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Creative Wealth Maximization Strategies

“OKAY, I GOT IT. WHAT’S NEXT?”

How a Short Attention Span Can Hurt Your Financial Progress

Here’s an interesting financial transaction. See if you can follow this hypothetical example:

1. You borrow shares of stock XYZ from someone else’s portfolio.
2. You then sell the shares of XYZ and put the proceeds from the sale in your own account.
3. Over the next few days, you watch as the share price for XYZ goes down. You buy shares of XYZ at the reduced price, and use them to replace the shares you borrowed. You keep the profits (the difference between what you received for selling the borrowed shares, and the cost of replacing them).

Got it?

This is a simplified illustration of a short-sale. A short-sale is a way for an investor to make money on a stock he doesn’t own by speculating that it will lose value. Depending on your perspective, short selling can be ingenious, sneaky or evil.

Short-selling has a long and controversial history in a variety of financial markets. Some historians have found that North American fur traders were early practitioners of short-selling, and short selling appears to have triggered the implosion of the Tulip Bulb market in Holland in the 1600s. In recent financial history, short-sellers have become famous for their profits and infamous for bringing exaggerated financial losses on others. Because of the extreme volatility that can result, financial regulators have often suspended the practice during periods of financial turmoil crisis. Napoleon supposedly declared that short-sellers were “enemies of the state,” yet a May 4, 2010 *Wall Street Journal* article found that several members of Congress held investments that made short-



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sales during the 2008 financial crisis, and renowned investor Warren Buffet has defended short-selling as a “counterweight to Wall Street bullishness.”

So, in regard to short-selling...what’s next?

Reading the opening paragraphs probably took less than a minute. But perhaps because short-selling is an unfamiliar topic and the explanation is a bit complex, it wouldn’t be surprising if your attention started to drift, even in that brief period of time. We live in a short attention span culture, and most of today’s communication mediums emphasize quick bursts of information and constantly changing inputs. When it comes to concentrated thoughts on complex ideas, most of us don’t get much practice. And that can be a problem, particularly when it comes to finances. We are conditioned to look for “what’s next?” without even being sure about what just was.

**Life is complex and integrated.
So is money.**

Short-selling is just one idea in the financial universe. But it’s a good example of what the financial universe is like, and it also illustrates why many people

struggle to obtain their financial objectives. In order to succeed, you must embrace the complex and integrated nature of the financial world. Maybe this sounds sort of metaphysical, but there are practical applications – *especially if you don’t pay attention.*

At first glance, short-selling seems counter-intuitive. But short-selling is actually the product of integrated

thinking; you take several investing strategies, and connect them. **This formula of integrating ideas to create complex and sophisticated systems is the foundation of human progress, and reflects the nature of life itself.**

Complex financial transactions are part of everyday life in the United States. Variable-rate mortgages, insurance, tax-deferred retirement accounts and hundreds of other financial vehicles are comprised of integrated ideas and substantial details. There are very few “simple” financial products in the marketplace.

Given the evidence for complexity and the fact that money plays such a large role in determining our material circumstances, why do so many people seem to have a short attention span when it comes to making good financial decisions?

Does Complex Technology Make Us “Shallow Thinkers?”

Part of the challenge may be 21st-century technology. In his recently released book, *The Shallows: What the Internet Is Doing to Our Brains*, author Nicholas Carr says our forms of communication affect how well we handle complex thinking. “The Internet encourages the rapid, distracted sampling of small bits of information from many sources...We are becoming ever more adept at scanning and skimming, but what we are losing is our capacity for concentration, contemplation, and reflection.” Similar charges are made against television and video games. Sampling, scanning and skimming might be considered higher-level mental functions, and operating a game controller certainly requires some complex manual dexterity. But when there’s no “concentration, contemplation or reflection” to accompany these tasks, the chances for success seem less probable.

This “short attention span” dilemma is pervasive. An example is the Congressional leader who said “We have to pass the bill so that you can find out what is in it.” The final version of the bill was 2,409 pages, and many legislators admitted they didn’t read it before they voted to approve it. Regardless of your perspective on the issue, it seems like the process for reviewing and debating the bill could have been a bit more “thoughtful” if more people took the time to read it, instead of saying “we’ll figure it out after we approve it.”

Consequences

A Short Attention Span Could Mean Missed Opportunities. An Example: whole life insurance is a complex financial product; even the best life insurance representative couldn’t accurately explain all the features and benefits in five minutes or less (don’t believe it? See the next article). In contrast, there are hundreds of TV

commercials for term life insurance, all conveying their message in 60 seconds. And for those dispensing financial advice to the masses, their message is to buy term. As one “expert” puts it “Keep it simple and buy term life insurance.” That is *simple*, isn’t it? Sounds like perfect advice for “short attention span” types.

However...in the long run, your financial situation may favor using whole life. Unfortunately, selecting term life insurance today – because it’s simple and quick – could possibly preclude obtaining whole life later. The time to pay attention is now!

A Short Attention Span Could Result in Financial Loss. For more than 20 years, Bernie Madoff’s investment operation was so complex, no one knew he was actually running a scam. Or more to the point, no one seemed to be able to pay attention long enough to figure it out. In 2000, broker Harry Markopolos said he knew in “five minutes” that Madoff’s operation was a fraud, and he reported this assessment to the SEC – in written detail. Unfortunately, it was eight years before

the authorities would follow through on Markopolos’ findings. How much money was lost because people had a short attention span?

Remember, not every complex idea works. Some projects fail because of flawed principles, others because the complexity is hiding fraud or other bad behavior. Those with an unwillingness to examine the details of their financial transactions are at great risk of being undone by their short attention spans.

Okay, I Get It... What’s Next?

How about a three-hour tutorial on the history of interest rates and inflation? That might provide some real insight into what’s next for the economy. *Just kidding*. If you’ve made it to the end of this article, you deserve a few summary bullet-point comments, just so you don’t suffer complexity overload.

- If you take the time to understand it, financial complexity can be a great asset.
- One of the best ways to achieve financial complexity is to use the knowledge of others. Most of the time, successful complexity is group effort. Only geniuses do it alone.
- Your best financial strategies are the ones that integrate all of your financial components – what you earn, what you own, what you owe, what you want.
- People who live in the shallows may see their financial progress go off the deep end.

WHAT’S NEXT? How about a review of your financial program, and the chance to see if a little complexity and integration could make a positive difference in your life?

Whole Life Insurance: *Complex, Ingenious*

What is whole life insurance? A simple answer, one you might find on a financial information website, might describe whole life insurance as a combination of life insurance and cash value. But once you get past this basic definition, the details and workings of a whole life policy can be quite sophisticated, maybe even confusing. Writing in the January 11, 2009 *Palm Beach Daily News*, life insurance expert R. Marshall Jones said that:

“Until recently, permanent life insurance was arguably the financial industry's most complex instrument...”

As with many other complex financial products, whole life insurance is the result of the integration of several basic financial ideas. The starting point for whole life is an understanding of some of the shortcomings with a simple financial instrument, term insurance.

Here’s the big issue with term insurance: As you get older, it gets more expensive. Because statistics show older people are more likely to die than younger people, insurance companies price the coverage accordingly. To illustrate, here are 50 years of scheduled premiums from a reputable life insurer for a healthy 35 year-old male non-smoker to secure \$500,000 of life insurance on a yearly renewable basis.

<u>YEAR</u>	<u>ANNUAL PREMIUM</u>	<u>YEAR</u>	<u>ANNUAL PREMIUM</u>
1	\$ 265	26	\$1,800
2	275	27	2,020
3	290	28	2,270
4	305	29	2,560
5	320	30	2,845
6	335	31	3,150
7	360	32	3,490
8	390	33	3,845
9	425	34	4,175
10	460	35	4,535
11	500	36	4,900
12	535	37	5,530
13	575	38	6,235
14	615	39	7,035
15	645	40	7,935
16	680	41	8,945
17	730	42	10,085
18	765	43	11,370
19	900	44	12,825
20	950	45	14,465
21	1,075	46	16,305
22	1,210	47	18,205
23	1,330	48	20,165
24	1,465	49	22,370
25	1,665	50	22,580

This pricing, while accurately representing the risks assumed by insurance companies as people get older, creates a dilemma for consumers. As they live longer, and pay increasingly expensive premiums, the cost of insurance becomes prohibitive. Thus, when they are most likely to die, they may not be able to afford the insurance. From a financial perspective, the only way to “win” in this transaction is to die “young,” before the insurance gets too expensive. Given the aversion most of us have to dying, the most likely outcome of yearly term insurance is paying premiums for a period of time, then lapsing the coverage. Even though the consumer may have a real need to provide the financial protection of life insurance, the yearly renewable premium schedule creates a financial incentive to drop the protection as soon as possible – or simply forgo life insurance altogether. This is a lose-lose proposition, for the consumer and the insurance company.

Integrated Solution, Step One

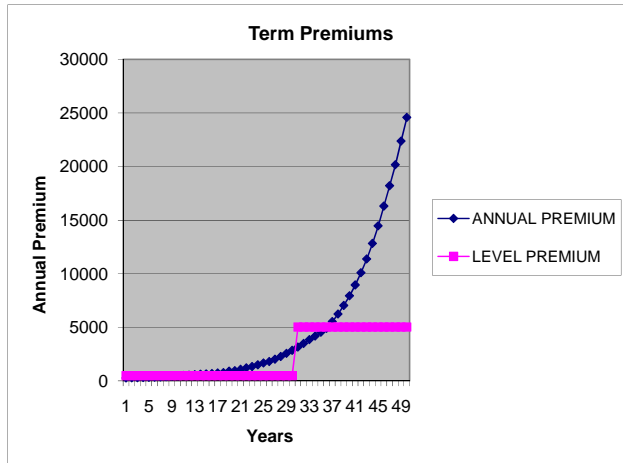
One response to increasing yearly renewable premiums is leveling the premium. Instead of increasing the cost every year, the insurer determines a flat rate for a specified number of years, i.e., for a term. A typical term may be 10, 15, 20 or 30 years. The level term arrangement results in a policyowner overpaying (relative to the true annual cost of insurance) during the early years of the term, then underpaying at the end. For the 35-year-old in the above example, the 30-year level term premium is \$490/yr. Compared to yearly renewable term, the level premium is more expensive for the first 10 years, then less expensive for the next 20.

To accurately price level term insurance, the insurance company must make some assumptions about the time value of money, because the “additional” premiums they collect in the first 10 years will be invested to subsidize the cost of insurance for the following two decades.

A level term premium schedule significantly resolves the problem of the cost of insurance becoming progressively more expensive in later years – at least during the term. But when the term expires, the problem returns. In our example, the cost to renew \$500,000 of life insurance at age 65 is \$5,025/yr. – providing the individual can prove excellent health by passing a new physical examination. Even if he is healthy, the new term is limited to 20 years (age 85). And what happens if this man lives to age 86? The scheduled renewal premium is now \$207, 990! For one year!

While level term premiums help consumers afford life insurance longer, the same end-of-life problem remains: Just when you are most likely to collect on the life insurance, you may not be able to pay for it. Level term insurance is certainly a win for the insurance company because policyholders pay more premiums

longer, but the financial outcome is less clear for most consumers using term insurance – they still are not likely to have an insurance benefit in force at death.



Integrated Solution, Step Two

A lifetime term policy with level premiums would solve the problem. But fairly pricing term for one’s entire lifespan creates a new problem: As illustrated by the yearly renewable table, the cost of insurance rises steeply after age 60. So even with a long time to “overpay” at the beginning, a policy guaranteed to be in-force at age 100 requires a sizable annual premium. In the case of our healthy 35-year-old non-smoker, the lifetime annual premium is \$6,165/yr., more than 12 times the annual premium for the 30-year term policy. Unless the consumer has money to burn, the idea of overpaying \$5,600 each year (the difference between the whole life and level term premium) for the next 30 years just to keep the premiums affordable in old age probably won’t set well. There’s just too much overpayment for too long to convince most consumers to set aside that much money for an event that may be 50 years in the future.

Enter the concept of cash value. The overpayment of premium in a whole life policy represents reserve capital the insurance company will use to cover the cost of insurance as the policyholder ages. In the meantime, this reserve capital will be invested to generate more capital. A portion of this excess cash value, and the earnings from it, is credited to a cash account tied directly to the policy. While the policy is in-force, the policyowner has the right to access this cash value, through a variety of transactions (loans, partial surrenders, dividends, etc.).

In a typical whole life policy, this cash value can eventually exceed the total premiums paid, i.e., the policyholder not only owns the insurance benefit, but has received a positive return on the premiums.

This blending of cash value and life insurance is a brilliant example of integrated thinking. A whole life

policy with a level premium provides economic certainty for consumers – they know how much insurance they will have, they know how much it will cost, and (as long as premiums are paid) they know the insurance will be in-force at the end of their lives. At the same time, the larger premiums give the insurance company greater financial stability. It has greater resources to meet its contractual obligations. And during the lifetime of the policy, the owner also has access to this stable source of cash value (and its growth) as well.

Complexity begets more complexity – and more opportunities

Besides turning the life insurance benefit into an asset instead of an expense, the cash value component opens the door to other possibilities. Dividends* can be received as income, or used to pay premiums. Additional paid-up insurance may be purchased. Depending on the performance of the cash value account, additional premium requirements may change or be eliminated.

Because the benefit paid at death is now certain, life insurance can do more than provide income replacement protection in the event of a premature death. Among other things, the proceeds can be vital in estate and inheritance planning, serve as a supplement to long-term care, pay creditors and fund charities.

Some might argue that it is hypothetically possible to project similar or greater financial results by choosing to use term insurance alongside other accumulation vehicles. On paper, this is possible. But while two simple stand-alone financial products might appear to out-perform whole life in a narrow set of criteria (such as pre-tax accumulation in a 20-year period), they cannot equal the combination of benefits, guarantees and flexibility that result from using a whole life policy. The integration of level premiums and cash value, and the resulting opportunities make life insurance a win-win for all parties.

Just as whole life is a multi-faceted complex financial instrument, there are many ways to position whole life in one’s financial program. Contact us to find out how whole life might best fit your current circumstances.

*Dividends are not guaranteed, and are generally declared annually by the company’s Board of Directors.

SOCIAL SECURITY: YOU MIGHT STILL GET IT – IF YOU LIVE LONG ENOUGH

With all the political rhetoric about the economy, notice there isn’t much noise about Social Security. In the midst of the toughest economic stretch since the

Great Depression, you'd think a national insurance and pension plan that is tottering toward a financial breakdown would generate some strong political discussion. Why so little dialog? Here are some thoughts.

First, the summary review: Social Security provides pension and insurance benefits for qualified recipients by collecting a payroll tax on all wage-earners. In the past, the number of wage-earners far exceeded those receiving benefits. However, increased longevity and the arrival of the Baby Boom generation on the threshold of retirement has skewed the math: At current tax rates, the Social Security Administration will not collect enough from those who are working to provide benefits to those eligible for benefits. In a word, the plan is broken.

Sifting through all the political posturing, there are only four possible real-world solutions to fix Social Security.

1. Increase taxes.
2. Decrease benefits.
3. Change the eligibility requirements.
4. Scrap the plan.

From a rational perspective, getting rid of something that isn't working is an obvious choice. But the question that follows is "what do we do for a replacement?" Change is fraught with unknowns, both for citizens and leaders, and even good ideas can be scared away by "what might happen." For three decades, the standard political response has been to defer making a decision, leaving the responsibility in someone else's hands. And as long as the checks keep coming, there's little call for change from the populace as well. The hope is "I get mine before the well runs out."

With a sluggish economy and growing sentiment that the national government has already spent irresponsibly, the idea of raising payroll taxes for all citizens doesn't have much popular appeal. While government leaders certainly look to squeeze every bit of revenue from the populace, politicians only rule if they get elected. Raising taxes is not a popular plank on the reelection platform this year.

20th century British scholar C. N. Parkinson observed that a "luxury once enjoyed soon becomes a necessity." Adapting this thought to Social Security, it's fair to say that what was once supposed to be supplementary income in old age has become a critical retirement component for many Americans. As such, it's hard to imagine a politician seeing much to be gained by threatening to decrease benefits.

That leaves changing the eligibility requirements. In mid-July, 2010, members of Congress from both parties mentioned two possible changes. The first is to raise the Social Security retirement age to 70 for people who are 50 or younger today. The second proposal up for serious

consideration is to include a means-test for benefits; those with more assets would receive smaller benefits.

Raising the retirement age is a logical response to the increased longevity of Americans since Social Security was established in the 1930s. As Patrice Hill of the *Washington Post* noted in a July 13, 2010 article "with people living longer and enjoying better health in their senior years, the nation simply can't afford any longer to be paying out benefits for as long as 30 years after retirement."

The rationale for implementing a means-test to qualify for benefits is simple economics. In the words of Ohio Congressman John Boehner: "If you have substantial non-Social Security income while you're retired, why are we paying you at a time when we're broke?" he said. "We just need to be honest with people."

A means-test would represent a fundamental change to Social Security. With benefits indexed to income or assets, it is possible that some affluent workers will never receive benefits even though they will make a lifetime of payments into the plan. While this approach won't result in an across-the-board decrease in benefits, making Social Security a clearly defined wealth transfer program has some political risk.

Twenty years ago, retirement planning was often pictured as a three-legged stool, with the legs being Social Security, the company pension, and personal savings. Today, the pension leg is rapidly vanishing from the financial landscape, personal savings have been pounded by the economy, and Social Security (if it survives) looks like it will come into play later in life. This turn of events leaves many Americans wondering if they will have a leg to stand on in retirement.

VOLATILITY UP, INVESTORS OUT (Should We Blame the Machines?)

Here's the lead sentence from a July 19, 2010 report on the stock market from BTN Research:

**The S&P 500 stock index
fell 2.9% last Friday 7/16/10**

Losing almost 3% of value in one day is a pretty big decline; for investors, July 16, 2010 was not a good day. However, it is worth noting that the July 16, 2010 decline had been preceded by eight consecutive days of gains – in the language of investors, July 16 was a "pullback." This is the nature of stock markets; they fluctuate.

But recently, the fluctuation, or volatility, has intensified. The BTN reported noted that "in the **last 50 years**, a 1-day gain or loss of at least 2% for the S&P 500 has occurred **every 21 trading days**. Since the beginning of September 2008 (i.e., the start of the global

credit crisis), a gain or loss of at least 2% has occurred **every 4 days.**"

In other words, for 50 years, sharp one-day changes occurred about once a month. But in the last two years, the steep moves have been happening once a week. Certainly the struggling global economy plays a part in the jumpiness of the markets, but there may be other factors at work.

The *Wall Street Journal's* July 12, 2010 front-page story carried this headline:

**Small Investors Flee Stocks,
Changing Market Dynamics.**

Two days later (July 14, 2010), the *WSJ's* "Money & Investing" section led with this title

Letting the Machines Decide

Here's the connection.

The July 12 article noted that the last three years have seen a steady defection of individual investors from the stock market – people have sold their stocks, liquidated their mutual funds, just cashed out. The principal reasons for leaving the market were losses and volatility. In the past, some individual investors may have been willing to ride out declines in the market, or get out slowly as they saw trends changing, but the recent volatility has been most unsettling. Several interviewees mentioned the "flash crash" of May 6, 2010 as an example of the type of extreme fluctuation that motivated them to leave the market. (In one of the largest one-day drops in history, several US indices plummeted almost 10% in 15 minutes before partially rebounding.)

As individual investors leave the market, large institutional investors exert a greater influence. And more often, institutional investors are relying on sophisticated computer models using artificial intelligence to make their investment decisions. These automated investing programs, controlling large blocks of investments, can potentially trigger strong movements up or down in markets, particularly when all the programs arrive at similar conclusions to buy or sell.

For the techno-geeks, the argument for using a complex algorithm to determine investment decisions is simple: "Human beings aren't improving," says Spencer Greenberg, founder of Rebellion Research in the July 14th article. But a side effect of removing the human factor from decision-making is the potential for increased volatility. When the computer model indicates "buy" or "sell," there are no emotions involved – no caution, no anxiety, no fear. Decisions are made without hesitation. So whatever happens, the results will often be seen quickly.

These trends don't necessarily preclude individual investors from participating in the stock market. Contrarians – those who believe in selling when everyone's buying and vice versa – might even see great opportunities in this type of scenario. But just as automation has made other processes move faster, the more machines control investing, the greater the likelihood of spikes – both up and down – in the markets.

Like other changes brought about by increased complexity, the challenge will be how to profitably integrate this development for individual benefit.

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