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REAL WEALTH

ONE BAG OF SHREDDED MONEY?

"Here's a great gag gift. Money to Burn!!! A zip-lock bag stuffed with genuine U.S. currency (all $100 notes) shredded for your convenience. No need to do it yourself, this money comes ready to burn! Start the BBQ with this! Show your friends how much money you have and how little it means to you!"

The description above is part of an E-Bay auction listed on August 19, 2007 (opening bid was 99 cents.)

According to the U.S. Treasury website (ustreas.gov), "the Federal Reserve System destroys currency at some of its various banks located throughout the country." The shredded money is sold, but only under contract to buyers who will purchase the entire amount for a one-year period. Shredded currency may be used as an ingredient in the manufacture of recycled products such as roofing shingles or insulation. The Treasury also permits buyers of shredded currency to have the shreds "placed in firmly sealed containers as novelty items like pens, ornaments and jewelry. Hence, the "money-to-burn" bag.

PAPER ASSETS: THEY ARE WORTH WHAT WE SAY THEY ARE WORTH?

While that bag of shredded $100s is certainly a unique conversation piece, what's most interesting is that the contents are worth *absolutely nothing*. What used to be several thousand dollars is now shredded paper. You can't buy a thing with it.

By itself, paper money is just pictures of "old dead dudes" unless someone is willing to exchange something of value for it. And it's almost the same thing with shares of stock we own. The paper (either as money or stock certificates) has no intrinsic value. Rather, the value comes from what we as buyers and sellers agree to say it is worth. There are a lot of factors that affect what value we assign those pieces of paper.

At a surface level, most of us accept this idea that paper values can change. We understand (sort of) how inflation has turned a $10 haircut into a $30 "styling" over 20 years, even if it was the same barber giving the same haircut. We know (in a fuzzy way) that because the Euro has increased its value in relation to the US dollar, some items are cheaper here (or is it there?). In the past few months, many companies listed on the stock exchanges have seen their values fluctuate wildly, both up and down. This fluctuation of value, whether it comes from inflation, currency rates, competition, or market sentiment, is something we hear about and experience all the time.

Fluctuation in value is a very important issue in long-term financial planning. Here's why: Even if you regularly save for the future, how do you know what your savings will be worth? Will its value be enough to accomplish what you had hoped when you saved it? Will $350,000 buy a nice retirement condo, or just a TV dinner?

A condo or a TV dinner? We know that seems far-fetched, at least as far as the range of choices. But shockingly, this is not an extreme comparison. During the early 1930s, inflation in Germany was so high that people literally brought wheelbarrows of paper money to buy groceries. Some workers demanded their pay every half-day, so they could use their lunch breaks to buy something before inflation made their paper money even more worthless.

Here's the profound part of this little thought exercise: **The amount of money (or stock certificates) you have doesn't determine your wealth.** ***The key is what you can buy with it.*** **And the purchasing power of those pieces of paper is changing all the time.**

This constant change in value leads to uncertainty, and the uncertainty can discourage saving. For example, why save for something (like a car) if the price will only go up each year? Instead, why not buy

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an item today, and at least get something for your money? Why risk holding onto money when it might be worthless? It's a disturbing thought: Not only are our personal futures uncertain, but so are our savings and investments. Maybe the only recourse is to live for the moment, go for the gusto, and let the future be whatever it will be, right?

No. A financial philosophy that's a cross between an old beer commercial and a Doris Day song is not a sound basis for making financial decisions. There's more to it.

THE RELATIONSHIP BETWEEN PAPER ASSETS AND REAL ASSETS

Let's go back to the bag of money. Instead of US currency, suppose we decided to shred a thousand dollar's worth of gold coins into gold shavings. Would those shavings be worthless, like the dollar bills? Or what if we had a million-dollar home, and disassembled it brick by brick? Would the materials be worthless? Your automobile, stripped down to scrap metal, would it be worthless? No. All of these things, to some extent, would continue to have some value. So what's the difference between a bag of auto parts and a bag of shredded paper? One is a real asset, and one is a paper asset.

A real asset has some value, in and of itself. Someone might find worth in a real asset, because they believe it can be used to produce something else. The gold shavings could be melted to form a ring. The auto part could replace a broken one in another car.

Paper assets don't have real value. As a piece of paper, a ten-dollar bill and a hundred-dollar bill are identical. They would burn just as fast, or make the same paper airplane. But the piece of paper with a picture of Ben Franklin has a representative value that's ten times greater than the bill with Alexander Hamilton's picture on it. Paper assets get their value from what they represent.

There are some interesting differences between real and paper assets. In general, real assets don't fluctuate much in their worth, relative to other real assets, and real assets retain their value in proportion to economic forces like inflation. A century ago, a one-ounce US gold coin would have purchased an evening's lodging in the finest hotel in New York City, or a quality suit of men's clothing. Today, one ounce of gold still has roughly the same purchasing power – if used as money, it would still afford you a stay in the nice hotel, or buy the suit. Gold fluctuates in terms of how many paper dollars it will buy, but its value has stayed fairly stable in relation to other real assets.

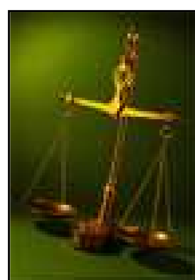
A building is another example of real assets keeping their value. Ask anyone who lives in a home they bought 20 or 30 years ago about the initial purchase price. Perhaps $30,000 to $50,000, right? What is the house worth today? $200,000? $300,000? Other than interior decorating, did the house itself change? Not really. Typically, this home increased in US dollar value, but its value relative to other properties in the neighborhood stayed the same. All that really changed was how many paper dollars would be needed to buy the property.

On the other hand, real assets can be rendered worthless by new technologies. Other than as a collector's item, no one wants an eight-track tape player, and even the materials from the tape player aren't worth enough to salvage. It's the same way with old computers. Would anyone be willing to exchange anything of value for a Compaq 286? You probably couldn't even buy a candy bar with it.

As we said earlier, paper assets (like currency, stocks and bonds) have value only by the agreement of buyers and sellers. Consequently, their values can fluctuate wildly, depending on the variables of the times. But paper assets have some positives that real assets lack.

Usually, paper assets are much more portable and exchangeable. Your home may be a storehouse of real value, but you can't take a brick from the house and plunk it down in the check-out to pay for your groceries. Getting value out of the home usually requires selling it, or taking a home equity loan, which means your home is not exactly an ATM machine.

On the other hand, most businesses still take US currency for almost any transaction. And while it would take a Brink's truck a week to haul a ton of gold from Los Angeles to New York, the same representative value on paper can be transferred instantly via electronic wire. Paper assets are a great convenience, and make it possible for us to buy and sell with minimum limitations.



BALANCING REAL AND PAPER ASSETS

Considering the advantages and drawbacks of both real and paper assets, it should be obvious that a solid financial program should consider a mix of real and paper assets. But all too often, we meet people who have the bulk of their savings (and financial future) in one type of asset or another. It's not that what they are doing is "bad." It's just a little unbalanced:

- the owner who says "my business is my retirement," but has no paper assets to respond to emergencies. Without some liquidity, the business may not survive. No business, no retirement.
- the professional who "just puts something in the company retirement plan each week," and watches helplessly as his stock values take a 30% plunge the year he plans to quit. And then realizes he still has 20 years of mortgage obligations, or must move into a smaller home. Securing the real asset (having the

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home paid for) might have made retirement a lot better, regardless of the stock market's performance.

As you review your financial plan, this discussion should lead to two points of evaluation.

1. How balanced are you in accumulating real and paper assets?

2. With all the fluctuations that can affect values, how easily can you move from real assets to paper assets, and vice versa?

When you sit down to tally your net worth, make sure to look beyond the bottom line. Take notice of which assets are real assets and which ones are paper. A solid financial plan needs both.

A NEW METHOD FOR CALCULATING DEDUCTIBLES

According to an August 2, 2007 article in the *Wall Street Journal*, a growing number of homeowners are facing sharply higher costs as more insurers change how they calculate deductibles. Instead of setting a specific dollar amount the homeowner must pay out of pocket on a damage claim, the newer method is based on a percentage of the insured value of your home, and varies according to the type of damage that causes a claim to be made.

Currently, many policies still retain specific deductible limits for standard perils such as fire and theft. Percentage deductibles, which are typically between 1% and 5% of the property's insured value, usually apply only to damage which results from natural disasters, such as hurricanes, windstorms or earthquakes. Percentage deductibles were first widely implemented in earthquake insurance in the West in the early 1990s, and later spread to wind and hurricane damage coverage in the South and coastal areas. Percentage deductibles arose as a way for insurers to handle the high costs from the large and wide-spread claims that arise from natural disasters.

While the typical standard homeowner's insurance deductible is between $500 and $1000, a 3% deductible on a $500,000 home is $15,000. In the event of a natural disaster, that may be a high threshold for receiving payment from your insurer. On the flip side, percentage deductibles may also result in lower premiums, since the homeowner is assuming a greater portion of the financial risk.

OUTSIDE THE BOX …

ATMs IN HOUSES OF WORSHIP?

Tucked in a corner of last year's Pension Reform legislation, Congress also made some changes regarding the tax documentation for charitable donations. Here's the official word from an Internal Revenue Service press release:

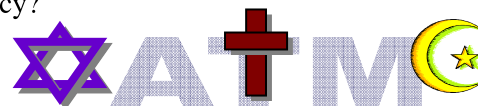
> To deduct any charitable donation of money, a taxpayer must have a bank record or a written communication from the charity showing the name of the charity and the date and amount of the contribution. A bank record includes canceled checks, bank or credit union statements and credit card statements. Bank or credit union statements should show the name of the charity and the date and amount paid. Credit card statements should show the name of the charity and the transaction posting date.
>
> Donations of money include those made in cash or by check, electronic funds transfer, credit card, and payroll deduction. For payroll deductions, the taxpayer should retain a pay stub, Form W-2 wage statement or other document furnished by the employer showing the total amount withheld for charity, along with the pledge card showing the name of the charity.
>
> Prior law allowed taxpayers to back up their donations of money with personal bank registers, diaries or notes made around the time of the donation. Those types of records are no longer sufficient.

The new requirements greatly minimize the possibility of deducting small cash donations. As Debra Neiman noted in a February 13, 2007 article for Entrepreneur.com, "before you drop cash into the Salvation Army Santa's bucket or into the collection plate at your house of worship, think about using a check if you want to take the deduction."

While donations made in money form (bills or coin) have steadily declined in the past decade, many non-profit organizations, particularly churches or other religious assemblies, often rely heavily on small, cash donations. The more stringent documentation requirement could deter giving because instead of just throwing in a $20 bill, one could imagine a congregation member saying, "I'll do it next week. I just have to remember to write a check."

In response, some churches have installed ATM kiosks in their lobbies. The machines will not dispense money, but rather allow attendees to authorize a donation by swiping a debit or credit card – and receive a printed receipt.

The idea of a banking machine, especially one that allows credit card transactions, inside a house of worship has generated some mixed feelings. In an ironic twist, the increased documentation requirement may be a boon for charities. Dr. Marty Baker, the pastor of Stevens Creek Community Church in Augusta, Georgia notes that contributions have increased 18% since his congregation installed its ATM. But as one commentator wondered in a July 30, 2007 Time/CNN article, "How would you feel if someone in your church was giving and giving on credit and you later find they have to declare bankruptcy?"



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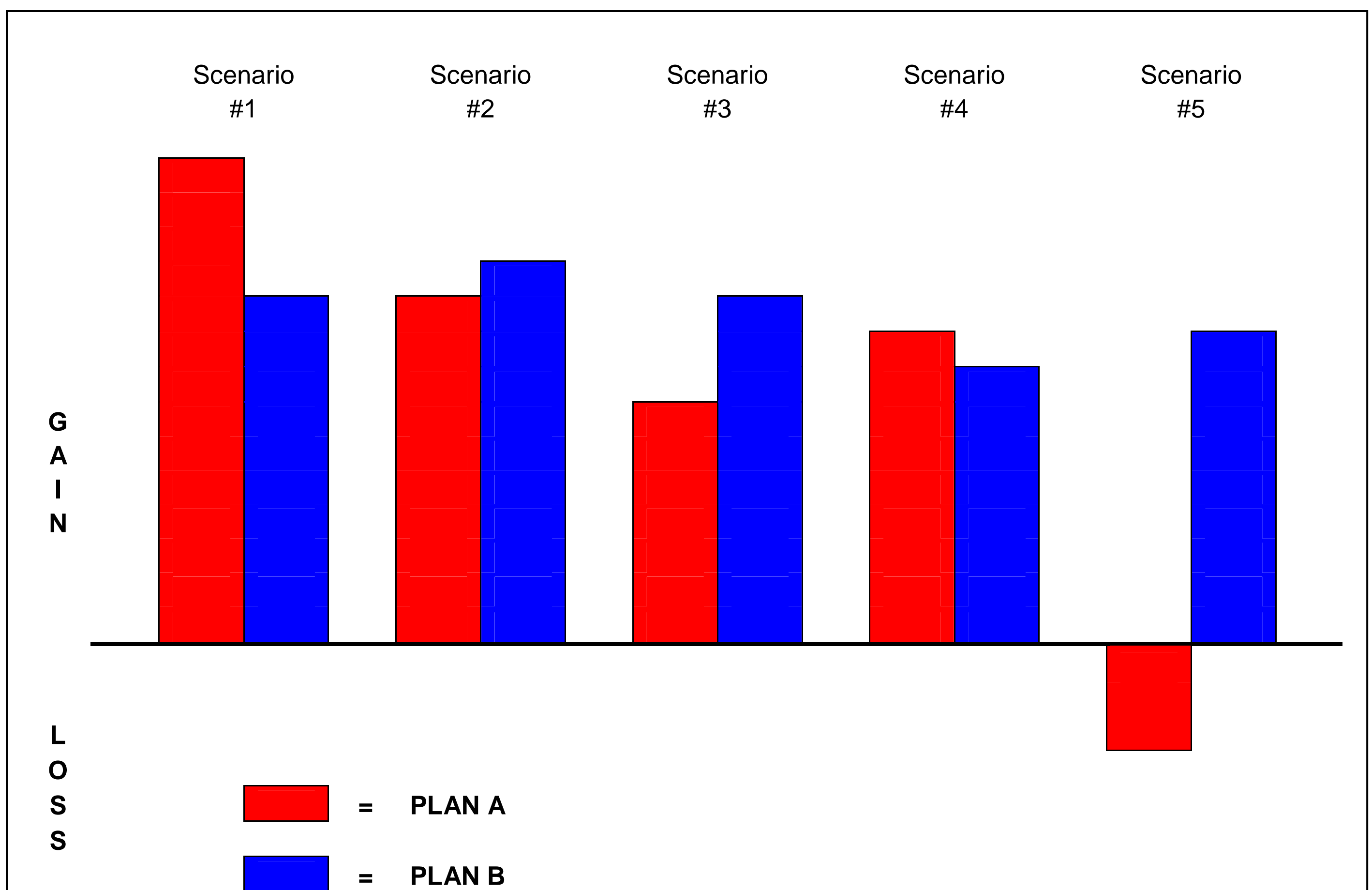
RISK TOLERANCE: WHICH PLAN IS MORE APPEALING?

When the issue is your financial future, how much risk are you willing to take? That's a hard question to quantify (does risk have a number?). Even though evaluating risk is often a subjective assessment, it doesn't stop financial service companies from constantly trying to help their customers define and gauge their "risk tolerance" through questionnaires and arbitrary formulas.

The illustration below is yet another attempt at assessing your risk tolerance. It's simple (one question), visual and conceptual – no lengthy calculations required!

Here's how it works: The graph represents the financial outcomes of two different hypothetical financial programs, labeled Plan A and Plan B. The results for Plans A and B are compared in five different scenarios, each of which reflects a different mix of variables (things like interest rates, real estate values, stock market trends, taxes, health conditions, etc.). In some scenarios, Plan A performs better, in others Plan B shows a greater gain. While Plan A shows the greatest gain under Scenario #1, it also shows a loss in Scenario #5.

Here's the one-question survey: ***Which plan would you choose?***



Commentary: For Plan A, Scenario 1 is the one in which everything goes according to plan; all variables play out favorably, and result in maximum profit. In Scenario 5, everything goes wrong, and all the variables conspire to not only diminish gain, but actually incur loss. The performance of Plan B varies little with each scenario, and while never as great as the optimum performance of Plan A in Scenario 1, significantly outperforms Plan on two occasions.

If the circumstances of Scenario 1 were a certainty, everyone would choose Plan A. Conversely, no one would select Plan A for Scenario 5. But since none of the scenarios are guaranteed, a strong argument could be made that Plan B, because of its relative stability, is the better choice.

What works best for you? A plan that offers the possibility of large returns, or one that delivers under all circumstances? Your answer is a simple, yet strong indicator of your risk tolerance.

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RATIONAL DECUMULATION

The efficiency of annuities in retirement

When it comes time to spend your accumulated savings to support your retirement, what financial asset class offers the best combination of return and security? The surprise answer, according to a recent study: Lifetime income annuities.

Rational Decumulation is the title of a research study co-authored by professors David F. Babbel and Craig B. Merrill, in conjunction with the Wharton Financial Institutions Center at the University of Pennsylvania. The study was first released in April 2006, and amended in May 2007.

"Decumulation" is a term coined for the spending of assets; it is the opposite of accumulation. In the study, the authors were attempting to evaluate several different types of asset classes and decumulation strategies in order to determine which financial vehicles were most cost-effective in providing retirement income.

Lifetime income annuities are financial contracts in which one party (usually an insurance company) agrees to provide a regular income (usually monthly) in exchange for a lump sum from the other party (usually an individual). While annuities can be structured to last for specific periods, a lifetime income annuity guarantees payments will be made as long as the individual is alive. The monthly income is contingent upon several variables, including the age and gender of the individual, current market rates, and the size of the lump sum used to purchase the annuity.

An August 9, 2007 *Business Wire* article summarized the study's findings:

> "Income annuities can provide secure income for one's entire lifetime for 25-40% less money than it would cost an individual to provide a similar level of secure lifetime income through traditional means, thanks to an insurer's ability to spread risk across large numbers of people.
>
> By covering at least basic living expenses with income annuities, consumers have much greater flexibility in other areas of a retirement plan, including the ability to make more investment risk with the remaining portfolio."

This conclusion is not a new one. The study notes that as far back as 1965, "Menahem Yaari demonstrated that full annuitization was the optimal asset allocation for retirement savings" and that, provided consumers could purchase life annuities at a fair price, they would "rationally seek to annuitize fully all of their savings."

But the title of the study provides hints at some interesting paradoxes. Babbel and Merrill write that in contrast to academic findings, "observed levels of annuitization are generally far below those considered optimal by most economists." In other words, financial consumers don't always act rationally.

And neither do their financial advisors. Even though the professors can logically and mathematically demonstrate that annuities are a superior asset class for retirement, they note it is their perception that "annuitization has been put on a shelf while other options are more widely pushed upon retirees by employers, mutual funds, and financial consultants."

Why the "irrational" aversion to annuities?

The authors note several factors they believe contribute to a low opinion of annuities.

First, there is the perception that other asset classes can deliver a better rate of return. Babble and Merril note that while this may be true in an accumulation mode, it is not the case in decumulation. In comparing annuities to what they call "phased withdrawal plans" from other asset classes, they conclude, "to achieve a similar riskless guarantee of income throughout one's uncertain lifetime without life annuities would cost between 25% and 40% more."

Another stated reason for not buying lifetime annuities is that they are expensive. However, Babbel and Merrill noted that annuities were considered fairly priced in 1995, and that institutional charges (commissions, fees, etc.) today are lower by half.

Perhaps the biggest impediment to lifetime annuity purchases is the fact that an annuity purchase is an irrevocable decision. While a lifetime annuity guarantees an income for life, if the annuitant dies shortly after establishing the contract, there is no refund of unused funds to heirs or the estate. Thus, while it "may be fully rational to annuitize a substantial portion of one's wealth at the onset of retirement, or even earlier, this psychological barrier is a real one for many people."

Messrs. Babbel and Merrill further state that most of the other issues consumers might have with annuities (such as how to handle irregular income needs, anticipate inflationary costs, or the desire to leave an inheritance) can be addressed through properly structuring the add-on features available in most annuities.

Given what he believes is conclusive evidence, Babbel sees lifetime annuities as the only rational choice for retirement.

"Living too long is fast becoming the major financial risk of the 21st century. Combined with the challenges facing Social Security and the decline of corporate pensions, this adds up to a 'perfect storm' for retirees who might outlive their retirement nest egg. Our research shows that only lifetime income annuities can protect individuals in an efficient way from the risk of outliving their assets and that this cannot be duplicated by mutual funds, certificates of deposit, or any number of homegrown solutions."

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BUY AN ANNUITY NOW, MAYBE YOU'LL LIVE LONGER

(Well, not really. But it will be cheaper.)

The "Rational Decumulation" study referenced in the previous article also contained a few interesting tidbits for consumers. For example, the authors referenced a 2004 study which showed that annuity purchasers live about 10% longer than non-purchasers. Why?

The theory is that individuals make personal actuarial evaluations. They consider their health history, or how long their ancestors lived, and make a decision whether or not the odds favor them living long enough to make a lifetime annuity pay off – i.e., whether or not the insurance company will end up paying them more than what the lump sum could have generated from a phased withdrawal from some other asset. Giving this perspective, it's not surprising that healthier, longer-living people tend to purchase more annuities.

In order to remain profitable (and solvent) insurance companies price their annuities according to these statistics. In effect, annuity prices are higher because they must account for the greater likelihood that annuity purchasers will live longer than the general population.

However, if more people bought annuities, the payouts would probably increase for everyone because the overall life expectancy would drop as more less-healthy, shorter-lifespan individuals become part of the "pool" receiving annuity payments.

But…

Lifespan is increasing for *everyone*, even those who are less healthy. If overall lifespan increases, the prices of annuities will also climb. According to Babbel and Merrill, a "1% annual improvement in mortality is associated with roughly a 5% increase in the price of an annuity, or a 5% reduction in monthly payouts. For example, suppose a current annuity purchase payment of $100,000 guarantees a lifetime income of $800/mo. If the average lifespan of annuity holders increases by 1%, $105,000 would be required to produce the same $800/mo. (assuming all other pricing factors, such as interest rates and company costs, remain the same).

So…

If you're thinking that a lifetime annuity might be a good purchase, one reason might be your personal circumstances lead you to believe you'll live a long time – and that belief may be accurate. If that's the case, the best time to buy a lifetime annuity may be now, as opposed waiting for another 5 or 10 years, when the cost of securing that guaranteed income may be higher.

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