

CREATIVE Wealth Maximization Strategies



Alliance Financial Group
14021 Metropolis Ave.
Fort Myers, FL 33912
Phone: (239) 561-2900
www.johnbellino.com
john@johnbellino.com

JUNE 2005

**“Putting off an easy thing makes it hard.
Putting off a hard thing makes it impossible.”**

- Charles Wilson

READ THIS ARTICLE ABOUT PROCRASTINATION *RIGHT NOW!*

Money isn't everything, but any normal, rational, well-balanced human being wants a solid financial life. Granted, a "solid financial life" is a vague term, and certainly the details of what constitutes a solid financial life will vary with each individual. But the concept encompasses desires that are almost universal: to feed one's family, secure good housing, provide education and opportunities for their children, and ensure an income in old age – with a minimal level of stress and reasonable level of assurance or guarantee.

Unfortunately, many individuals, even in the United States, fall short of reaching these primary financial objectives. Most Americans may get by, but they struggle to get ahead. A brief sampling from last week's financial headlines: "Americans' Retirement Optimism Likely Built on Shaky Ground", "Future High Earners May Not Get Social Security", "Car Shoppers Drown in Debt", and "Risks From Falling Home Prices".

Even if some of the headlines are hype, the underlying story is: most Americans are not succeeding in their financial planning. And for the most part, the failure is not because they lack the resources, but rather because they have been unable to consistently execute basic financial strategies.

Why do most Americans fail to achieve a solid financial life?

From empirical observation and statistical surveys, those in the financial services field like would answer as follows:

- 1. They don't start soon enough**
- 2. They don't plan long enough**

Why don't most Americans start soon enough and plan long enough? You could list a number of factors that contribute to this misunderstanding (*see box*).

But (in our humble opinion) one of the biggest reasons most Americans don't start planning soon enough and don't plan long enough is because they don't fully understand the immediate and long-term consequences of their current financial decisions.

WHY don't Americans plan soon enough and plan long enough?

- **Everyday emergencies make it hard to plan for the future.**
- **Powerful cultural messages promote instant gratification; messages which are constantly reinforced by all sorts of retail advertising.**
- **Consumers are confused as a result of so many choices ("should I believe the infomercial on real estate, take the seminar on day-trading, or open an account with a discount broker?").**

FINANCIAL PLANNING ISN'T ABOUT A BETTER FUTURE – IT'S ABOUT A BETTER "NOW".

Financial planning is often perceived as a decision about delayed gratification. It's something that involves "tomorrow." A "tomorrow" mindset invites procrastination, because as long as you can put it off until tomorrow, why do it today?

In our financial culture, "tomorrow" is retirement. And even though retirement is an important financial topic, it's not urgent. So if you are:

- ♦ 30 years old, retirement is at least 25 years off.
- ♦ 40 and haven't planned, you tell yourself that you are probably going to work until 65 anyway, so tomorrow is still 25 years out.
- ♦ 50, well, you've decided you want to work as long as you can, so there's still time before you start planning for the future.

As long as financial planning is part of your tomorrow, you will never reach your financial potential, because there simply isn't enough motivation to act today. Discussions about products, an analysis of stock market trends, even sophisticated projections for the future don't motivate most Americans (or anyone else) to effective financial action – to start soon enough and plan long enough.

Consider the difference in urgency between an issue that you perceive as requiring immediate attention and one that can wait until later.

(Continued on next page)

THE TIME TO STOP THE BLEEDING IS NOW.

Suppose on your way to work this morning you suffer a seemingly minor cut. It starts bleeding, not too much, but steadily. You apply a bandaid, but notice an hour later that it's soaked. The wound doesn't really hurt, and you aren't panicking, but you are concerned that the bleeding hasn't stopped.



When things don't get better that afternoon, you decide you shouldn't wait any longer. You seek medical attention before you go home.

As you pondered how to respond to the cut, did you think "I wonder if this wound could shorten my life expectancy or affect my quality of life after age 60?" Of course not! This wasn't a decision about the future – it was about right now! Even though there might be long-term health consequences related to the cut, you didn't need to reflect on possible future-related issues to conclude you needed further medical attention. It was obvious that something was wrong with your present plan. The recognition of the immediate problem prompted immediate action.

Suppose for some reason, you decided to put off examination and treatment, and just put a new bandage on it every morning. You might not die. But is there any doubt that ignoring the cut could jeopardize your long-term health? Understanding the health risks, most normal, rational people will act now.

ANOTHER REASON TO ACT NOW: WHAT YOU DON'T DO TODAY HAS A BIG IMPACT ON WHAT YOU CAN DO TOMORROW.

When you don't plan your financial life, you are in danger of "bleeding" financially. Every little "cut" that isn't given attention hurts you – *today*. And while you may not be in danger of immediate financial demise, you must recognize that conditions left untended will result in negative consequences.

Remembering that everyone's situation is different, some possible examples of financial bleeding could be:

- credit card interest
- low deductibles on auto and homeowner's insurance
- income taxes on savings and investments
- institutional surrender charges
- term life insurance premiums
- loans against qualified retirement plans

If you are bleeding, and if these cuts are affecting your financial health, the normal, rational response is to take corrective action now. Even if they recognize the financial bleeding is occurring in the present, some people will, almost from habit, argue that "it's just a scratch" that will heal on its own.

No. Not true.

Once a financial loss is incurred, the bleeding doesn't ever really stop. The opportunity cost of losing money because of a poor decision compounds against you forever. **The financial "mistakes" made early in life are the most costly, simply because the lost opportunity costs that you incur as a result accrue against you for the longest time.**

Suppose you make a series of decisions that lead to an additional \$1,000 of financial costs at age 25. Those mistakes could theoretically compound against you for the next 50 or 60 years. Calculated at 8% annually, the \$1,000 "cut" left unattended has the potential to "bleed" you of \$16,000 by age 70. In the context of considering opportunity costs, making similar financial mistakes at 70 doesn't do nearly as much damage. This perspective puts a high premium on becoming financially literate and efficient as soon as possible. True financial planning should be applied to stop the bleeding now so that you have the best possible chance of succeeding tomorrow.

FURTHER...WHAT YOU DON'T DO TODAY HAS A BIG IMPACT ON NOT JUST YOU, BUT FUTURE GENERATIONS.

Because many Americans associate their "tomorrow" with their own retirement, they assume that the consequences of their financial planning end when their lives end. But in ways that you might never imagine, your financial plans have ripple effects that extend far beyond your lifetime. Lost opportunity costs reverberate through successive generations.

Using another simple example: Suppose a 43-year-old father bleeds off \$5,000 from his net worth through poor planning over the previous decade. He makes changes to stop future bleeding, but the opportunity costs continue to accumulate on his previous missteps. Assuming he lives to 79, and using the 8% annual rate, the opportunity cost calculation grows to \$40,000.



Suppose this man has a daughter, aged 16 when he is 43. At her father's death, she stood to inherit his assets. Theoretically, his lost opportunity cost is passed on to her, in the form of money she doesn't receive (the daughter is 52 at her father's death). If she lives until age 86 (and women usually live longer than men), the opportunity cost has now reached \$640,000. Take this same calculation out one more generation, and the cost of the loss is well over \$3 million.

LOST OPPORTUNITY COST IS HYPOTHETICAL, BUT THE CONSEQUENCES ARE REAL

You might dismiss this opportunity cost calculation as mere speculation. After all, opportunity cost isn't real, right? It's a hypothetical assessment of what something might have been worth if you had it – and you don't. But here's the chilling part: Even if the math is hypothetical, the lost wealth effect is real. Here's a quote from a May 13, 2005 Wall Street Journal article by David Wessel:

A substantial body of research finds that at least 45% of parents' advantage in income is passed along to their children, and perhaps as much as 60%. With the higher estimate, it's not only how much money your parents have that matter – even your great-great grand-father's wealth might give you a noticeable edge today.
(bold type added) (Continued on next page)

Wow. Not only is good financial planning about making things better right now, it also affects tomorrows that are far beyond your own retirement. This is not to say your children are doomed by your financial missteps, nor does your good planning ensure financial success for your dependents. But the consequences of your financial decisions can be far-reaching.

Given these perspectives, no one with financial aspirations – for themselves or their future generations – has the luxury of procrastinating. The time for planning – and acting – is now.

Procrastination is the stealthy killer of financial success.

Things that make you go “hmmm...”

NOBEL PRIZE WINNER EXPLAINS WHY SOCIAL SECURITY MAKES IT IRRATIONAL TO SAVE -- THEN PROPOSES ANOTHER IRRATIONAL APPROACH

Edward C. Prescott is a co-winner of the 2004 Nobel Prize in Economics, a senior monetary adviser for the Federal Reserve Bank in Minneapolis, and a professor of economics at Arizona State University. As the debate over President Bush’s proposals to reform Social Security began to heat up after last year’s election, Mr. Prescott, in a December 29, 2004 *Wall Street Journal* opinion piece, weighed in with some interesting observations.



First, Prescott notes the usual numerical/demographic issues affecting Social Security: taxes from 41 workers were supporting each elderly retiree in the 1930s, compared to a 3-to-1 ratio today. Then he acknowledges the likely consequences of attempting to maintain such a program going forward: Workers will pay higher taxes today and receive smaller future benefits. Given these numbers and the possible results, Prescott notes that although Social Security was intended to guarantee that no senior citizen should live in poverty, the program is a classic example of how “good ideas don’t always equal good policy.” In fact, from Prescott’s perspective, the current pay-as-you-go system actually makes it more likely that more senior citizens will “under-save” and become a “welfare burden.” Says Prescott:

“If somebody knows they will be cared for in old age – even if they don’t save a nickel – then what is their incentive to save that nickel? Wouldn’t it be rational to spend the nickel instead?”

So...people are acting rationally when they choose not to save. We have rational people making choices based on the rules. The trick is to get the rules right.”

How would Prescott propose making the rules “right?”

By establishing “a system of mandatory investment accounts for retirement” with strong government controls, such as limiting investment choices to a small menu of low-cost, conservative, index-oriented investment options. Prescott sees this format as one that would transform Social Security from a welfare program to one that benefits from “individual maximizing incentives.”

Hmmm...If people can make rational decisions not to save based on the government’s rules, shouldn’t they be able to

make rational decisions *to* save? If Prescott’s “better idea,” still requires a compulsory savings program under government control, it might indicate that his “rules” for fixing Social Security aren’t right either.

ARE THREE YEARS OF LONG-TERM CARE INSURANCE ENOUGH?

One of the major financial planning dilemmas facing individuals is whether to purchase long-term care (LTC) insurance or simply plan to pay long-term care costs (if they arise) “out-of-pocket” from existing accumulations. This is a daunting decision because long-term care costs have the potential to deplete an entire lifetime of financial accumulation.



On the other hand, it is possible that an individual may never enter a state of long-term care, and thus any premiums paid for long-term care coverage are “lost assets” that can never be recovered. In fact, Jesse Slome, editor of a LTC industry magazine says that the perception that the insurance coverage is “too costly, is the number one reason many people give for not buying LTC protection.”

One way to make LTC insurance more affordable is to limit the length of time benefits will be paid. According to Slome, consumers can realize a 35-40% decrease in annual premiums if they purchase coverage that provides three years of benefits instead of a policy that offers lifetime protection. This approach reduces the consumer’s costs, but raises the question: ***Are three years of benefits enough?***

To answer that question, Milliman, an LTC actuarial and product development company, conducted a comprehensive survey of long-term claims data from 1.6 million long-term care policies currently in force. The survey reported that only 14.4% of closed long-term care insurance claims (i.e., where the long-term care situation had been resolved) had lasted longer than 24 months, and only 5.6% of closed claims exceeded 36 months. In contrast, almost one-third of open claims (those where benefits were still being paid) had exceeded 24 months, and 16.2% were still open at 36 months. Overall, the study determined that 8% of policyholders with three-year benefit periods exhausted their policy.

Slome concludes “there are indeed catastrophic situations where individuals need long-term care for many years. But according to the study’s findings, for the vast majority of individuals with long-term care insurance protection, a shorter duration policy could be adequate. This is an especially important message for those individuals who find unlimited protection is too expensive. Indeed for many Americans, some protection will prove to be better than none.”

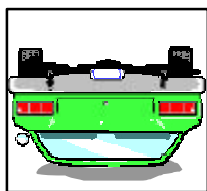
Statistically, a plan with an 8% chance of failure is better than a plan with no chance of success. But if your financial goal is, in the words of Warren Buffet, to build an “economic castle with an unbreachable moat,” then a moat that covers 92% of your long-term care risk really isn’t unbreachable. Developing an effective long-term care strategy for your individual situation is a topic that requires serious study and planning.

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.)

MANY AMERICANS ARE "UPSIDE DOWN" WITH THEIR CARS

...Suffocating under a mountain of debt has become an accepted part of living in America these days. And it's getting to be a real problem for car buyers, who are busy measuring their own necks for what could turn out to be a painful financial noose.



According to a recent Kelley Blue Book study, six out of ten new-car shoppers, in an effort to cope with mounting sticker prices, opt for a longer-term loan with lower payments instead of taking on a smaller debt overhang. That shortsightedness has given rise to consumers being caught "upside down," or owing more on a car than it's worth.

For example, if you owe \$20,000 on a car that's only worth \$15,000, you're considered to be \$5,000 upside down and monthly payments can get ugly fast when it's time for a trade-in.

The study also found that about one-third of these buyers, even willing to spend money they don't have, end up in this debt bind when they hit showroom floors for their next purchase.

Shawn Langlois, *MarketWatch*, April 28, 2005.

WILL BOOMER RETIREMENTS CAUSE A MARKET MELTDOWN? YES AND NO.

For tens of millions of baby boomers and younger workers, the basic long-range financial plan is simple: accumulate stocks and bonds while working, then slowly sell them off to keep up a comfortable lifestyle in retirement.



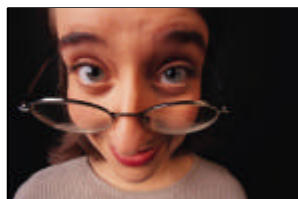
Not so fast, says Jeremy Seigel, the Wharton School finance professor well-known until now for recommending stocks as a long-term investment. In speeches and a new book, he is warning that a flood of boomer retirees with trillions of dollars of assets to sell over the next 20 to 40 years threaten to crush stock and bond prices. He says it will take a massive investment in U.S. stocks by people in India, China and other developing countries to prevent a market meltdown.

Robin Brooks, an economist at the International Monetary Fund, scoffs at the warning. He thinks the wealthy individuals who own a large percentage of U.S. stocks won't need to sell, and companies may boost dividends so retiree investors can hang on to their shares.

E.S. Browning, *Wall Street Journal*, May 5, 2005.

MISGUIDED OPTIMISM

Seven in ten Americans say they are confident or hopeful about their retirement finances and four in five report taking steps to prepare for their retirement years, according to a recent national survey of non-retired adults for Thrivent Financial for



Lutherans. Unfortunately, the survey also revealed that people's optimism may be misguided.

The survey found most Americans have never estimated how much money they will need for retirement and most also fail to regularly monitor their retirement assets. In addition, three in five have not met with a financial services provider, seven in ten have not sought retirement advice from books, magazines, television or the Web, and one in four have personally saved less than \$5,000 for retirement.

Business Wire, March 17, 2005.

GENDER DIFFERENCES IN INVESTING

Women may be savvier investors than men – despite having less knowledge on the subject. So reports Merrill Lynch Investment Managers, which surveyed about 1,000 investors about their financial mistakes. The survey found women made up for gaps in their investment knowledge by being more patient investors and seeking financial advice.



When it comes to investment errors, women are less likely to make so-called "glamorous" mistakes. Such errors include buying a "hot" investment without research (24% of men say that they have done this compared with 13% of the women), holding a losing investment too long (47% of men versus 35% of women) or waiting too long to sell a winning investment (43% of men vs. 28% of women).

Women also tend to exhibit investment behaviors that help them get ahead. Specifically, they seek financial advice and have solid investment goals. While 70% of women have a financial adviser, only 50% of men do.

Marshall Loeb, *KRT News Service*, May 2, 2005.

LIVING LARGE ON A REVERSE MORTGAGE

In a sign of how comfortable Americans are becoming with tapping their home equity, retirees are increasingly drawing on it to finance a more lavish lifestyle. The tool involved is one of the fastest-growing products in the mortgage industry. Called a reverse mortgage, it allows homeowners 62 or older to essentially sell their home back to the bank in exchange for monthly payments, a lump sum or a line of credit. Though still a tiny fraction of the overall mortgage market, reverse mortgages are seeing incredible growth.



Homeowners are using reverse mortgages to do everything from buying airplanes or recreational vehicles to renting apartments a few months a year in Paris.

Kelly Greene, *Wall Street Journal*, April 26, 2005.



THE TYPICAL AMERICAN MAY HAVE AN 80% INTEREST MORTGAGE *(at least from one perspective)*

What is the current interest rate on your mortgage? Is it under 6%? Or over 80%? The answer depends mostly on how you do the math.

Most loans or mortgages are structured to be repaid in equal monthly installments over time, according to an amortization schedule. In this format, payments made early in the term of the loan consist mostly of interest and very little principal. As the borrower continues to repay the loan, the ratio of interest to principal gradually changes, and at the end of the loan's term, the final payments are mostly principal.

Amortization is a mathematical reflection of risk assumed by the lender. At the beginning, the borrower has incurred very little out-of-pocket cost to secure a home or automobile, while the financial institution has, through its loan, paid the "full price" for the item, and will only profit from the transaction if the loan is repaid in full.

It's also important to note that the longer the term of the loan (such as a 30-year mortgage), the greater the percentage of interest in the initial monthly payments. For example:

Assume an individual has a 30-year mortgage for \$200,000 at 6% annual interest, with interest calculated monthly. To repay this loan, the borrower commits to 360 monthly

payments of \$1,199.10. The chart at the bottom of this page is a breakdown of the interest and principal for the first year's payments.

After one year, the borrower has made a total of \$14,389.20 in payments ($\$1,199.10 \times 12$) on the \$200,000 loan, yet still owes \$197,543.99. Of the first year's payments, \$11,933.19 – or 82.9% of the total payments – consisted of interest.

Assuming the borrower continues faithfully to make payments, the proportionate amount of interest will decrease every year, but for the first five years, the percentage of each payment that is comprised of interest declines slowly. Over 60 months of payments (\$71,946.00), interest still represents 80.6% of the total payments. From the perspective of evaluating how much of one's monthly income is allocated to interest charges, one could be said to have an "80% mortgage," even though the annual interest rate is 6%.

A twisted mathematical conclusion? Maybe, but there's an application.

The discussion above may seem like an exercise of mathematical "spinning," creating an outrageous number from a typical financial transaction, but there's some real-world relevance to the idea.

Because of the ever-changing circumstances of life (career moves, interest rate drops, other financial opportunities, etc.) consider that a lot of people either bought a new residence, or refinanced their existing mortgage within the past five years. Then consider that many are likely to buy a new residence or refinance within the next five years. Most of the time, each new mortgage or re-financing puts the borrower on a new amortization schedule – they start all over again at 30 years of scheduled payments with a high percentage of each monthly payment consisting of interest.

For reasons beyond the math, it may be perfectly logical to make the change and start a new 30-year amortization schedule. But the costs do add up.

Just to keep it simple, suppose our hypothetical individual in the \$200,000 example above initiated a mortgage five years ago, then refinanced the same amount today, again at 6% annual interest. He continues to make payments for the next five years, when he repeats the refinancing process. Five years later, he decides to sell the property and move to a retirement community in New Mexico. After 15 years, our three-time borrower has made \$215,838.00 in monthly payments and still

MONTH	PAYMENT	INTEREST	PRINCIPAL	REMAINING BALANCE
1	\$1,199.10	\$1,000.00	\$199.10	\$199,800.90
2	\$1,199.10	\$ 999.00	\$200.10	\$199,600.80
3	\$1,199.10	\$ 998.00	\$201.10	\$199,399.71
4	\$1,199.10	\$ 997.00	\$202.10	\$199,197.61
5	\$1,199.10	\$ 995.99	\$203.11	\$198,994.50
6	\$1,199.10	\$ 994.57	\$204.13	\$198,790.37
7	\$1,199.10	\$ 993.95	\$205.15	\$198,585.22
8	\$1,199.10	\$ 992.93	\$206.17	\$198,379.05
9	\$1,199.10	\$ 991.90	\$207.20	\$198,171.84
10	\$1,199.10	\$ 990.86	\$208.24	\$197,963.60
11	\$1,199.10	\$ 989.82	\$209.28	\$197,754.32
12	\$1,199.10	\$ 988.77	\$210.33	\$197,543.99

* Calculations reflect rounding to the nearest penny.

owes \$186,108.79 on his \$200,000 mortgage!

(Note that this illustration does not factor the equity increase or decrease that the borrower might have realized based on the market value of his property at the time of sale, or whether the refinancing in the 5th and 10th years allowed the borrower to receive \$13,891 in cash each time the mortgage was re-established at \$200,000. However, presuming the lender would not approve a loan for more than the property's value, it would be reasonable to credit the borrower with \$41,673.63 in received principal over the 15-year period.)

Playing the Amortization Game

On the surface, the numbers generated from this example might seem to make a case against refinancing. After all, if our borrower had just continued to pay the \$1,199.10 on the first mortgage for 15 years, the outstanding balance would be \$142,097.99, not \$186,108.79, a difference of \$44,010.80. But if the borrower had invested the \$13,891 he received at years 5 and 10 at 6% annually, the net amount owed would be the same.

The real issue in this discussion is what else happens in your financial world when you start amortizing all over again. Many homeowners have justified their constant refinancing because interest rates have dropped and housing values have skyrocketed. This has meant increased equity and decreased payments, both good things. But if interest rates increase (and



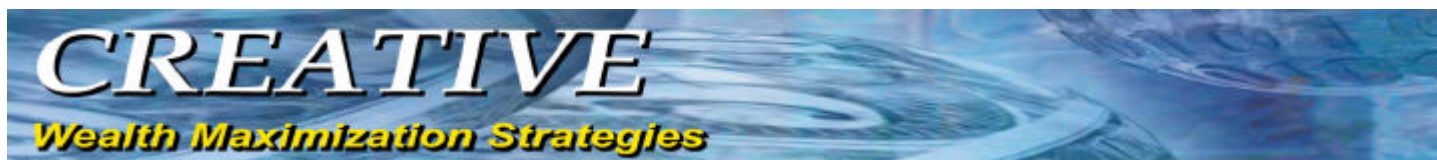
the consensus is they will) and housing values stagnate (it has happened before), the consequences of perpetual borrowing could come back to haunt you, because you will be facing a situation where your monthly payments may not improve your equity position at all.

On the other hand, if you have used refinancing to extract financial value from the property and reallocate it somewhere else where it can continue to increase your net worth, starting over on a new amortization schedule might be a smart move.

Returning to the example above: If our \$200,000 borrower did receive some cash out with each re-finance, and was diligent to reinvest it, the increased accumulation apart from the mortgaged property could offset the cost of starting anew on the amortization schedule. Later, this outside accumulation could be used to reduce the amount that might be refinanced after another five years, or eventually used to pay the outstanding balance in full.

If you don't have a plan to resolve long-term debt, you run the risk of being devoured by the high cost of rolling it over and working from a new amortization schedule each time. Ask any lender: Most people who refinance (to consolidate debt, or buy a boat, etc.) end up further in debt. Five years later, they are back again, hoping to bail themselves out by tapping more of their equity or reducing their monthly payment. As the debts increase, their payments creep up, but they own less and less.

Look at your own refinance and amortization history. Are most of your payments early in their amortization schedules? Do your borrowing strategies need to be re-evaluated?



John J. Bellino III
Alliance Financial Group
14021 Metropolis Ave.
Fort Myers, FL 33912
Phone: (239) 561-2900
www.johnbellino.com
john@johnbellino.com

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.