CREATIVE
Wealth Maximization Strategies

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

Frank Z. Levine
Financial Specialist

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THE BEST FINANCIAL STRATEGY: IT'S ALL ABOUT INCOME

So many choices, so many voices, so little clarity

21st century technology offers infinite financial possibilities. With a single click from their home computers, individuals can buy shares on a foreign exchange, get competitive quotes for insurance, analyze years of financial data, receive up-to-the-minute reports or on-the-spot prices of precious metals, and execute hundreds of other financial transactions – all by themselves. For those with an Internet connection, there are no restricted areas, no products that can't be purchased, no places that can't be reached.

However, expanded choices also necessitate more decision-making. With so many financial products and strategies available, how does the consumer determine which ones fit their objectives and circumstances? In this open access environment for financial products, institutions recognize they must differentiate themselves from their competitors; companies can't simply present and explain their products and services, they must ***market*** them. Thus, unlimited choices are accompanied by advertising that features attention-grabbing curiosities like talking-baby stock traders, animated green lines for retirement, and profound (yet utterly fictional) e-mail conversations about the financial future.

While this type of advertising may help consumers remember the name of the company or its products, it is questionable if marketing actually provides consumers with any clarity regarding their financial decisions. Instead, they are inundated with a combination of emotional images and conflicting financial perspectives, which offer little guidance or education. In the end, most mainstream financial "information" delivered by mass-media outlets does little more than add new voices to the cacophony of opinion and hype. Infinite choices and multiple messages equal consumer confusion.

One approach that always makes sense

Making sense of the multitude of messages and endless array of financial products requires a unifying financial objective, one that provides a context for evaluating all the possibilities available. To that end, here is arguably the best

financial strategy, one that addresses the most pressing financial challenges, yet allows room for opportunities:

It's all about income.

It is not about total return, or net worth, or risk tolerance, or financial ratios – it's all about income. With this strategy, most financial issues can easily be filtered, understood and resolved by answering one question:

"How will this decision affect my income?"

Perhaps this sounds too simplistic. But try it.

How will buying a new car affect your income? (If the monthly payment is more than what you were paying, your income will be negatively affected. Is it worth it, or would you be better off finding reliable transportation for a lower price?)

How will investing in a qualified plan affect my income? Long-term the hope is your investment will compound greatly to increase future income. On the other hand, money set aside in an account meant to remain untouched until age 59½ reduces your current income. Considering your personal circumstances, which is more important, income now or income later?

If you make good decisions based on increasing your income benefits, your financial life will make steady progress.

The compelling case for income

Most Americans do not function in a closed, self-sufficient economic system where we meet our material needs and desires by growing our own food, making our own clothes, generating our own electricity, etc. In order to acquire both the necessities and luxuries of life, we use

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money. Since maintaining our material world is a daily, weekly, monthly and never-ending task, the need for spendable money (i.e., income) is daily, weekly, monthly and never-ending, providing income is the essential and foremost financial priority in everyone's life.

The financial priority of income cannot be overstated. A major portion of our tax structure centers on income. With every election cycle, politicians of every stripe inevitably tout "jobs creation" as one of their legislative priorities. (Is this because more people want to *work*? No, it is because people want – and need – ***the income*** that comes from having a job.) Similarly, the debates about Social Security, Medicare and health insurance are ultimately concerns about providing and preserving income, and the costs of doing so. As a nation, we are obsessed with income.

Many people could benefit from using financial assets under their control to generate more immediate income.

Income defined

For our discussion, income is any financial gain that puts spendable dollars in your hand. A paycheck is income, as are payments received from loans and rental agreements. Interest and dividends are also income. A stock that grows in value to $10/share from $5 has experienced appreciation, but there is no income *until the stock has been sold at a profit*. Similarly, homes and other real assets, while they might be listed on your net worth statement, are not income until their value has been converted to spendable dollars.

The 4 facets of income planning

As the number one financial priority in everyone's life, income activities can be categorized in four distinct actions.

1. Generating Income

The foundation of every good financial program is the ability to manage assets to generate income. If you are employed, your ability to work is one of the assets you manage. Interest from a savings account, certificate of deposit or other financial instrument is income. The profits from a rental property can be considered income. (In contrast, a personal residence, while a financial asset, is not usually a source of income; the house may appreciate in value, but that appreciation doesn't deliver spendable dollars.)

For most, the default option for income generation is a job, i.e., getting paid for services rendered. While this is undoubtedly the predominant form of income generation, it is not the only method. A narrow focus on employment for income generation is a shortcoming of many financial strategies. Many people could benefit from using financial assets under their control to generate more immediate income, instead of focusing exclusively on accumulating for retirement.

2. Accumulating Future Income

In the simplest sense, "accumulating future income" is simply saving today to provide income in the future. But just as income generation may mistakenly overemphasize just getting a good job, *saving* can also be over-simplified to amassing the largest possible number on a balance sheet. As Barry J. Dyke puts it, "a major problem in financial planning today is that 401(k) and mutual fund marketers have successfully blurred the difference between 'saving' and 'investing.' When one saves, money is safe and liquid. When one invests, 100 percent of your money is at risk 100 percent of the time." Some assets, while highly valued, are not always good sources of income. For example, a rare collectible may be appraised at $1 million, but this asset only becomes income when it is sold, which requires finding a buyer and relinquishing the asset.

3. Protecting Income

Since most income generation comes through work and employment, it makes sense to protect both the generating asset (i.e., the individual) and its income potential. One of the reasons health insurance is such a prominent political issue is because almost everyone's income is affected by their health, and the cost of maintaining it. The same rationale extends to obtaining both disability insurance and life insurance: when individuals stop generating income, everything else usually grinds to a halt.

Income protection is more than protecting the individual's ability to earn income. As recent history shows, sudden changes in markets can turn profitable investments into sizable losses. Given this volatility, individuals may consider it prudent to "move" accumulated future income to various insured accounts to "lock in" their income-producing potential.

4. Distributing Income

In industrialized Western economies of the late 20th century, the template for income success was long-term employment during one's working years, followed by pension incomes (from government and private plans), supplemented by personal accumulation.

In this model, the emphasis in personal accumulation was on maximizing valuation because all assets were assumed to be easily convertible to income at a later date. If you owned a home, it was assumed you could sell it for a profit. If you held stocks, future share prices were projected to be higher, and dividends consistent.

In considering employment and pensions, recent experience suggests the 20th century model for income may be outdated. In the Information Age, lifetime employment is less likely, private pensions are disappearing and government programs appear statistically unsustainable in their current formats. This puts a greater income burden on personal accumulation. Since much of the guaranteed income sources of previous generations are either disappearing or diminishing, individuals must place a greater emphasis in income generation from their personal savings.

Financial professionals, such as attorneys, accountants, insurance agents, and stockbrokers, may have knowledge in tax law, estate planning, portfolio selection, risk management, and other specialized areas. These specialties are important and necessary, but the over-arching purpose of these professionals and their specialties should be to enhance the income positions of their clients. If the four aspects of income planning are properly addressed, financial success will inevitably follow.

Do your financial actions improve your income, both now and in the future?

Are you working with someone who understands why it's all about income?

GUARANTEES, PROMISES AND CONTRACTS

If you want to ensure a steady stream of income in retirement, what's the best approach? Any assessment of meeting the challenge of retirement income inevitably reduces to two options: group plans or individual contracts.

Social Security, Employer Pensions, Individual Annuities

Most developed nations have established some version of a national retirement income program funded by taxes; in the United States, the plan is Social Security. These programs cover just about everyone and participation in the plan (through taxes) is mandatory. Income payments are made for the retiree's lifetime, and in some cases, for the lifetime of the retiree and his/her spouse.

Employer-sponsored pensions are another large-group mechanism for retirement income. The employer establishes and funds a plan to provide retirement income benefits to employees. The retiree's income benefits are based on a formula that usually includes years of service and the level of income earned while employed. Like Social Security, employer pension plan benefits are paid for the retiree's lifetime with survivorship benefits usually included.

The individual strategy to lifetime retirement income is the purchase of an annuity from an insurance company. In return for depositing a lump sum with the company, the individual receives a guaranteed stream of payments. The amount of the payment is dependent on the age and gender of the individual (called the annuitant), and the payment terms selected. Like government programs and employer pensions, payments from an annuity can be structured to be received for as long as the individual lives (the life-only option), or as long as the individual and a designated beneficiary live (life and joint-survivor option). Most insurance company annuity products also allow several other income options, such as receiving payments for a specified period, or a combination of lifetime and periodic payments.

Similarities, Differences & the meaning of "Guaranteed"

In several ways, the working parts of government plans, employer pensions and individual annuities are quite similar. Payouts in all three programs are based on actuarial calculations involving age at retirement, projected lifespan and the lump sums available to provide ongoing benefits. But beyond the basics, the plans diverge dramatically.

Both Social Security and employer pensions involve large groups of retirees, whose numbers are always changing (as some people become eligible and others die). Meeting the funding obligations of large groups of people requires ongoing deposits to the plan. For Social Security, the deposits come from taxes; with pensions, the employer is required to make annual contributions. In contrast, an individual Single Premium Immediate Annuity (SPIA) is a one-time financial transaction involving a single person. This distinction is significant.

In a courtroom, the exact phrases describing this difference between group and individual plans would be more precise and nuanced, but for purposes of discussion, let's use these simple terms: Social Security and employer pension plans are **promises** to deliver retirement income, while an individual annuity is a **contract**. This difference greatly affects the meaning of "guaranteed" in the respective plans.

For Social Security and employer pensions, "guaranteed" means that participants can expect a retirement income, but both the eligibility requirements and the amounts received may be subject to change. For individual annuity owners, guaranteed means the insurance company is legally required to honor the specific terms of the agreement, without change – for the entire period of the of the agreement.

Social Security participants (essentially all American wage-earners) make tax payments today not knowing what they will receive in the future. Likewise, employees in companies that offer pension plans are forgoing current income in exchange for the employer setting aside funds for retirement income – again, not knowing exactly what they will receive. In contrast, the purchaser of a fixed annuity contract knows exactly what he will receive for his one-time payment. All payments have been made, and the terms of the agreement are precise.

Considering these differences, which retirement income format can best be described as "guaranteed?"

It is common knowledge that Social Security, in its present format, is under-funded – going forward, there isn't going to be enough money to provide the benefits "guaranteed" by the program. The proposed strategies are to reduce (or delay) benefits, or increase taxes, options which face some strong opposition from the electorate given the current state of the economy. What does this mean for retirees and their income? Carina Smith, a commentator writing on October 6, 2010, for the Puritan Financial Group, presents the following scenario:

> **If nothing is done to alleviate the coming deficit in Social Security funds, benefits are guaranteed to drop. Specifically, failure to resolve the budget issues well in advance will cause the trust fund to run out around the year 2037, when low-income retirees (whose benefits are already below poverty level) and the richest retirees will see the reduction of benefits by 22% - almost a fourth of what In less than three decades, federal deficits will result in the inadequate funding of the Social Security system, which will decrease benefits significantly for workers who will retire after 2037.**
>
> **they now receive. The sudden benefit cuts will also be felt by retirees, no matter what their states of health or finances are. Doing nothing to the current structure of America's retirement system will ensure that most people who've contributed throughout their years of work will face significant financial losses.**

In addition, Ms. Smith notes that

> **The retirement program's administration adds the issue of irregular paychecks to an abrupt cut in a retiree's fixed income, along with the reduction of benefits by unknown percentages. For example, a previous monthly payout of $1,000 won't be lowered to around $800 - instead, Social Security will give retirees full benefits during the months it has collected enough funds through payroll taxes, and issue no payments at all when there are inadequate funds to pay participants in full.**

When a guaranteed plan has phrases like "significant financial losses" and "irregular paychecks" associated with it, does this arrangement sound like a guarantee you can count on?

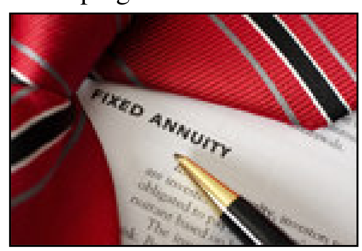
Employer pensions have some "guarantee" issues as well. An expanding number of eligible retirees coupled with diminished returns on investments have left many employer pensions under-funded. Similar to Social Security, one of the proposed strategies to the funding dilemma is to decrease benefits for retirees. Another option is to terminate the plan, and have it taken over by the Pension Benefit Guaranty Corporation, a government-sponsored pension insurance entity, which will also result in diminished benefits for many retirees.

How can a pension plan modify or sidestep the promises made to retirees? Here's an example:

A current lawsuit brought by Minnesota state employees and retirees says the state's pension board acted illegally by cutting promised benefits. In response, Assistant Attorney General Rita Coyle DeMueles defends the action, saying the state has the right to modify benefits to pensioners because no contract existed between employees and the state. As Jonathan Miltimore, a national reporter for *The Franklin Center for Government and Public Integrity* noted in a Sept 15, 2010 online post, DeMueles told the court that "There is no contract here, express or implied."

On the other hand, annuities are contracts, and since the annuitant has fulfilled his part of the contract by making full payment to the insurance company, the company is now legally obligated to deliver the benefits as stipulated in the annuity agreement. A failure to perform doesn't allow the insurance company to ask for additional funding or decrease benefits. Once the contract is established, the insurance company is on the hook to fulfill it.

Fortunately, insurance companies have an excellent track record when it comes to keeping their commitments. A June 19, 2009 article by Barry J. Dyke published in *Medical Economics* noted that even during the "Great Depression, when more than 10,000 banks failed, 99.9% of consumers' savings in life insurance and annuities remained safe with legal reserve life insurance companies." Dyke also cites a 2009 report that showed many Federal pension funds are predominantly invested in "annuity contracts underwritten by major U.S. life insurance companies…"



The Security of an Income That You Cannot Outlive

The value of a pension is the security of having an income you can't exhaust or outlive. Both government programs and employer pensions attempt, with good intentions, to deliver this type of retirement security. But because these plans involve so many people, require ongoing funding, and include multiple variables that could affect the solvency of the plan, the promised benefits are subject to change.

Individual fixed annuities offer the same income security features – with a much greater degree of assurance that the promised benefits will actually be delivered.

This guarantee difference between large group plans and individual annuities illustrates one of the apparent paradoxes of a free-market economy. Insurance companies transact business on an individual basis with large numbers of people, yet the end result of the process achieves economies of scale, and makes it possible for all annuitants to receive a certain and secure retirement income. Both Social Security and employer pensions are beyond-your-control benefits with default participation that may or may not deliver their promised benefits. But the strongest guarantees for future income distribution are achieved through individuals structuring annuity contracts to meet their unique financial objectives.

- **HOW SOLID ARE THE GUARANTEES IN YOUR PENSION AND RETIREMENT INCOME PLANS?**
- **IS IT TIME FOR AN INCOME CHECKUP?**

WILL THE CHANGING NATURE OF EMPLOYMENT DRIVE PEOPLE TO INDIVIDUAL STRATEGIES …OR REQUIRE A LARGE-GROUP INTERVENTION?

Even as the larger economy appears to have moved toward a wobbly recovery, analysts have noted that hiring has remained stagnant. Some commentators attribute this to employer uncertainty over issues like access to credit, the potential costs of health care, and the effects of deficit spending. If and when things look better, the expectation is that hiring will take off.

But others see a fundamental change in the nature of employment in the United States. In an October 13, 2010 *USA Today* article, Paul Davidson writes

> **"Across the nation, many companies are shifting to a more flexible workforce populated by temporary workers, contractors and freelancers, loosening the bond between businesses and employees… The trend is subtly reshaping a workforce in which businesses traditionally employed workers through good times and bad, protecting them with benefits and job security."**

The article goes on to state that some analysts believe that "contingent workers," i.e., those who work steadily but not exclusively for one employer, constitute up to 20% of the labor force, and that number is projected to rise to 25% in the near future.

For many employees, a great portion of their financial security has come not only from the steady paycheck but also other income-protection benefits offered through their employer (such as health, life and disability insurance), as well as access to a retirement plan. But if one in four workers will no longer be tethered to a full-time employer, how will these individuals obtain the essentials of long-term income security?

It is easy to project the solutions to these income security issues moving in one of two directions. The marketplace already provides individualized insurance and investment products, so a free-market response might be for insurance companies and financial institutions to offer packages of benefits to defined groups of temporary workers. Assuming the groups would be large enough to achieve economies of scale, it is conceivable that these package plans for temporary employees would be cost-competitive with group plans from full-time employees.

However, there is another issue of temporary work: sporadic and irregular income. When premiums are due monthly but there isn't income in a particular month, what happens to the insurance?

Since the government is already involved in cushioning the impact of irregular income by administering unemployment benefits it isn't a stretch to see the call for a broader universal employment package perhaps be paid through payroll taxes. The benefits might include not only health, disability and life insurance, but also emergency fund accounts that could be accessed only during periods of unemployment. Coverage could be completely portable, regardless of one's employment status.

Some think tanks and policy research centers are already studying proposals for this type of income-security protection. Some approach the issue from a health insurance perspective, while others emphasize modifications to qualified retirement plans. Some proposals are funded by additional payroll taxes, others by voluntary contributions to special accounts.

In theory, a government-administered universal benefits package is attractive, both for employers and employees. Employees would know they have basic income security protection, regardless of their employment circumstances. Employers would no longer have to provide benefits or differentiate between full and part-time employees. However, the challenge to any tax-funded program is keeping costs in line with benefits. Insurance and investment companies have the dual constraints of profitability and competition driving them to place the best products in the marketplace. Government programs have no profit incentives and no competition. Historically, this results in bloated bureaucracy and poor value.

If the trend toward contingent employment continues, it will be interesting to see which ideas win the day.

WHAT IS YOUR EMPLOYMENT STATUS?
HAVE YOU BECOME A "CONTINGENT WORKER?"

IF SO, SHOULD YOUR INCOME PROGRAMS BE ADJUSTED TO MEET THE CHALLENGES OF A CHANGING WORKFORCE?

INCOME STEALER FOR RETIREES: CREDIT CARD DEBT

An October 22, 2010 article released by the Reuters news service carried the following headline:

Retired and broke:
Why retirees are declaring bankruptcy

The article noted that while personal bankruptcy filings are up for all Americans, the fastest-growing age demographic for bankruptcy were those 65 and older. As the article stated, "for more and more seniors, retirement doesn't mean a debt-free life of leisure."

A number of inter-connected items have contributed to this dramatic increase in financial insolvency among retirees.

One of the biggest problems for financially troubled seniors is credit card debt. Compared to other bankruptcy filers, those over 65 have higher credit debts – and they have more credit cards in their pockets.

Why so much credit card debt? A simple answer is some retirees live beyond their means; they use credit cards to buy what they can't afford. But some experts see a deeper reason than irresponsible spending habits. Many retirees have an income problem.

In the Reuters article, Stephanie Osterland, a supervisor in the bankruptcy department at Green Path debt solutions, said many retirees are "just trying to live off of a fixed income, and that's usually Social Security. Maybe they have a small pension. We find they've used credit cards to supplement that income and expenses or they just end up getting into a lot of medical debt."

In addition, the article mentioned that many seniors have experienced declines in their investment portfolio values due to a lagging stock market. This leaves retirees less able to cope with unexpected financial obligations. As a result, credit cards have become a "maladaptive coping mechanism," according to John Pottow, a University of Michigan law professor who authored the research on bankruptcy filers.

It's hard (and unfair) to apply hindsight to the individual actions of large groups of people, but one wonders if these retirees' situations would have better had they chosen to guarantee more retirement income through the purchase of a lifetime annuity.

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Certified Financial Services
Frank Z. Levine
Financial Specialist
Flevine@cfsllc.com

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