

# CREATIVE Wealth Maximization Strategies



Alliance Financial Group  
14021 Metropolis Ave  
Fort Myers, FL 33912  
239-561-2900  
**John J. Bellino III**  
John\_J\_Belliono@glic.com

January 2004

## WHATEVER HAPPENED TO EMERGENCY FUNDS?

### Here's how it used to be, 30 or 40 years ago:

You had a job with a big corporation.

In exchange for your services, the company wrote you a check every week or two.

You cashed the check.

You paid your bills, and put some money in the bank.

You took your first big financial step, and bought a home. You also bought a modest life insurance policy with an accidental death benefit, and started accumulating cash value.

You avoided debt, using your savings to buy new cars, and only used credit cards to buy appliances.

As your savings account grew, you bought a Certificate of Deposit.

Finally, after much discussion, you took some of your savings and invested in a mutual fund.

As the savings account continued to grow, you sometimes bought a Treasury Bond, and made additional deposits to the mutual fund.

Late in your working career, after the kids were through college, you bought a few individual stocks.

After thirty years of loyal service, you retired with a generous company pension.

Combined with Social Security and your conservative personal portfolio, the end result was a comfortable retirement.

### Here's how it is today:

U.S. Department of Labor statistics show that the average person will have 3.5 different careers in his or her lifetime and work for 10 employers, keeping each job for an average of 3.5 years.

Compensation varies – most of the time you get a regular paycheck, but bonuses and stock options can also figure prominently in the pay package.

You pay your bills, sometimes using a credit card to get frequent flier miles.

With almost no money down, you buy a house, usually trading up with each job change.

You have balances on two or three credit cards, two car payments, and a home equity line of credit to handle emergencies.

You buy term life insurance, and as soon as you can, start contributing to a 401(k), investing in aggressive growth funds since retirement is a long way off.



Between the \$1 million-plus you plan to accumulate in your 401(k), and the portfolio you've accumulated through the stock incentive of successive employers, you hope to semi-retire by 50, and pursue another less stressful and more rewarding occupation.

At 40, you change your mind, borrow from the 401(k), max out the credit cards (and apply for more), leverage the home equity, and start your own company.

In five years, the company goes public, and you cash out, wealthy enough to not only semi-retire, but also wealthy enough to never have to work again.

**Ah, progress. A lifetime of routine and relative security has been replaced by a world of change and unlimited opportunity, in which almost anyone can become an overnight billionaire.**

***But... What if there's a bump in the road...***

***a glitch in the program...***

***an "error in the execution code?"***

What's the financial response to:

- an unexpected illness
- a dishonest partner
- a family crisis
- a down economy
- three losing years in the stock market...
- or some other unforeseen challenge?

**When the unexpected happened, here's how it used to be:**

It used to be you tapped the money in your savings account to meet the emergency. Before you bought a home, took on the risks of the stock market, or started a business, you built an “emergency fund”. It wasn’t anything glamorous. The earnings weren’t high at all. But the point wasn’t to earn a high rate of interest. The goal of an emergency fund was to keep you out of debt if things went bad, and to have some ready money for opportunities if things went well.

It used to be that every “financial planner” – whatever that term means – talked about the importance of building the emergency fund. Secure, liquid funds in the bank (or an insurance contract) were a fundamental part of a solid financial foundation.

#### **Here’s how it is today:**

You borrow. First, from the retirement plan, if you can. Then from home equity. Next are credit cards (you’re pre-approved), and finally, from the bank. And, as your monthly interest payments to financial institutions begin to add up, you rationalize that while it might not be the best, going deeper in debt isn’t all that bad. After all...

“I couldn’t turn down the chance to get the tax-deferral,” (even though you will pay the 401(k) loan back in after-tax dollars, and be taxed again in retirement).

“The mortgage interest is tax-deductible,” (and the bank is still earning 8% on your money, instead of you earning 1% in savings or 3% in the insurance policy cash values).

“If I pay the balance in six months, it’s only 4.9%,” (If you are so strapped you needed a cash advance from a credit card, what’s the chance you will pay it off before the 21.9% rate kicks in?)

“Since I put the money in the stock market instead of savings, I’m way ahead anyway. Even after I pay back the loan, I’m still ahead.” (Oh, wait a minute. That might have been true in the 1990s, but not the past few years. When the market goes down the tubes, and your portfolio follows, there’s no guarantee that there will be enough left to address the emergency.)

In a pinch, you could use these resources for emergencies, but each option has drawbacks. The real solution is the old-fashioned one: an emergency fund.

It’s easy to implement. There’s minimal financial risk or downside. So why do many otherwise financially intelligent people operate without one?

#### **Here’s the problem:**

Hindsight will show that sometimes you didn’t need a safety net. But hindsight can’t predict when you will need it in the future. And people still need emergency funds. All you have to do is look at the statistics showing the high number of 401(k) participants who end up taking loans against their plans. According to statistics from Fidelity Investments released in May 2003, the number of 401(k) loans grew by 10% to 12% last year, “largely because many people who have already borrowed are tapping their accounts yet again.” (*Wall Street Journal*, May 1, 2003.) In addition, a survey from the Profit Sharing/401(k) Council of American showed that one of every four 401(k) participants borrowed against their plan in 2001. Those surveyed said the primary purpose of the loans were to pay credit cards, take vacations, and meet other unexpected expenses – *just the type of things that would ideally be handled by an emergency fund.*

**Thus, the question: Should financially savvy individuals deliberately operate without a safety net of readily accessible cash?**

And further, would a “good” financial planner let them?

In a perfect world, the answer to both questions is “no.” But we aren’t living in a perfect world. There are a several factors that keep the establishment and maintenance of an emergency fund from being a priority.

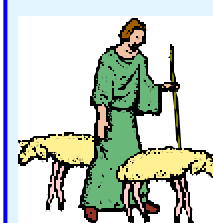
First, emergency funds have never had much sex appeal, and it’s even worse, now that interest rates are so low. (When did anyone ever say, “Hey, 1% on my Money Market is so cool?”) Even losing mutual funds have a better reputation, because losing money implies that you are brave enough or wealthy enough to risk it in the first place.

Second, brokers and financial advisors usually don’t have much financial incentive to present or recommend typical emergency fund vehicles, i.e., savings accounts, money markets, certificates of deposit, or even whole life insurance cash values. Most of the savings vehicles mentioned above don’t pay commissions or fees to the broker for monies deposited to the accounts. And while life insurance policies do usually generate commissions, they also require the prospective owner to undergo medical examination, and usually premiums must be paid for at least three years before any significant cash is available.

Third, since emergency funds aren’t glamorous and brokers don’t have a financial incentive; both the customer and the advisor often try to justify using other vehicles as “substitute” emergency funds. This is illustrated in the increased use of home equity lines of credit, and the rising number of participants borrowing from their 401(k)s. Even though each method includes interest costs, repayment obligations and other restrictions, the institutions providing these vehicles prominently market the ability to access your liquidity. Supposedly, it’s a way for you to have your cake and eat it too.

But quite often, the reason you might need an emergency fund also involves factors that may make using substitute emergency funds less effective. A change or termination of employment may end your participation in the 401(k), and with it the opportunity to borrow from it. If the job change is a result of a lagging economy, the downturn may also be reflected in declining stock values, thus decreasing the amount you have available for emergency use. A bank might be less enthusiastic about extending a line of credit to someone currently unemployed. In short, substitute emergency funds run the risk of not being as available or reliable as the real thing.

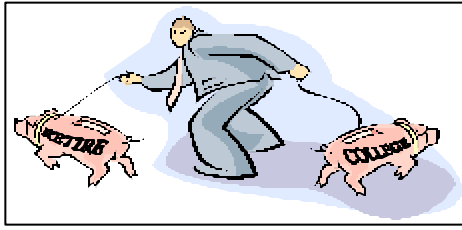
**DO YOU HAVE EMERGENCY FUNDS? IS IT TIME TO “GET A NET” UNDER YOUR FINANCIAL ACT? TRUE PROSPERITY IS PROGRESSIVE: SAFE & SECURE FIRST, THEN COMFORTABLE, THEN WEALTHY.**



**“Know well the condition of your flocks,  
And pay attention to your herds;  
For riches are not forever,  
Nor does a crown endure to all generations.”**

*- Proverbs 27:23 (Proverbs of Solomon).*

## THINGS THAT MAKE YOU GO “HMMM...”



### RETIREMENT OR COLLEGE FUNDING: WHICH COMES FIRST?

According to an article posted on the web site for Fleet Bank ([www.fleet.com/smarterdecisions](http://www.fleet.com/smarterdecisions)), many Americans face a difficult decision: should they be saving for retirement or for their children's college education?

How does Fleet Bank answer the question?

“There's no doubt, education and retirement goals deserve your attention. But in the competition for your investment dollars, one goal often must outweigh the other. And that probably should be your retirement.”

The web site article goes on to explain the reasons for retirement getting top billing.

**-You must take care of yourself first.** Keeping oneself financially sound is “one of the most important things you can do for yourself and your family.” Staying financially independent means you are less likely to rely on the assistance of children or other family members.

**-You can pass on assets if you don't use them.** Instead of providing money now for college, you can provide an inheritance later.

**-Retirement costs more than a college education.** A four-year college education at a public university averages \$45,000 (according to the College Board). That same \$45,000 wouldn't fund much more than a year of retirement for most middle-income households. And retirement usually projects to last longer – at least 20 years, maybe more. Securing a retirement requires a huge financial commitment.

**-There are other ways to pay tuition besides from savings.** Loans, grants and scholarships are available for college costs. Unfortunately, there aren't any “retirement loans” or scholarships for retirees.

**-Your kids can (and should) help pay for their education.** After all, it's their future, and requiring them to chip in is reasonable. The education and degrees they receive are benefits to them, and paying for those benefits gives them ownership and responsibility.

*Hmmm...It's an interesting parlor room debate, but who said you had to choose between retirement and college funding? An “outside-the-box” thinker might try to make a child's college years a retirement-enhancing opportunity, perhaps by buying a rental property near campus, paying tax-deductible “management fees” to the son/daughter, and selling the house for a profit after graduation.*

## News Digest

*(Snippets from stuff we've read, including differing points of view, not all of which we agree with. Want to know more? Give us a call and we can provide you with the complete article.)*

### CAN'T AFFORD TO RETIRE? THE JOB MARKET IS IMPROVING FOR OLDER WORKERS



“For the growing number of people who need to work deep into their 60s – or who flunk retirement, get bored and want a job – things are looking brighter. With baby boomers approaching retirement, more will be leaving the nation's workforce than there are to replace them, creating worries of a critical worker shortage that could enhance the value of old-timers.

“In the old days, when people in their late 50s hung it up, companies would go to college campuses and recruit more. That's going to become more difficult for many,” says John Carney of the Carney Group, the Blue Bell, Pa. Firm that specializes in recruiting and placing older workers.

In 2008, there will be 34.1% more workers in the 50-59 age group than there were in 1998 and 15% fewer workers ages 25-40, Carney said. In 2002, more than 1 in 8 people older than 64 were working or looking for work.”

*Tip Sheet, December 15, 2003.*

### FOR MOST, THE PROSPECTS OF AN INHERITANCE ARE SLIM



“Today's retirees are the wealthiest ever, but that doesn't mean they'll be leaving behind significant bequests to bail out baby boomers. A report released this month by AARP, the organization that represents seniors, said only 26.8% of boomers surveyed in 2001 had received or expected to receive an inheritance.

With baby boomers themselves approaching retirement, there has been speculation they might be relying on inheritances to boost savings that would otherwise be insufficient to maintain their lifestyles. The AARP report indicates they don't have much to expect.

Of the boomers surveyed by the Federal Reserve in 2001, the median value of the inheritance was \$47,909. Less than 2% of them had received more than \$100,000.”

*Pete Swenson, Associated Press, November 24, 2003.*

### OUTDATED BENEFICIARY DESIGNATIONS CAN SABOTAGE ESTATE PLANS



“An outdated beneficiary designation or the failure to name a beneficiary will add expense, confusion and can even destroy an otherwise perfect estate plan.

One of the most important aspects of any estate planning is to verify the proper naming of beneficiaries in your insurance policies and retirement plan

documents, as well as in the will and trust. A lawyer cannot do this by herself (or himself), but must rely upon you to correctly determine and record the names of the beneficiaries.

The designation of a beneficiary of an IRA is extremely important because if a person is not named as the IRA beneficiary, the estate becomes the beneficiary and the distribution options are severely limited.”

Alan S. Novick, *Scripps Howard News Service*, October, 13, 2003.

### DISAPPEARING TAX BREAKS

“The tax cuts of 2003 may be a boon to the economy and provide welcome padding to some taxpayers’ wallets, but for others those cuts will prove to be a mirage. That’s because lower tax rates will push more people into paying the Alternative Minimum Tax, rendering some of those much-heralded breaks moot. An estimated 2.5 million U.S. taxpayers will be caught in the AMT’s noose when they file their 2003 taxes, rising to 3 million in 2004, according to the U.S. Congress’ Joint Committee on Taxation. That’s up from about 1.1 million in 2001, according to the IRS’ most recent figures.



Taxpayers who exercised incentive stock options, claim a lot of miscellaneous itemized deductions or personal exemptions or live in high-tax states such as California, New York, New Jersey or Pennsylvania are particularly likely to pay the AMT.”

Andrea Coombes, *CBSMarketWatch.com*, December 2, 2003.

### A REVERSE MORTGAGE: THE ESSENTIAL RETIREMENT ASSET?

“Retirees may not like reverse mortgages, but they will learn to love them.

One glance at these loans, and you will likely suffer severe sticker shock. Reverse mortgages, which allow those aged 62 and up to borrow against their home’s value without making repayments during their lifetime, are pretty darn expensive. Nonetheless, I would advise boning up on the topic, for one simple reason: these things are going to be huge.

Today, reverse mortgages are a modest business. Consider the Home Equity Conversion Mortgage, which accounts for an estimated 90% of all reverse mortgages. In the 12 months ending September, there were only 18,097 HECM loans originated. Still, that number represented a 39% increase from a year earlier, and I suspect the number will skyrocket in the decades ahead. The fact is, a reverse mortgage may be the only way cash-strapped baby boomers can salvage their retirement dreams.”

Jonathan Clements, *Wall Street Journal*, December 17, 2003.



# RULE OF 72

## BE SMARTER THAN THE AVERAGE AMERICAN

### KNOW THE “RULE OF 72” – IN JUST FIVE MINUTES!

If you are already familiar with the Rule of 72, you have permission to skip this article.

If you think the Rule of 72 refers to an ancient dynasty in Greece or China, you don’t remember history very well.

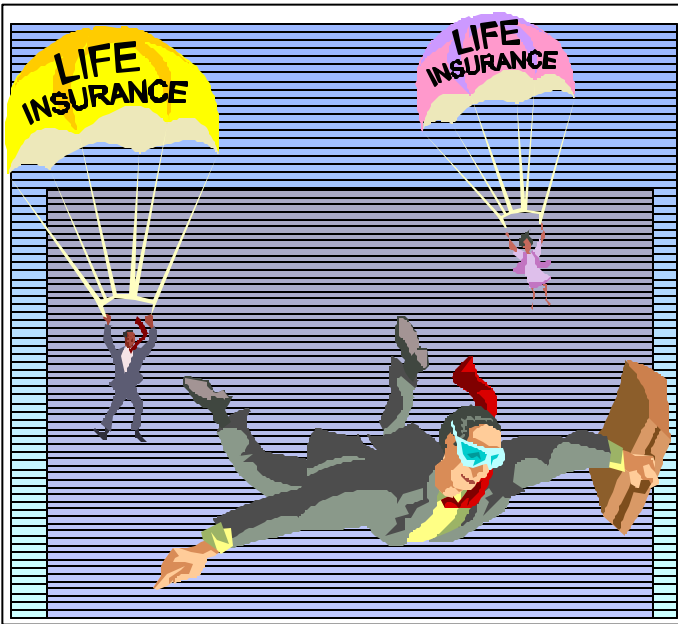
And according to recent surveys, if you ask the average American what the Rule of 72 is, you’re likely to get a blank stare. So, if nothing else, five minutes of reading can make you smarter than most of the people standing around the water cooler next Monday morning.

The Rule of 72 is the formula for determining how long it will take money to double in value at a certain compound interest rate. The time it takes for money to double is determined by simply dividing 72 by the interest rate. For example: At 6% annual interest, it takes 12 years for \$10,000 to double to \$20,000 (72 divided by 6 equals 12)

Since several numbers easily divide into 72, here’s a simple chart.

Annual Rate of Return	Time for deposit to double
At 3 percent ...it takes	24 years
4 percent	18 years
5 percent	14.4 years
6 percent	12 years
8 percent	9 years
9 percent	8 years
12 percent	6 years
18 percent	4 years
24 percent	3 years

Pretty simple, eh? Not only will your friends and co-workers be amazed, but also this is just the type of thing to teach your kids – they will think you are a financial genius! All in just five minutes! You’re welcome.



## HANG ON TO YOUR LIFE INSURANCE!

At some point as an adult, you recognized the financial desirability of obtaining life insurance. This decision to purchase life insurance was probably based, at least in part, on a perception of need – in the event of your death, those left behind would need additional financial resources to maintain their standard of living, fund a college education, operate the business, etc.

As time passes, some of the financial needs that life insurance was meant to cover may also pass. Retirement funds may accumulate, children may graduate, and the business may be a large conglomerate that no longer relies on the efforts and expertise of one individual.

But even if the original needs for life insurance are gone, it doesn't mean you should surrender life insurance coverage. Although the logic may run contrary to many conventional financial experts, there are several good reasons for keeping life insurance policies in force

In discussing these arguments for keeping life insurance, it may be helpful to review comments from previous issues regarding life insurance.

The following facts are noted:

**-Everyone dies.**

**-Life insurance is unique.** It is the only type of insurance involving a guaranteed event (see Rule #1). Every policy in force at death results in the payment of a claim.

**-Life insurance is a business proposition.** Dying is an emotional subject, but the decision to buy life insurance is ultimately a financial decision, not an emotional one.

**-Life insurance prices are based on statistics and probabilities.**

From these facts, two general conclusions are offered:

**-The sooner you obtain life insurance, the better.** The annual premiums will be lower, and the likelihood of qualifying for coverage and receiving a favorable price is the greatest.

**-Keeping life insurance in force until you die is the only way to guarantee a return on the dollars spent on coverage.** If you obtain coverage, but do not maintain it, the insurance company keeps some or all of the premiums, while you forfeit the benefit.

Chuck Jaffe, a *CBSMarketWatch.com* writer, echoes the last conclusion in a November 28, 2003 article:

*“Half of all life insurance policies lapse within five years and nearly three-quarters are surrendered within a decade. This cost structure virtually guarantees big profits for the issuer and little likelihood that the buyer sticks around long enough to make it worthwhile. Investors should ideally buy a policy they are comfortable holding forever, so paying a premium for the freedom to drop it doesn't always make sense.”*

Without getting into a lot of math, surrendering a life insurance policy results in a financial loss. Paid premiums, and the interest that could have been imputed to them, represent a “lost opportunity cost” that cannot be recovered. For some, the ongoing cost of maintaining coverage, especially if premiums are increasing annually (such as in term insurance), may represent an even greater financial drain. But with either circumstance, surrendering coverage is still a losing monetary decision.

The conventional argument for surrendering no-longer-needed life insurance is that the money once allocated to premiums can now be invested in other vehicles that have the potential to deliver returns great enough to “make up” for the costs of paying for life insurance and then surrendering it. The success of this strategy is dependent on the performance of the vehicle chosen, and most likely, the returns from such options are not guaranteed.

A follow-on argument against keeping life insurance is that the financial benefit isn't realized until a claim is paid after the death of the insured. In many instances, this means paying (premiums) for something that can't be “used” or spent by the payer. In other words, if you don't get the money until you're dead, what's the point?

Life settlements address this issue, and allow policyholders to receive financial value from their life insurance policies even while alive. According to a December 4, 2003 article from *Business Wire*,

*“Life settlements have emerged as an important financial planning tool that many individuals use as their personal finance needs change throughout the year.*

*“A life settlement refers to the sale of an existing life insurance policy insuring a person over age sixty-five (65) to a third party funding group for a lump sum of cash. This represents the true market value and is always more than the policy's cash surrender value. This year alone, hundreds of millions of dollars worth of*

*insurance policies have been sold in life settlement transactions. Individuals can now reap the benefits of policies that no longer fit the owners' needs."*

As the baby boomers move toward their sixties, the number of life settlements can expect to increase along with the demographics.

"An unwanted life insurance policy has proven to be a financial windfall for many seniors," said Jolene Fullerton, general counsel for Life Asset Group, one of the industry's leading life settlement brokers. Life Asset Group has brokered over \$87 million this quarter and expects to broker more than \$200 million in the face value of policies by the end of this year. "With the exponential year-to-year growth of this industry, more and more seniors will be able to turn their unwanted life insurance policies into cash."

Life settlements can also be used very effectively for charitable or philanthropic purposes. The owner of the policy can:

1. Make a donation to their favorite philanthropic organization without depleting cash reserves or losing income-producing assets;
2. Get a tax deduction for the fair market value (selling price) of the life insurance policy instead of only the cash surrender value;

3. Be able to see their donation put to use during their lifetime rather than after their death if the organization did not utilize a Life Settlement;
4. Eliminate the requirement of continued premium payments on the policy;
5. Remove a taxable asset from their estate if the policy was individually held.

Some of these ideas and applications have tax consequences, so you must discuss the details of your individual situation with your financial and tax advisors. Even if none of these alternative uses of life insurance fit your current circumstances, don't surrender any life insurance coverage casually. Even if you don't "need it," there may still be some good use for it.



### John J. Bellino III

Alliance Financial Group, Inc.  
14021 Metropolis Avenue  
Fort Myers, FL 33912  
(239)-561-2900  
(800)-964-6639 (where available)

Please add a FREE subscription to your monthly newsletter for the following people. I understand you will send them a note explaining I suggested they get this FREE subscription. All they have to do is contact us if they wish to cancel.

1. Name \_\_\_\_\_  
Address \_\_\_\_\_  
City \_\_\_\_\_ St \_\_\_\_\_ Zip \_\_\_\_\_  
E-Mail \_\_\_\_\_
2. Name \_\_\_\_\_  
Address \_\_\_\_\_  
City \_\_\_\_\_ St \_\_\_\_\_ Zip \_\_\_\_\_  
E-Mail \_\_\_\_\_

Material discussed is meant for general illustration and/or informational purposes only and it is not to be construed as tax, legal or investment advice. Although the information has been gathered from sources believed reliable, please note that individual situations can vary, therefore the information should be relied upon when coordinated with individual professional advice.