

CREATIVE

Wealth Maximization Strategies

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Which Stones Will Make Big Ripples?

“In this information-saturated era, we expect no surprises, yet we are constantly surprised. We have huge amounts of data, so we assume that risks can be calculated and avoided. But we also have exceedingly complex systems.”

**L. Gordon Crovitz, “Tsunamis of Information,”
Wall Street Journal, March 21, 2011.**



Tsunami
hazard sign.

If you hear the following phrases (or something like them), be on your guard:

“We should have seen this coming.”

“In light of these facts, there is only one reasonable conclusion.”

One is a statement about the past, the other about the future. Both statements embody the belief that cause-and-effect relationships are at work in the universe, and that those who understand these relationships can both accurately discern the past and confidently predict the future.

Theoretically, this paradigm is correct. But practical application of it is almost impossible. Why? Because there are so many inter related causes and effects. In a laboratory, scientists can isolate one or two factors, conduct focused research, and derive concrete conclusions that are both observable and repeatable. But while this information may give insight into the functions of a particular system or its interaction with a specific number of variables, the results may or may not have practical use in the “real world.”

For example, lab research may show a direct correlation between cigarette smoking and the incidence of cancer. Further field studies may indicate that smokers do in fact have a higher incidence of cancer than the general population. However, research cannot explain why some smokers do not succumb to cancer. Why? Because there must be other cause-and-effect factors in play as well.



Perhaps there are genetic patterns or lifestyle choices that offset the negative effects of tobacco. Maybe age and gender make a difference, or geography plays a part in either contracting or resisting the disease. As much as we know about the harmful effects of smoking, cancer and other related diseases, no one can say with absolute certainty that abstaining from tobacco is *guaranteed* to keep you from getting cancer. Even with the benefit of hindsight, there is often no way to determine which decisions, which environmental components and which genetic factors ultimately “cause” the events that come to pass.

Economics is another field in which we encounter overwhelming complexity and a limited ability to determine which factors lead to success or failure. Ask 100 economists to determine the causes of the real-estate bubble, or how to reduce the national debt, and you will get 100 different answers – with supporting research. These differences of opinion aren’t because today’s world is more complex; the same divergence of opinion has applied to assessments of previous economic events as well (after 80 years of debate, there is still no consensus over the causes of the Great Depression).

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This inability to adequately understand and respond to the cause-and-effect events that impact our lives can be disheartening. On one hand, we know our decisions will impact our future. On the other hand, we don't know precisely what the impact will be, good or bad, from those decisions. As we consider the future, each decision is like a pebble dropped in a pond, and we are constantly asking, "What ripples will come from this decision, and will the effects be good or bad?"

Dealing with complexity: Better Models or Basic Principles?

In general, there are only two approaches to financial decision-making that stand any chance of succeeding. One approach is idealistic and should be continually studied; the other is pragmatic and should be used in the real world.

The idealistic approach to financial decision-making is to develop ever-more complex models to explain and predict events. Today's computers make it possible for data to be assembled, sifted, and analyzed to a degree that was unthinkable even 20 years ago. As a result, there are "new and improved" economic models for all sorts of issues. In theory, these historically-accurate, probability-factoring, multi-scenario financial calculators promise to deliver a better retirement, build a bullet-proof investment portfolio, determine whether it's better to buy or lease, and inject "certainty" into your financial affairs.



Some day, in a perfect world, the breadth and depth of our knowledge may finally match the complexity of our world, and when it does, we will unravel the mysteries, anticipate the unforeseen, and master the universe. This is a noble pursuit, and anything that adds to our financial knowledge is worthwhile. However...

Even in their most advanced forms, these models are largely dependent on human factors. Someone has to decide which data is relevant, and someone has to interpret it. Inevitably, some of these human decisions will turn out to be faulty, which means progress toward a perfect financial model is going to be a long history of trial and error. Knowing these limitations, do you want your decisions tied to financial models that might prove to be in error tomorrow?

Further, even with increased knowledge, understanding the past and predicting the future are two different things. Assuming a financial model could get the history right, there is still no way to account for future events that might add new variables into the decision-making equation. Thus, while better analysis and more complex financial models may make us more knowledgeable, these programs still aren't smart enough to predict the future and guarantee financial success.

Instead of futilely seeking perfect information on which to make a perfect decision, the pragmatic view is to recognize that you can't know or control all the variables. It is a more productive approach to recognize and consistently apply general financial principles. These principles are statements of economic reality that are generally true; and if followed, they will bring about positive outcomes, under almost all circumstances. For example:

- Save consistently
- Reduce debt
- Avoid financial losses
- Maintain flexibility in your financial programs.

This is not new information and it is not complex. But can anyone dispute the validity of these statements? Can anyone say, "You know, what's killing you right now is that you keep saving money." No. They might take issue with *where* the money is accumulating (under your mattress as opposed to the bank), but not with saving money. Likewise, can you imagine someone telling you, "If only you had more debt, you'd be better off?"...or "Losing money is going to make you rich!" Please.

While these general principles always work, notice they don't quantify the extent to which they should be applied, or guarantee the magnitude of benefits that will follow. For example, the general principle to save consistently doesn't say that if you save at least 10 percent of your annual income for 30 years at a 5 percent annual rate of return you will be guaranteed a comfortable retirement. It just says that all other things being equal, saving money is always a good thing to do, and saving money is always a better decision than not saving. And this is

the key: Regardless of the details, deciding to do these things always moves you forward. It's like dropping small pebbles in the pond, and knowing that every little ripple that hits the bank, no matter how large or small, is going to be a good one.

With the advent of complex financial models, all sorts of people have touted new "discoveries" and "secrets." Some of these claims are pure marketing from people looking to make a buck. Others come from intelligent, well-intentioned people who really believe they have found the magic bullet for financial profitability and security. Then remember that meteorologists have a hard time explaining or predicting the natural phenomena that influence the weather. Financial issues are impacted by at least as many factors – including the often irrational actions of human beings. In the face of this much complexity, relying on a model to guide your decisions is a risky proposition. Better to stay with what works than chase an ideal that cannot be found. Remember, the results from principle-based decisions might not always make big waves, but the ripples are always positive. Over time, these positive decisions, no matter how small, have a cumulative effect.

WHAT PRINCIPLES GUIDE YOUR FINANCIAL DECISION-MAKING?

ARE YOU RELYING ON FINANCIAL MODELS THAT CAN'T DELIVER?

IF YOU ARE READY TO TAKE YOUR APPLICATION OF TIME-TESTED FINANCIAL PRINCIPLES TO THE NEXT LEVEL, IT IS TIME TO SCHEDULE AN APPOINTMENT.

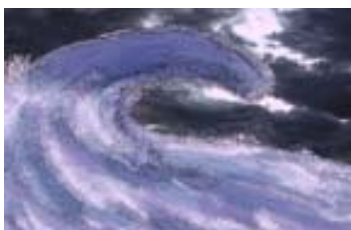
P.S. There is a Place for Complex Financial Technology

Even though financial models of increasing complexity may fall short as predictive aids, there are many ways to effectively apply technology in your financial programs. The first is **organizational**, the second is **accounting**. Comprehensive on-line programs can consolidate, condense, and organize your financial data into an accessible and manageable format. Once assembled, all sorts of accounting information can be produced, like annualized total returns, allocation percentages, etc. Financial technology may not be able to tell you what to do, but it can do a great job of telling you what you have, and how well it's working.

Many financial institutions have great on-line tools to help you organize and assess your financial situation. Take advantage of these services.

Two Overlooked Principles That Can Cause (or Prevent) Big Ripples

Most of us are familiar with basic financial principles like the ones listed above. But here are a couple of basic concepts that are perhaps not as well known, yet just as important, with great practical value.



1. Good decisions and bad decisions are magnified over time. Economists use terms like “present value vs. future value,” or “opportunity costs” to quantify the difference between deciding to do something today as opposed to waiting until some time in the future. Strip away the fancy language, it comes down to this: The sooner you start to make good decisions – and stop making bad ones – the better off you will be.

An extra dollar saved today may be worth hundreds or thousands of dollars in the future. Similarly, an extra dollar of interest paid is not only a present expense, but creates a loss in your financial world that continues into the future. Even though many of these decisions may involve small amounts of money, they determine whether time is on your side or working against you. Think about it: What would be different today if you had saved an additional \$100 each month for the past 10 years? Or what if you had avoided credit card debt? Consistently making good decisions on “small” financial issues *today* has a tremendous cumulative effect. If there is something you can do today to improve your financial situation, do it!

2. It is better to insure against loss than believe you can avoid it. Insurance can be a financially exasperating issue, because every time you pay a premium and don't make a claim, it seems like money down the drain. When your health, home, and automobile are still intact, the

only thing that's changed is the balance is lower in your checkbook. And with so many other aspects of your financial life needing attention (like retirement, saving for college, etc.), the temptation may be to cut corners on insurance.

After all, maybe you will get lucky. Maybe you will continue to be healthy, your home will not be damaged, and no one will be involved in an auto accident. Maybe you can even find statistics to prove the odds are on your side, and justify dropping coverage, decreasing benefits or lowering premiums. Maybe.

But in doing so, you have increased risk and added uncertainty to your financial life. And many of these risks are not only things beyond your control, but financially catastrophic if they occur. One unprotected event has the potential to undo a lifetime of financial progress.

Obvious examples of financial devastation might involve disability or an early or unexpected death. Lawsuits and risky investments could cause similar financial distress as well. Unlikely to happen? Perhaps. But since you can't guarantee these events will never happen to you, insurance is essential.

Even financial professionals sometimes underplay the importance of insurance, so it pays to keep this principle in mind with every financial transaction. Is there insurance involved? Should it be part of this decision? As the old adage says, you never appreciate insurance until you really need it. And if you really need it, nothing else is as valuable.

One unprotected event has the potential to undo a lifetime of financial progress.

Estate Planning: A Pebble That Can Ripple for Generations

It is an indelicate question, one that almost seems impolite to ask...

What will happen to your stuff when you die?

As much as it might seem crass or rude, this is a legitimate and critical question for spouses, children, creditors, business partners, charities, even the government. The resolution of assets and obligations at one's death is a matter of great importance for all interested parties. In some cases, the impact of estate planning may reverberate through several generations.



Because of the significance of these end-of-life decisions, the disposition of one's estate has long been regulated by law. (In an 1854 essay on the purpose of government, Abraham Lincoln wrote that one of the legitimate purposes

of government, along with law enforcement, public roads and highways, was to administrate “the estates of the deceased.”)

These legal parameters are meant to protect rightful heirs, repay creditors and discourage theft and fraud. In some instances, these regulations also include determining if the estate should be taxed. In order to receive these legal protections, estate plans must be made in accordance with the law and, in the absence of a legally valid plan, the government reserves the right to administer an estate according to its own standards.

Conclusion: If you are going to establish an estate plan, you must make sure it is done correctly.

The Purpose of an Estate Plan

An estate plan serves as a legal road map for the disposition of your assets and obligations at the time of your death. Done properly, an estate plan not only ensures that all property will be distributed according to your personal wishes, but also attempts to deliver the largest distributions possible with a minimum amount of delay to the appropriate parties. Besides providing financial certainty for beneficiaries, estate planning encourages individuals to settle other important end-of-life decisions, such as guardians for minor children, healthcare preferences, and funeral arrangements.

Considering the wide range of topics that impact the disposition of an estate, a typical estate plan will often require consultation with a number of professionals, including lawyers, financial counselors, accountants and life insurance representatives. **Estate planning is not a do-it-yourself project.**

Basic Estate Planning Instruments

Each estate plan is unique, and the legal and financial instruments that comprise the plan will depend on the size of the estate, the number of beneficiaries, and the purpose of distributions. However, most estate plans will probably include some form of the following:

A Will. The most common estate-planning instrument is the will. A will sets forth who will inherit an individual’s property at their death. Additionally, wills often appoint guardians for minor children, name financial representatives, specify funeral arrangements, and may enumerate other end-of-life details.

To ensure that all of an individual’s assets and incidents of ownership are properly transferred, wills pass through a legal process known as probate. Depending on the nature of the assets and the parties involved, probate may be lengthy and expensive. This may result in considerable delays for beneficiaries receiving distributions, and possibly diminish the amounts.

However, not all estate assets are subject to the probate process. Property owned jointly with right of survivorship (such as bank accounts, home, cars) is not usually probated. Instead, these assets pass directly to the control of the spouse, children, or business partner, etc. with whom the asset was jointly owned. Assets with named beneficiaries (life insurance death benefits, retirement plan benefits, individual

retirement accounts, and annuities) also are typically transferred outside the probate process.

A Trust. A trust is a legal method of transferring property to an artificial legal entity. The person creating the trust is known as the settlor, and the individuals benefiting from the trust are the beneficiaries. A beneficiary may be a family member, a friend, a charity, even a pet. The person or institution who oversees the property and carries out the instructions of the trust is the trustee.

There are two kinds of trusts, revocable and irrevocable. If you (as settlor) name yourself as the sole Trustee of your Trust during your lifetime, you will be able to manage the Trust while you are alive. If the trust is revocable the settlor can change it or decide to take the property back any time during his/her life. If the Trust is irrevocable, the settlor cannot change it once it has been established.

As an artificial legal entity, a trust never dies. This means assets held in trust do not have to undergo probate, even when the settlor dies. Instead, the trust continues to operate according to its instructions on behalf of the beneficiaries. The avoidance of probate can be a major advantage in estate planning, and is one of the principle reasons many estate plans will include a trust.

Other Issues

Except for Federal estate taxes, most estate settlement issues fall under the jurisdictions of the individual states. Some states impose additional estate taxes at the state level, others do not. Definitions for the survivorship rights of spouses may differ substantially in each state. These ownership issues can be further complicated when individuals own property or have business partnerships in different states. It is essential that the individual and his/her financial and legal professionals are aware of these differences and have planned accordingly.

Besides an awareness of the estate issues unique to their state(s), individuals and their advisors must also stay abreast of the constant fluctuation in federal estate legislation. In the past decade, the estate tax has been a political football, with several drastic changes as the result. After failing to agree on a long-term tax policy, Congress recently established new estate guidelines, but these are set to lapse after 2012. With each change in legislation, estate plans need a thorough review. Kelly Greene of the *Wall Street Journal* explained in an April 16-17 “Personal Finance” report,

All this means that families need to be prepared for any contingency. The way many estate plans are currently worded could cause them to backfire, either by triggering estate taxes or even accidentally disinheriting a surviving spouse.

SIMPLE QUESTION #1: DO YOU HAVE AN ESTATE PLAN?

SIMPLE QUESTION #2: IS THIS PLAN CURRENT? YOUR PREPARATIONS WILL AFFECT FUTURE GENERATIONS.



Life Insurance in Estate Planning

A life insurance policy is often a vital instrument in an estate plan, because a life insurance benefit delivers a specific amount of cash upon the death of the insured. For the beneficiaries of an estate, life insurance can provide:



- ongoing income for living expenses,
- educational funding,
- liquidity to pay death taxes,
- payments to settle outstanding obligations,
- funding for business buy-sell agreements,
- completion for retirement plans.

Under good management instructions, in combination with other assets, life insurance can allow the estate to satisfy the claims of beneficiaries, retain ownership of its most valuable assets, and buy time so other assets don't have to be liquidated at a discount.

However, to be most effective in an estate plan, the life insurance must be properly established regarding the design of the policy/ies and legal considerations. Some examples:

Policy Design. Because some estate plans will not become effective until the death of the second spouse, a financial professional may recommend a second-to-die, or survivorship life insurance policy. This policy, which insures both husband and wife, does not pay a claim until both spouses have passed. Because the claim is not paid until the second death, premiums may be lower than if the spouses held two individual policies.

If the primary emphasis of life insurance in the estate plan is to provide proceeds at death as opposed to liquid cash during one's lifetime, some insurance professionals may also recommend blended policies (i.e., a combination of term and cash value life insurance) which emphasize a guaranteed death benefit, with minimal cash value accumulation.

Ownership. Proceeds from life insurance that are received by the beneficiaries upon the death of the insured are generally income tax-free. However, while not incurring income tax to the beneficiaries and avoiding probate, these proceeds may also become part of the deceased's estate; a \$1 million insurance benefit could add \$1 million to the value of the estate, and in doing so, incur additional taxation. According to Cathy Pareto, a Certified Financial Planner writing for *investopedia.com*, the inclusion of life insurance in an estate occurs if:

- The proceeds are paid to the executor of the decedent's estate.
- The decedent at death possessed an incident of ownership in the policy.
- There is a transfer of ownership by the Insured within three years of death (three-year rule must be observed).

To avoid adding life insurance proceeds to the estate, the policy may be owned by children of the insured, or placed within an irrevocable trust under specifically delineated terms. Each of these options, along with several others, should only be undertaken with input from competent legal and insurance experts.

Because of the financial leverage of life insurance (the ability to reserve a large amount of money for the future with a small premium), it is an ideal financial instrument to protect the best assets in an estate and maximize distributions to beneficiaries.

IF YOU ALREADY HAVE LIFE INSURANCE, NOW WOULD BE A GOOD TIME TO FIND OUT IF YOUR CURRENT COVERAGE CAN SERVE YOUR ESTATE PLANS AS WELL.

"A millstone around your neck"

Definition: a problem or responsibility that you have all the time which prevents you from doing what you want.

College-Loan Debt: A Millstone on a Graduate's Future

Want to give your children a financial advantage for the rest of their lives? Then help them graduate from college without any debt, particularly student loan debt.

As Tamara Lewin reported in an April 11, 2011, *New York Times* article, "Student loan debt outpaced credit card debt for the first time last year and is likely to top a trillion dollars this year as more students go to college and a growing share borrow money to do so."

There are plenty of statistics supporting the long-term economic benefits that coincide with a college education. But these benefits can be blunted by heavy debt burdens. Consider the following statistics cited by Ms. Lewin:

- Two-thirds of bachelor's degree recipients graduated with debt in 2008, compared with less than half in 1993.
- Last year, graduates who took out loans left college
- s with an average of \$24,000 in debt.

And then, there's this personal anecdote:

During the 2008 presidential campaign, Barack and Michelle Obama spoke about how their loan payments after graduating from Harvard Law School were more than their mortgage payments. At that time, Mr. Obama said:

We left school with a mountain of debt. Michelle, I know, had at least \$60,000. I had at least \$60,000. So when we got together we had a lot of loans to pay. In fact, we did not finish

paying them off until, probably, we'd been married for at least eight years, maybe nine.

Ms. Lewin adds that Mrs. Obama said it took the royalties from her husband's best-selling books to help pay off their loans.

Beginning a career with significant debt obligations is like entering a race with a grand piano tied around your waist. The dead weight of debt not only makes it harder to get started, but also means it will take longer to reach milestones. And most college graduates will not be able to write a book to pay off the debt. In the *NYT* article, Lauren Asher, president of the Institute for College Access and Success, summarized the impact as follows:

If you have a lot of people finishing or leaving school with a lot of debt, their choices may be very different than the generation before them. Things like buying a home, starting a family, starting a business, saving for their own kids' education may not be options for people who are paying off a lot of student debt.

And for many graduates, the dilemma of student-loan debt is not going to be resolved after a few years of working. In the current environment, student loans are becoming more long-term in their impact. Mark Kantrowitz, publisher of *FinAid.org* and *Fastweb.com*, who has compiled the estimates of student debt, added this sobering thought:

In the coming years, a lot of people will be paying off their student loans when it's time for their kids to go to college.

From a personal fulfillment and employment perspective, a college education may provide an entrée to a long and satisfying career. But if obtaining a degree also means that other material aspirations will have to be postponed or eliminated, the financial advantage is diminished. If you have children (of any age) who will want to attend college, these realities should prompt some serious discussions about tough alternatives. For example:

- Is community college a better financial alternative, particularly for obtaining undergraduate credits?
- Is a program of part-time school and part-time employment a good idea, even if it takes longer to graduate?
- Should military service be considered because of the tuition assistance programs?
- Would your children rather have an inheritance or a college fund?
- Can any current financial assets be rearranged to qualify for greater financial aid?

And...if your child's college education is a priority, you should be thinking of ways to save for these upcoming expenses. You should also be educating your child about the financial ramifications of debt, helping him/her to understand the value of a debt-free start on his/her working life.

Like several other topics in this issue, small decisions made today can make a huge difference in the future, both for you and your children. **The sooner you start preparing, the more resources you'll have, as well as better options for allowing your children to graduate debt-free.**

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