

CREATIVE

Wealth Maximization Strategies

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“In human affairs – political, social, economic, and business – it is pointless to try to predict the future, let alone attempt to look ahead 75 years. But it is possible – and fruitful – to identify major events that have already happened, irrevocably, and that therefore will have predictable effects in the next decade or two. It is possible to identify and prepare for the future that has already happened.”

- Peter Drucker, *The Futurist*, November 1998

Did Retirement Die? (And did you know about it?)

Even in the more temperate regions of the United States, you can still get hit with a blizzard from January to April 15th, only this blizzard isn't snow. It's the avalanche of media advice encouraging you to make contributions to a qualified individual retirement plan.

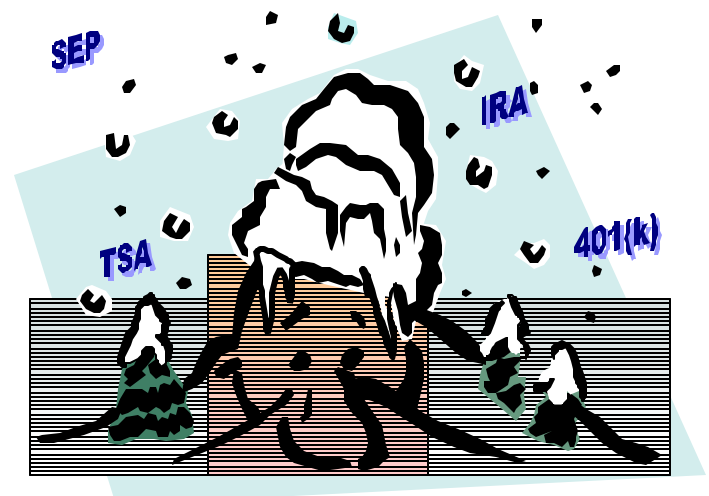
No matter where you live, you can't escape this snowstorm of popular opinion. It's a two-fold message repeating endlessly on television, in newspapers, magazines and books: First, retirement is the goal. And second, the path to retirement is paved with contributions to your IRA, 401(k), TSA, SEP,

Think this is overstatement? Check some recent headlines and quotes from articles appearing in newspapers in a one-week period:

- ?? **“Contact your human resources department to see how you can “max out” your retirement plan before the end of the year”** John F. Wasik, from a *Bloomberg News* article on December 23, 2002.
- ?? **“Retirement time frame should guide investments”** - headline from a December 30, 2002 syndicated article from the *Raleigh (NC) News & Observer*
- ?? **“Re-establish your 401(k) and hit it hard”** Albert P. Herzog, Certified Financial Planner, giving advice to a couple deep in debt that wants to retire in six years in a December 30, 2002 *Detroit News* column.

These few samples are just the tip of the iceberg. Check for yourself. **No matter what** the stock market is doing, or where interest rates stand, or how the economy is functioning, the message remains the same. Retirement is the primary goal and qualified plans are the vehicle to get you there.

Just like a real snowstorm, this “financial advice blizzard” is the result of several factors combining to create a larger force. Only the forces at work here aren't meteorological, but psychological.



First, while many financial concepts are somewhat complex (ever try to explain amortization?), the retirement/qualified plan concept is really simple. A “good retirement” is portrayed as not having to work, and yet having the financial wherewithal to do what you want. It's like a vacation, but at a slower pace for a longer period of time – what's not to like? And if you use a qualified plan to pursue this goal, you receive an immediate tax break, because deposits are made on a pre-tax basis. It's a savings plan that also delivers instant gratification! In its most basic form, these are easy-to-grasp messages with great marketing appeal.

Second, as the public embraces the message, the “experts” fall all over themselves endorsing the program, and the flurries of support turn into a snowstorm of prevailing opinion. The TV talking heads, the newspaper columnists and magazine article writers all jump on the bandwagon. In short order, so do the financial institutions, trotting out new products and programs designed “especially” for the retirement-through-qualified plan path.

The simple idea now has acceptance as the consensus perspective, and the herd mentality kicks in. For both the media and the financial institutions, it's like a stampede. You have to keep running with the crowd, or you risk getting run over. In fact,

to recommend anything else, to run against (or outside) the herd, is considered foolish and risky.

But ... (here's a risky and foolish thought)

What if retirement isn't really the financial "holy grail" that the consensus has made it out to be?

And if retirement isn't the ultimate financial goal, then how worthwhile is a qualified retirement plan?

Ooooooh.

Interesting questions. But are they legitimate items for consideration?

A second (and last?) look at retirement

Let's look at retirement, and let's start with a definition.

What is retirement? Here's a dictionary definition: "The withdrawal of oneself from business, public life, or active service." In a nutshell, it means not working.

There are two reasons why people retire. Either they have to, or they can afford to. They have to because old age or disability has diminished their capacity to work. Or they can afford to because they have accumulated enough assets to eliminate the need to work.

Life being the uncertain adventure that it is, there is the real possibility that retirement may be forced upon us, even if we think we wanted to work until we died. Forced retirement presents the terrible dilemma of having to live, but not having a way to pay for it. That's a sobering thought, and one that usually compels most prudent people to consider saving if not for retirement, at least for a rainy day,

This is the siren song of the financial planning industry: Become our client, and we will enable you to retire, yet live as well as when you were working.



A (very) brief history of retirement

Historically, retirement is a relatively recent concept in Western culture. For the majority of history, most people have worked until they died. For those who were forced to retire due to infirmity, one's family usually took

responsibility for the retiree's care. Even for those whose industry or inheritance had made them wealthy enough not to work, management of those assets still required the attention of the owner. Managing an estate might not have been manual labor, but it was a full-time job.

In the mid-1880s German chancellor Otto von Bismarck established the first national social-insurance program, in which benefits were provided to all citizens through compulsory contributions (taxes) from workers and employers. These benefits included regular income payments for those who became sick or disabled, or over age 65 and not working.

Similar "social security" programs were established in Great Britain in early 1911, and greatly expanded after World War I. In the United States, Congress passed the Social Security Act of 1935 with the intention of providing a guaranteed pension for workers over age 65.

All of these government "retirement programs" use Bismarck's format: taxes from those currently working are used to provide benefits for retirees.

Employer retirement plans

Along with the establishment of governmental retirement programs, the 20th century also ushered in company-sponsored retirement plans, in which long-time employees were eligible for a pension income from their employer. These plans have predominantly followed two formats.

The first is a **defined benefit plan**, under which the employer promises specific pension benefits based on the employee's earnings and length of employment. A defined-benefit plan is funded through employer payments based on actuarial calculations including the number of retirees entitled to benefits, the amount owed, and the investment performance of assets previously invested. In a year where investment returns were high or payments were low, the employer may not need to make a deposit to the plan. Conversely, low returns or high payments (for employees released through "forced retirement" incentives) could mean a large pension expense for the company.

The other employer-sponsored program is a **defined contribution plan**. This plan makes specific deposits each year (usually based on a percentage of the employee's wages). The amount available at retirement is then dependent on the investment performance of those deposits. In some plans, employees can also contribute additional dollars to the plan.

Individual Retirement Accounts

Since Social Security alone did not provide an adequate retirement for most workers, and since not all employees had access to employer pension plans, Congress established Individual Retirement Accounts (IRAs) in the mid-1970s. The IRA was the forerunner of the 401(k), TSA, SEP, etc. Individuals can make deposits to these accounts on a pre-tax basis to a variety of approved investment vehicles. The deposits and any subsequent earnings are not taxed until the individual takes receipt of the funds. With some exceptions, funds withdrawn prior to age 59 ½ are subject to additional penalty taxes.

The retirement paradigm

Using these three programs – government social insurance, employer pensions, and individual retirement accounts – this was the resulting retirement concept:

Work steadily for 40 years, for a few employers, earning a pension from each. Contribute additional dollars to a qualified individual retirement account. At 65, retire and live off of payments from Social Security and the company pension, supplemented by earnings from an IRA.

During the economic and stock market booms of the late 1980s and 1990s, the paradigm expanded (or contracted) to include "early retirement," in which earnings from assets in individual plans were large enough to allow one to retire before age 60.

Is the retirement paradigm still valid?

There are some crucial demographic and economic factors at work since the 1880s which have upset the actuarial factors

Pension Plans

IRAs

involved in the three retirement programs and the paradigm mentioned above.

First, people are living longer and entering the work force later. In the paradigm example, a retirement began at 65 and lasted 10-15 years. The majority of those retiring in the 1970s and 1980s did not have a college degree. That meant 40-45 years of work provided for a decade or so of retirement benefits.

But when people live longer, enter workforce later (because more of them obtain college degrees), and retire earlier, the ratio of working years to retirement years changes dramatically. An early retiree (say age 60) with a college degree and a life expectancy of 82 has 35 years of earnings to provide for more than two decades of retirement.

When Bismarck proposed a retirement age of 65, the average life expectancy in Germany was reported to be 47. That meant relatively few retirees and relatively low compulsory contributions/taxes to support those retirees. Even in 1935, life expectancy in the United States was below 70. While there might have been a greater percentage of retirees to support, the thought was they wouldn't be living a long time after retirement. However, as life expectancies have increased, the cost of providing more retirees with longer periods of retirement benefits has become exorbitant. Because of these changes in demographics, in its present form, Social Security is seen as a financially unsustainable program.

Modifications have already been made. Taxes have increased, and the age at which one can receive full benefits is increasing from 65 to 67 over the next several years. Going forward, most analysts acknowledge three possible modifications: A continued reduction or delay in benefits, an increase in contributions/taxes, or a dismantling of the program.

But the challenges with Social Security aren't just the result of demographic changes. Even at the beginning, Bismarck recognized the political aspect of social insurance programs. People receiving government benefits tend to vote their interests. Politicians seeking election can promise changes in current programs as a means of garnering support. This means government retirement programs are subject to change, depending not only on demographics, but also the political advantage that might be presented.

Employer-sponsored pension plans don't have the political aspect to contend with, but like Social Security, they face the same demographic challenges: more retirees living longer. Combined with a stock market decline and sputtering economy, many companies are struggling to meet their pension obligations. Large companies such as IBM, General Motors and Ford have all told the Pension Benefit Guaranty Corporation (PBGC) that their plans are currently underfunded.

The PBGC is a federal agency created to guarantee benefits for private-sector workers (up to certain limits). Using premiums collected from employers, the PBGC acts as "insurance" for retirees of companies that close or file bankruptcy. In December 2002, the PBGC announced it was planning to take over the pension plan of the National Steel Corp., which includes more than 35,000 workers and retirees. If the PBGC takeover is approved by the courts, many extras in the pension plan will be dropped, including health insurance.

In response to this underfunding dilemma, many employers are petitioning the government for permission to convert their defined benefit plans to cash-balance plans. A cash balance plan imputes a "current value" of the employees future pension benefit

and, going forward re-makes the plan into a defined contribution. This limits the employer's future responsibility to making annual contributions, and removes any income guarantees for the future.

People are changing jobs more often. Blame the companies with their downsizing policies. Blame the employees for their mercenary attitudes. But whatever the cause, the old concept of loyally working 30 years for one employer is long gone. Many don't stay with one employer long enough to vest in a pension program.

Since Social Security is an uncertain variable, that leaves individual retirement plans as the only recourse in building a retirement plan.

But most people aren't using their individual retirement plan opportunities. According to Bill Wolman and Anne Colamosca, authors of *The Great 401(k) Hoax*, many employees don't even enroll in their new company's individual plan, and of those that do, 80 percent spend their accounts when they change jobs, rather than rolling the previous employer's account into an IRA.

People are working longer – because they want to, and because they have to. The old retirement concept ignores the psychological reality that most of us are happiest when we are productive. Not only is life expectancy increasing, but so is the duration of one's productive years. Especially if one is engaged in work that they find enjoyable, there is a desire to continue doing it. In fact, retirement is so foreign to human nature, there's a cottage industry of "experts" who provide advice on dealing with the feelings of loss and despair that often accompany retirement.

But there's another factor involved. Digest the following comments by Peter Drucker:

The dominant factor for business in the next two decades – absent war, pestilence, or collision with a comet – is not going to be economics or technology. It will be demographics. The key factor for business will not be the *over*population of the world, of which we have been warned these last 40 years. It will be the increasing *under*population of the developed countries – Japan and those in Europe and in North America.

The developed world is in the process of committing collective national suicide. Its citizens are not producing enough babies to reproduce themselves, and the cause is quite clear. Its younger people are longer able to bear the increasing burden of supporting a growing population of older, nonworking people.

In other words, there aren't enough new workers to replace the old ones. Not only can they not replace the retirees, but they can't support them either. Drucker adds that even a dramatic increase in birth rates would take 25 years to offset this trend.

In summary, these demographic and economic factors cause all sorts of retirement variables to become skewed or impractical. As a result, government is attempting to decrease its responsibility for retirement, and placing more burden on the individual. It is allowing employers to do the same, through changes to cash balance plans. Added to this decrease in outside assistance, the stock market decline has wiped a lot of wealth off the ledger.

Given all these indicators, what's the prognosis for retirement as we have known it?

There will always be exceptions, but it seems reasonable to conclude that, as a general trend, the old-fashioned retirement concept is dying, if not already dead. Most likely, retirement now means continuing to work, but working at something you really

enjoy, and doing so on a much more flexible basis, perhaps as a part-time worker or consultant.

If retirement is dead, what's alive and relevant for the individual, in terms of financial planning concepts?

The idea that deposits to individual retirement plans should be a foremost priority certainly merits deeper scrutiny, on several levels.

First, if job changes are more frequent, and those changes often require dipping into savings (for moving costs, or covering expenses while in between employment), there will be a need for ready cash. It doesn't make sense to build up a 401(k), then have to cash it out, or borrow from it. Doing so means mandatory repayment (another bill), or additional taxes and penalties.

Second, if any of these job changes entail self-employment, there may be the need for a one-time infusion of capital (for a down payment, inventory, or a year's living expense, for example) – before age 59 ½. A large withdrawal from a qualified plan could also mean a large tax obligation, which is no small issue for a start-up business.

Third, if one is working longer, there's the likelihood that some of the projected "tax savings" of pre-tax saving will not pan out. The mandatory distribution age for most individual retirement plans is 70 ½. What does that mean if you are still working? It means paying tax on a distribution in one's highest marginal tax bracket, even if you don't need the money, or want to spend it.

Assuming that someone who has saved and worked so diligently also pays their bills and lives without dependents other than a spouse, the chances are that any large personal deductions (like mortgage interest, or children) will be negligible. Thus, the per-dollar cost of receiving the money may well be greater than the tax advantage that was received when it was deposited.

Set aside all of the artificial projections that the financial services industry is so fond of relying on to prove the validity of certain products or programs. If the old model of retirement is dead, an individual retirement plan is no longer the crown jewel of financial planning.

Yet ironically, the consensus from the media continues: Retirement is the goal, and qualified plans are the path. Does that make sense?

A recurrent theme in this newsletter is the need for individuals to develop sources of working capital. That means saving and accumulating money in ways that allow the money to be used before age 59 ½. Because if retirement is dead, the last thing you want to do is bury your money in a qualified plan for the next 20 years.

IS TOO MUCH OF YOUR MONEY "BURIED" IN RETIREMENT ACCOUNTS?

IS IT TIME TO REVISE YOUR FINANCIAL PLAN?

IS THERE WORKING CAPITAL IN YOUR FINANCIAL WORLD?

**"Don't speculate
unless you can make it
a full-time job."**

- Bernard Baruch

BUY? SELL? WHO KNOWS?

"What do you call an economist with a prediction? Wrong."

- Robert, Kuttner

Not that it makes any difference in the actual outcome, but current commentary on the stock market is beginning to sound a lot like that scatological analogy about opinions and a part of one's anatomy ("everybody's got one, and they all stink").

For example, read some recent economic commentary.

"Mutual fund shareholders currently enamored with money market accounts and bonds, the bear's safer havens, might be interested in what some Wall Street firms are saying: Increase your stock holdings."

"We believe the S&P 500 and Nasdaq (composite) may advance in the range of 8 percent from current levels by mid-year 2003 and approximately 15 percent by year-end," said Sam Stovall, S&P's chief investment strategist."

- Amy Baldwin, *Associated Press*, December 15, 2002.

Here are a couple of predictions. My guesses are as good as the so-called experts: (1) 2003 will be the fourth year of the worst bear market in American history, and (2) Bush will lose the presidency in 2004 for the same reasons his father lost. So plan accordingly.

How do I know? Last year Barron's and others polled economists and Wall Street gurus. They were optimistic (just like they are this year). Turns out they were also wrong.

- Paul B. Farrell, *CBS MarketWatch.com*, December 31, 2002.

"This month's explosive rally changed a lot of minds on Wall Street, and there's a growing sense that the long bear market may finally be over."

But is it? My market-timing instincts are as good as any on Wall Street. In other words, like everybody else, I haven't a clue what will happen next. My hunch is that stocks have bottomed. But I had the same hunch in April 2001, September 2001 and July 2002."

- Jonathan Clements, *Wall Street Journal*, October 23, 2002.

So, is it time to buy? The answers are yes, no, and I don't know. Well, those perspectives sound like the making of a definitive trend, don't they?

Obviously not, which is why Jeff Opdyke of the *Wall Street Journal* offered these tips for portfolio repair:

- Sell your losers, but don't give up on stocks.
- Buy bonds and certificates of deposit for cash needs
- Consider adding fixed annuities to your portfolio
- Trim the annual withdrawals from your retirement funds
- Lower portfolio growth projections to 7% or 8%
- Reassess your tolerance for stock-market risk

In other words, if you don't know what to do, do everything. Something has to work, right?

STAYING LATE IS COMMON

“We come early, we stay late and the average commute has become a bear, now topping 42 minutes. That’s the workplace we all know and endure, right?”

Pretty much.

A survey last month of 1,385 employees found that the mean work day is now 9 hours, 8 minutes, for a weekly total of 46 hours, 16 minutes. The mean response for the number of sick days was 6.5, although most people said they used fewer than three.

When asked what a good work day would be, the mean answer was 8:51 a.m. to 5 p.m. That almost never happens, though, with 49 percent saying they stay late every day and more than 80 percent staying late a few days per week.

The survey was conducted by the Sidney, N.Y.-based Consumer & Office Products Group.”

Tip Sheet, November 25, 2002.



by about \$6.2 billion at the end of the year; returns on its pension assets fell 11.5 percent through Oct. 31.

The U.S. Treasury proposed regulations last week that would give the green light to employers who want to save money by converting defined benefit pension plans to cash balance plans.”

Tip Sheet, December 16, 2002.

RISING HEALTH CARE COSTS WILL AFFECT EMPLOYEES

“The sharpest rise in years in employee health-care costs is spurring employers to make the most significant changes in their workers’ insurance plans since the managed-care revolution took firm hold in the early 1990s.

This dose of bad news, despite the nation’s preoccupation with terrorism and a sluggish economy, is expected to make health care a major political and personal concern in 2003, and a hot campaign issue in 2004. Already, companies are passing along the cost increases by raising premiums, co-payments, and reducing benefits to a degree not seen in years. Some small employers are eliminating coverage altogether, which is certain to swell the ranks of the uninsured.”

Michael Waldholz, Wall Street Journal, December 12, 2002.

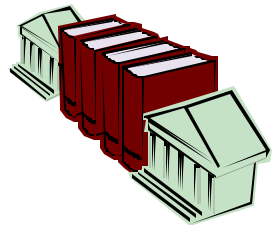


THE HIGH COST OF REGULATION

“Susan P. Dudley, writing in a recent issue of Regulation magazine, notes that the federal government alone printed 64,431 pages of rules and announcements last year. It spent a record \$25 billion to run the regulatory agencies in fiscal 2002. It is estimated that the regulated public is forced to spend \$45 in compliance costs for every dollar spent on regulation, more than double the amount of 25 years ago. That’s close to \$1 trillion, or one-tenth of the U.S. economy.

Small businesses, unable to afford the large legal and accounting staffs big corporations employ, are screaming. According to the Small Business Administration, firms with fewer than 500 employees spend \$5,000 annually to cope with government regulations; regulations take 19 cents out of every revenue dollar of firms with 25 to 49 employees.”

George Melloan, Wall Street Journal, November 5, 2002.



THE SOONER YOU SAVE, THE HAPPIER THE RETIREMENT

“The greatest tool in your pursuit of a financially secure retirement is time. According to a study by Harris Interactive, a major polling firm, the happiest retirees are those have spent the most time preparing for retirement. For example, 61 percent of retirees who saved for 25 years or more said they were extremely satisfied with retirement. Among those who saved for less than 15 years, only 46 percent expressed extreme satisfaction with retirement.

According to the poll, retirement happiness is directly linked to the number of years you’ve been saving for retirement, rather than net worth. Certainly, the two are related, but the lesson is clear: Stop dreaming about retirement, and start preparing for it today!”

Investment Focus, Winter 2002.



PENSION SHORTFALL

“Traditional pension plans are currently underfunded by some \$300 billion, the head of the government agency that insures pensions for about 44 million Americans says.

Steven Kandarian, executive director of the Pension Benefit Guaranty Corp., said the pension shortfall increased in the past year because the falling stock market hurt companies’ pension fund assets.

Several large companies, including International Business Machines Corp. and General Motors Corp. in recent weeks have said that their pension plans are underfunded. Earlier this month, Ford Motor Co. said its U.S. pension plan would be underfunded



ONLY HALF HAVE RETIREMENT SAVINGS

“More than half of the paid workers ages 25 to 64 in the United States don’t own retirement savings accounts of any kind. About a third work for employers who don’t offer retirement benefits, a congressional study said Friday. Slightly over half of workers with access to employer-sponsored plans participated in 2001, according to the Congressional Research Service analysis of Census Bureau data. The study looked at 113 million workers ages 25 to 64 who earned money, including full-time, part-time, private, public, and self-employed.”

Associated Press, December 14, 2002.



THINGS THAT MAKE YOU GO HMMM...

A BACKLASH AGAINST THE 401(k)s – AND THEIR PLAN MANAGERS



Bill Wolman and Anne Colamosca are authors of *The Great 401(k) Hoax*, a book released in May 2002. In the book, Wolman and Colamosca attempt to explain “how the 401(k) has come to dominate the American family’s long-term investment portfolio and why it is inadequate.” (This description comes from the publisher’s blurb

on the barnesandnoble.com web site.) Interestingly enough, the authors don’t take issue with the *plan* as much as the *people* in charge of it.

Paul Farrell, who reviewed the book in a December 31, 2002 *CBS.MarketWatch.com* column, made this provocative comment:

Wolman and Colamosco say investors are making a huge mistake in allowing employers, Corporate America, Wall Street and politicians to do your thinking for you. Because they create and control 401(k) assets for their benefit, not yours.

Farrell goes on to add, “As I see it, the biggest enemy is your 401(k) plan manager.” To illustrate his point, Farrell puts forward “six facts” regarding Fidelity Investments, and how in his words, “America’s biggest 401(k) plan manager lost an awful lot of your money in this bear market, and yet Fidelity’s owners, directors and portfolio managers continue to live high-on-the-hog.”

Hmmm...When things go wrong, it’s human nature to find a scapegoat. Some of the issues Wolman, Colamosco and Farrell bring up are obviously worth consideration, and are things we often mention in this newsletter. But one wonders if these same writers were slinging the same criticisms when both Fidelity and 401(k) participants were reveling in a decade of stupendous returns.



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