “ordinary people and scholars may treat the



same ideas differently.” But “in terms of influence, it is the Folk Beliefs of ordinary people that matter, not the beliefs of scholars.”

Statement 3: Once a Folk Belief takes hold, it can be a long time before it lets go.

When Sigmund Freud's theories of psychoanalysis and human behavior were first published in the early 1900s, they were met with immediate criticism from other scholars. The intellectual criticism has been continuous ever since, and much of Freud's work has been discredited – by the scholars.

But for the masses, Freud's ideas exerted a strong cultural influence through the 1950s and 1960s – even though Freud died in 1939. Says Kling: “Many people adopted Freudian Folk Beliefs without ever reading any of Freud's work. With Folk Beliefs, this is the norm rather than the exception. Somehow, major ideas seep into the popular culture, promoted by disciples and spreading by word of mouth.”

(continued...)

Question 1: What does this have to do with economics?

A number of recent publications by economists support the premise that economic prosperity is largely dependent on the prevailing Folk Beliefs of a society. In *The Mystery of Capital* (Basic Books, 2000) Hernando de Soto states that the reason “capitalism triumphs in the West and fails everywhere else” is primarily because of the strong belief in property rights and the rule of law. David Landes’ *Wealth and Poverty of Nations* (Norton, 1999) declares “cultural mores” are the reason some nations prosper and others flounder.

Kling summarizes:

- ◆ People behave differently based on what they believe.
- ◆ People support different institutions and policies based on what they believe.
- ◆ People’s beliefs tend to reflect the beliefs that they are exposed to in their immediate family and peer groups.
- ◆ Because of the importance of peers and family, beliefs among a group can remain stable for a long time, and then rapidly evolve when a critical mass of people experience a change of mind.

Question 2: How does this apply to personal finances and future planning?

Applying some of the observations outlined above, let’s consider one of the common Folk Beliefs from the realm of personal planning: **The cornerstone for one’s financial plan is a tax-deferred retirement plan, such as a 401(k).**

In the past 20 years, the tax-deferred retirement plan has seeped into the popular culture, supported by a bunch of media “disciples” who make their living telling you how to get rich and retire. A 401(k) is what “they” say “everybody” should do. It’s a full-fledged Folk Belief. That’s why you’ll hear:

- “I maxed out my 401(k) contributions this year.”
- “What did your quarterly statement look like?”
- “When you get to invest pre-tax, it’s like the government is giving you free money!”
- “If you don’t participate in the company plan, you’re stupid!”

These are typical statements, made by ordinary people – your neighbors, colleagues, family members. Are they 401(k) “experts?” Probably not.

Does it matter that some financial “scholars” consistently take issue with the 401(k) concept, offering logical and detailed reasons to perhaps consider other alternatives?

No.

And it’s not likely to change any time soon. The 401(k) has become embedded in the culture. For many, a discussion of its relative merits may be a waste of time, because as Kling notes, Folk Beliefs established by the ordinary people are “much more settled than Scholarly Beliefs.” And those in the “401(k) group” aren’t likely to change their beliefs – unless they do so as part of a new group.

Question 3: Do you really want to be part of this group?

The belief in a 401(k) is just one example of the financial Folk Belief systems prevalent in the United States today. Assuming you accept the premise that people act according to their beliefs, it’s reasonable to ask, “**are these belief systems profitable?**”

Consider the following (and read the details elsewhere in this issue):

- ◆ The personal saving rate for American families in 2005 was negative for the first time since the Depression.
- ◆ The average college graduate has student loan debts between \$19,000 and \$100,000.
- ◆ 10% of U.S. households hold 70% of all net worth, while 50% own only 2.6% of the total (see graph, next page).

Just to be clear: No one is saying that belief and participation in a 401(k) leads directly to a negative savings rate, student loan debt, and a disproportionate transfer of wealth. Kling is quick to say that just because something is a widely held Folk Belief doesn’t mean it is “wrong”. The importance is recognizing how deeply entrenched beliefs have a widespread impact on attitudes and actions.

But as you become aware of the particular Folk Beliefs about money and planning, including those about retirement, it is also worth noting the results that appear to follow. And at some point during this evaluation, a question should pop up...

Do you really want to be part of this group belief system?

The Decision: Which group are you going to belong to?

Think of a time in your life when you decided to stand apart from the crowd, or chose to head in a different direction than the herd.

Maybe it was because of your personal conviction, or maybe it was just stubbornness, but you weren’t doing what everyone else was doing. And in that moment, when you made the decision to take a different path, do you remember the feeling of being alone? Do you remember the moment when you thought, “I’m not part of the group anymore, I’m going to lose some friends?”

Maybe later on, your decision to take “the road less traveled” was vindicated, and others congratulated you, or even joined your side – and you became part of a group again because people joined *you*. But for awhile, you were on the outside. And no matter how independent and self-confident you are, nobody likes to be outside the group. You must find a group to which you can belong. Your long-term survival, mentally, physically and *financially*, depends on it. And if you want to succeed, the **belief system of the group** will be a critical factor in whether you achieve your goals.

It’s clear that some financial beliefs are better than



Which group are you going to belong to?

others in producing “economic well-being” – the 10% of American households that control 70% of the nation’s net worth must think and act from a better financial belief system.

A couple of final points: Just because some financial belief systems don’t “work” – i.e., they don’t lead to greater financial well-being for the group – doesn’t mean people will stop believing in them. The psychological power of being part of the group is often greater than the economic realities that result from the belief. Even though communism has never resulted in economic success, there are many who have remained true believers, right to the end. The collapse of the Soviet Union was a “surprise” to them, even though many scholars saw it as inevitable.

Here’s the follow-up thought: Because of the power of group belief, one individual almost never changes a group belief. So if you embrace a different belief, you’re going to have to find a different group.

- ◆ **What are the financial belief systems of your group?**
- ◆ **Are you satisfied with the results?**
- ◆ **If your beliefs (and economic expectations) have changed, are you in the right group?**
- ◆ **Would you like our help to determine if the goals of your current belief group are in line with your personal goals?**



THE COST OF GENEROSITY: PAYING TAX ON INCOME YOU DON'T RECEIVE

It would be possible to fill every “Things that make you go ‘Hmmm...’” column with head-scratching tax stories. But too much ridiculous taxation reading might lead to depression. Still, every once in awhile there’s a doozy that you just gotta read, even at the risk of your sanity.

This is another item from Eva Rosenberg, a nationally syndicated columnist who calls herself the “Tax Mama.” (Another sanity question: Why would anyone want to be a “Tax Mama?”) From a February 21, 2006 article, here’s the story:

A couple in Washington was building a vacation home, and received a \$70,000 loan from a relative to finish the project. The couple was going to repay the loan in full as soon as the construction was complete by refinancing the property with a conventional mortgage. Since the loan was to a family member, and the expected repayment was within a year, the relative generously offered the loan interest-free. In preparing to file their taxes, the couple wrote Ms. Rosenberg asking if they should report the loan, since both individuals are self-employed, and the IRS might question the origin of the additional \$70,000 deposited to their account.

Ms. Rosenberg responded, telling the Washington couple there’s “good news for you – and bad news. And more good news.”

The first good news? The loan isn’t taxable. The couple just needs to keep records of the construction costs, and the repayment. Nothing too controversial or unusual in that statement.

But the Tax Mama’s “bad news” is rub-your-eyes, shake-your-head, and absolutely mind-boggling. Says Ms. Rosenberg:

“You’re going to have to face your very generous relative and tell her that *she will have to pay tax on the interest income she didn’t receive.*” (italics added)

Pay tax on interest income she didn’t receive? No way! Oh yes way. The IRS calls this “imputed interest.” Thus, even if you lend money interest-free, and the loan is over \$10,000, you must still pay tax on the interest you *could have* received, using interest rate tables provided by the government. And there are actually two sets of rates, one for short-term loans (less than a year) and long-term rates.

Which leads to the final piece of “good news.” If the IRS insists on taxing the imputed interest for the lender, the borrower (in this case, the couple building the house) can also claim a deduction for the same interest they didn’t pay!

Hmmm... Representative Gil Gutknecht, R-Minnesota made this comment on taxation in an April 15, 2006 *World* article: “*There is an old adage that if you want more of something, you should subsidize it. If you want less of something, you should tax it. And what do we do in America? We tax income. We tax investment. We tax savings. We tax all of the things we want more of, and yet we subsidize consumption, indirectly.*” If that’s true, what does the government want less of, family generosity?

“Somehow or another, it never dawns on most financial gurus that you *can* control the financial environment in which you operate. Perhaps it is caused by a lack of imagination, but whatever the cause, learning to control it is the most profitable thing you can do over a lifetime.”

- R. Nelson Nash

NEWS DIGEST

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

2005 WAS NOT A GOOD YEAR FOR AMERICAN SAVERS

From baby-boomers ill-prepared for retirement to people in their 20s deep in credit card debt, the personal savings rate of Americans dipped below zero last year for the first time since the Great Depression.

The Commerce Department reported that the personal savings rate in 2005 fell to negative 0.5 percent, meaning that Americans spent their paychecks and then dipped into savings or borrowed to spend more. In December, personal savings was a negative \$67.4 billion.

It was the first time since the 1930s that the government had recorded personal spending surpassing personal income for an entire year.

Laura Smitherman, *Baltimore Sun*, January 31, 2006.



LONG-TERM CARE INSURANCE: A VALUABLE EMPLOYEE BENEFIT?

For working Americans and their employers, caring for an incapacitated parent or spouse can be expensive. "It's costing an estimated \$659,000 over the lifetime of each and every employee," says Carmen Truesdale, CEO of LTC Financial Partners, publisher of a new guidebook on the subject. That figure includes time spent away from work caring for family members, lost wages, and lost contributions to Social Security and pensions. In addition, companies suffer from reduced productivity as employees worry about their loved one or rush off to handle emergencies.

"Caregiving and productive work don't mix," says Truesdale. "But who says performance needs to suffer just because an employee's family member needs help?" The answer, says Truesdale is long term care insurance, "so money is available to pay someone else to tend the loved one."

PRNewswire, April 4, 2006.

DOES YOUR RELATIONSHIP NEED A "SPOUSAL AUTHORIZATION LIMIT?"

Marital disharmony in America could be eased overnight by a little machine that would sit next to cash registers at every retailer. It would authorize not only your credit-card limit, but also your "spousal authorization amount."

That would be the maximum dollar figure you are permitted to spend without informing your spouse. Each couple would determine its own limits in advance, a giant



bureaucratic agency would be informed, and countless money battles and divorces could be avoided.

Surveys show that up to half of all couples admit that they commit "financial infidelity" – lying to spouses about expenditures they've made.

Jeffrey Zaslow, *Wall Street Journal*, March 30, 2006.

A COLLEGE EDUCATION = A DEGREE IN DEBT

Tuition costs have jumped 32% at four-year private colleges over the past 10 years and 41% at public universities, according to the College Board. Average tuition, room and board fees at private colleges are \$29,000 this year and \$12,000 at public universities.

For graduating seniors, the average student debt is about \$19,000 financial aid experts said. Graduate students have an average debt that ranges from \$19,900 to \$105,000 for medical students including college costs, according to the Department of Education.

Pamela Brogan, *Gannett News Service*, March 24, 2006.



A NEW ERA FOR OLD AGE COULD REALLY CHANGE RETIREMENT PLANS

Modern medicine is redefining old age and may soon allow people to live regularly beyond the upper limit of 120 years, experts said Wednesday.

It used to be thought there was some inbuilt limit on lifespan, but a group of scientists meeting at Oxford University for a conference on life extension dismissed that idea. Paul Hodge, director of the Harvard Generations Policy Program, said governments around the world – struggling with pensions crises, graying workforces and rising healthcare costs – had to face up to the challenge now. "Life expectancy is going to grow significantly, and current policies are going to be proven totally inadequate," he predicted.

Ben Hirschler, *Reuters*, March 15, 2006.

3.6 MILLION OR 9.3 MILLION? IDENTITY THEFT NUMBERS OVERSTATED

An estimated 3.6 million U.S. households – or about three out of every 100 – reported being victims of identity theft, according to a government study that counted misuse of someone else's cell phone, credit card or personal information. The figures released Sunday by the Justice Department differ from findings of a previous government study that counted 9.3 million victims of the crime.

Pauline Jelinek, *Associated Press*, April 3, 2006.



THE 80-20 RULE

(NOT EXACTLY, BUT PRETTY CLOSE)

A brief Internet search turned up no definitive answer for the origin of the 80-20 Rule. But when in doubt about the origin of a phrase, it's always safe to attribute it to Ben Franklin or Albert Einstein. Hey, they were smart guys. And even if they didn't say it, they could have. So, as Ben or Albert once said...

80% of the value resides in 20% of the people/assets.

Thus...

- 80% of the work is done by 20% of the employees.
- 80% of business comes from 20% of the customers.
- 80% of one's productivity comes from 20% of one's activity.
- 80% of the money is earned by 20% of the workers.

You can also flip the 80-20 rule around, meaning...

- 20% of the work is done by 80% of the employees.
- 20% of business comes from 80% of the customers.
- 20% of one's productivity comes from 80% of one's activity.
- 20% of the money is earned by 80% of the workers.

If the 80-20 Rule is true, then in a capitalistic free-market economy, 80% of the wealth should be controlled by 20% of the people. Guess what? That statement appears to be true, at least in the United States.

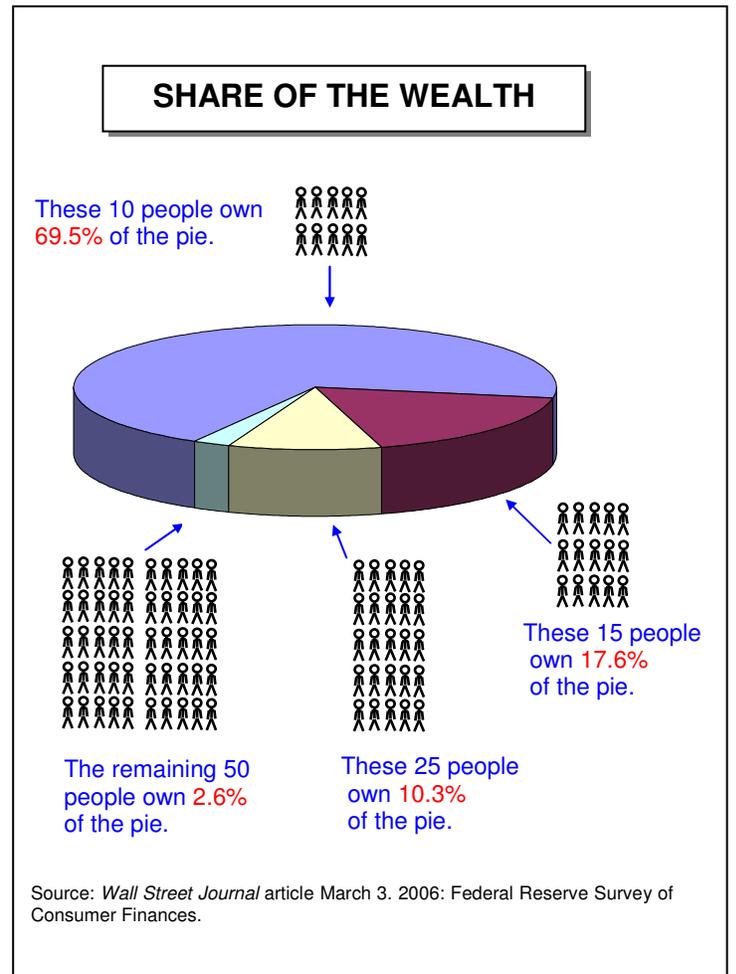
Every three years, the Federal Reserve Board conducts a nationwide Survey of Consumer Finances. The most recent survey (released in March 2006) provided information about 2004. The survey attempts to assess the total net worth held by American families. Net worth is the value of all assets – houses, cars, retirement plans, savings accounts, stock portfolios, etc. – minus all liabilities (mortgages, loans and the like).

The Fed estimated the total net worth of families to be about \$50 trillion. Of that \$50 trillion, 69.5% of it is held by the top 10% of American families. In other words, the 80-20 rule is closer to the 70-10 rule. The average net worth of the families in the top 10% was \$831,600.

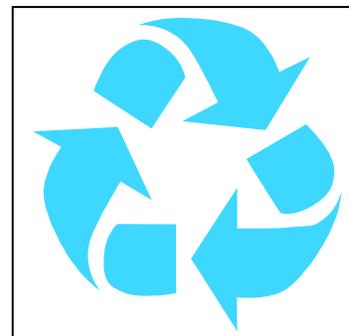
This ratio has stayed quite stable over the past 10 years. In 2001, the top 10% of families owned or controlled 69.7% of all net worth. In 1998, the figure was 68.5%; in 1995, 67.8%. (The survey doesn't break down the results for the top 20%, but does report that the top 25% held 87.1% of all net worth. So if you don't like 70-10 ratio, 87-25 is accurate as well.)

The flip-side of the rule, the 20-80 part, is quite sobering. The bottom half of American families hold only 2.6% of the nation's net worth.

(See graph)



Source: Wall Street Journal article March 3, 2006: Federal Reserve Survey of Consumer Finances.



A RECYCLED TOPIC WITH A NEW SPIN:

“Do I Really Need Life Insurance?”
(Maybe You Shouldn't Be The One To Decide!)

Read financial publications long enough, and you soon realize a lot of the material is recycled – the same topics appear over and over, just dressed up a little differently. This recycling isn't a lack of creativity on the part of the publishers; there are legitimate reasons to regularly revisit some financial issues. First, new readers may not have read about the topic. Second, old readers might just now find the topic relevant. Third, new information may actually change the nature of the discussion. (continued...)

Considering all three reasons for recycling, here's a short commentary on a Financial Planning 101 topic: **Do I really need life insurance?**

In the April 12, 2006 edition of the *Wall Street Journal*, columnist Jeff Opdyke covered the conventional responses to this question. The author started with reasons to buy (or not buy) life insurance, then proceeded to offer formulas to calculate the amount of life insurance "needed." There was the "Rule of Thumb" calculation (five to 10 times annual salary), followed by the "income replacement" and "financial need" calculations. Blah, blah, blah. There's nothing new here, just a recycling of standard financial commentary on what many consider an unpleasant but necessary part of personal financial plans. In fact, if this article was just a condensed version of the afore-mentioned *Wall Street Journal* article, you should've stopped reading.

But wait, there's more...

Ian Hodge, a consultant from Australia with 11 years of experience in the investment industry, is the author of *Making Sense of Your Dollars* (Ross House, 1995). Described as a book on "wealth strategy" covering a range of financial topics, Hodge provides an interesting perspective on the decision to buy life insurance.

Hodge begins with two simple premises:

- ◆ First, insurance is a method whereby a group of people join together to share the risks that are involved in a particular activity.
- ◆ Second, risk is an inescapable part of life.

Given the reality of these two statements, "the only question available to us is where we wish to locate the risk and how we wish to ameliorate difficulties that occur." In other words, what is going to serve as your life insurance?

Concludes Hodge:

If a man refuses to buy life insurance on himself, he has nominated his wife, children, family, church members, or tax payers to bail out the family should he die early (assuming he's not rich enough to bear the cost from his estate).

Should a man refuse to buy life insurance, it seems fair that he should do so only after consulting his wife and children and perhaps other family members, to make sure they are able and willing to bear the cost. If he's a member of a church he should be willing to discuss this matter with the deacons and elders to make sure the church is willing to bear the financial burden. If he expects his wife to live off government welfare, he should consult with all other taxpayers (i.e., his neighbors) to ascertain if they are willing to bear the risk. If anyone refuses to contribute to his welfare at this point, the man has a moral problem to overcome: should he force others to bear the risk when they do not wish to take on the burden and, perhaps, cannot afford the liability.

Only an insurance policy that people can purchase voluntarily overcomes the coercive alternative. Through the insurance company all those who voluntarily pay premiums are declaring: "Yes, I'm willing to finance the burden of your loss."

Can you imagine the discussions that would result if the question, "Do I really need life insurance?" was answered not by you, but by your children, your relatives, your religious or fraternal organization, or your neighbors!

As Hodge says, the risk in life is inescapable. But the decision on how to best insure against that risk affects a lot more people than one might first consider.



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