



APRIL 2010

“Some macroeconomists say if we just study the numbers long enough we’ll be able to design better policy. That’s like the sign in the bar: Free Beer Tomorrow.”

- Russ Roberts, Economics Professor

HAVE YOU BEEN **FRAMED?**

One of the assumptions of free-market economists is that fully-informed individuals usually act in accordance with their own interests. In other words, they make financial decisions based on what they believe is best for them. However, sometimes people appear to repeatedly act against their best interests; they act irrationally, even when they have accurate information. Why is this?

In January 2008, four economists working for the National Bureau of Economic Research (NBER) published the results of an extensive study regarding retirement decisions. This information caught the attention of financial writer David Adler, who included some of the findings in his book *Snap Judgment: When to Trust Your Instincts, When to Ignore Them, and How to Avoid Making Big Mistakes with Your Money* (FT Press, 2009).

The primary feature of the NBER study was a pair of simple one-question quizzes given to 1,300 respondents over the age of 50, with each respondent only answering one quiz. A comparison was then made between the two groups. Because you aren’t part of the study, you can take both quizzes – and see the results!

Here’s the setup:

The quiz involves an evaluation of two fictional, identical individuals, in this case named **Mr. Red** and **Mr. Gray** (in all, there were seven fictional persons, with names like Mr. Orange, Mr. Green, Mr. Brown).

- Each person made permanent decisions on how to spend a portion of their money in retirement.
- Each has some savings and can spend \$1,000 per month from Social Security in addition to the portion of income mentioned in each question.
- They have already set aside money to leave for their children when they die.

The choices are intended to be financially equivalent and based on personal preferences for spending in retirement. You are asked to evaluate which retirement option represents the “better deal.” Read each choice carefully.

Quiz #1

Mr. Red’s option: Mr. Red can spend \$650 each month, along with Social Security, for as long as he lives. When he dies, there will be no more payments.

Mr. Gray’s option: Mr. Gray can choose an amount to spend each month in addition to Social Security. How long his money lasts depends



on how much he spends. If he spends only \$400 per month, he has money for as long as he lives. When he dies, he may leave the remainder to charity. If he spends \$650 per month, he has money only until age 85. He could also spend down faster or slower than each of these options.

Quiz #2

Mr. Red’s option: Mr. Red invests \$100,000 in an account which earns \$650 each month for as long as he lives. He can only withdraw the earnings he receives, not the invested money. When he dies, the earnings will stop and his investment will be worth nothing.

Mr. Gray’s option: Mr. Gray invests \$100,000 in an account which earns a 4% interest rate. He can withdraw some or all of the invested money at any time. When he dies, he may leave any remaining money to charity.

Question: Who has made the better choice?

Mr. Red and Mr. Gray selected different options on

how to spend their money in retirement. You are asked to evaluate their decisions.

Can you guess which options were seen as the best in each quiz?

In **Quiz #1**, **72%** felt **Mr. Red** made the better decision.

In **Quiz #2**, **79%** felt **Mr. Gray** made the better decision.

But there's a mind-blowing twist to the study: Each quiz presented the same options! Mr. Red's plan is the same in both scenarios, and so is Mr. Gray's!

So, if both plans are the same, why did respondents overwhelmingly choose Mr. Red in the first quiz and Mr. Gray in the second? The answer is "framing." Our interpretation of new information is dependent in part on the context in which we receive it, i.e., what our "frame of reference" is for a particular scenario. As the NBER researchers put it, "experimental findings suggest that choices are not solely based on material consequences, but instead are filtered through the particular frame that individuals use to interpret choices."

In these two instances, the "frames" made the difference in the decisions. In the first example, the frame was **consumption**. The focus was on how much could be spent, and for how long. From this perspective, the emphasis on a larger monthly amount available for consumption, with the guarantee of continuing no matter how long one might live, was seen as most attractive.

The second example was framed by **investment**. While the numbers remained the same in terms of possible monthly income, the quiz also mentioned that Mr. Red would have access only to the earnings from his investment, and nothing left when he died. In contrast, Mr. Gray had access to his original \$100,000 principal at any time, and the prospect of leaving any remainder to heirs.

Analyzing this example, Adler summarizes the effects of framing: "Context can be as important as content when it comes to financial decisions, even very important financial decisions."

But wait, there's more...

Beyond the "wow, that's interesting" factor of the results, both Adler and the NBER researchers believe their study has some significant practical applications.

According to Adler:

"The larger point of the experiment is not just that framing has an impact; it is

Context can be as important as *content* when it comes to financial decisions.

specifically about how retirement planning is 'framed' in the U.S. and how we are conditioned to think about it. Should our financial focus be on building wealth for retirement, or on what we can consume after we retire?"

Jeffrey Brown, one of the NBER researchers, contends we have been conditioned to think about retirement as mostly an investment decision, similar to quiz #2. But in Brown's opinion, retirement is largely a consumption decision. Says Brown,

"The messages that individuals receive when encouraged to save are all about how much you have in your account and your rates of return. But really you should think about how much can you eat each month, how much can you consume."

And there's even more...

If you didn't already know it, Mr. Red's retirement decision is a simple description of a lifetime annuity. A life annuity is a relatively straightforward financial transaction: In exchange for a lump sum payment, an insurance company guarantees monthly payments for your lifetime, no matter how long it may be.

The NBER study (titled "*Why Don't People Insure Late Life Consumption? A Framing Explanation of the Under-Annuity Puzzle*") is an attempt to explain why some people don't buy annuities despite their significant financial advantages.

Life annuities are not new. They have a long history, but are infrequently selected by consumers. However, as company pension plans steadily disappear and are replaced by personal accumulation accounts, such as IRAs, 401(k)s, etc., retirees are beginning to reconsider annuities in retirement. But because many potential buyers have an "investment" frame of reference; the idea of "losing" any leftover principal at death is perceived as a strong deterrent to purchasing an annuity.

In contrast, most economists, especially those whose "frame" is consumption, see annuities in a very positive light. You don't have to worry about outliving your money - ever. If you live beyond your life expectancy, there's a good chance the guaranteed payments will deliver higher returns than what would have come from traditional investments. Once implemented, there are no management decisions required, and no investment risk. As Adler says, "the wildly enthusiastic consensus among most economists, to say nothing of the insurance industry, is that annuities are a great thing."

Finally, there's this...

In spite of all the statistical evidence supporting annuities, there's still a mental snag for many individuals considering a lifetime annuity. When an annuitant with a lifetime annuity dies, the payments stop (unless a refund feature or term certain feature was elected). There are no refunds of "unused principal." In a worst-case scenario, someone gives the insurance company a big chunk of change to buy a life annuity, then dies within a short period of time. This possibility, framed from an investment perspective, is probably the biggest reason many people reject a lifetime annuity.

But curiously enough, it seems some of the fears of not living long enough to receive full value from an annuity can be alleviated... by buying one.

Steven Levitt and Stephen Dubner are co-authors of the best-sellers *Freakonomics* and *SuperFreakonomics*. Both books take a simple economic idea, that incentives matter, and apply it to a variety of unusual financial, environmental and cultural situations. One of their chapters discusses actions which could lead to a longer lifespan. Among the diverse factors: career choices, winning a Nobel Prize, having a woman doctor...and buying an annuity. Yep, you read that right. Here's the reason:

"People who buy annuities, it turns out, live longer than people who don't, and not because people who buy annuities are healthier to start with. The evidence suggests that an annuity's steady payout provides a little extra incentive to keep chugging along."

Wow. Based on this evidence, annuities sound like a financial "silver bullet" and a fountain of youth!

But this article really isn't about annuities...

Whether or not you should buy an annuity depends on your unique circumstances.

A greater issue is who or what is framing your financial decisions, and whether that frame is the most beneficial perspective for you and your future.

A parallel issue, one that may offend some sensibilities, is whether all frames are equally viable. Specifically, are the consumption and investing frames just two approaches to the same objective, or is one better than the other?

While historical and mathematical arguments can be made for either the consumption or investing frame, there is strong psychological support for the consumption paradigm. In March, the Employee Benefits Research Institute (EBRI) released its 20th annual report on retirement confidence. One of their findings: "Nearly half of all workers would opt for a guaranteed income for life."

Perhaps this inclination toward security is primarily a reaction to the recent financial turmoil. But more likely, it points to the real value of financial security.

Maximized consumption isn't just a framing option. It's the better choice for financial success and contentment.

DO YOUR FINANCIAL OBJECTIVES INCLUDE A CONSUMPTION FRAME OF REFERENCE?

HOW MUCH OF YOUR FINANCIAL FUTURE IS SECURED?

Student Loans: "Toxic Debt" for Graduates

In terms of financial value, has a college degree reached its "tipping point?"

Since the end of World War II, obtaining a higher education has been touted as one of the surest paths to a higher income and better financial life. Supporting this idea, various government programs have been established to make it possible for more people to afford a college education. Included in these programs are grants, scholarships and work-study options, but the most widely-used assistance plans are student loans, which allow individuals to borrow money in order to finance their education on very favorable terms. (Not only are government-approved student loans generally issued at lower interest rates, but most do not become due until after several months after graduation.)



President Ronald Reagan was not an economist, but he was fond of repeating several economic adages that succinctly expressed his views. Among those most frequently recited: "If you want more of something, subsidize it." This statement has proven true in higher education; more Americans are attending college – and more Americans are using government assistance to do it. But subsidies, government or otherwise, have other consequences as well.

When the demand for something increases, the price usually goes up as well. A 2008 report from the National Center for Public Policy and Higher Education found that "published college tuition and fees increased 439% from 1982 to 2007 while median family income rose 147%." In other words, the cost of a college education over those 25 years had tripled in relation to family income.

Because higher education costs more money, the Center's report adds that "student borrowing has more than doubled in the last decade." The public service web site www.finaid.org acknowledges borrowing is now almost inevitable: "Few students can afford to pay for

college without some form of education financing. Two-thirds (65.6%) of 4-year undergraduate students graduated with a Bachelor's degree and some debt in 2007-08, and the average student loan debt among graduating seniors was \$23,186."

As the cost of education and the amount of borrowing necessary to finance it both increase, the financial value of a higher education begins to decrease relative to its cost. A February 2, 2010 *Wall Street Journal* article titled "What's a Degree Really Worth?" presented some calculations that the financial advantage of a college education had diminished by almost 60% in the past decade.

Various data collected from 1999 through 2002 and used in publications by the Census Bureau and the nonprofit College Board showed a college education paid off in an average lifetime earning advantage of \$800,000 to \$1 million, compared to those without degrees. However, using current numbers reflecting the disproportionate increase in costs compared to incomes, the American Institutes for Research, another non-profit, found the lifetime advantage had diminished to \$280,000.

Beyond the possibly diminished advantage in lifetime earnings, the increase in student loan indebtedness may present greater financial dilemmas for college graduates. Student loans are unique financial obligations, and their negative financial impact can last a lifetime.

Particularly in a tight job market, repaying student loans can be a financial hardship when one is just beginning a career. In response, lenders may offer options to postpone or modify payments, but forbearance on large sums can make future payments positively overwhelming. In a February 13, 2010, *Wall Street Journal* article ("The \$550,000 Student-Loan Burden"), Mary Pilon detailed how the student loan debt of a family practitioner ballooned from \$250,000 to \$550,000 in the eight years after her graduation because of deferrals and charges.

Since most student loan debt is secured debt borrowed from the federal government, it can almost never be erased, even by filing bankruptcy. As www.collegescholarships.org says on its website: "Student loans are rarely forgiven since they are guaranteed government funds dispersed with low interest to all kinds of people with no credit history. You don't expect the IRS to forgive you on all taxes that are owed, so expect the same treatment with your student loan."

Jeffrey J. Williams, a professor at Carnegie-Mellon University, writes that student loans "stipulate severe penalties and are virtually unbreakable, forgiven only in death, not bankruptcy, and enforced by severe measures,

such as garnishes and other legal sanctions, with little recourse. (In one recent case, the Social Security payment to a person on disability was garnished.)"

Even if you can make regular payments following graduation, the terms are heavy. "Student debt is a long-term commitment — fifteen years for standard Stafford guaranteed federal loans," says Williams, author of *The Post-Welfare State University*. "With consolidation or refinancing, the length of term frequently extends to thirty years—in other words, for many returning students or graduate students, until retirement age." Having student loan payments at age 55 or 65 is a sobering thought.

Because of these sizable long-term obligations, "College student loan debt has revived the spirit of indenture for a sizable proportion of contemporary Americans," says Williams. "Because of its unprecedented and escalating amounts, it is a major constraint that looms over the lives of those so contracted, binding individuals for a significant part of their future work lives." Pilon agrees, saying "in practice, student loans are one of the most toxic debts, requiring extreme consumer caution."

Conclusion: Education Good; Debt Bad; Preparation Essential

In almost every instance, more knowledge and greater skills are valuable, even if the financial calculations seem to indicate the benefits aren't as great as they used to be. The critical financial questions about a higher education are whether it's worth mortgaging a significant portion of one's future to acquire a higher education, and whether using student loans is a preferred method of financing.

In addressing these questions, there is another dynamic. The person who will be most affected by this decision is often financially inexperienced and possesses limited resources. Bruce Necker, writing a "President's Page" opinion piece in the March, 2002, issue of the *Michigan Bar Journal*, related that

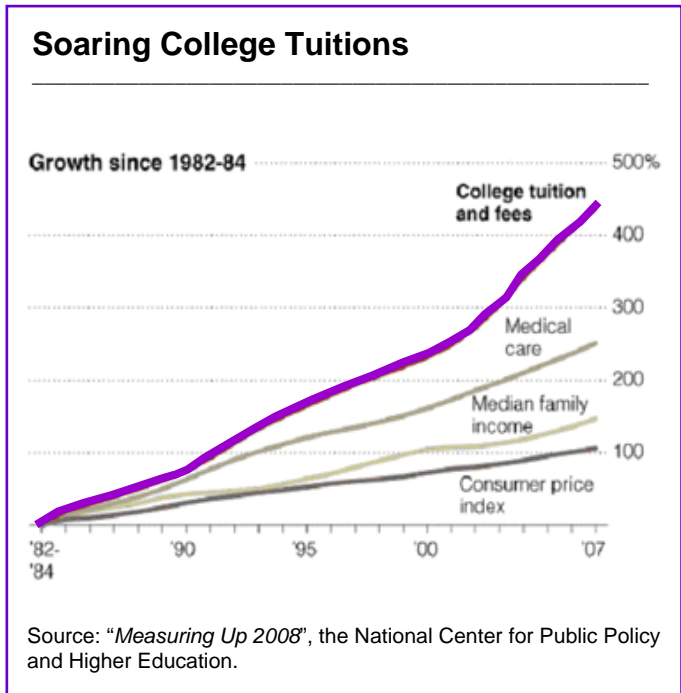
"One of my friends, a successful obstetrician in Grand Rapids, told me that if she had to do it all over again, she would forgo her medical school education rather than strap herself for her entire life, to decisions she made as a 22-year-old before entering the profession. I hear the same tale from young lawyers. Borrowing is the easy part. Repayment proves to be more difficult."

In reality, these hard financial decisions about college education are greatly determined by earlier financial decisions made by a student's parents or guardians. If

**With consolidation or refinancing, the length of term frequently extends to thirty years—
for many returning students or graduate students, until retirement age.**

they haven't made preparations for college funding, the choices for their children are limited: athletic or academic scholarships, need-based financial aid, or loans. Scholarships are available to a uniquely gifted portion of the population, and need-based funding has decreased with the economic decline. That leaves either loans – or forgoing college.

IS COLLEGE EDUCATION ON YOUR LIST (OR YOUR CHILDRENS')? IF SO, NOW IS THE TIME TO EXPLORE FUNDING ALTERNATIVES TO STUDENT LOANS.



The Disability Insurance That Makes You Wait



The potential for financial devastation from disability is substantial. For most Americans, the ability to earn an income is their primary financial engine. If something stops the engine,

everything else comes to a halt as well.

In spite of the critical need for ongoing income in most people's financial program, relatively few Americans obtain personal disability income insurance from an insurance company. Some may pick up group disability coverage from an employer, but for most Americans, their primary disability insurance is through the Social Security Administration (SSA).

According to the SSA website (www.ssa.gov), Social Security provides disability benefits for all workers who qualify, i.e., they have "worked long enough and paid Social Security taxes."

Like other private forms of disability insurance, SSA benefits can only be paid if your disability fulfills or meets a pre-established criteria. SSA considers you disabled* if:

- You cannot do work that you did before;
- SSA decides that you cannot adjust to other work because of your medical condition(s); **and**
- Your disability has lasted or is expected to last for at least one year or to result in death.

SSA explicitly states "This is a strict definition of disability. Social Security program rules assume that working families have access to other resources to provide support during periods of short-term disabilities, including workers' compensation, insurance, savings and investments."

Under the law, your payments cannot begin until you have been disabled for at least five full months. Payments usually start with your sixth month of disability, providing your disability is approved (more on this later).

The amount of benefit paid will depend on several factors, including your earnings and family size. In some situations, additional benefits through the Supplemental Security Income (SSI) program may be available. Benefits may be paid until you return to work or reach retirement age, at which time your payments will be disbursed from your Social Security retirement.

In summary, the SSA disability insurance is minimal when compared to coverage available through insurance companies, but certainly is better than no coverage.

But beyond the strict definition of disability, lengthy waiting period and limited benefits, disabled workers face a significant hurdle when applying to receive SSA benefits: The claims process itself.

According to the SSA, the **average processing time** for an individual awaiting a decision from Social Security with regard to a disability claim is **442 days**.

That's almost 15 months!

And that's just to get a **decision**. Approval is another matter altogether, because according to the Social Security and Disability Resource Center (www.ssdrc.com), only about 40 percent of all claims are approved from the initial submission.

If you are denied benefits, SSA offers two appeals. The first is called Reconsideration (in which another 20 percent are approved to receive benefits), and the final appeal is a hearing before an Administrative Law Judge.

How quickly a SSA disability claim is resolved depends on a number of factors, many impossible to determine in advance. As the SSDRC says:

*Please contact the Social Security Administration for complete eligibility criteria. The text above is a summary of those requirements.

“Social Security Disability and SSI cases can be won in as little as 30 days, or take as long as two years for benefits to be awarded. There is simply no way to predict how long a case will take because unlike other programs (Dept of Social Services, for instance), the federal disability program does not have deadlines for applications or appeals.”

The bureaucracy and legal procedures involved in receiving SSA benefits has made professional assistance almost a necessity. SSA claims have become a specialized niche for some law firms.

Participation in Social Security is mandatory for almost all Americans who earn an income. And if you are entitled to benefits from SSA as a result of a disability, you should by all means make a claim. But honestly...

Is this the only insurance protection you want in place in the event of a disability?

How Would **MR. RED** & **MR. GRAY** “Frame” Life Insurance?

Using concepts from the NBER survey, here’s a framing example with life insurance:

Quiz #1

Mr. Red spends 5% of his annual income to buy a \$500,000 life insurance policy that includes a cash value. Most of the premiums in the first two years are used

cover insurance costs, while the savings accumulates gradually on a guaranteed basis.

Mr. Gray spends 1% of his annual income to buy a \$500,000 life insurance policy with level premiums for the next 20 years. He invests 4% in a variety of investments, with his returns reflecting market conditions. He has access to his investments and earning at any time, and after 20 years when the life insurance policy is no longer active, will let his investment accumulation function as his “life insurance.”

Quiz #2

Mr. Red uses 5% of his annual income to secure \$500,000 of permanent life insurance at a guaranteed rate for the rest of his life. Combined with a disability waiver of premium and a guaranteed cash value, Mr. Red has established a “plan*” that can provide income and asset guarantees for almost every circumstance in every stage of life.

Mr. Gray secures \$500,000 of life insurance, but only for 20 years. He also has investments but they are not guaranteed, and he must avoid disability in order to cover both his insurance and retirement needs.

Comment: In Quiz #1, the framing for life insurance is cost. In Quiz #2, the frame is benefits and guarantees. While not a detailed example, this roughly imitates the discussion over permanent (whole) life insurance and the strategy of buying-term-and-investing-the-difference.

*It must be added that whole life insurance is a complex financial product, and an apples-to-apples comparison with term insurance-plus-investment alternatives is a difficult task. Still, it’s easy to see how framing can influence consumer perceptions and decisions.

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