CREATIVE
Wealth Maximization Strategies

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

Richard Aronwald
Financial Specialist

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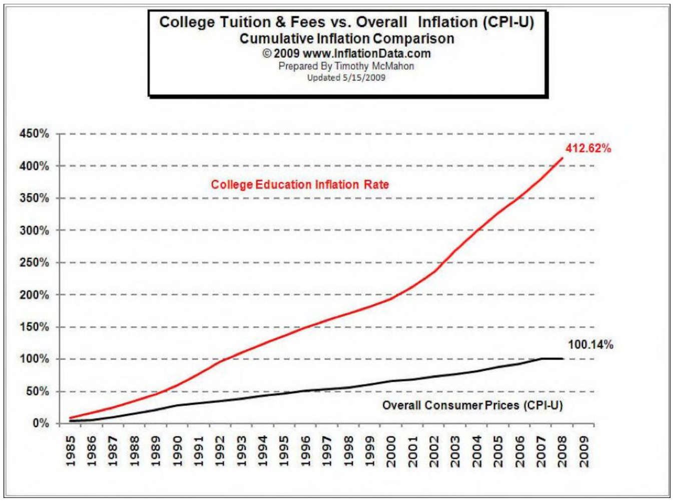

Figure 1

THE PROBLEM WITH STUDENT LOAN DEBT

To Borrow or Do Without?

When you don't have the money to buy something, you either borrow or you do without. So what are the factors that determine whether it's best to borrow or do without?

Through the history of finance, the consensus has been that borrowing to increase wealth is a worthwhile endeavor, while borrowing for leisure or consumption is unwise. The basic assumption behind "good borrowing" is that the financial gain one hopes to achieve from using borrowed capital will result in greater prosperity – even after the debt has been repaid. This paradigm of borrowing to increase prosperity is the essence of "good" banking, in that both the borrowers and lenders are better off. (In contrast, when consumers incur debt for leisure or consumption, the profitability of these transactions heavily favors lenders; borrowers may realize some immediate enjoyment, but often end up poorer.)

One of the concerns with borrowing, in any context, is that a borrower may take on so much debt that it becomes impossible to repay it. For countries, businesses or individuals, an out-of-whack debt situation is a financial death spiral in which the likely result or outcome is default and bankruptcy – outcomes that hurt both borrowers and lenders. For this reason, borrowers and lenders have strong incentives to monitor debt ratios.

Student Loans: Good Borrowing Gone Bad

For at least the last half-century, borrowing to obtain a higher education has been seen as good borrowing, because of the assumption (strongly supported by statistical evidence) that a degree will lead to higher income and greater financial opportunity. But too much debt or not enough earnings can undo the good idea of borrowing for a college education. And today, the numbers and anecdotal evidence strongly suggest that the fundamentals of educational borrowing are trending toward trouble.

First, there is the fact that education-related debt is mushrooming:

- Late last year, the Federal Reserve reported that Americans now owe more than $1 trillion in student loans, exceeding what is owed on credit cards and automobiles.
- An October 18, 2011, article in *USA Today* noted that outstanding debt has doubled in the past five years.
- The College Board reports that, *adjusting for inflation*, students are borrowing twice what they did a decade ago.
- In 2010, the Project on Student Debt found that two-thirds of college students needed student loans, and their average loan balance was $25,500.

Not surprisingly, the increase in borrowing has meant an increase in payments due after graduation:

- The Bureau of Labor Statistics says average loan payments have risen 83% over the past decade.

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- Stories in the *Chicago Tribune*, *Wall Street Journal* and *Detroit News* featured graduates whose monthly student loan repayments comprised 40 to 60% of the graduates' take-home pay.

Adding to the problem of larger balances: less work, more defaults.

- The April 18, 2012, *Wall Street Journal* said "The unemployment rate for young college graduates rose from 8.7% in 2009 to 9.1% in 2010, the highest annual rate on record."
- The April 17, 2012, *Detroit News* quoted a New York Federal Reserve article stating 27% of active student loan balances are 30 or more days past due.

Suddenly, student loan debt is becoming a national issue, generating provocative sound bites:

- *Chicago Tribune* reporter Becky Yerak leads off with, "Move over, mortgages. Get out of the way, Greece. Another economic doomsday scenario is emerging."
- In the *USA Today* article, Nick Pardini, a Villanova grad student in finance, warns student loan debt is "going to create a generation of wage slavery."
- Illinois Attorney General Lisa Madigan testified before a U.S. Senate subcommittee in March 2012 that, "Just as the housing crisis has trapped millions of borrowers in mortgages that are underwater, student debt could very well prevent millions of Americans from fully participating in the economy or ever achieving financial security."

These comments reflect concerns that an out-of-balance student loan situation has become severe enough to impact the national economy. *Slate* writer David Indiviglio notes the U.S. government now holds almost half of all student loan debt; defaults would mean "taxpayers are on the hook again…and it puts U.S. higher education in the embarrassing position of hindering, rather than helping to fuel, economic growth."

The potential impact isn't just national and financial; it's personal, and it spills over into other areas of life. Graduates say that the burden of student loan debt forces them to defer marriage and children, prevents them from qualifying for a mortgage, limits their access to credit cards or car loans, and restricts their opportunities for post-graduate education that might significantly increase their earnings.

In some cases, student loan debt is so great that graduates face the prospect of never getting out from under it – the loans will be a lifelong economic barrier to prosperity.

Why College Borrowing is Out-of-Balance

Considering the context in which these life-altering decisions are made, it shouldn't be surprising that borrowing for a higher education is creating a potential financial crisis.

On a macro level, college expenses have been rising faster than the cost of living for the past three decades (see Figure 1 on page 1).

This means paying for a college education requires a larger percentage of household income.

At the same time, while a college degree generally results in much higher earnings compared to individuals with a high school diploma, the rate of real income growth is actually declining for young college graduates. Writing in a March 2, 2012 *New York Times* op-ed, Tyler Cowen, a professor of economics at George Mason University, noted that "Real earnings for men, [ages] 25 to 34, with bachelor's degrees are down 19% since 2000, and for female college graduates of that age they are down 16% since 2003." (See Figures 2 and 3.)

And yet, Cowen also notes that not having a college degree today has even greater *negative impact* on earnings: "Thirty years ago, college graduates made 40% more than high school graduates, but now the gap is about 83%." **In summary, it costs more to get a college education, but *it costs even more to go without one*.** In this damned-if-you-do-damned-if-you-don't environment, it's easy to see how the math of student loan debt could turn ugly.

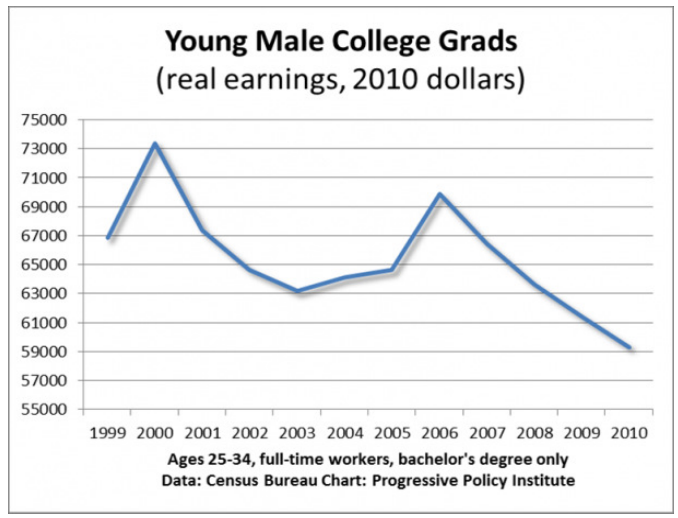

Figure 2

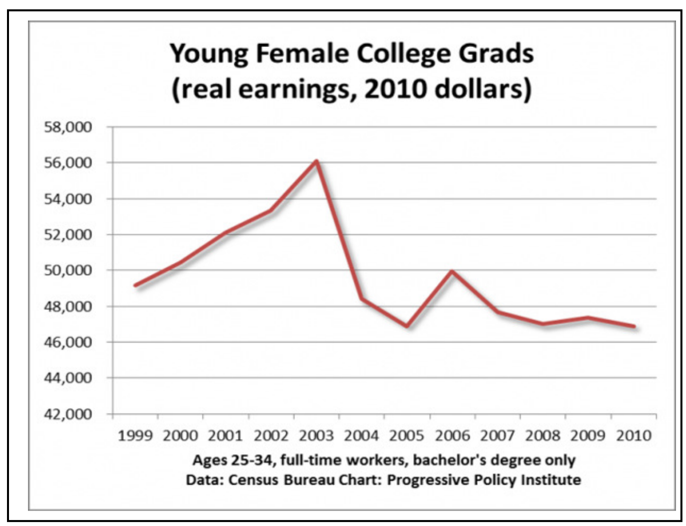

Figure 3

Add to these macro issues the personal challenges in figuring out college funding. Few 18- or 19-year-olds have an accurate idea of what they want to study or the career they want to pursue. The norm is changing majors, sometimes changing schools, taking longer than four years to finish – then taking several years to settle in a profession. Change and uncertainty in any endeavor make it hard to plan for the future; it's even tougher when, for many, paying for college is their first encounter with long-term financial decision-making.

And studies indicate both parents and their children are ill-informed about their borrowing options. Sue Shellenbarger, writing in the April 18, 2012,*Wall Street Journal*, says "Most students get little help from colleges in choosing loans or calculating payments." Deanne Loonin, an attorney for the National Consumer Law Center, finds many borrowers "are very confused, and don't have a sense of what they've taken on."

Given these factors, it's easy to see how student loan debt can put many graduates behind before they ever get started, and how difficult it can be to undo poor planning.

Fixing the Funding Dilemma

Most of the top-down proposals coming from legislators and education advocates regarding student loan issues are tweaks to the existing system. There are proposals to limit loan payments to a percentage of income, relax the qualifications for forbearance, and expand the criteria for loan forgiveness. However, each change that lowers payments or reduces balances also increases the probability that lenders will either charge more or tighten their qualifications. These ideas, while well-intentioned, aren't going to be game-changers, which means parents and prospective students need to find other ways to get a degree without going broke.

Given this information, a simple response is **rearranging priorities to save more money.** If a college education is integral to your children's future, paying for it has to become a high-priority financial objective – maybe even more important than retirement (for awhile). Every tuition dollar that isn't borrowed delivers big returns down the road. Consequently, a thorough review of current allocations and accumulation strategies may be in order.

Another fundamental action is **becoming informed.** Several experts stated most borrowers aren't aware of the differences between government loans and private loans. And while the evidence is mostly anecdotal, scholarships go unfilled each year. For those who have time to prepare, knowing the pros and cons of Coverdell and 529 plans, UGMA accounts, and how eligible assets are reported on the FAFSA form can be invaluable in receiving grants and other types of financial aid.

A practical consideration is to **start slowly, and stay local.** Attending a community college for a few years may dramatically reduce tuition costs, buy time to carefully consider a career path and allow for some financial life experience (like paying rent or following a budget).

Look for innovative market solutions. More than ever, a college education seems essential to long-term career and financial success. But the current student loan paradigm as a way to obtain a college education is not sustainable. The need for a "work-around" to the current funding paradigm is a huge entrepreneurial opportunity to make college education more affordable. There are rumblings that on-line classroom formats are poised to revolutionize the delivery of higher education. And some employers (such as the military services) subsidize or reimburse higher education expenses for their employees; this practice could expand. Finding entry-level employment with a company that offers an "earn and learn" program could be a huge funding source.

Set a limit on debt, and agonize over exceeding it. Just because a lender is willing to give you more money doesn't mean you will be able to pay it back. Earning a degree while accumulating too much debt is a recipe for financial failure. Many of the personal stories accompanying articles about student loan debt feature people who "had no idea my payments would be this big" after graduation. Their thought process was "don't worry about it, just focus on your studies. You can work out the details once you find a job." Regardless of the topic, that's no way to make an informed financial decision!

If people have the aptitude, they should make every effort to get a higher education, because earning a college degree has a strong positive correlation for a broad range of financial and personal well-being factors. But a poorly considered borrowing plan has the potential to negate these advantages by shackling graduates to an anchor of long-term debt. Understanding what's at stake, it should be clear that deciding to borrow for college is a project that requires thorough examination and careful deliberation. In the current financial environment, these are decisions that have a tremendous lifetime impact.

- **SERIOUS ABOUT COLLEGE FUNDING?**
- **GET INFORMED, GET ASSISTANCE, AND GET STARTED!**

PERMANENT LIFE INSURANCE:

The Best Coverage for the Short Term?

One of the challenges in buying life insurance is that purchasers are making a financial decision regarding an unknown future event which could occur as soon as tomorrow or 50 or 60 years in the future.

Since the particulars of life are constantly changing, the odds are high that many of today's financial decisions will be modified at a later date. In this constantly changing environment, how likely is it that a life insurance program established a few years (or a few decades) ago will still fit today's realities?

Many consumers end up repeatedly changing their life insurance coverage, just as they make adjustments to other pieces of their financial life. They drop existing coverage, change policy types, switch companies, add or subtract benefits. While these changes may be reasonable based on current circumstances, they may not be financially efficient. If a change in life insurance represents a "new beginning," there's a strong possibility previous life insurance decisions resulted in financial waste.

Some might say this financial inefficiency is to be expected with all insurance. People pay premiums for protection against an event they hope will not occur – an accident, a fire, a theft, an illness. If things go well, and nothing bad happens, then money spent on insurance is "lost;"

If you're going to buy insurance for something you know will happen, structure the coverage so that a lifetime of premiums can be recovered by the inevitable claim.

the expenditure did not provide a benefit, other than peace of mind. Since the best-case return on insurance is a financial loss, the primary financial objective with insurance is to find the lowest rate to minimize anticipated losses.

But life insurance is a unique financial product with different parameters, so focusing exclusively on the lowest rate is not always the best criteria. Because of these differences, what some consider the most "expensive" type of life insurance is arguably the approach that delivers the best benefits – over a lifetime and in the short term.

The basic concepts of life insurance are fairly straightforward: A policy in force at death will deliver a cash benefit to beneficiaries. The applicant's good health is a qualifying factor in securing coverage. These components aren't much different than other types of insurance. But there are other considerations unique to life insurance.

First, everyone dies. You may never have an accident, your home may never burn down, but mortality is a certainty – it's just a matter of when. If you're going to buy insurance for something you know will happen, it makes sense to structure the coverage so that a lifetime of premiums can be recovered by the inevitable claim.

The cost of life insurance increases with age because as people get older, insurance companies have a shorter time to accumulate the reserves needed to pay death benefits. In addition, future good health is not a given. Both these factors provide incentive for consumers to obtain life insurance sooner rather than later.

But in order to keep a life insurance benefit in force until death, policy owners are faced with the possibility of years, even decades, of premium payments. In light of the other financial changes that are certain to occur, keeping life insurance policies in-force can become problematic; regular premium commitments may not match an up-and-down financial life. This tension between the desirability of securing coverage as soon as possible and the logistical challenge of keeping it in force for a lifetime often makes it challenging for households to construct a life insurance program that delivers protection today and maximum benefits over time. In response, the life insurance market provides two basic options: term and permanent/cash value insurance.

In regard to initial premium outlay, term insurance is definitely less expensive. But term insurance is a limited contract; the premiums paid provide a death benefit only during the specified term (10 years, 20 years, etc.). If you don't (or can't) pay a premium, the coverage ends. If the term expires, the insured may re-establish coverage at a higher rate, but may be required to undergo a new health evaluation. With most term polices, there is no refund of premium (those that offer this feature do so by increased premiums).

In contrast, permanent insurance is a financial product with options, choices, and the capability of adjusting to changing circumstances. Unlike term, permanent insurance is designed (and priced) to provide an insurance benefit for a lifetime, not just a 10- or 20-year period. Once premiums have been paid for two or three years, and cash values have accumulated, automatic loan provisions* may keep coverage in force during periods when cash flow isn't available. Cash values and insurance benefits can be increased incrementally through the purchase of paid-up additions. In a typical dividend-paying** whole life policy, cash values may exceed premiums paid (usually before fifteen years). So even if you surrender the policy and forfeit the insurance benefit, there can be a positive return from the premiums paid. These multiple benefits result in substantially higher initial premiums, and the challenge for some consumers is justifying the difference in premiums compared to term insurance.

Besides the long-term advantages of permanent insurance, it is also worth considering how these same features perform in the short-term, under changing circumstances. To illustrate, let's project two events – one realistic, one fantastic – in a ten-year period following the purchase of a 10-year term policy and a permanent policy.

The Realistic Event: In the fourth year, suppose the policy owner experiences a layoff or termination of employment, resulting in a significant decrease in monthly income. How will the life insurance coverage remain in force? With a term policy, the individual must maintain premium payments, even on a restricted budget. If budget constraints mean deciding between some necessity and an insurance premium, the choice may be to surrender the coverage. On the other hand, a well-designed permanent policy could use a premium loan from cash values to keep the policy in-force until finances stabilize.

The Fantastic Event: In the tenth year, suppose the government unveils a new form of national life insurance. Every citizen is covered and every citizen must obtain a minimum level of coverage. In assessing this completely unexpected event, the policy owner concludes there is no longer a need for keeping the individual policies. Both policies are surrendered. The term policy simply ends, and a decade of premiums – and what those premiums could have earned had they been invested – is gone. However, when the permanent policy is surrendered, the policy owner receives the accumulated cash value, which nearly equals premiums paid.

With Expert Guidance, You Can Have a Permanent Life Insurance Program

Once consumers understand the benefits and flexibility of a permanent insurance policy, many must still resolve how to meet the higher premium requirements. A knowledgeable insurance agent can be invaluable in this process, because many permanent insurance policies have riders that allow for combinations of term and permanent features, with options to convert or change the configuration over time. This format secures coverage today under the most favorable terms, anticipates a lifetime benefit, and makes provision for adjustments along the way.

Since change in the rest of life is certain, why not be sure your life insurance program is positioned to remain a profitable asset through the years?

* Loans and loan interest reduce policy benefits. Dividends, if any, are affected by loans and loan interest.

** Dividends are not guaranteed and are declared annually by the company's board of directors.

MEGA MILLIONS WINNERS TAKE THE LUMP-SUM

(What do they know?)

When three tickets matched all six numbers in the Friday, March 30, 2012, Mega Millions lottery drawing, the winners were faced with a wonderful dilemma: How to receive their portion of the record $656 million jackpot?

A little background: The announced Mega Millions jackpot is based on the cumulative value of 26 years of annual payments. Instead of annual payments, winners also have the option of receiving a lump-sum payout, for a lesser amount. If the winner chooses a lump-sum distribution, the amount received is further reduced because taxes are withheld.

In this case, the $656 million was divided by three, leaving each ticket holder with an announced jackpot of $218.6 million, or $8.4 million a year for 26 years. The gross lump-sum amount was $158 million. In a future value calculation, $158 million would have to earn approximately 2.8 percent each year to provide $8.4 million a year for 26 years.

Due to different levels of state income tax (the winning tickets came from Maryland, Illinois and Kansas), the net lump-sum distributions ranged between $105 million and $110 million.

All three winning parties chose the lump-sum payment. Why? From a sampling of commentary, the two primary reasons were income taxes and estate considerations.

While there hasn't been much information regarding the personal financial conditions of the three winners, adding either $8.4 million or $158 million to this year's income puts the winners in the highest marginal tax rate; there is no obvious tax advantage to defer income. If tax rates increase over the next two decades, deferring the winnings could result in higher tax costs. An April 2, 2012, *Wall Street Journal* article discussing the distribution decisions stated most advisers recommend the lump sum because the consensus is income tax rates will be increasing in the future.

Advisers also recommend the lump sum approach for the long-term planning advantages. The *WSJ* noted that if a lottery winner dies before the scheduled stream of payments is complete, "the total value of the future payments could be subject to a one-time estate tax – which could be difficult for a winner's family to pay." This is especially relevant for older winners (the Illinois winner was a 65-year-old retiree). Taking control of the money now allows winners to settle tax issues, and allocate assets to trusts or other estate planning devices, maximizing value for beneficiaries.

What Drives the Decisions?

At first glance, winning $218 million and deciding to walk away with $110 million seems like giving up a lot. But part of the distortion is the difference between the "announced" jackpot and its present value; showing the big number is a marketing strategy. However, the real takeaways from this event are the perception that income taxes will be going up, and the value of having the money under one's control.

Whether you are a lottery winner trying to secure unexpected good fortune, or someone who is diligently saving for the future, tax treatment should figure prominently in your financial decisions. For the Mega Millions winners the question was simple: lump sum or 26 payments? For others, the issues may be more complex: A bonus this year, or deferred to next year? Before- or after-tax savings vehicles? The over-arching consideration: Better to pay the tax now, or later? For the Mega Millions winners, the decision was clearly to pay the tax now.

Besides a lower cumulative tax bill, the decision to take a lump sum puts more assets under individual control sooner. If a Mega Millions winner wants regular payments, there is a reasonable argument that a personally managed portfolio could achieve the investment results required to provide 26 payments – and perhaps quite a bit more. The lump sum recipient is assuming the investment risk, but the 3 percent return required to match the lottery's offer is not a steep hurdle. Further, when the distribution is under the individual's control, changes in strategy and amounts are possible. Once a winner elects to receive annual payments from the lottery, flexibility is gone. The only way to undo the annual income plan is to sell the remaining payments to a private financial institution at a discount in exchange for a lump sum.

Steven Levitt and Stephen Dubner are the co-authors of *Freakonomics*, a best-selling collection of strange-but-true economic stories with insightful explanations. Levitt and Dubner say the unifying theme of *Freakonomics* is "People respond to incentives." This applies to the Mega Millions winners: Their decision to receive a lump sum instead of regular payments was a logical response to the tax and estate planning regulations/incentives currently in place.

- **DO YOUR ACCUMULATION DECISIONS ADDRESS HIGHER TAXES IN THE FUTURE?**
- **ARE YOUR FINANCIAL ASSETS AND ESTATE PLANS UNDER CONTROL?**

IF YOU'RE READING THIS ARTICLE, YOU MAY LIVE TO BE 100.

The following two paragraphs opened an April 11, 2012, article from *Reuters*:

People worldwide are living three years longer than expected on average, pushing up costs of aging by 50 percent, and governments and pension funds are ill-prepared, the International Monetary Fund said.

Already the cost of caring for aging baby boomers is beginning to strain government budgets, particularly in advanced economies where by 2050 the elderly will match the number of workers almost one for one. The IMF study shows that the problem is global and that longevity is a bigger risk than previously thought.

So… this "problem is global" and a "bigger risk than thought." Nothing like laying a guilt trip on people for exceeding their life expectancy. Who knew simply living longer could throw a monkey wrench in the global economy?

Sarcasm aside, the article highlights two important points:

1. Lifespans have seen a sharp uptick in the past two decades.

2. The assumptions used by governments to provide pension and health benefits are inaccurate.

The fact that people are living longer has to be considered good news, given the alternative. As for the inaccurate assumptions, this really isn't a surprise, except perhaps to the politician that believes the fundamentals of socio-economics can be overruled by legislation. So instead of fretting over what some short-sighted prognosticators see as a looming catastrophe, why not embrace the probability of a long life? And why not figure out strategies to make that long life enjoyable?

This optimistic approach actually has some strong statistical support. In a March 29, 2012, article from *U.S. News and World Report* titled "Do Rich People Live Longer?" reporter Kimberly Palmer mentions a "wealth gradient in mortality." A simplified explanation of the wealth gradient states there are certain demographic and behavioral factors that strongly correlate to longevity. Not only do these factors tend to predict longevity, they also project positively on the quality of life these people will enjoy while living longer.

The factors which figure strongly in the wealth gradient are **education, lifestyle behaviors** and **income.** It is difficult to say which factor is primary, as each factor influences the others. US Census statistics show wealthiest Americans have longer life expectancies. This is no surprise, because as David Hill writes in a March 15, 2012, article for *Singularity*:

"…the upper class has access to better resources, such as quality food and health care. They are also more informed, have the best education, and have access to more opportunities. (All of these factors collectively contribute to an improved quality of life. And…a better quality of life extends longevity.")

James Smith, a senior economist for the Rand research group, says the causality goes both ways. "Because you are healthy, and able to work, you are wealthier." George Vaillant, a professor of psychiatry at Harvard, identifies education as a catalyst for both health and wealth. In the *USN&WR* article, he says: "People who go to college are more likely to smoke less, drink less and are less likely to be obese." In addition, "Educated people are more forward-thinking."

If you set aside all of the apocalyptic jabber about governments struggling to pay for their social entitlements, living longer is actually indicative of living a ***better*** life. And while living longer may require some adjustment to societal norms (retirement may not begin at 65), the future doesn't need to be viewed with trepidation. The vast majority of people alive today who make it to age 100 will work longer, make more money, and live healthier lives.

Financially, the only things that may change are the paradigms in which we frame our expectations. When retirement is hypothetically scheduled to begin at 65, providing for 35 years of retirement seems like a daunting task. But if retirement begins at 75 or 80, that's 10-15 more years of earning and saving, and 10-15 fewer years of retirement. And since most of us find great satisfaction in being productive at something we enjoy, maybe "deferring" retirement isn't really a failure or cause for alarm.

LIVING LONGER MEANS MORE OPPORTUNITIES TO EARN, TO SAVE AND PLAN AND ENJOY LIFE. TAKE ADVANTAGE OF YOUR LONGEVITY.

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

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