

CREATIVE

Wealth Maximization Strategies

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**“The universe rewards us for understanding it
and punishes us for not understanding it.”**

- Jack Cohen and Ian Stewart

PLAN A, B, or C?

It's been said in this space before, but for those of you new to our publication, we will repeat it. The financial planning industry is a lot like the diet industry – a new program comes out every day, and most of them don't deliver the results they promise.

Strip away all the marketing (Deal-a-Meal, Weigh Down, Fat Burner). The basic dieting strategies are:

- A. *Exercise more.*
- B. *Eat less.*
- C. *Combine A and B.*

That's all there is to it, really. Right? Oh sure, you can develop some specific “scientific” plans, but those programs only fine-tune the basic strategy. If you aren't executing at least one of the basics, the special things don't work.

So what's the likelihood that financial planning can also be reduced to a few basic concepts? Here's our list:

- A. *Earn more.*
- B. *Spend less.*
- C. *Combine A and B.*

Wow. That's it? No need for 50-page financial analyses, 30-year projections, and a portfolio asset allocation? In the most basic form, yes. However, just to make sure there's no misunderstanding, let's elaborate.

Plan A – Earn more. One of the first evaluations in a financial plan – before the discussion of investment objectives, risk tolerance, estate planning, and the like – should be, “*are you earning enough to make saving for the future a real possibility?*” If the current earning arrangement isn't going to be enough, discussing anything else is probably a waste of time.

First, let's make a distinction. Most of the “wealthy people” that we know from TV and newspapers are not wealthy because of financial planning. *They are wealthy because they earn so much money from their work that they can't out-spend their earnings.*

Oprah Winfrey, Tiger Woods, Bill Gates, even Donald Trump would still be wealthy even if they never invested in the stock market and just deposited their extra earnings in a shoe box. This is true of a lot of other highly skilled professionals and



successful businesspeople. Unless they have an addiction (to alcohol or gambling, for example) or a compulsion to be a conspicuous consumer, most high-earners will not spend everything they earn – they are usually too busy making money to spend it all. They are like highly-trained athletes who are too busy training to sit around and eat.

In fact, most of these high-earners probably only became investors because they had money “laying around”, and someone convinced them to take a chance, knowing it was money they could afford to lose. (Of course, with any luck at all, some of those chances paid off. That's why the rich get richer.)

The wealth of high-earners is not necessarily the result of good planning as much as of simple abundance. In fact, these high-earners may make a lot of financial mistakes – but they make so much money that it overwhelms any errors.

Don't confuse those high-earners with the rest of us. As a percentage of the total population, the high-earners discussed in the previous paragraphs are extremely rare. How rare? Statistics from the Tax Foundation indicate those earning more than \$300,000 a year represent less than 1% of the U.S. population, and the Oprahs and Tigers comprise a tiny fraction of that 1%. While high-earning can lead to wealth, very few have the earning capacity to make wealth occur “accidentally” simply because they make so much money.

However, just because you may never be in a situation where your work will result in mega-earnings, **don't overlook the necessity of planning to earn more!** If you aren't planning to earn more – by getting a better job, changing careers, starting a business, etc. – you are ignoring financial reality.

The vast majority of Americans who save or invest do it by design – they consciously commit to saving by *not spending*. Every decision to save is a debate between having something now, or waiting for something later. (A new TV or a deposit in the mutual fund? A cruise or putting more in the 401(k)?)

But the cost of “now” makes it harder to save for “later”. It is becoming progressively more expensive to provide for the standard of living that creates a positive environment for one's family. “The basics” include a home (with a mortgage), multiple vehicles, televisions, microwaves, cellular phones, and computers – none of which were considered essentials to Depression-era families, or even families 20 years ago.

Taxes, as a percentage of income, are proportionately much higher than 50 years ago. Add it all up, and it means there's more stuff to buy, but less to buy it with. Inflation hides some of the impact (“Wow, I'm making \$75,000 a year, and my dad never made more than \$30,000”), but even with more money, the “modern world” is expensive.

A January 2003 *Newhouse News Service* syndicated column addressed this problem of earning more while having less, citing the example of a Los Angeles couple that earned over \$150,000 last year, yet struggled to qualify for a mortgage in the suburbs. The husband's comment: “We had good credit, which carried us through, but can you imagine? We are considered poor in the neighborhood, and we just paid \$550,000 for our house. Unbelievable!”

In New York City, an advertising executive earning over \$100,000 can't even afford to buy a home. Instead, he's living in an \$1,800-a-month fifth-floor Manhattan apartment – with no elevator. Comparing his existence to that of his immigrant grandparents, he says, “Here I make more money than I thought I'd ever need to live well, yet I live more poorly than I ever thought I would.”

When “basic needs” require immediate attention, you don't save for the future. Fixing the roof, paying the property taxes, and getting braces for a child take priority over the retirement plan every time.

A recent June, 2000 *USA Today* survey showed that 60% of men were dissatisfied with their level of savings, and a report from Fidelity Investments showed that many were falling short in their retirement plans because they had to take loans from their 401(k)s. Even if they attempt to save, their long-term plans are undone by current expenses. They aren't earning enough money to cover both the present and the future.

There's often a “Nike” attitude about spending less and starting to save – “just do it.” But like the old agricultural phrase states, “you can't make a silk purse out of a sow's ear.” **If you don't have money, you can't make it earn interest.** That's why in order to save, you may have to address Plan A (earning more) first.

A lot of responsible, decent, hard-working people are over-

whelmed by debt. They don't have money and feel compelled to borrow to meet their needs. Given the choice between seeing their family go without now, and the prospect of going without in retirement, they take on the debt, hoping someday to catch up.

But they won't catch up unless they commit to making more money. Even if they spend less, it won't allow them to save – it will only keep them from more debt.

Plan B – Spend less. Assuming you can say, “yes, I am earning enough to save,” then it's time to address spending less.

While it might not make the same headlines as an athlete's contract or an actor's film deal, spending less and slowly accumulating wealth is a steady, reliable path to financial success. As an illustration, many people who experienced the Depression adopted this conservative approach, with great success. According to a recent article from the *Raleigh News & Observer*, “These big savers/small spenders have amassed trillions of dollars that economists predict will constitute the largest generational transfer of wealth in U.S. history.”

Saving money, while a proven wealth strategy, is one that can be difficult to execute. It involves self-denial and delayed gratification, two actions that are especially tough to maintain in our contemporary culture, which emphasizes immediate gratification. Credit cards

make almost every material item obtainable instantly – “and you pay nothing for six months!” (And then you pay forever.)

John Savage, a noted financial planner, used to say there are two ways to achieve less spending. One is to prepare a budget and save what's left. The other is to take the savings out before any spending occurs. Guess which method works best? (Hint: it's not budgeting.)

The individual who commits to “paying himself/herself first” has the mindset needed to successfully execute Plan B. This is not to say other approaches won't work. But a systematic plan to save a specified amount each week, or month, allows for the greatest chance for saving to occur.

How much should you save? Well, if you can't save 15-20% of your earnings, you probably aren't going to save enough to be wealthy before age 65. In order to have the chance to arrive at real financial independence, it requires building capital – i.e., savings – at a rate large enough to make a difference.

On the other hand, a number of studies have shown that over 95% of individuals who worked and saved consistently, even at modest levels, have a comfortable retirement. Just executing the basics of Plans A and B almost guarantee success.

Combine A and B. Saving 15-20% may seem like a big number. But this is where good financial planning can really make a difference.

Assuming you have demonstrated an ability to execute the basic strategies of earning more and spending less, a good financial plan can “turbo-charge” your wealth.

When you have the money and you have capital, you can act. When your advisors show you how to save on taxes, or restructure your debt, or optimize your insurance benefits, you can do it. You have the financial capacity and the discipline to execute the finer points of money strategies and maximize your wealth.



When Plan A and Plan B are combined, there's a snowball effect. Your financial decisions become more efficient, thus saving even more money. The extra dollars you earn and save can be put to multiple uses, and the results can be astounding. Saving 15-20% now becomes a real possibility. And when you are saving that much, the wealth begins to accumulate quite rapidly.

But for good financial strategies to really deliver, you must first have mastered the essentials – earn more, spend less. Otherwise, good strategies can lead to disastrous results.

Refinancing is a good example of how an otherwise viable “financial planning strategy” often makes things worse for people who haven't mastered the basic actions for financial success.

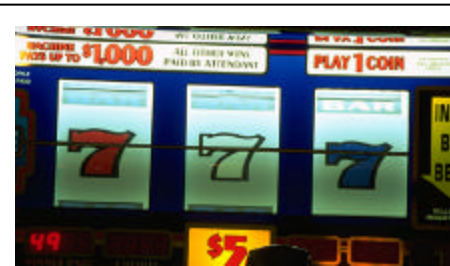
Ask a banker about situations where a family used mortgage re-financing to get rid of credit card balances. Unless the basic financial behavior changes, it's quite likely that within two years the credit cards will have balances again, and the family will actually be worse off than before. This is how a “winning strategy” actually makes things worse for those who don't do the fundamental things right.

In conclusion, here are a few points of self-assessment.

?? *Does the earnings potential of your career meet the level of your financial aspirations, or do your aspirations require a career change?*

?? *If you earn enough to truly save money, are you “paying yourself first”, or is your saving a haphazard, hit-or-miss activity?*

?? *Is it time to apply some financial strategies to “turbo-charge” your efforts?*



WHAT ARE THE ODDS?

It's not really an investment issue, but one of the significant changes in the financial landscape is the proliferation of gambling facilities – casinos, riverboats, and casinos on Indian reservations – throughout the country. As gambling is increasingly considered a legitimate leisure activity, it's important to remember there can be a financial impact:

“If you want to make money in a casino, own one.”

- Steve Wynn, chairman and CEO of Mirage Resorts

“There is, according to Las Vegas lore, a 17% chance of walking away with the casino's cash. That, for those of you with bad math, means there's an 83% chance of getting cleaned out.”

- Niall McKay, in *Red Herring*, February 2000.



Q: WHAT'S THE DEFINITION OF RICH?

A: SOMEONE WHO MAKES MORE THAN ME!!

When President Bush recently proposed a tax-cut plan, critics immediately attacked it for unfairly benefiting “the rich.” Which begs the question: Just exactly *who* are the rich? The answer depends on who you ask.

Here are some statistical markers, provided by the Tax Foundation, from the most recent Internal Revenue Service data, which was for 2000:

- ✂ The adjusted gross income of the top 1% of all taxpayers was at least \$313,469.
- ✂ The top 5% earned at least \$128,336.
- ✂ The top 10% earned at least \$92,144.
- ✂ The top 25% earned at least \$55,225.

However, just because their income would place them in the top 525 % doesn't mean that these people feel rich. According to John Barry at the Tax Foundation, “most people feel they're in the middle class, no matter what they make.”

John Fitzgerald, an economics professor from Bowdoin College in Maine has research to support Barry's observation. Each year he asks his students what income level they believe it takes to put one in the top 10%. According to Fitzgerald, “students from low-income families will say something around \$60,000. Students from high-income families will pick \$500,000.”

RoperASW conducted a survey of Americans with incomes above \$75,000, asking what income they thought was needed for a family of four to be considered “rich.” The results:

- ✂ 21% named a figure less than \$200,000.
- ✂ 51% named a figure between \$200,000 and \$499,999.
- ✂ 20% named a figure between \$500,000 and \$999,999.
- ✂ 7% named a figure of \$1 million or more.

Marian Salzman, Chief Strategy Officer at Euro RSCG Worldwide, the fifth largest advertising network in the world, said one of the firm's research reports concluded that “no matter what you have in income, double it, and you would feel rich.”

SOCIAL SECURITY IS ONLY INCOME SOURCE FOR 40% OF U.S. RETIREES

“Four in ten of the nation’s retirees count on Social Security checks for almost all of their monthly income, according to a recent study by the Employee Benefit Research Institute in Washington, D.C.

Social Security beneficiaries – some 32 million retirees, 7 million survivors of deceased workers and 7 million disabled workers and their families – will get a 1.4% cost of living increase in their benefits. But some of that will be eaten up by an increase in the deduction for Medicare coverage. The average retiree’s check will rise to \$895 a month, or \$1,483 for a couple – not a lot to live on, said Don Silver, author of *Baby Boomer Retirement*.

Those figures should be a wake-up call to workers, to make them understand that Social Security is a supplemental program and that they need to save more, he said.”

Eileen Alt Powell, *Associated Press*, January 5, 2003.



THE CASH-OUT CRUNCH

“Is the equity in your home going up in smoke?”

A growing number of experts worry that the record rush of mortgage refinancings, spurred by homeowners seeking savings with lower interest rates, actually left many in worse shape financially.

The culprit is cash-out refinancings – when a borrower takes equity out of the home as part of the refinancing. In some cases, experts say, homeowners are left owing more than the home is worth.

Cash-out exploded, fueled by rising home values and falling mortgage rates. Freddie Mac, the mortgage underwriter, estimates that during the past two years, more than half of refinancings have been cash-outs – when the loan amount rises by more than 5%.”

Danielle DiMartino, *Dallas Morning News*, January 21, 2003



MORE PAIN AHEAD FOR THE U.S. STOCK MARKET?

“There could be much more pain ahead for U.S. stocks, given comparisons between gross domestic product (GDP) and market valuations, we hear from money manager K.C. Grainger. When the value of a country’s stocks exceeds 75% of its GDP – the total of all goods and services produced in a year – it means that stocks are greatly overvalued and the market is due for an extended slide. The 50-year average stock valuation is 52% of GDP – but even with this bear market, U.S. stocks are now at 92% of GDP. In the 1929, the stock market peaked at 123% of GDP and didn’t recover until World War II. In March 2000, U.S. markets peaked at 182%.”



Bottom Line Personal, February 1, 2003

RAISES WILL NOT GO UP AS MUCH THIS YEAR

“Employers realize that salary increases are a reward for hard work, a financial pat on the back that makes you a loyal, productive and happy worker. But many businesses are facing tough cost-cutting decisions as they try to survive the slow economic recovery. Some companies have frozen current salaries and started new employees at a lower level. Other companies are giving smaller raises than in the past.

Studies show that the average raise for 2003 will be only 3.9% – which is far less than the 6% raises that became routine in the halcyon 90s, said Carol Kleiman, author of *Winning the Job Game: The New Rules for Finding and Keeping the Job You Want*.”

Tip Sheet, December 30, 2002



IRS IS STILL TAKING TWO STEPS BACK

“The Office of Management and Budget (OMB) has cut the IRS’s fiscal 2004 request for business modernization from \$450 million to \$357 million, citing the IRS’s continued inefficiency and waste. The OMB is still troubled by former IRS Commissioner Rossotti’s spending on customer service projects rather than infrastructure and internal management improvement projects. No one appears to be running the technology portion of the IRS, as the OMB also complained that the IRS has devoted insufficient resources to oversee past projects. Despite recent improvements in customer service, the IRS will continue to stumble in achieving meaningful audit rates and tougher collection enforcement for at least the next three years.”



TAX Hotline, February 2003

INTEREST RATES EXPECTED TO REMAIN LOW

“Americans who have been treated to the lowest interest rates in 40 years on home mortgages and many other types of loans should be able to take advantage of those low rates at least until summer, private economists said Monday.

They pointed to turbulence on Wall Street over rising worries about a war with Iraq as a primary reason the Federal Reserve will leave interest rates at a 41-year low.”

Martin, Crutsinger, *Associated Press*, January 27, 2003





REVERSE MORTGAGES: Another source of retirement income?

For those approaching retirement age, the equity in a home may often be one of your larger financial assets. On a net worth statement, this equity can look pretty impressive, especially if the

home is held free and clear (i.e., there's no mortgage against it).

While the home equity looks good on a balance sheet, it doesn't necessarily translate into spendable income. Depending on income needs (along with other factors), retirees may feel that circumstances dictate selling the home, "downsizing" to smaller accommodations (like an apartment or condominium), and using the proceeds from the sale to provide additional income in retirement.

For some, the decision to sell makes sense for more than just financial reasons. Maybe your health makes it difficult to handle the maintenance or navigate the stairs. Maybe the neighborhood has changed and friends have moved away, so there isn't the same emotional attachment.

But what if you don't want to sell? What if you don't want the stress of moving? Or what if you want the property to be part of an estate that's transferred to your heirs? How do you tap the equity but keep the property?

You could take a new mortgage or open a home-equity line of credit. (Which also means adding another monthly obligation – not always desirable in a retirement scenario.)

Or you might consider a reverse mortgage.

A reverse mortgage is similar to a traditional mortgage, with one significant exception. With a reverse mortgage, the borrower doesn't have to repay the loan until one of the following occurs: they sell the home, move out of the home permanently, or die. The loan then due may be repaid through proceeds from the sale of the home, cash payment from heirs of the estate, or in some instances, the lender may simply assume ownership of the property.

Proceeds from a reverse mortgage may be received as a lump sum, fixed monthly payments, a line of credit, or a combination of the above. The reverse mortgage proceeds are a loan, and an American Bar Association guide* states that generally, "the IRS does not consider loan advances to be income," so in many situations, there is the likelihood that fixed monthly payments would be non-taxable. (However, depending on how funds are received, you may lose your eligibility for SSI, Medicaid and other government programs.)

Reverse mortgages have been available for years but didn't really gain public awareness until the early 1990s. The National Reverse Mortgage Lenders Association reported that for the fiscal year that ended September 30, 2002, lenders closed a record 13,049 reverse mortgages – a 63% increase over the previous record of 7,982 in 1999.

According to a January 2003 *Associated Press* article, "Today, reverse mortgages are increasingly a salvation for seniors whose health costs have risen and retirement incomes have fallen in tandem with the stock market and interest rates."

A reverse mortgage allows a senior citizen to "continue to live independently and comfortably, right where they are," said Peter Bell, president of the Reverse Mortgage Lenders Association.

For all the positives (cash-out without payments, tax-favored status, etc.), reverse mortgages are complex financial contracts that require extensive study. These are some basic guidelines:

Applicants must be at least 62 years old. They must own their own home and have equity in it. They must live in the home as a principal residence. All owners (i.e., husband and wife, if both are listed on the title) must be listed on the application. And all applicants must receive mandatory counseling about the particulars of reverse mortgages.

The amount of the loan is determined by the age of the applicants, the current value of the home, the amount of equity in the home, and the location of the property. (The Federal Housing Administration places a cap on reverse mortgage loan amounts in some high-cost urban areas.)

Since reverse mortgage borrowers continue to own their homes, they remain responsible for property taxes, insurance and repairs. Failure to pay these expenses can result in the loan becoming due and payable in full.

The essential calculations in a reverse mortgage are actuarial. The amount a lender decides to make available from a reverse mortgage is not based solely on the value of the home, the amount of equity in it, and interest rates. The age of the borrower is a critical consideration.

Because the borrower makes no monthly payments, the amount owed on the reverse mortgage loan grows larger over time. And in a reverse mortgage, the borrower can never owe more than the value of the home at the time of repayment (i.e., the borrower's death, or permanent move). Given this restriction, the amount of the loan offered today is an amount that the lender believes will not exceed the future value of the home at the time of repayment.

Thus, an older homeowner will usually receive a higher loan offer than a younger one – for the same property. This is because the lender assumes the older applicant will die sooner, and full repayment will occur earlier.

In a sense, this actuarial factor may make a reverse mortgage more "valuable" as an asset to tap later in life, rather than sooner, since the amount available to be loaned generally increases with age.

Integrated with other financial decisions, a reverse mortgage can be a very efficient financial strategy, even for those who may not "need" the income, and want to ensure the home remains part of an inheritance for heirs.

For example, a life insurance policy on the borrower can be used to repay a reverse mortgage loan at the borrower's death. This combination of reverse mortgage and life insurance can provide the borrower with tax-free equity funds while living, and yet retain the property – free and clear – for transfer to heirs.

From this brief overview, one can see reverse mortgages offer an intriguing method for utilizing the equity in one's home. But the particulars of each individual situation require additional study and counsel. The American Association of Retired Persons (AARP) has a website (www.aarp.org/revmort) with reverse mortgage information (which makes a good starting point for becoming better educated).

Even those not yet 62 may want to consider discussing with their financial advisors the ways to make a reverse mortgage a profitable alternative in the future.

* *Reverse Mortgages: A Lawyer's Guide*, American Bar Association, 1997



THINGS THAT MAKE YOU GO “HMMM...”

SEVEN YEARS LATER, HE’S BACK – WITH THE SAME “GUARANTEE”

Here’s a blast from the past:

This was the text from a December 1995 promotional brochure for a \$99-a-year investor newsletter:

You have less than 100 days to the biggest stock market wipe out of our lifetime. The stock market is about to give back a year’s worth of gains in one day.

The market will crash any minute now. The Dow is going to fall 1,000 points in a day. In the weeks and months after the crash, the Dow will fall another 1500 points. We are on the verge of the biggest bear market ever. Before it’s over, the stock market will be trading under 2000. Millions of trusting mutual fund investors will be wiped out. Half of America’s wealth will be vaporized.

Either the market crashes, or your subscription is absolutely free.

Wow. What an offer. A free subscription for advice that was absolutely wrong. Since the stock market proceeded to rocket through the roof, and the Dow soared to 12,000, you would think someone so off target would quietly disappear, never to be heard from again. But noooo...

Here’s a promo letter from January 2003. It’s the same “guru,” still offering a \$99 one-year subscription, with the same type of come-on.

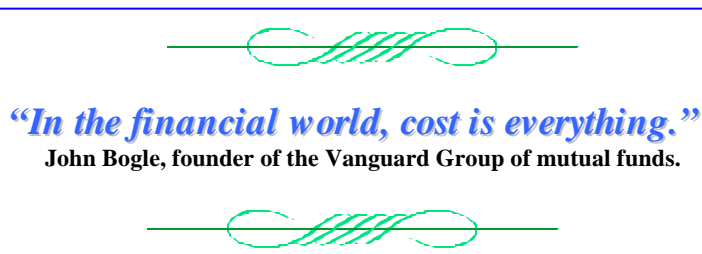
I promise you will turn every \$15,000 you invest into at least \$250,000 in the next six months, or everything I sent you is absolutely free, including your subscription.

Take just \$15,000 of your portfolio. Follow the strategies I outline in your special report on the coming war with Saddam. Use the updated advice I give you in each issue.

Then by the end of your subscription, count your profits.

If you haven’t made \$250,000, let me know. I’ll give you a full 100% refund of your subscription price.

Hmmm...just to review, what’s the value of free advice if it turns out to be wrong? And further, doesn’t the condition for receiving a “full refund” really cost \$15,000?



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