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First Financial Group

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IS SAVING FOR SUCKERS?

Adam Smith was an 18th century Scottish social philosopher who is often considered the founder of modern economics. In 1776 he published a groundbreaking treatise, titled *An Inquiry into the Nature and Causes of the Wealth of Nations*, a work that today is still considered one of the most influential studies of Western civilization.

One of the major premises put forward in the *Wealth of Nations* is that individuals pursuing their self-interests act as a collective “invisible hand” to shape market demands, set prices and promote competition. This invisible hand compels businesspeople to supply the goods and services consumers want, to produce and deliver them efficiently, and to charge only what they are worth. As a result, the overall economic well-being of society is promoted.

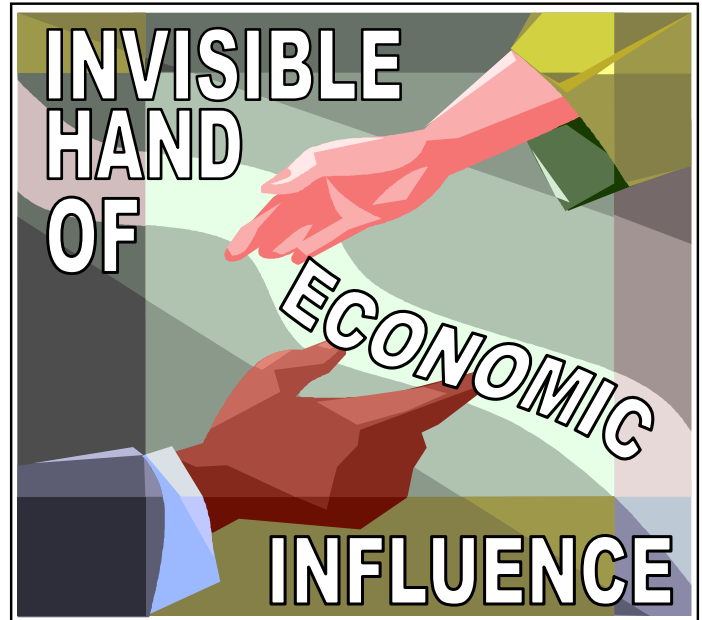
The invisible hand of collective self-interest is not only the driving force behind free-market capitalism, but Smith also saw it as the driving force that encourages people to save money because future-oriented individuals see that delaying their immediate gratification can make it possible for them to attain greater financial security or more material possessions.

However, Smith also held that government intervention into the economic life of a nation can warp the self-interests of individuals. As a result, the invisible hand may actually encourage financial behaviors that are counter-productive. Taxes, tariffs, and other government-imposed regulations may have unintended financial consequences, often directly opposite to what was hoped for.

Today, the “Invisible Hand” moves people to spend rather than save.

As a current example, Henry Blodget, a former Wall Street analyst, wrote an article for *Slate* titled “*Spend Every Dime! Why U.S. Tax Policy Makes Saving a Sucker’s Game.*” Posted online April 12, 2007, Blodget observed that,

“for the first time since the Great Depression, the U.S. personal savings rate has ‘gone negative’...”



“Why are we doing this? Partly because we’re acquisitive consumers obsessed with instant gratification and toys. Partly because soaring real estate and stock markets make us feel rich. But also because we’re not suckers. Perverse tax laws for investments discourage saving, so it’s no surprise we spend.”

Blodget goes on to elaborate that taxation and inflation make conservative saving in instruments such as Treasury bills a losing proposition; the real value of the money you’ve saved – including the interest – is actually worth less than what it was when you started. In response to this reality, the invisible hand moves toward spending and away from saving:

If I said to you, “you can have \$10,000 to spend now – or \$9,500 to spend in 10 years,” which would you choose? Probably the \$10,000 now. And in doing so, you would be making the same choice many Americans make when deciding whether to save or spend their hard-earned cash.

An interesting bit of anecdotal evidence tends to support Blodget's observations. In a January 23, 2007 Wall Street Journal article titled "What, Me Save?", Robert Frank reported that even the nation's richest bankers and stock traders were spending most of their performance bonuses; "they figure they have plenty of time to save and invest. And so, they say, they'd much rather spend."

Going on to investment options with the potential for higher return than Treasury bills, Blodget writes that while the taxes on stock dividends and long-term capital gains may not be as high as the income tax charged on interest, these taxes still function as an invisible hand to shape investor behavior. For example, "if your stock's best gains are behind it, if you switch to a better stock, it might be years after paying your tax bill before you get back to even." Blodget also notes that today's government authorized retirement vehicles are "only *tax-deferred*. When you fork over income tax on withdrawals, much of the tax advantage is lost."

All in all, Blodget makes a persuasive case for spending the money now. Considering taxes and inflation, saving just doesn't seem to be in your best interests.

Of course, there's one problem: If you don't have an income, you can't spend. As long as we are working, our wages can provide the income to pay the bills and meet our needs and wants. But eventually, most of us lose some or all of our working capacity, and are faced with retirement. Now we need savings to provide the income. While Social Security may still be one source of income for retirement, the consensus is that you will need savings of your own – even if the Invisible Hand is moving you to spend instead. Under current tax and inflationary conditions, saving might be a sucker's game, but *not saving* isn't the answer. There's got to be a different approach.

Re-educating the Invisible Hand

In the *Wealth of Nations*, Adam Smith mentioned other forces besides government intervention that could skew the results of the invisible hand. Free markets delivered the best results when all parties had good information and open access to the market. But when some groups had inside information while others were ignorant, it created competitive disadvantages. The ignorant invisible hand moved people to make stupid decisions.

Blodget may be correct in characterizing U.S. tax policy on investments as "perverse." **But the bigger problem might be ignorance among the general public as to the best purpose and value of saving.** For a large percentage of the populace, saving is a one-step process with the primary objective of securing a retirement. You make deposits. The account compounds. At retirement, the compounded savings provide an

income. Simple as 1-2-3. That's the perspective many people have in regard to saving. And while it may be the prevalent view, you can make an argument that it's not the most informed one.

There's a simple axiom of success that says "If you want to be successful, do what successful people do." Did you ever ask yourself what truly wealthy people have done to accumulate their wealth? Did you ever wonder about the success principles they use? And did you ever wonder if the successful individuals "save for retirement"?

Think of someone who you consider very prosperous. Did they "become rich" by "saving for retirement"?

Our guess? Their prosperity is almost certainly the result of something other than good saving habits. Through education and/or experience, they may have developed a very sought-after, highly-compensated skill. Or perhaps they established businesses or acquired properties to achieve a high level of income. And quite likely they used the profits from their own efforts to take a financial stake in people who are doing the same thing.

As James Davidson, an investor, economist, and author of the *Sovereign Individual*, states:

"Simply penny-pinching, per se, is not a recipe for becoming meaningfully rich. It is only a preliminary step that would permit someone without inherited capital or a significant annual cash flow to make the kind of investments that could actually lead to riches."

Andrew Carnegie was the wealthiest man in the world at the beginning of the 20th century. In his time, his net worth was higher than Bill Gates' is today. Carnegie wrote a book, *The Gospel of Wealth*, which detailed his thoughts and insights into prosperity. As part of the book, Carnegie made some basic observations about wealth and the place that *saving* played in achieving it.

Carnegie said true prosperity was defined as,

"fortunes, not moderate sums of money saved by many years of effort, the returns from which are required for the comfortable maintenance and education of families."

For Carnegie, true financial success came from "fortunes, not moderate sums." He didn't dismiss saving as wasted effort, but was clear that saving was only a

Saving was the amassed capital that made it possible to begin pursuing true financial prosperity. Savings are most productive when "active."

minor part of obtaining prosperity. He said saving “is not wealth, but only competence, which it should be the aim of all to acquire.” Saving was a basic trait that all financially responsible people should develop, but also just a starting point.

Most wealthy people have not achieved their financial success by long-term saving. Whatever excess they accumulated was not put in “compounding mothballs” for two or three decades, but rather used as the springboard to launch or improve some business, project, development, etc. From this perspective, saving was the amassed capital that made it possible to begin pursuing true financial prosperity. Savings is the catalyst for something greater.

Thus, based on observation, it is reasonable to conclude that saving, in order to capitalize an ownership or a development opportunity, is a financial strategy with far greater potential than simply “saving for retirement.”

This observation can be expanded to a general application: **One’s savings are most productive when “active.”** A “stagnant” savings account delivers only one action, compounding interest. Savings, actively applied as capital, can be used to deliver a variety of additional benefits and opportunities.

“But what if I don’t want to change careers, start a business or buy real estate?”

While ownership or development opportunities may offer the greatest opportunity for significant wealth, not everyone has the inclination or ambition to use savings for entrepreneurial ventures. Even the best business opportunities have risks, and some people are risk-averse, especially when it comes to their savings. No matter what the opportunity, they can’t handle the emotional stress that would result from using savings as capital for another venture. However...

There are other ways to “activate” your savings. While these strategies may not be as dramatic, even smaller actions can result in increased profitability. As good financial professionals, we have lots of these ideas for clients.

From a marketing perspective, saving for retirement is the “easy sale” – simple to comprehend, designed for the masses. And because of this simplistic approach, many people remain tied to doing nothing more than making a deposit now, and hoping there will be something meaningful awaiting them at a later date. Meanwhile the invisible hand of self-interest keeps slapping their subconscious mind, saying, “why are you doing this, when your savings are losing purchasing power the longer you hold them?”

If the only plan for your savings is to compound, Blodget might be right: Taxes and inflation could make saving a sucker’s game. But if you want the Invisible

Hand to pat you on the back and encourage you to save money, consider ways to make your savings active.

IS YOUR FINANCIAL PROGRAM “ACTIVE” OR STAGNANT? IS IT TIME TO GET MOVING? WE HAVE MANY IDEAS FOR “ACTIVATING” YOUR SAVINGS TO DO MORE.

THE COST OF NOT HAVING WORKING CAPITAL

cap·i·tal 'ka-pa-tal, *noun*.
Accumulated goods devoted to the production of other goods.



Think about your own situation. You probably have a mortgage, a car payment, maybe a couple of credit cards with balances on them. In a “typical” household with a \$200,000, 30-year mortgage at a fixed rate of 6.5%, the monthly payment is \$1,265. A \$20,000, 60-month auto loan at 8.5% is \$400 a month. Add in credit cards, college loans, etc., and the cost of using someone else’s capital could easily be payments of \$2,000 or more each month.

How much of that \$2,000 monthly outlay is just interest? During the first four years of the 30-year, \$200,000 mortgage, interest comprises 84% of the payment! If the auto loan is less than two years old, and only minimum payments are made on the credit card balances, the greater portion of each payment is interest. Thus, for \$2,000 in payments to creditors, it wouldn’t be unusual for 80% (or \$1,600) to consist of interest. A lot of your income is transferred away, earning someone else interest because **they had the capital available for use, and you didn’t.**

Evaluating Your Financial Team:



4 Levels of competence and compatibility

Success in any endeavor is usually a group effort. There are several reasons for this. First, most of us don’t have all the requisite skills, expertise or time to be excellent at everything. Second, a collaborative effort often yields results that are greater than what one person could have achieved alone. While it is possible to go it alone, things often go better when you have a team working with you.

If you are serious about ordering your financial world and striving to reach specific objectives, you will want to assemble a team of financial professionals to help you.

While there are no written-in-stone rules about the composition of your team, a typical roster should include people who have expertise regarding legal issues, taxation and accounting, insurance and investments.

When we say assembling a team, this doesn't mean you must meet with other friends at a bar and hold a draft to designate an attorney, CPA, insurance agent and broker ("Hey, you're on the team. Practice is at six on Thursday. Our uniforms are *sweet!*"). But you should develop a working relationship with these people so that when something comes up, from an audit to a windfall, you know who to talk to.

As you consider who might be a good fit for your financial team, the following is a simple checklist you can use as a guideline to assess potential candidates, as well monitor how well these professionals are performing on your behalf.

Philosophy. Philosophy is the way you see things, particularly the way you see money in relation to the rest of your life. Everyone has a philosophy, even if they don't articulate it. And everyone has a financial philosophy that's more sophisticated than "I wanna be rich." There are other factors like the motivation for wealth, the amount of energy and effort pursuing wealth should take, etc. You want your team of professionals to have financial philosophies that if not similar to yours, are at least compatible.

Principles. Principles are basic courses of action that correspond with your philosophy. Not necessarily hard and fast rules, they are standards to help you make practical application of your philosophy. When faced with a new financial situation, your team should help you determine which principles have direct application. For example, your philosophy of borrowing may be to use it sparingly with the goal of eventually becoming debt-free. At a principle level, you might break it down by saying you will not borrow for depreciating items (like cars or computers) but will borrow to acquire assets that often appreciate or provide income (real estate, rental equipment, etc.).

Planning. At some point, you will need specific direction regarding your unique situation. The discussion must move from the abstract generalities to concrete details. So, if your philosophy makes an inheritance a priority, you may quickly conclude that obtaining life insurance is a smart way to address the issue. Now you need to take action. You must decide on a specific type of policy in an amount that matches your specific objectives. Your specialists must have the ability to develop specific detailed plans that reflect both your philosophies and principles.

Precision. Even if you have the specifics of your plan lined up, there's still the matter of executing. It's like a man who has a target, a gun, and ammunition, and the physical and mental ability to load the gun and pull

the trigger. He has all the resources required to hit the target; but there's still the issue of aim. Many well-conceived financial plans fail because of sloppy execution.

Precision is being able to successfully execute the task at hand. It may be as small as changing a beneficiary on a retirement account, or something more significant like corresponding with the IRS in a timely manner. The question is: Did the job get done, and did it get done right?

Some additional thoughts:

Even though the philosophy drives everything else, it's probably the toughest thing to evaluate. In many cases, the only way to accurately assess whether your financial philosophies are compatible is by getting to know the individual over a period of time. But most interaction with financial professionals doesn't begin at a philosophical level. Quite often, it's just the opposite. You want a will and trust prepared before traveling overseas, or a tax return filed before the extension deadline. Those are specific precision-level issues that need to be addressed now. No philosophical discussion is necessary.

A person who provides competent service and advice at a Precision level is more valuable than someone with a compatible Philosophy, but poor execution. A great idea that's never implemented is worthless. Work with people who have a track record of getting things done – correctly and on time.

If you have strongly-held philosophical beliefs, you may still be able to work well at a Precision level with those who aren't perfectly compatible with you. If you decide you want automobile insurance with a \$1,000 deductible, and no collision coverage, you may not need anything more than a Property & Casualty agent to execute your orders. If you know you need an extension filed with the IRS, a philosophical discussion of taxation isn't relevant. Just make sure the people on your team know their assignments – if you don't need another philosophical adviser, make that clear.

Eventually, establishing a priority relationship with someone like your financial professional can result in the coordination of all your other advisers, assuming all four levels are compatible.

Make a mental list of the players on your financial team. Better yet, write it on paper. (If you're married, share the list with your spouse, and see if your picks are the same.)

Now evaluate each of them based on the four criteria listed above. Are these people philosophically aligned with you? Can they provide practical principles that coincide with your philosophy? Have they helped you develop specific plans and then completed them?

How good is your team? Does it need to be upgraded? Remember, the better the players around you, the more likely you can win the game.

SUBPRIMES ARE NOT SUBLIME

In the past three months, a new phrase has moved to the top of the financial lexicon: **Subprime**. Some headlines:

Subprime Fears Spread, Sending Dow Down 1.97%
(*Wall Street Journal*, March 14, 2007.)

Loan Rangers, Default rate by subprime mortgage borrowers is the wild card in a strong economy.
(*World*, March 10, 2007.)

What's going on? What Are Subprime Mortgage Loans?

Typically, a prospective borrower's FICO (credit) score and loan-to-value ratio determine the type of loan a borrower will qualify for. Subprime loans (because they are made to less-than-prime borrowing candidates) allowed borrowers with low FICOs and minimal down payments to purchase homes. Because subprime borrowers are a greater default risk, subprime loans carry higher interest rates than conventional loans for higher-rated, "A-paper" borrowers. Certain types of subprime loans such as "no documentation" or "stated income" are priced at even higher interest rates, sometimes several points above traditional loans. Most subprime loans are Adjustable Rate Mortgages (ARMs).

A while back, lenders were willing to make loans for 90% or even 100% of the property's value because the housing market was booming. These loans were extended not only to buyers of individual homes, but also to multi-unit and investment properties.

These relaxed lending standards helped fuel a housing boom, and as long as the boom continued, everything was okay. But as the housing market cooled, problems appeared.

The primary subprime loan is a 2-yr ARM. If a borrower had poor credit, this was their main option. Ideally, the hope was that within two years the borrower would improve his or her credit score and be able to refinance into a "prime" loan before the ARM interest rate adjusted. Subprime loans have a margin of 6% versus about 2% for prime loans, meaning their interest rate adjustments would be significant, making it difficult for the borrower to continue making payments.

The fact is many subprime borrowers don't clean up their credit. After 2 years, their best bet is to try to refinance, usually into another subprime 2-yr ARM. Since many of these loans were made at 90-100% loan-to-value to begin with, the only way the borrower could refinance was if their homes had sufficiently appreciated. When the housing market slowed and values plateaued (or declined in some areas), the ability to refinance was gone. The original ARM interest rate would adjust upward, the borrower couldn't afford the new payments, and the foreclosure process began.

According to a March 10, 2007 article by Timothy Lamer in *World*, the default rate on subprime mortgages

was over 13% in the last quarter of 2006. The subprime banks making these loans and ultimately selling them in blocks to Wall Street investors have to unload their non-performing loan pools at steep discounts, creating enormous losses for the banks making these loans. One major subprime lender, HSBC Holdings, estimated a loss of more than \$10 billion on home-loan defaults.

The defaults have had a ripple effect on the rest of the economy. If too many mortgages default, banks have to tighten their standards on everyone in order to cover previous losses. If it's harder to get loans, it becomes harder to buy houses...for everybody. Fewer people buying fewer homes often has a negative impact on the economy as a whole.

The fall-out? Most prime banks already have tightened some of their credit policies on the riskier loans. Subprime loan features will still be available but will require stronger credit profile characteristics such as:

- Higher FICO scores
- Lower DTI (debt-to-income) ratios
- Greater asset reserve requirements

While some subprime lending was intended to help lower-income families become home owners, the programs were also used by investors and speculators attempting to increase their profit margins. Higher profits also usually attract less-solvent investors hoping to make a big score, and the recent cooling of the real-estate market has weeded out many of these people who were on shaky ground in the first place. Regardless, responsible borrowers can still find willing lenders – and some properties may begin falling to "bargain-level" prices.

NOTE: That's how real wealth gets transferred – wealthy people pick things up at discounts, like real estate. But you have to have the capital to take advantage of the opportunity. (See "Is Saving for Suckers?" and "The Cost of Not Having Enough Working Capital" earlier in this issue.)

COMPARE AND CONTRAST: WHO'S PAYING, WHO'S GETTING PAID

On April 16, 2007, the day before U.S. citizens were required to file their 2006 income tax returns, two articles highlighted different aspects of the nature of taxation in the United States.

WHO PAYS

First, writing on the Opinion page of the *Wall Street Journal*, ex-White House press secretary Ari Fleischer cited the following statistics for 2004, supplied from a study by the Congressional Budget Office (CBO):

- **40% of the country's households pay no income tax at all.**
- **Among the remaining 60%, the top 40% (those whose annual adjusted gross income was \$43,200 or higher) pay 99% of all personal income tax.**

Breaking it down further:

- **The top 10% (those with an AGI over \$87,300) pay 71% of all taxes.**
- **Finally, the top 1%, which earns slightly less than 17% of the nation's income, pays 37% of its taxes.**

Recent tax rate cuts and expansion of earned income tax credits mean "America has created this situation in which fewer people are more responsible for paying more and more of the income tax." The percentage of the tax burden placed on those with higher incomes has progressively increased. In 1979, the first year the CBO kept track of this information, the top 1-percenters paid 18% of the country's income tax. 25 years later, that percentage had more than doubled.

WHO GETS PAID

On the flip side, an article in the *Christian Science Monitor* the same day reported that "slightly over half of all Americans – 52.6% – now receive significant income from government programs." Using data from an analysis by Gary Schilling, an economist from Springfield, NJ, this figure represents the highest percentage since 1980, when the figure was 55%.

Schilling's analysis found that about 1 in 5 Americans hold "a government job or a job reliant on Federal spending." A similar number are Social Security or other government pension recipients. Other large categories are those on food stamps, receiving subsidized housing, and eligible for education grants. In Schilling's study, dependents were counted as well as the "direct recipients of government income" assistance.

Given current demographic and spending trends, Schilling predicts the number of "government beneficiaries" will increase to 60% by 2040.

WHAT IT MEANS

Both Fleischer and Schilling acknowledge the ambivalence in the statistics. In some cases, those paying taxes are also government beneficiaries. Nobody wants higher taxes applied to them, but most are reluctant to relinquish the benefits they receive as well.

But the **impact of governmental financial decisions (both taxing and distributing) is so broad that any changes will have a wide ripple effect, touching almost everyone.** One way or another, Uncle Sam has become a silent, yet influential partner in almost everyone's financial lives.

An enduring financial principle says prospective investors should never base their decision to participate in an opportunity purely on tax issues. While that is still true, the current integration of government into all aspects of financial life is such that no financial decision can be made without considering the tax implications.

As you assemble a team of financial professionals to help you achieve your objectives, you must make sure you have included someone with expertise in governmental programs & taxation.



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