CREATIVE
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> **"Wide diversification is only required when investors do not understand what they are doing."**
> - Warren Buffett

Retirement Planning Should Not Be a Group Project

"There is strength in numbers."

"Larger organizations can achieve economies of scale."

These are some of the reasons people choose to use group structures to meet their financial objectives. For things like auto and health insurance, being part of a group usually means lower rates, easier qualification standards, and other advantages that might only be available to large numbers of people. It is conceivable that almost every facet of an individual's financial program could be transacted within groups – insurance, retirement, investing – the whole shebang.

Human beings are social creatures. It is in our DNA to want to be part of a group, to form associations with others. In many ways, our individual identities are defined by our group associations. We call ourselves liberals, conservatives, jocks, nerds, believers, unbelievers. Being part of a group is comforting; it tells us we are not alone. Being part of a group can also be empowering; "think of what we can do if we work together!" If people don't feel like they are part of a group, they usually find a way to form their own. (By the way, isn't a "singles club" an oxymoron?)

But sometimes, the group format just doesn't fit. No one wants to wear the same clothes as everyone else, eat the same food, go to bed at the same time, or watch the same television shows. (Think about it: people who do this are usually in prison.) And as much we may find strength and comfort in group affiliations, we are still individuals with unique desires and preferences. So while there are many benefits to being part of a group, not every challenge in life has a group solution, including financial challenges.

In particular, observation suggests that many people might be better served by establishing individual retirement programs apart from the group plans provided by employers or the government. At first hearing, this statement may seem contrary to much contemporary financial opinion, but there are solid reasons to hold this view.

Issues with group retirement plans…

Group plans do deliver retirement benefits, but in doing so, these programs have some inherent drawbacks for individuals. Some of it is simply because group dynamics require a one-size-fits-all format and attempting to please everyone usually means fully satisfying no one. This is the same tension between the group and the individual that plays out in other aspects of life.

But beyond the group-vs.-individual conflict, there is the tendency of financial group transactions to move away from the discipline of free-market competition. Instead of a thousand individual decisions accurately shaping a market to meet consumer demands, groups often attempt to command the market (and consumers) to adjust to the objectives of the group – even if these objectives aren't realistic. And the results are predictable: plans that under-perform, excess regulations, and constant change.

The scenario is similar to countries that have attempted to operate a command economy, as opposed to a free market economy. The government declared the price, determined the level of production, then discovered the price was too high and production was too low. To fix the problem, the government persisted in its price and production standards, but added more regulation and stepped up enforcement. But even with total control, their economies failed to prosper because the actions weren't based on economic realities. The following is list of the challenges facing group retirement plans, because free-market principles have been ignored.

1. Inaccurate projections. Constructing a group pension plan requires smart people to make complex projections using assumptions about the future – things like how long retirees will live, what rate of returns will be earned on investments, how large benefits will be, etc. If just one of many variables in the projection turns out to be incorrect, the pension plan can unravel. And because the calculations involve a group of people (rather than just an individual) the consequences of a mistaken projection can be huge, and difficult to correct. By itself, making exact calculations for a large number of people is problematic.

But compounding the problem of inaccurate projections is evidence that pension funds may have some incentive to ignore economic reality and continue working with inaccurate pension models. As David Reilly reported in the September 18-19 *Wall Street Journal* ("Pension Gaps Loom Larger"),

> **"Many of America's largest pension funds are sticking to expectations of fat returns even after a decade of paltry gains, which could leave U.S. retirement plans facing an even deeper funding hole and taxpayers on the hook for huge additional contributions."**

Rather than increase pension funding, the less-costly adjustment for the employer is to project a higher rate of return, and hope the money doesn't run out. Of course, sometimes (quite often) those hoped-for projections don't come true, which results in another issue.

2. Insolvency. One of the reasons defined-benefit pensions have almost disappeared from the workplace is the reluctance of employers to be obligated to lifetime retirement income payments. After ignoring the true cost of funding a pension for an extended period, many older companies suddenly find the "legacy costs" of retiree benefits are too costly to bear. As a result, the company ceases operation or applies for bankruptcy protection and restructuring. The pension plan is often terminated, and the responsibility for the payment of remaining benefit obligations is transferred to the Pension Benefit Guaranty Corporation (PBGC), a government-sponsored pension insurance program.

While the PBGC promises to continue pension payments, it does not promise that beneficiaries will receive their full pension income. For 2010, the maximum annual PBGC payment is $54,000. While PBGC says their research indicates "the overwhelming majority of the participants in plans taken over by the agency face no reduction in benefits due to the legal limits on coverage" (from an October 27, 2009 press release on www.pgbc.gov), the agency also says "the largest reductions occur in cases where participants earn pensions that 1) significantly exceed the maximum insurance benefit, or 2) provide generous early retirement subsidies." In other words, those who earned the highest pension payments are most likely to lose retirement income.

Because of demographics, Social Security also faces a solvency issue as well. As the number of retirees eligible to receive benefits increases, there are also proportionally fewer workers to foot the bill through their payroll taxes – and there is no PBGC to make up the shortfall. In order to maintain the integrity of the plan, administrators (i.e., legislators) must reduce benefits, change the eligibility age, or raise taxes – or a combination of all three. None of these options are politically palatable, so once again, economic reality is ignored, and the problem is kicked on to the next session of Congress.

3. Investment risk. Defined-contribution plans do not have to deal with income guarantees and solvency issues, because the responsibility for profitable investing now defaults to the individual participant. Considering the challenges professional pension fund managers face in delivering acceptable returns, it seems unlikely that employees can make profitable investment decisions by taking 15 minutes once a year to "rebalance the portfolio" after reviewing a quarterly statement. And while Social Security can appeal to Congress and failed pensions can rely on the PBGC, defined-contribution participants have no fallback position – one investment misstep can erase years of saving and accumulation – and there are no bailouts. Primarily as a result of the financial turmoil of the past three years, and the significant losses which individuals have incurred, there is a new appreciation for stability and guarantees, particularly in retirement accounts. Carrying all the investment risk is a heavy burden.

4. Plan Restrictions. Group retirement plans are not designed for personal preferences and circumstances; most start from a one-size-fits-all template with minimal alterations allowed. For all but a tiny minority of Americans, participation in Social Security is mandatory. Pension plan parameters (vesting, retirement age, years of service requirements, etc.) are determined by the pension administration, not the individual. When you are part of the group, you adjust to the rules of the plan, and accept its terms.

Defined-contribution plans, even while they offer some choices, are replete with restrictions. Government regulations define contribution amounts, limit the type of investments that may be held in plans, set loan provisions, and determine when and how the funds may be distributed. Through their plan administrators, employers decide which investments will be offered, the terms for matching contributions, and what additional features will be included in the plan. Successfully navigating these restrictions can be a challenge, especially since they often change.

5. Unforeseen Changes. Retirement is a long-term project, one in which decisions made today may have a significant impact years later. But it is difficult to make good decisions when so many aspects of group plans are subject to change. For example:

Should your retirement plan include Social Security benefits, knowing that the system is unsustainable in its current form? One of the current proposals to "fix" Social Security is decreasing benefits based on a sliding scale against you if you have other retirement resources. Now, saving in one vehicle could diminish your returns from another.

What if the age for full distribution changes? How will that affect your decision to keep working?

What about taxes? If marginal rates go up, will it mean paying a higher tax on distributions than the credit that was received for contributions?

What if the plan changes the investment options? What if loan provisions are terminated?

What about the match?

What about the match? Many participants in 401(k)s were attracted by their employer matching contributions. However, the recent economic downturn has severely curtailed employer contributions. And an August 3, 2010 *Wall Street Journal* article, *Employers Slow to Resume Pay Perk,* notes that matching contributions have been "restored only sporadically."

Some of these changes may be favorable, some may not. You just don't know. You can't plan for them, either. You can only react.

Is there a better group plan, or is it time to go it alone?

As it stands, Social Security is actuarially unsound, many of the pension plans still in existence are failing to meet their funding obligations, and employee participation in defined-contribution plans is declining. Facing this "retirement crisis," observers see two clear options: Establish larger, tighter-controlled group plans or allow expanded individual options.

Retirement USA is an organization that defines itself as "a national initiative working for a new retirement system that, along with Social Security, will provide universal, secure and adequate income for future retirees." The organization came into existence because it recognizes "that retirement income security is a major issue of concern for current and future retirees." The Retirement USA web page lists more than a dozen different proposals for establishing new group retirement plans. Some have names like "Government Retirement Account" or "Uncle SAM Retirement Plan – (Safe and Adequate Model Retirement Plan)," and almost all emphasize government administration, guaranteed returns, mandatory contributions, and greater restrictions on access to funds. It's a Big Brother approach: "we know what's good for you, and for your own good, we're going to make you do it."

On the other hand, the financial marketplace currently provides all the products necessary to deliver a great retirement. The investment choices are limitless. If individuals want a guaranteed monthly income, they can shop any number of insurance companies for an annuity. An individual can retire as young or old as they want to. Assistance is available, and individual financial products have a great track record for performance and guarantees, arguably better than the performance of group plans. Given the right resources, you can tailor your retirement program to fit your circumstances. What's not to like?

The well-intentioned Big Brothers of the world fret that some people will not take advantage of these free-market opportunities – they won't be responsible, won't save, etc. and may become a burden for the rest of us. To compel people to do what they should, group plans often procure tax-favored status for their programs which, on paper, may make the private alternatives seem less-attractive. But think about it: many of the tax advantages are deferrals, meaning tax is going to be due some time in the future. What will tax rates be? You don't know. If you are successful in accumulation and tax rates rise to meet higher government costs, will the deferral be worth the regulation, change, investment risk and general uncertainty?

HAVE YOU EXPLORED THE POSSIBILITY OF INDIVIDUAL RETIREMENT PLANS INSTEAD OF GROUP PROGRAMS?

GROUP RETIREMENT PLANS: What are we talking about?

A group retirement plan is any government- or employer-sponsored program that is intended to provide retirement income. Social Security is a group plan. A defined-benefit pension is a group plan. Defined-contribution retirement plans such as 401(k)s, 403(b)s, and 457s, even though they consist of individual contributions and accumulations, are also group plans because of other features in the plans.

Social Security

The basic components of a pension are the formulas for calculating retirement income benefits and the method of funding used to provide them. In the case of Social Security, individuals receive a lifetime retirement income based on a calculation of their earnings, working years and age. These benefits are funded by taxes collected by the US Treasury for the Social Security Administration from both employers and employees.

Social Security is the ultimate group retirement plan in the United States. The National Committee to Preserve Social Security and Medicare (NCPSSM) states that Social Security is the only source of retirement income for 20% of all Americans, and comprises more than half of the retirement income for two-thirds of US retirees.

Defined-benefit plans

Similar to Social Security, a defined-benefit pension plan guarantees an employee will receive a definite amount of benefit upon retirement, typically based on age, average salary, and years of service. These benefits are funded by the employer contributions to a privately administered pension fund. The amount of the employer's contribution will depend on actuarial calculations of the present and future obligations to retirees and the performance of the underlying investment pool.

50 years ago, defined-benefit pensions were commonplace, but today defined-benefit pensions are vanishing from the retirement landscape. Government employees (including state and municipal employees, and teachers) along with some large corporations are among the few sectors where defined-benefit pensions remain in place.

Defined-contribution plans

In a defined-contribution plan either the employer or employee makes funding contributions to the plan. The allowable annual contribution amounts vary with the type of plans (see chart), as does the criteria for employer contribution to the plan (some may match employee amounts, contain percentage caps, etc.). Using a plan administrator, the employer typically provides a menu of investment options for the plan participants, but assumes no responsibility for the performance of the accounts. At retirement, the benefit received will depend on the investment performance of these contributions, and the method in which the retiree chooses to take distributions.

2010 Contribution Limits for Select Qualified Retirement Plans

PLAN TYPE	MAXIMUM ANNUAL CONTRIBUTION Under age 50	Over age 50
IRA	$5,000	$6,000
Simple IRA	$11,500	$14,000
401k	$16,500	$22,000
403b	$16,500	$22,000
Sec. 457	$16,500	$22,000

PERMANENT LIFE INSURANCE:

A FEW QUESTIONS FOR THE "EXPERTS", AND A FEW ANSWERS FROM CONSUMERS

As has been mentioned in previous issues, permanent/cash value life insurance (i.e., any life insurance policy designed to remain in-force for one's lifetime) is a complex financial product. Perhaps because of this complexity, the value and application of permanent life insurance in a financial program generates a wide range of opinion, and some of it is quite stridently opposed to it.

Consider the following commentary from two financial experts regarding permanent life insurance, and some questions that might follow:

Expert #1: The following is an excerpt from the website of a financial guru with a nationally syndicated radio program:

> **"If you follow my plan, you will begin investing well. Then, when you are 57 years old and the kids are grown and gone, the house is paid for, and you have $700,000 in mutual funds, you'll become self-insured. That means when your 20-year term is up, you shouldn't need life insurance at all—because with no kids to feed, no house payment and $700,000, your spouse will just have to suffer through if you die without insurance."**
>
> **Don't do cash value insurance! Buy term and invest the difference.**

Hmm. A few questions:

- How does this plan ensure "investing well?"
- What if the kids aren't grown and gone and the house isn't paid for? Is there still a need for life insurance?
- If someone is unable to complete this plan in the 20-year time frame, how will they maintain life insurance coverage?
- 20 years from now, how does one know $700,000 will be enough for the surviving spouse to "suffer through" if the other dies without insurance?

Expert #1's perspective on life insurance is colored by his belief that he can deliver a best-case scenario by "investing well" and teach others to do the same. However, if "investing well" doesn't happen within the 20-year window of the term insurance, this approach could easily unravel and deliver far less than promised.

Expert #2: This comment comes from a book about how to "manage a modern financial life and prepare for a secure retirement" by an investment advisor whose work is cited regularly in the *Wall Street Journal* and other financial media.

> **"There can be a place for permanent life insurance, but it generally only makes sense for people with significant wealth or income. While this is a generalization, you probably need income of about $200,000 or assets above $1 million before a permanent policy would offer many benefits. There are certain tax and estate planning reasons that make permanent policies attractive, but again this is the exception, not the rule. If you are considering a permanent policy, work with a qualified financial and tax advisor to determine if the policy offers you some financial benefit."**

A few questions:

- If someone anticipates earning an income of $200,000 or accumulating $1 million in assets, *when* should permanent insurance be purchased – before or after they "make it?"
- Because of health issues that may arise in one's later years, is there a concern that waiting to purchase permanent life insurance could possibly result in not being able to get it?
- If those considering a permanent life insurance policy should consult with a qualified advisor regarding their unique circumstances, what is value of generalizations about permanent insurance?

Expert #2 admits permanent life insurance makes sense, but sees using it as the "exception, not the rule." The only way to determine if you are the exception is to consult an expert.

Granted, these excerpts represent abbreviated commentaries from these experts. But these comments reflect their over-arching perspectives on permanent life insurance: Most people shouldn't have it.

Yet even though the experts are less than enthusiastic about permanent life insurance, it appears consumers have other ideas (see below).

GUESS WHAT CONSUMERS SAY?

On September 14, 2010, Newswire released an article titled ***"Permanent Life Insurance Grows in Popularity among Middle Class."*** Here are three paragraphs:

> **"As the economic downturn rolls into its third year, middle-class consumers are showing a growing interest in managing financial risk through the use of permanent life insurance products."**
>
> **"This seemingly old-fashioned product remains popular because of its long-term value, flexibility and stability. The guarantees offered by these policies make it an especially appealing choice during the uncertainties of the current economic crisis."**
>
> **"After years of following the popular pitch to 'buy term and invest the difference,' consumers are now seeing how a market downturn can threaten a seemingly sound financial strategy," said Scott Spiker, CEO of First Command Financial Services, Inc. "These numbers support findings by others in the industry who note that Americans are turning to permanent**

life coverage as a time-tested tool for managing long-term risk."

So, middle-class consumers like whole life, even while many of the "experts" hold a less favorable opinion. Why?

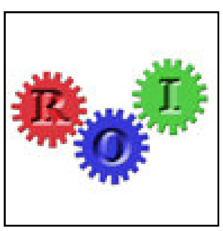
One possibility is that consumers are beginning to realize their limitations. After three years of financial bad news (or more precisely, one year of really bad news and two waiting to see either a recovery or a bottoming out), consumers have less confidence in their ability to invest well and manage risk. And because their financial decisions have a direct impact their future, managing risk has become a higher priority.

Experts, on the other hand, are perhaps unshaken in their belief they can successfully avoid investment risk rather than manage it. After all, they *are* experts. But this time, consumers might be ahead of the experts.

A September 24, 2010 **Wall Street Journal** article announced *'Macro' Forces in Market Confound Stock Pickers.* The article discussed the plight of professional stock market investors who made their reputations discovering undervalued or unknown stocks. As Tom Laurencella and Gregory Zuckerman report, "the market turmoil…has made their entire investing approach feel like an exercise in futility." Big-picture issues like the economy, politics and regulation have made stock pickers realize that "long-held investment strategies are no longer working very well."

It is natural that experts would constantly be in search of a "better way" to reach financial objectives. But for many non-experts, the best way is sticking with something that works instead of chasing something that might – or might not – deliver better results. Properly positioned, permanent life is a "time-tested tool for managing long-term risk."

INSTEAD OF CONTINUING TO LOOK FOR "BETTER WAYS," YOU MIGHT BE BETTER SERVED BY PUTTING TIME-TESTED METHODS INTO ACTION. GET PROFESSIONAL INPUT AND GET STARTED.



(BTW: Economists Like Permanent Life Insurance, Too)

Jesus Heurta De Soto is a Spanish economist from the Rey Juan Carlos University in Madrid. In 1998, de Soto published a detailed study of how lending and saving are connected in *Money, Bank Credit and Economic Cycles* by Jesus Huerta De Soto. Besides discussing banking issues like fractional reserve lending, de Soto pauses to praise insurance companies and permanent life insurance for its stabilizing economic influence on both individuals and society.

Among his comments, de Soto says: "(T)he contracts offered by these institutions make it possible for broad layers of society to undertake a genuine, disciplined effort to save for the long term. Indeed life insurance provides the perfect way to save…"

"Moreover life insurers develop and operate large commercial networks which specialize in emphasizing to families the fundamental importance of committing to long-term, disciplined saving, not only to prepare for the possible misfortunes associated with death, disability or illness, but also to guarantee a decent income in case of survival beyond a certain age. Thus we could conclude that life insurance companies are the quintessential 'true financial intermediaries' because their activities consists precisely of encouraging long-term saving in families and channeling saved funds into very secure long-term investments (mainly blue-chip bonds and real estate)."

As Employment Changes, What Will Happen to Mortgages?

Here's a small item that appeared in the August 23, 2010 "By The Numbers," a weekly one-page bulletin of personal finance and investment bullet points.

> **In the 1930s, the average length of a home mortgage taken out by an American homebuyer was only 3-5 years** (source: Financial Times).

Are you kidding? How could most homebuyers finance such a large transaction over such a short period? There must be more to the story. And there is.

The Rest of the Story

Katherine V.W. Stone is a law professor from UCLA whose research verifies the statement above, but Prof. Stone adds some information crucial to understanding its context. In a November 2008 article published by UCLA online titled "The Deeper Roots of the Mortgage Crisis: Employment Instability," Stone wrote:

> **"Prior to the 1930s, homes were financed by short-term interest-only balloon loans, usually five years or less in duration. Homeowners typically rolled over their loans when they became due by taking out new ones."**

Interest-only balloon loans that are rolled over don't result in mortgages being paid in full after five years. The mortgages of the early and middle 20th century were completely different than the ones used by homebuyers today. Stone's article also provides some insight into how and why mortgages changed from short-term balloons to 30-year amortized (i.e., principal-and-interest) loans:

> **In the early 1930s…banks were faced with a crisis because borrowers were out of work and unable to refinance loans. Banks were reluctant to offer new loans in the midst of the Depression, and owners had no equity to pay off their loans.**

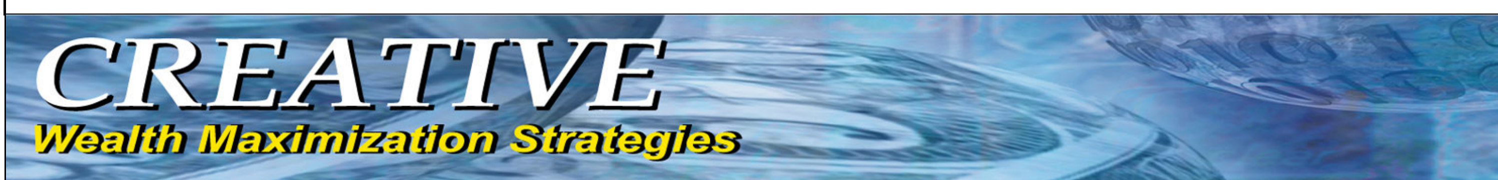
The solution, promoted by the New Deal's Home Owner's Loan Corporation, was to offer 20-year (and soon 30-year) loans to middle-class Americans with stable employment. Stone writes: "The idea was that workers with long-term mortgages would also have stable jobs so they could repay the mortgage with interest over the life of their career, and pay off their homes just about when they retired."

The key factor was the presence of a steady, long-term job. During the 20th century, much of the American middle class had this type of employment. As Stone puts it, middle-class homeowners had "de facto job security, orderly promotion opportunities, a rising wage trajectory, dependable benefits and a reliable pension upon retirement." This arrangement made 30-year loans eminently logical, and a win-win for both lenders and homeowners.

Over the past two decades, the transition from an economy dominated by manufacturing to one of information and service has severely shaken the employment stability of homeowners. And this development makes 30-year mortgages less practical – for lenders and homeowners:

The problem now is that few people have the kind of long-term job security that our housing policies take for granted…Today people have a more episodic experience in the labor market, moving from employer to employer, with periods of employment often followed by periods of unemployment and transition. When unemployment strikes, mortgage payments that once had been manageable become impossible.

If Stone's assessment is correct, the logical result will be new and different types of mortgages. One could imagine that payment schedules may become flexible, higher down payments and/or home equity will be a condition of getting the mortgage, and balloon provisions may allow the lender to reset the terms on a regular basis. For many Americans, the new mortgage landscape may have an eerie similarity to that of 100 years ago. Or as Yogi Berra would say, "It's déjà vu all over again."



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