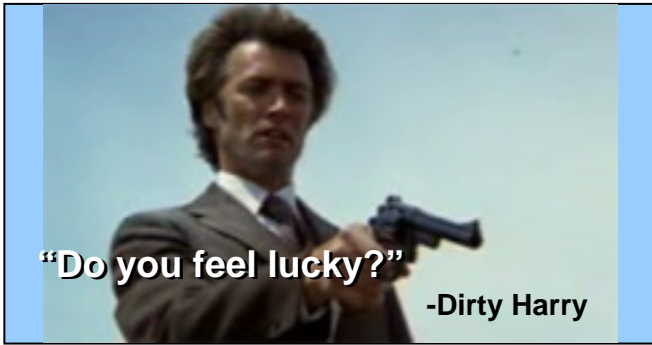




JUNE 2007



## TAKING AIM AT WEALTH BY BORROWING

This article takes several shots at explaining an alternative to simply saving for the future. By the end of the article, with apologies to Clint Eastwood, you might ask yourself, “did they fire six shots or only five?” Well, in all this excitement, we kind of lost track. So... you’ve got to ask yourself a question. “Do you feel lucky? Well, *do ya?*”

### Bullet point:

- **There are two ways to accumulate wealth. One is to save, the other is to borrow. Of the two approaches, saving is easier to understand and easier to execute. But prudent use of borrowing strategies may deliver better results.**

Upon reading the previous paragraph, several financial “experts” have just choked on their morning Starbucks in shock and outrage. You can almost imagine the wailing: “*When the average American consumer has over \$9,000 in credit card debt, the national savings rate is negative, and personal bankruptcies are at an all-time high, how could anyone responsibly recommend borrowing as a suitable financial strategy? People borrow enough already – they need to save, not borrow more!*”

But after cleaning up their spills, the “experts” should read on...

### Bullet point:

- **There is a difference between “good” borrowing and “bad” borrowing. This difference is summarized in the following axiom:**

*Borrow to multiply assets, not to satisfy consumption desires.*

For most Americans, a good portion of their borrowing is for consumption – the “assets” they acquire through borrowing will be used up, not multiplied. The reasons people have \$10,000 balances on their credit cards are either:

1. They had to meet an immediate need (kids’ school clothes, a medical situation, etc.); or
2. They wanted something now, didn’t have the money to pay cash, and didn’t want to wait (a shopping spree, a vacation).

When you borrow because you can’t meet your present financial obligations, it’s “bad” borrowing. When you decide to borrow because you can’t wait, that’s bad borrowing, too.

Even some accepted and prevalent forms of borrowing are tainted by bad borrowing. A case can be made that both automobiles and personal residences qualify as assets – a car is an essential tool for earning an income, and most homes have the expectation of appreciation. But when you decide to “step up to luxury” because the car payments are only a \$100 more each month, is that really good borrowing? Or when you see that an additional \$200,000 in mortgage debt puts you in an exclusive subdivision, is it really a matter of higher long-term value or ego gratification? Despite the claims of car salespeople and real estate agents, borrowing more to buy a nicer car or a bigger home is not usually a wealth-building move.

### Bullet point:

- **The key component of “good” borrowing is the financial leverage it creates.**

Borrowing allows you to control an asset – and benefit from its value – without paying the full price. Of course, in exchange for control you must also assume the obligation to repay the loan that made the leverage possible.

Here's a very simple hypothetical comparison:

On January 1, 2007, you place \$100,000 in an accumulation account. In the upcoming year, the account generates a return of 8%. Thus, on December 31, 2007, the account has an ending value of \$108,000.

*or...*

On January 1, 2007, you purchase a \$500,000 commercial building by making a \$100,000 down payment, then borrowing \$400,000. During the course of the year, the rent you receive from the tenants is just enough to cover your mortgage payments, taxes and maintenance expenses. The commercial property market is sluggish; by December 31, 2007, values are up only 2%. Adding the minimal increase to your equity as a result of one year's mortgage payments, the total value of your commercial property is somewhere over \$110,000.

Both strategies involve a \$100,000 investment, but through the financial leverage gained in the purchase of the commercial building, a 2% annual return was better than 8% – because the 2% was applied to \$500,000 while the 8% accrued on \$100,000. This is the significance of leverage.

The simple illustration detailed above does not take into account the tax consequences of either transaction. And because tenancy is not guaranteed, the owner of the commercial building might be forced to use other assets to make ongoing mortgage payments. This means the investment risk of the commercial building might be greater than simply placing money in an accumulation vehicle. Conversely, most landlords hope for a positive cash flow from their tenants, not just equity appreciation, so actual gains might also be greater. In summary, a “real number” comparison of saving versus borrowing could be much different than this simplified example.

Also, real estate isn't the only situation where leverage can generate greater increases in wealth than by simply saving. For a business, borrowing to obtain additional equipment could result in increased production, efficiency and sales. For an investor, borrowing to buy a company could be desirable because the immediate income may be greater than a savings alternative – even when factoring in the cost of borrowing.

Which leads to the next comment on good borrowing...

**Bullet point:**

◆ **To use good borrowing strategies, you may want to change the way you save.**

The real-life implementation of borrowing-for-leverage strategies can be complex – both to execute and evaluate. But one way or another, regardless of the details, a lender must believe that the amount borrowed can be repaid.

In a perfect world, the loan payments might come from tenants or revenues generated by the asset purchased. But experience shows that buildings are sometimes not fully occupied, and business income doesn't always flow in a steady stream. Thus, a prudent borrower makes provisions to cover unexpected expenses like capital improvements, repairs or monthly mortgage payments. The best way to do this is with savings in a liquid emergency fund that's readily available.

Stashing some money in a safe, conservative accumulation vehicle may mean foregoing some opportunities for higher returns, but a borrower whose ability to repay is predicated solely on ongoing personal wages may not be adequately prepared to borrow effectively. When borrowing results in foreclosures and repossessions, they are not profitable transactions.

Also, many borrowing transactions involve down payments. Knowing you might want to obtain leverage and control of an asset through borrowing,

you should save accordingly. With a downpayment in mind, you could ask yourself if it makes sense to fully fund a qualified retirement plan. Perhaps not. The past year has seen some solid returns from the stock market, but what happens if the market is plunging at the time you want to liquidate the account? What happens if the market is skyrocketing? Do you really want to get out while it's climbing?

**Bullet point:**

◆ **Good borrowers have assets to multiply.**

If borrowing to obtain leverage is such a powerful financial idea, why doesn't everyone do it? Why aren't more people buying commercial real estate, expanding businesses, etc? As we said before, lenders only make loans they think can be repaid. It's sort of a rich-get-richer situation, but borrowing usually works best for those who already have assets and want to multiply them.

Some people have tangible assets - they have paper assets, real property, business ownership. Lenders are willing to give them money because they have evidence

- ◆ There are two ways to accumulate wealth. One is to save, the other is to borrow.
- ◆ There is a difference between “good” borrowing and “bad” borrowing.
- ◆ The key component of “good” borrowing is the financial leverage it creates.
- ◆ To use “good” borrowing strategies, you may want to change the way you save.
- ◆ Good borrowers have assets to multiply.

of responsible management; because they have been able to save and accumulate, there is a reasonable expectation they will also be able to repay any debt they acquire.

Some people have intangible assets. They may have an idea, service or product that can be leveraged through duplication. Instead of making five widgets a week, a new factory could produce 50 – at a lower cost. One store could become a chain of six, multiplying sales while achieving economies of scale in costs.

### So, was that six shots or five...?

Who cares? The more important questions:

**Do you have assets to multiply?**

**Are you saving in a way that you could take advantage of a borrowing/leverage opportunity if it came along?**

**If so, take the opportunity to ask questions and discuss options with your financial professionals.**

## MORE OUTSIDE-THE-BOX IDEAS

One of the most astounding things about capitalism is the creative energy it unleashes in people. Every day, someone, somewhere, thinks of another way to add value and make money. Some of the ideas inspired by the pursuit of wealth are life-changing (like cellphones or personal computers), some almost too stupid to be believed (“*a pet rock? You gotta be kidding me!*”). But in ways large or small, ingenious or idiotic, humankind is constantly finding new ways to make a buck. The following articles highlight two unique ideas worthy of a smattering of media attention.

### Idea #1: Bet your home equity

With a slogan of “possibilities, not payments,” a small San Francisco investment company is offering a unique arrangement to home owners with plenty of equity. REX & Co., with financial backing from a subsidiary of American International Group, has a program in which homeowners can tap home equity without selling the property or taking a loan. Instead, the company will “pay homeowners cash now in exchange for a right to a part of the proceeds when the home is eventually sold,” according to a May 8, 2007 *Wall Street Journal* article written by James R. Hagerty. The article notes that this no-loan/equity-out agreement is currently approved in only nine of the 50 states, but expects nationwide availability within the next two years.



An example: Suppose your home is currently worth \$750,000. REX might offer you \$100,000 in exchange for a 50% share of the change in value when the home is sold. That’s \$100,000 with no monthly payment, just an obligation to settle up when the house is sold.

If the future sale price is \$850,000, REX would receive \$150,000 - \$100,000 as return of principal, and \$50,000, representing half the increase from the date of the transaction. Conversely, if the property sold for \$650,000, REX would receive only \$50,000 (\$100,000 in principal *minus* half of the property’s decline in value).

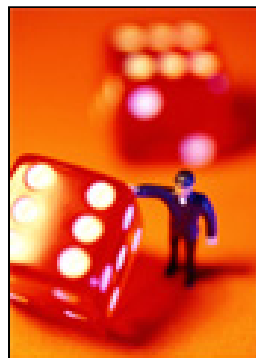
At first glance, one wonders how REX can win this bet. After all, the homeowner controls both the time of sale and the price, and no one controls the housing market. While housing values may continue to climb, who can be sure they will keep pace with other investment choices?

Further examination reveals the REX agreement has several contractual restrictions which may improve the company’s chances of recouping their investment. Todd Sullivan and Timothy Collins, writing on the weblog seekingalpha.com, reported not only the *Wall Street Journal* article, but also provided some information based on calculations and details provided at the REX web site. First, the amount of the equity draw is typically limited to 13% of the value of the house. Second, the term of the note is between 30 and 50 years, depending on the state. Third, homeowners who take an equity draw and sell the house before a specified period of time (typically five years) face penalty charges for early termination of the agreement.

Some commentators have expressed the opinion that this equity-out option is very similar to reverse mortgages that senior citizens have used to tap home equity now, and repay the amount either at death or sale of the property. Others saw the REX agreement resembling a zero coupon bond. Another big question is who determines the current market value. REX would have a strong interest in understating the current market value as a means to maximize the spread in a future sale.

### Idea #2: Bet your life

10 years ago, when he was 90, Englishman Alec Holden made a bet with bookmaker William Hill: That he would live to 100. The gambling house took Holden’s 100-pound wager, giving him odds of 250-1. On April 24, 2007, after joking that he had been “very careful” in the past few months, Holden collected \$25,000 pounds.



Though the story originates in England, anyone familiar with Las Vegas knows it’s possible to place a bet on just about anything, including the length of

your life. So while it's amusing, the bet isn't really that outrageous. In fact, Rupert Adams, a spokesman for William Hill, acknowledged the company had paid off two similar wagers in 2004 and 2005. The more interesting part of the story is the bookmaker's decision to revise the age limit in accepting such wagers.

"When we started taking these bets, 100 years old seemed to be an almost mythical landmark and we were prepared to offer massive odds," said Adams. "But these age wagers are starting to cost us a fortune and from now on we are going to push out the age to 110."

The decision of oddsmakers to "push out the age" is just another financial adjustment as a result of increasing longevity. For example, many insurance companies that used to price their whole life insurance policies on a "whole life" being 100 years old are now using age 120.

A decade ago, demographics seemed to indicate the beginning of a massive wealth transfer to Baby Boomers from the "Greatest Generation." But Michael Madden in the April 16, 2007 *National Underwriter* reports that only 1 in 5 families report ever receiving an inheritance. One of the reasons? "People are living longer and are more likely to deplete their savings."

## Whole Life Insurance: The Financial Multi-Tool



Even though it has a long history, whole life insurance remains a unique, outside-the-box financial product. There really isn't anything else like it.

Combining the unique design of a whole life insurance policy with a variety of riders and other special features can

make the product hard to explain to consumers. A frequent criticism of whole life insurance is that policyholders often don't fully understand what they have purchased, and how it fits into the rest of their financial plans. Not that this article will magically dispel all of the confusion, but it is an attempt to provide a general overview.

### Living Benefits, Death Benefits

If you pick up a typical whole life insurance brochure from an insurance company, part of the description will be a list of benefits that may be received while the insured is living, and a list of benefits that will be paid when the insured dies.

The death benefits are the easiest to understand, but merit a brief mention.

- In most circumstances, life insurance proceeds are distributed tax-free to beneficiaries.
- Life insurance proceeds payable to a named beneficiary will not be included in the probate estate.
- The services of a lawyer are not necessary to collect or distribute life insurance proceeds.
- In most states, interest is paid on life insurance proceeds from the date the insured dies until the payment is made. (This interest is taxable.)
- The entire death benefit can be paid in as little as a week following proof that the insured died.
- If desired, life insurance proceeds can be paid over time with interest, assuring that persons unfamiliar with large amounts of money don't spend it too quickly.

Most consumers come to an awareness of the value of life insurance within the context of providing for loved ones in the event of a premature death. But because whole life insurance is designed to be in force for one's "whole life," the above features may be critical in shaping the particulars of an estate plan, apart from simply providing cash to sustain a spouse and children. Because of the financial leverage that can be realized by using some assets to secure a much larger death benefit, a whole life insurance policy is often the centerpiece of a comprehensive estate plan.

### Living Benefits

Turning once again to a typical insurance company brochure for a living benefits overview:

- ♦ **Every permanent life insurance policy can be converted into an annuity.**
- ♦ **Under the terms of optional riders, if the insured becomes terminally or chronically ill, part of the death benefit can be paid while the insured is still living. An optional Disability Waiver can ensure that if the insured becomes disabled, the policy will continue to perform as if premiums were being paid.**
- ♦ **Most whole life insurance is eligible for annual dividends. Dividends are not guaranteed, but when they are paid, they can be used in a variety of ways, providing flexibility in the management and performance of the policy.**
- ♦ **Whole life insurance provides a guaranteed cash value (which can be further increased by the application of dividends, if dividends are paid under the policy).**

### Wait, there's more...

A company brochure can describe the generic features of a whole life policy: the insurance benefit, the cash value accumulation, and the riders. But a listing of the

features doesn't fully explain the value of a whole life policy.

A whole life contract is like a financial multi-tool. Depending on the circumstances, the policy can serve a variety of financial purposes. For example, a whole life policy can be:

- **A source of college funding.** Currently, financial aid rules allow parents to exclude home equity, retirement account accumulations and life insurance cash values from a calculation of family assets available for college tuition. In a properly structured policy, cash values can be used to help pay for college without jeopardizing qualification for other grants and financial aid.
- **A tax-free retirement income.** Strong dividend accumulations can allow policy owners to systematically withdraw cash values (as surrenders or loans) to create a tax-free retirement income.
- **A supply for financing large purchases.** Some policy owners have found it advantageous to tap cash values for automobile purchases, then making "car payments" to themselves to replenish the account for the next purchase.
- **An additional resource for long-term care expenses.** While not a replacement for long-term care insurance, an Accelerated Benefits rider can provide substantial tax-free benefits.
- **A tax-free life settlement.** Knowing the death benefit is guaranteed, institutions and individuals may be willing to "buy" the death benefit (at a discount) from the policyholder through a viatical settlement, collateral assignment or similar arrangement. The policyholder receives cash today, the investor receives the insurance proceeds at death.
- **A "permission slip" to spend other assets in retirement.** Having a guaranteed death benefit means other assets may not have to be conserved to provide for surviving family members or left as inheritance. This means other assets can be spent/enjoyed today without fear of jeopardizing the financial future.
- **A safe haven for assets.** Although the provisions vary from state to state, life insurance cash values enjoy favored "safe harbor" protections against creditors and legal actions.

**Advisory Note:** The above is just a brief listing of what can be accomplished with a whole life insurance policy. Understanding the basic financial principles of life insurance, creative financial minds are continually developing more possibilities.

**A whole life contract is like a financial multi-tool. Depending on the circumstances, the policy can serve a variety of financial purposes.**

Many of the above options available to whole life policyholders are impacted by specific tax laws and contract provisions. If you are going to maximize the value of a whole life insurance policy, you need to work with a knowledgeable life insurance professional. This is not a do-it-yourself project!

### "Yeah, but..."

One of the common characterizations of whole life insurance is that it's "expensive". Seeing whole life as expensive is a misunderstanding.

A good multi-tool sells at retail for about \$75-\$100. By contrast, a good screwdriver cost \$5. Some might say, "why spend \$75 if the only thing you needed was a \$5 screwdriver?"

If hindsight was possible before making every financial decision, everyone would be able to choose exactly the right product, in exactly the right proportion. But the reason someone spends \$75 for a multi-tool to put in their pocket or glove box is because they *don't know what they will need*. The multi-tool is worth the price because it is a multi-faceted tool, adaptable to a variety of circumstances.

Understood and used appropriately, whole life insurance is like a financial multi-tool that can adapt to a variety of financial circumstances and consistently deliver solid results.

## **In A Paperless World, Will Anyone Be Able To Locate Your Estate Plan?**

If you're a technophile, your financial world may already be completely paperless. You don't get a paycheck because it's deposited directly into your bank account. You pay bills online instead of writing checks. No monthly or quarterly financial statements or transaction confirmations are mailed to your house; instead you have 24/7 access via a password. And for "cash" purchases, there's a debit card.

In this paperless/password paradigm, there aren't many scraps of information that can accidentally fall into the wrong hands. That's a good thing if you're trying to keep your financial world safe from identity theft. But it can be a problem for heirs when you're gone. According to Kaja Whitehouse in a May 19-20, 2007 *Wall Street Journal* article ("Paperless World Can Leave Heirs In the Dark"), "If you don't keep careful records, your family might not even know where to start looking for accounts. In a worst-case scenario, some assets may never be found."

Even with paper documentation, locating every life insurance policy, investment account and property title can be tough. Many people have an “it’s-all-in-my-head” index combined with “junk-drawer” filing system (“*I know we still have that, and I’m pretty sure it’s here somewhere.*”). As long as they’re alive, stuff either turns up, or they know how to get updated copies. When they die, their survivors become detectives, sorting through whatever bits of information they can find. Making the trail a paperless one, with a password the only point of access, takes the detective work to another level of difficulty.

For everyone’s sake – from your loved ones to your creditors – you need to have your critical personal and financial information organized and available so designated “gatekeepers” can properly manage your affairs in your absence.

### **It’s A Detail-Driven Assignment – So Get One of Your Professionals To Do It!**

When it comes to financial documents, no one is better equipped than your personal financial professionals to handle the details. They work with these items every day, so why not enlist their expertise, and create a little “value-added benefit” for yourself?

Most financial service companies have a process and format for establishing and maintaining a written record of your estate plan. This format should include:

- **A list of primary contacts. These are people such as the executor of your estate, guardians for children, and financial advisors, such as attorneys, accountants, brokers, insurance agents, etc.**
- **A list of relatives and friends to notify.**
- **The location of your safe deposit boxes, safes, or other secured document storage repositories.**
- **A list of key instructional documents, such as wills, trusts and DPOA agreements.**
- **Information on key banking, brokerage and insurance accounts.**

### **But Can I Still Keep My Information Online?**

Some financial service companies offer encrypted online “vaults” where clients can store personal information. Paper documents (tax returns, wills, deeds, etc.) can be scanned and uploaded. Many financial accounts (bank checking and savings, mutual funds, brokerage, etc.) can be electronically updated on a regular basis. Even personal items like photos can be stored online.

The online vault can certainly serve as your storage system. But there must be a procedure for allowing someone else access if you’re no longer alive or competent to manage your affairs. **Somehow there’s got to be a way to pass on the password.**

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2431 Atlantic Avenue  
Manasquan, NJ 08736  
732-528-4800  
[www.CA-Strategy.com](http://www.CA-Strategy.com)