Get Smarter, *Do Something*

BEHAVIORAL FINANCE REVEALS TIME-TESTED WEALTH FORMULA

In the past decade, a new category of financial study has emerged. It's called ***behavioral finance***, and it attempts to understand how cognitive and emotional biases can effect financial decisions. In other words, behavioral finance tries to explain why people sometimes make irrational or counterproductive decisions with their money.

Annamaria Lusardi and Olivia Mitchell are a team of researchers in the field whose work in behavioral finance has focused on why Americans aren't saving enough for retirement. Since 2003, Lusardi, a professor of economics at Dartmouth College, and Mitchell, a professor of risk management and insurance at the University of Pennsylvania, have published several papers which provide interesting insights into the attitudes and actions that are crucial to achieving retirement success. They conclude that the key ingredients leading to a satisfying retirement are:

1. Financial literacy
2. Having a plan.

Wow. Those are surprises, aren't they?

The Value of Financial Literacy

Actually, Lusardi and Mitchell's research is quite compelling in that it reveals the main reasons why many Americans "will arrive close to retirement with little or no wealth." In the summary preceding their November 2006 paper titled, "Financial Literacy and Retirement Preparedness" the authors state the following:

> ***"Our review reveals that many households are unfamiliar with even the more basic economic concepts needed to make saving and investment decisions. Such financial illiteracy is widespread: the young(er) and older people in the United States and other countries appear woefully under-informed about basic financial computations, with serious implications for saving, retirement planning, mortgages and other decisions."***

A follow-up paper released in October 2007 asked survey respondents a series of "financial literacy" questions. The multiple-choice financial questions were very basic, even for the "tougher" portion of the test. Yet less than half of the 800 individuals who took the Basic Financial Literacy test answered all five questions correctly. And only 20% of the respondents correctly answered the eight questions that comprised the *Sophisticated Financial Literacy* section. (To see the questions, turn to "Are You Smarter Than a Fifth Grader?" on page 3.)

Evaluating the results, Lusardi and Mitchell found a direct correlation between financial intelligence and net worth. Financially savvy people were more likely to take advantage of financial opportunities and less likely to make financial mistakes. (The difference in financial success was especially true regarding the comprehension of "higher-level" financial concepts. Respondents who correctly answered questions about compound interest

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had a median net worth almost three times that of those who missed the questions.)

From other questions, the researchers also found that financial literacy was not something most individuals obtained during their formal education in high school or college. Rather, financial literacy was something they acquired as working (or retiring) adults. And this financial education did not have to be extensive. Lusardi and Mitchell found that those who attended retirement seminars had a 20% increase in net worth, with the greatest increase being among those with the lowest net worth.

After collecting their own data and reviewing other research, Lasardi and Mithcell believe there is a clear-cut connection: "By every measure, and in every sample we have examined, we concluded that financial literacy is a key determinant of retirement planning."

But being financially literate isn't enough. The other part of the financial success equation is making a plan.

In a 2004 study, Lusardi and Mitchell found that those individuals who did "a lot" of retirement planning had a median net worth that was 150% greater than those who did the least. Even the survey respondents who said they did "a little" planning were significantly better off.

What constitutes "a little" planning? It could be something as basic as using an on-line retirement calculator program. Or writing out a set of goals on a napkin. Or simply thinking through some financial details. Anything that focuses on planning for a specific solution instead of contemplating abstract ideas is helpful.

According to Dr. Richard Peterson, the author of the book *Inside the Investor's Brain*, "planning helps us overcome the internal blocks that lead us to procrastinate and worry." For behavioral finance researchers, the act of making a plan is a "psychological trigger" that helps people break through the subconscious emotional and mental restraints that may be keeping them from success.

And once a plan gets started, anything that minimizes disruptions or makes financial preparation easier helps people keep their positive momentum. Particularly in regard to saving and accumulation, the researchers point to the success of automatic withdrawals in enabling people to stay on track. Whether it is a retirement plan contribution withheld from a paycheck, an insurance premium paid withdrawn from a checking account, or an investment made on-line, the benefits of having the transaction completed with minimum personal effort are notable. When convenience makes it easier for a plan to be executed, positive behavioral finance habits are established.

Putting financial literacy and planning on "auto-pilot"

If becoming financially literate and making a plan are critical elements for financial success, and if the chance for success increases when the process is made easier, then the ideal situation is one where learning and planning are done automatically. With a little prompting, your financial professionals should be able to help you develop "auto-pilot" successful financial behaviors.

As far as financial literacy goes, most financial professionals are great sources of information. It's true that many people in the financial service industry make their living by selling products like life insurance, mutual funds, stocks and bonds, retirement plans, etc., but in order to do so, most agents and brokers acquire a thorough understanding of all the economic factors that impact those products. Want to better understand how insurance works? Want to know the tax laws that affect your 401(k)? Ask the representative whose name is on your statement.

Turn your financial professionals into information deliverers. Ask them not only for sales literature and prospectuses, but also for third-party commentary on the ideas. Regularly schedule a time – each month, quarter or half-year – when they will contact you and apprise you of new developments in their field. If they have a client newsletter, get on the mailing list.

Besides information delivery, you should also take full advantage of any automated services these financial professionals offer. Use electronic transfer of funds (ETF) features to pay insurance premiums or make regular deposits to accumulation accounts. Learn how to access your account statements online. If your representative offers a personalized on-line data vault to store and update your financial records, check it out (especially if the service is complimentary).

When you retain the services of a competent financial professional, your path to financial success can be considerably smoother. *You* still have to get smarter and *you* still have to make a plan. But you don't have to do all the grunt work. It's like driving: you must take the wheel, but you don't have to build the car.

How's your financial literacy?

Do you have clearly-defined plans?

Do you have an "auto-pilot" program in place to make it easy to stay on track?

If you can answer "yes," you know your behaviors are aligned to succeed financially. If you're not so sure about your answers, maybe you should contact us.

- **GET SMART ABOUT MONEY.**
- **TAKE ACTION ON WHAT YOU KNOW.**

When It Comes To Money,
Are You Smarter Than A Fifth Grader?

Below are 13 questions used in research by Annamaria Lusardi and Olivia Mitchell in their ongoing study of the connections between financial literacy and retirement planning. The questions are divided into two categories, Basic Financial Literacy and Sophisticated Financial Literacy.

(The average score for the Basic section was 4 of 5 answered correctly. For the Sophisticated portion it was 6 of 8.)

Basic Financial Literacy Questions

1. Numeracy (Numerical Literacy)

Suppose you had $100 in a savings account and the interest rate was 2% per year. After 5 years, how much do you think you would have in the account if you left the money to grow?

a. More than $102 c. Less than $102
b. Exactly $102 d. Don't know

2. Compound Interest

Suppose you had $100 in a savings account and the interest rate is 20% per year and you never withdraw money or interest payments. After 5 years, how much would you have in this account in total?

a. More than $200 c. Less than $200
b. Exactly $200 d. Don't know

3. Inflation

Imagine that the interest rate on your savings account was 1% per year and inflation was 2% per year. After 1 year, how much would you be able to buy with the money in this account?

a. More than today c. Less than today
b. Exactly the same d. Don't know

4. Time Value of Money

Assume a friend inherits $10,000 today and his sibling inherits $10,000 3 years from now. Who is richer because of the inheritance?

a. My friend
b. His sibling
c. They are equally rich
d. Don't know

5. Money Illusion

Suppose that in the year 2010, your income has doubled and prices of all goods have doubled too. In 2010, how much will you be able to buy with your income?

a. More than today
b. The same
c. Less than today
d. Don't know

Sophisticated Financial Literacy Questions

6. Function of the Stock Market

Which of the following statements best describes the main function of the stock market?

a. The stock market helps to predict stock earnings.
b. The stock market results in an increase in the price of stocks.
c. The stock market brings people who want to buy stocks with those who want to sell stocks.
d. Don't know.

7. Knowledge of Mutual Funds

Which of the following statements is correct?

a. Once one invests in a mutual fund, one cannot withdraw the money in the first year.
b. Mutual funds can invest in several assets, for example invest in both stocks and bonds.
c. Mutual funds pay a guaranteed rate of return which depends on their past performance.
d. Don't know.

8. Relationship between Interest Rates and Bond Prices

If the interest rate falls, what should happen to bond prices?

a. Rise.
b. Fall.
c. Stay the same.
d. Don't know.

9. Safer: Company Stock or Mutual Fund

Buying a company stock usually provides a safer return than a stock mutual fund.

a. True
b. False
c. Don't know.

10. Riskier: Stocks or Bonds

Stocks are normally riskier than bonds.

a. True
b. False
c. Don't know.

11. Long Period Returns

Considering a long time period (for example 10 or 20 years), which asset normally gives the highest return?

a. Savings accounts.
b. Bonds.
c. Stocks.
d. Don't know.

12. Highest Fluctuations

Normally, which asset displays the highest fluctuations over time?

a. Savings accounts.
b. Bonds.
c. Stocks.
d. Don't know.

13. Risk Diversification

When an investor spreads his money among different assets, does the risk of losing money:

a. Increase.
b. Decrease.
c. Stay the same.
d. Don't know.

Answers: 1.a 2.a 3.c 4.a 5.b 6.c 7.b 8.a 9.b 10.a 11.c 12.c 13.b

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Ever play *"Would you rather…?"* It's a sit-around-the-table conversational game where you're asked to choose between two equally good (or bad) scenarios. For example:

Would you rather…

a. make a lot of money doing work you hate, *or*
b. do work that you love, but never get a raise?

Would you rather be given…

a. a one-year all-expenses paid trip around the world, *or*
b. a vacation home but never travel overseas?

As part of a poll conducted between October 2007 and January 2008 by Ipsos Public Affairs and ING regarding Americans' attitude toward life insurance, over 1,000 Americans were asked some would-you-rather-questions involving talking to an agent about life insurance.

For example, given the choice between bungee jumping or talking with an agent about life insurance, the choice was bungee jumping. Most people also say they'd prefer to speak in front of a crowd.

But on the other hand, talking about life insurance was seen as better than sitting through a job performance review or filling out a college application.

Risk Management Is The Ugly Duckling of Financial Planning

Beyond the amusing choices, the survey revealed another relevant statistic: While 86% of respondents felt they should have life insurance, only 71% owned coverage of any kind.

Put the pieces together: Almost 9 in 10 Americans believe they should own life insurance, but most consider a discussion of the topic distasteful – hey, they would rather endure the stress of public speaking than talk about life insurance!

ING's press release noted that insurance has a "low profile compared to the prevailing popular focus on wealth accumulation and investing." Catherine Smith, CEO of ING U.S. Insurance lamented that "life insurance has become the forgotten foundation of a long-term, comprehensive financial plan."

But it's not just life insurance that gets overlooked or dismissed. Any type of insurance or risk management strategy often gets relegated to the "necessary evil" category.

Until something happens.

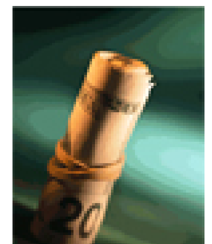
Someone loses a job, has an accident or gets disabled. A hurricane or forest fire sweeps through. All of a sudden, the money you spent on insurance seems like the best decision you ever made.

Insurance provides social and financial stability that makes greater opportunities possible. If there was no homeowners insurance, banks would be less inclined to write large mortgages – and they would require lenders to make larger down payments. Without widespread disability insurance (including Social Security), most consumers would not be able to buy on credit without some other form of collateral. Without life insurance, how many families would feel compelled to keep their children "down on the farm" in case the parent died? When large groups of people can share their financial risks, everyone has more opportunities to prosper.

In reality, the modern insurance industry has done such a good job mitigating the adverse financial consequences from unexpected events that it has come to be taken for granted. In fact, the financial protection provided by insurance is so effective some people begin to think they can actually get by without insurance. But the best financial programs understand the central position of insurance and risk management.

> ***"The simplest way to manage or avoid risk is to put it (money) into a safe asset."***
>
> **- Professor Zvi Bodie,**
> Boston University School of Management

HELOCs and the Cash Crunch



A declining dollar. Higher fuel prices. When prices go up, or the dollar doesn't buy as much as it used to, the result is a cash crunch – people don't have enough money to pay their bills or maintain their standard of living.

Facing a cash crunch, most consumers respond by trimming their discretionary

spending. They cut back on travel, don't eat out as much, or stop paying for the premium channels on their cable service. But sometimes cutting back isn't enough. So when their child needs braces or the house needs a big-ticket facelift, how do cash-strapped Americans solve their cash crunch?

One popular option has been borrowing against the equity in your home. But while popular, the economic events of the past year have uncovered some new cautions for this approach. Here's a brief overview of the pros, along with some "new" cons that might deter you from using this resource.

Pros

Home equity loans, either as second mortgages or home-equity lines of credit (HELOCs), can be attractive sources of emergency funding, particularly for those individuals who have accumulated significant value in their personal residence. While most lenders will restrict the total indebtedness to a percentage of the property's market value (such as 80%), some generous lenders have been willing to allow borrowers to borrow up to the home's full value (more on this later).

When borrowing in the form of a second mortgage or equity line of credit, interest rates are usually favorable because the loan is collateralized by the property. In addition, repayment can usually be made over longer time periods, such as ten years, maybe more. With lines of credit, many lenders will allow interest-only payments, with a balloon payment after a specified period. In addition, the interest from home equity loans is often tax-deductible.

Cons

When interest rates were low and housing values were climbing, both lenders and borrowers figured the loans could be resolved later, either through a re-financing based on the appreciated property values, or from a sale as homeowners "traded up" or cashed out. This format was a win-win for both parties: homeowners accessed their equity at minimal cost, and banks earned profitable fees for writing and rewriting loans on the same property.

But the decline in real estate values has put an end to this happy arrangement. Homeowners don't have as much equity and banks are more cautious about the loan-to-value limits and their lending criteria. In some situations, the drop in property values has prompted lenders to freeze the line of credit or reduce the limit.

Besides a loss in available credit, falling home values and rising defaults have introduced another potential problem for consumers with second mortgages or HELOCs: They may not be able to refinance their primary mortgage.

When a lender makes second mortgages and HELOCs available, they agree to stand as second-place creditors. If the borrower defaults, the lender who holds the primary mortgage gets paid first. But if the homeowner wants to restructure or replace the first mortgage, the secondary creditors must agree to the new terms. According to a March 6, article in the *Wall Street Journal* ("Some Borrowers Hit New Snag In Refinancing"):

> ***"Homeowners who in the past would have been easily approved for a mortgage refinancing are finding that they can't get their home-equity lender to give the go-ahead, which is required to complete the transaction."***

On the flip side, some lenders are refusing to refinance the primary mortgage until the HELOC limit is reduced. "For homeowners trying to improve their situation, this is a nightmare," said Richard Redmond, a California mortgage broker.

Here's an example of how these lending changes could cause financial discomfort:

On a home appraising for $300,000 in 2006 with a 15-year mortgage for $150,000, a bank might authorize a line of credit for around $90,000. (This would make the total indebtedness $240,000, or 80% of the home's market value.)

But in today's soft market, suppose the home's market value is only $260,000. Using the 80% loan-to-value ratio, the amount available as a line of credit would decrease by more than $30,000. Obviously, a line of credit reduction could be troublesome in a cash crunch.

In this hypothetical situation, suppose you used $50,000 from the HELOC two years ago to make some home improvements, knowing there was still $40,000 in reserve for emergencies, or to finish Phase 2 of your remodeling. Today, that emergency "reserve" probably isn't much more than $15,000, and Phase 2 isn't going to get done.

Add another wrinkle: In response to your cash crunch, suppose you want to re-structure the existing mortgage to 30 years and lower your monthly payments. But the HELOC lender may not be willing to sign off on the change. Or the new primary lender may insist on a reduction in the HELOC limit. And your ability to ease your cash crunch may be out of your hands.

“PLAN B” OPTIONS FOR A CASH CRUNCH

These potential home-equity problems emphasize the importance of establishing cash reserves you can control. As a cash-crunch resource, tapping home equity may have been an attractive “Plan A,” especially when interest rates were low and values were soaring. But where’s Plan B, the one you can fall back on if things don’t go as planned?

For many Americans, Plan B is increasing their credit card balance or borrowing against their 401(k). But there may be another resource: ***Life insurance cash values***. And in some instances, cash values may really serve as a Plan-A resource for meeting a cash crunch.

The specifics will vary depending on the type of policy, how long it’s been in force, and how much has accumulated, but the typical whole life insurance policy has some beneficial features when addressing a cash crunch.

The accumulated values are stable. In ordinary whole life policies, cash values are not affected by market volatility. Thus, your emergency reserves will not fluctuate, as could be the case with equity based on housing values.

There is no application process, credit check or “approval process.” The cash values are available to the policy owner on demand, according to the terms of the contract.

The withdrawal and repayment terms are under your control. Depending on the specifics of the contract, cash values may be taken as withdrawals (partial surrenders) or loans. Unlike HELOCs or 401(k) loans, repayments terms are usually flexible as well. (An important note: Loans and withdrawals may incur tax consequences and/or affect the life insurance benefit. Make sure your decision to tap cash values is based on all the pertinent facts.)

The loan-to-value (LTV) ratio is very high. A typical whole life policy will allow owners to access between 90% and 95% of their cash values, while still keeping the life insurance in force. This ratio compares favorably to a HELOC (LTV is usually up to 80-90% depending on the property) or 401(k) loans (50% of account balance, up to a maximum of $50,000.)

If you have a whole life insurance policy, and are in the midst of a cash crunch, maybe you should meet with your financial specialist and discuss how the cash values might assist you in weathering the storm or getting back on your feet.

If you have ordinary whole life insurance, you could have a source for extra cash.

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