

CREATIVE

Wealth Maximization Strategies

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*“Everything has been thought of before,
the problem is to think of it again.” – Goethe*

Financial Philosophy

PUTTING YOURSELF ON PARETO'S GOOD SIDE

Why Should You Read This Article?

By the time this newsletter reaches you, it will be the middle of January. And if you're like most people, you will already be behind. Between catching up at work, paying for excessive holiday spending, and trying to keep even one New Year's resolution, you've already shifted into warp speed just trying to stay even with the challenges of everyday life. So when this publication arrives in your mailbox (or electronic in-basket) your first question is...

“Why should I take time to read it?”

Our answer: Because you want to stay on the good side of Vilfredo Pareto.

“Huh? Who is Vilfredo Pareto? And why should I be scared of this guy?”



You shouldn't be scared, but it's still prudent to stay on his good side. Vilfredo Pareto was an Italian economist whose life spanned the end of the 19th

In 1867 *Vilfredo Pareto* earned a degree in mathematical sciences, and in 1870 a doctorate in engineering. In 1906 he made the famous observation that 20% of the population owned 80% of the property in Italy, later generalized by Joseph M. Juran and others into the so-called Pareto Principle (also termed the 80-20 rule. Source: Wikipedia)

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and beginning of the 20th centuries. Pareto pioneered the use of statistics to explain the economic and sociological actions and reactions of financial decisions. He is most famous for developing Pareto's Principle, which states that, for many phenomena, 80 percent of the consequences stem from 20 percent of the causes.

“Oh. So he's the guy that thought up the 80-20 rule.”

Precisely.

“So whaddya mean I should stay on Pareto's good side?”

Pareto's economic theories, even though they were put forward over 100 years ago, seem to have on-going validity. In a December 6, 2006 article, the Associated Press cited a report from the Helsinki-based World Institute of Developmental Economic Research that showed the richest 10% of adults owned 85% of the world's assets. That's not quite 80-20, but it's close. Even more extreme, the report added that in the year 2000, the richest 1% of adults – most of whom live in the United States or Europe – owned 40% of global assets. By contrast, the bottom 50% of the world's adult population owned barely 1% of the world's wealth.

Financially, being part of the 20% that owns 80% is better than the other way around. It's the same with other economic applications of Pareto's law. 80% of the productivity comes from 20% of the employees. 80% of the sales come from 20% of the customers. If you were → an employee, you would probably want to be one of



the company's 20-percenters, right? And as a customer, which group is most important, the 20% that comprises 80% of its business or the other way around?

In most circumstances, the 20% group is the one with the advantage, especially when it comes to money. That's what we mean by staying on Pareto's good side.

“And how does reading this newsletter help me stay on Pareto's good side?”

If the Pareto Principle is true (and we'll assume that it is at least a little bit true), people are forced to consider the ramifications of its validity. Those in the financial business – investment firms, insurance companies, banks, and the like – are inevitably drawn to focusing on either those in the 80% or those in the 20%. And from our perspective, this is where things get interesting.

For those focused on the 20%, the purpose of any analysis, commentary, strategy or financial vehicle is simple: “How do I get to be part of the 20%? And if I'm already part of the 20%, how do I stay that way?”

For those in the financial arena whose business is focused on the 80% (after all, it's a much larger market), the goal isn't necessarily on having the 80% act like the 20%. Instead, quite often the underlying attitude is “the 80% isn't like the 20%, and probably never will be. Consequently, the 80% needs different analysis, commentary, strategy and investment vehicles.”

This is a broad generalization, but from our perspective, much of the information presented through mass media outlets is geared toward helping the 80-percenters to improve the financial conditions of their 80% world. There's an 80% way to save, an 80% way to insure, and 80% way to buy a house, and an 80% way to retire.

While many of the financial issues may be the same, the 80% and 20% philosophies aren't compatible. As David Gunn says, “80 percent of the rules of thumb apply only 20 percent of the time.” Our conclusion:

If you want to become (or stay) a 20-percenter, knowing how to be a better 80-percenter isn't going to help you.

This newsletter's purpose is to provide its readers with “20% information.” Not surprisingly, it means some of the analyses, commentaries, strategies and financial vehicles might be a little outside the 80% box. That's why when the Associated Press leads off its financial New Year's Resolutions article with “maximize your 401(k),” we say “There might be a better alternative.” When Internet insurers tout the lowest term life insurance premiums, we may make an argument for obtaining “expensive” whole life coverage instead. When bookstores promote the strategy of making bi-weekly mortgage payments as “The Banker's Secret” we give you reasons to keep the 30-year mortgage – and still pay it off early. That's why...

“I get the picture. If I want to be a 20-percenter, I should pay attention to information that comes from a 20% perspective. But ya know, I've heard this before.”

We know. But you need to hear it often, because being in the 20% group isn't “natural.” In many ways, it's abnormal. Think of the statistics from the Helsinki report cited earlier. Nine out of every ten adults are sharing 15% of the pie, while one holds the other 85%. The “normal” thing is to be in the 80 (or 90) percent.

But while the financial behaviors of the 80% may be the norm, it doesn't mean one's financial position is a matter of genetic destiny. Acknowledging some people may have certain material advantages that make it easier for them to be part of the 20% group, our opinion is that attitudes and actions are the greatest determinants of financial success. And ideas are the keys to shaping attitudes and determining actions. Hopefully, we are a resource for 20% ideas, attitudes and actions.

One of the “action” aspects of this newsletter is continually saying the same things in different ways each month. That's because repetition and reinforcement are the catalysts that allow people to move from merely understanding concepts to applying them. The first time you encounter a 20% idea it may make sense, but your understanding isn't great enough to really make you change. Over time though, the repeated exposure has an effect. Slowly or all of a sudden, you say “I've got it!”

That's why you should give this newsletter five or ten minutes of your time. Even if the information isn't new, it's something to remind you to keep taking steps to stay on the good side of Pareto.

“We are what we repeatedly do. Excellence, therefore is not an act, but a habit.” - Aristotle

“One definition of an economist is somebody who sees something happen in practice and wonders if it will happen in theory.” - Ronald Reagan

Risk Management

Preventive Medicine: The Corrosive Financial Cost of Poor Health

What's the biggest threat to your retirement? Is it inflation? A stock market crash? Taxes?

No.

It's probably your health. →



More than any other issue, poor physical health (and the medical costs that come with it), can wreak financial havoc in your life. Inflation and taxes are “creeping threats” that may gradually erode your purchasing power, but not obliterate your wealth. A stock market crash could be devastating, but it is possible to avoid or minimize the impact by diversifying or staying out of the market altogether. In



contrast, the financial effects of poor health can be sudden, on-going and overwhelming. And while you may physically recover from a major health incident, your finances almost certainly will not.

Poor health and old age have a long historical connection; as we get older our physical condition declines. But only recently have these two factors combined to make a significant financial impact. A hundred years ago, when someone’s health failed, they often died shortly thereafter. Because the timeline from the onset of illness or infirmity to death was so short, and because the medical procedures to deal with these conditions were rudimentary or non-existent, there wasn’t much cost.

Due to increased standards of living and advances in medical knowledge and treatment, health conditions which were once fatal can be treated. As a result life expectancy has increased. But so have the costs. And individuals are assuming a greater percentage of these health-care costs as employers cut back or eliminate health insurance benefits for retirees. How to provide for these health costs has become a major retirement issue.

In many ways, poor health has a financial impact similar to rust or other corrosive agents on a water conduit. For a long time, the functional capacity of pipe may not be impaired, but once a rupture occurs, there’s no chance of restoring the pipe – it is broken beyond repair. Likewise, you may be able to get away with being physically negligent during your working years, but over time the strain catches up with you. And when it does, there may not be a remedy. And either way, the financial cost of attending to the problem is usually pretty steep.

What is the cost of health care in retirement? Robert Powell, in a March 14, 2006 *MarketWatch* column says:

“A 65-year-old couple retiring today will need on average a tidy \$200,000 set aside to pay for medical costs in retirement, according to an annual Fidelity Investment study released this week.”

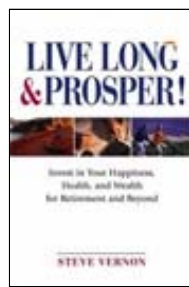
Powell elaborates on the Fidelity report, noting that Medicare B and D premiums accounted for \$64,000 of the estimated costs, while cost-sharing co-pays (\$72,000) and

out-of-pocket costs (\$64,000), comprised the rest. The \$200,000 amount also didn’t include expenses from over-the-counter medicines, dental care and long-term care, and was based on an assumed life expectancy of 85.

Even if you have a million dollars socked away for retirement, \$200,000 is a big chunk of change. And that amount assumes you stay reasonably healthy. Add nursing home or other long-term care expenses to the list, and the total health-care cost in retirement could be staggering. To make matters worse, expenses have been increasing at a rate of 5.8% since Fidelity started conducting the annual survey in 2002. At that rate of annual increase, 55-year-old couples are facing a \$350,000 obligation for health care costs if they retire in 10 years – more if their life expectancy has increased as well.

How to pay for it?

The obvious response to the daunting challenge of health-care costs in retirement? You’ll just have to save more money. And expect to spend more of it for things like long-term care insurance, instead of a trip to Europe. But there may be another option.



Steve Vernon, the author of *Live Long and Prosper*, told Powell that he believes the best way to pay for medical costs is to maintain or adopt a healthy lifestyle now. “A lifetime of bad habits will result in higher medical costs,” says Vernon.

The idea that taking care of yourself can decrease your medical expenses is logical, but not necessarily profound. But the “wow” moment is this: Vernon estimates that pre-retirees and retirees “can reduce the odds of having high medical costs in retirement, and especially those associated with long-term care, such as nursing homes, by 75% simply by eating right, exercising and reducing stress.”

75 percent? That means a \$200,000 obligation drops to \$50,000. Wow. That’s a big deal!

So, if you want more money in retirement for enjoyable things like golf and trips to visit the grandkids, you might want to buy a treadmill, skip the super-sized fast food meals, and sign up for yoga classes. Not only will you look and feel better, but in an indirect way, you’ll be saving for retirement.

A disclaimer: Obviously, there are no guarantees that getting healthier today will result in overall savings tomorrow. Further, just because you decide to embrace a healthier lifestyle, doesn’t mean you can ignore the financial decisions related to the health care issues of retirement. But understand there is a strong connection between the health decisions you make today and the financial consequences that may be incurred tomorrow. “Most of the diseases and illnesses associated with long-term care are due to lifestyle decisions,” says Vernon. →



It's been said that most people have a stronger motivation to protect what they already have as opposed to obtaining more. In that context, committing to a healthier lifestyle today could be considered a form of "nest egg protection." Thus, maintaining good health means being able to do more in retirement – from both a physical and financial perspective.

Details

The True Cost of Home Ownership

Even during the past decade, when low mortgage rates, flexible lending terms and skyrocketing housing values led to a boom in home ownership, some financial observers remained skeptical about the financial desirability of owning a home. And with the prospect of rising interest rates and flat or declining real estate values, more people are wondering: *Does it really pay to own your home?*

Items for consideration

From a financial perspective, owning a home is a multi-layered transaction. This is because the purchase of a home (i.e., a personal residence), is not simply a calculation of the purchase price. The owning of a residence usually results in additional ongoing "carrying charges" such as interest, insurance, property taxes and maintenance expenses. All of these costs, while not part of the purchase price for a home, are incurred as a result of the purchase and should be considered in evaluating the profit (or loss) realized from the decision to buy a home. The evaluation that follows is an attempt to include these factors in the financial analysis.

Financially speaking, owning a home is a multi-layered transaction. The purchase of a home is not simply a calculation of the purchase price.

A financial concept that plays a prominent role in the evaluation of the economic value of a particular financial decision is "opportunity cost". Opportunity cost is a way to determine what the money used for one asset could have been worth if invested somewhere else. In theory, an opportunity cost calculation is one way to determine if your proposed decision, given other alternatives, is really the most profitable one. Application of opportunity cost calculations can be used to better assess the true value of owning a home.

Arriving at an "average" scenario

For purposes of this discussion, we have tried to construct a hypothetical "average" home ownership scenario. The real estate values, insurance costs and taxes in your region may vary significantly from this example,

but hopefully our example can provide a template for making your own in-depth evaluation. Here's the scenario:

- Assume that a home was purchased for \$300,000 in 2004. (According to a Federal Reserve Board report by Morris A. Davis and Michael G. Palumbo in May 2006, the national average home value in 2004 was \$307,000, with prices highest on the East and West Coasts, and lowest in the Southwest.)
- We will assume the buyers are "moving up" and using the equity from their previous residence as a 20% down payment. Thus, the mortgage will be for \$240,000. Possessors of a good credit score, our hypothetical buyers obtain a fixed 30-year mortgage at 6% interest. This results in a monthly principal and interest payment of \$1,439.
- When you buy a home, you also assume the obligation of paying taxes on property. Calculating an average property tax is tricky, because there is no uniformity in how states assess and tax real estate. (The Affordable Housing Institute (AFI) notes that property tax rates vary so much that homeowners in New Jersey are assessed six times as much as those in Alabama.) However, AFI's David Smith, in a Jan. 31, 2006 weblog (affordablehousinginstitute.org), calculates property tax as a percentage of annual income, with the U.S. average being 3.1%. Investopedia (investopedia.com) says "Generally speaking, most prospective homeowners can afford to mortgage a property that costs between 2 and 2.5 times their gross income." Thus, we'll assume our buyers have an annual income of \$150,000. This results in an average property tax bill of \$4,650/yr., or \$387.50/mo.
- Insurance costs can vary even more than property taxes, especially in areas like Texas and Louisiana that have been ravaged by hurricanes in the past few years. A March 31, 2006 article from *Forbes*, published on-line at *MSN Money* (moneycentral.msn.com), uses data from the National Association of Insurance Commissioners (data source: 2003) to determine a national average cost for homeowner's insurance as approximately 1% of the value of the home. In our example, that's \$3,000, or \$250/mo.
- Maintenance costs will also fluctuate greatly, depending on things like the size of the property, age of the home, etc. But Carlos Tejada, in a January 16, 2006 *Wall Street Journal* article, says it is reasonable to expect annual maintenance costs will be between 1% and 1.5% of the home's value. Choosing the lower number, that means another \$3,000 a year, another \$250/mo. →



Let's summarize the monthly costs of our hypothetical home ownership:

Mortgage	\$1,439.00
Property Taxes	387.50
Insurance	250.00
Maintenance	<u>250.00</u>
TOTAL	\$2,326.50/mo.

What do you get for \$2,326.50 each month? Well, obviously, you get a place to live, and all the psychological benefit that comes with having control of your own living space. Each mortgage payment adds to your equity. Over time, there's the expectation that market value of the property will increase as well. And the interest is tax-deductible. But is this really a profitable arrangement? Here's one way to calculate the gain/loss:

(Note: The calculations that follow contain more assumptions. While our assumptions may be "reasonable," they are not necessarily historical. Using "real numbers" specific to your situation, or other assumptions will obviously affect your results.)

Although property values have declined in some parts of the United States over the past few years, let's assume this particular housing market experiences a steady annual growth of 3% for the next five years. Thus, the \$300,000 house purchased in 2004 will be worth \$348,500 in 2009.

In addition, by 2009, the 60 monthly payments have reduced the mortgage balance to \$223,300. Over five years, the homeowner's equity has increased by \$65,200, from \$60,000 to \$125,200. At first glance, this might seem to be a profitable decision; double the equity – and a place to live too! But wait, there's more!

Over five years, this homeowner pays \$69,655 of interest. But if the homeowner isn't subject to the Alternative Minimum Tax, this interest may be tax-deductible. For simplicity, assume this deduction results in a 30% reduction in mortgage interest cost. In real life, this saving doesn't show up until the homeowner completes his annual tax return, and pays less in income taxes. But to accurately account for the value of the deduction, we'll assume this homeowner makes a deposit each month into a separate account in an amount equal to tax savings. Assume a conservative after-tax annual rate of return of 5.5% on deposits made to this account. To illustrate:

In the first monthly mortgage payment of \$1,439, \$1,200 is interest and \$239 is repayment of principal. 30% of \$1,200 is \$360 – the tax savings on the deductible interest. Deposited in a separate account at 5.5% annual interest/earnings, the balance would be \$361.65 after one month. In the second month, the interest portion of the payment is \$1,198.81, so \$359.64 would be added to the separate account. By the start of the third month, the

account balance would be \$724.60. And so on for the next 60 months.

After 60 months, the total accumulation value of this mortgage-interest-tax-savings account would be \$24,142. Add this to the \$65,200 increase in home equity, and the five year increase in financial assets from buying the home is approximately \$89,400.

But what about the costs?

It's more than likely that property taxes, insurance premiums and maintenance costs would increase over five years, but for simplicity, let's keep these costs stable. Thus, the following 5 year totals:

Property taxes	\$23,250
Insurance	15,000
Maintenance	<u>15,000</u>
TOTAL	\$53,250

Note that these incidental costs do not add value to the homeowner's property – if not incurred as a result of purchasing the home, this is money that could have been used elsewhere. If the monthly carrying costs of \$887.50 (for taxes, insurance and maintenance) is allocated to a separate account (at the same 5.5% annual rate of return as the mortgage interest tax savings), the calculated opportunity cost over five years is \$61,400. So...

In this hypothetical example, the homeowner realizes a net profit over five years of approximately \$28,000 in buying the house (\$89,400 in gain minus \$61,400 in costs). On a monthly investment of \$2,326.50 each month for 60 months (\$139,590 total), this equates to an annual rate of return of approximately 6.5%. Not bad, eh?

On the other hand...



What if you rent instead?

Suppose our prospective homeowners decided not to buy a new house in 2004, but instead put their \$60,000 of equity in some other investment and satisfied their housing needs by renting. Let's assume their monthly rent was equal to the house payment (\$1,439/mo.) And also assume that the additional \$887.50 that would have been allocated to property taxes, insurance and maintenance is also invested. This is another opportunity cost evaluation – determining the value of using the money differently (while still meeting the need for housing).

Because of annual contribution limits, the \$60,000 lump-sum could not be placed in a tax-favored account, such as a 401(k) or IRA. This means income taxes may decrease the overall rate of return. For purposes of this example, let's assume an after-tax net annual return of 6%. (Because the larger amount would permit greater investment opportunities, possible reductions in fees, and be held for a longer period of time, this after-tax rate of return is assumed to be slightly higher than the monthly →



deposits made into the tax savings account mentioned earlier.) In five years, this lump-sum deposit would have grown to \$80,300.

For the \$887.50 of “cost savings” deposited each month into an accumulation account, assume a 5.5% return, compounded monthly as before. Over 60 months, the total accumulation is \$61,400. Added to the \$80,300, the total accumulation from choosing to rent instead of buy is \$140,700, an increase in assets of \$80,700. →

Conclusions

In our hypothetical scenario, the decision to own (or not own) a home isn't a clear-cut slam dunk – even after the numbers are crunched. The results of these calculations are largely dependent on the variables and assumptions. Change the tax rate, annual rate of return, or appreciation of home values, and the results could be significantly different – both positive and negative. (By the way: the variables for this example were chosen prior to any calculation based on what were considered “reasonable assumptions” of tax rates, rates of return, etc. The fact that the comparison between buying and renting came out so close was not intended – although it is easy to see how a little “tweaking” of the variables could easily skew the evaluation.)

Either by buying or by renting, our hypothetical example started with \$60,000 of equity and allocated \$2,326.50/mo. for five years to address housing needs and/or accumulate assets. As a homeowner, the decision to purchase the \$300,000 home resulted in total home equity of \$125,200 plus an additional \$24,142 in tax savings, for a total of \$149,342.

As renters (with no incidental expenses and no tax breaks), the total accumulation after five years is \$140,700. While the accumulation is 6% less, the entire amount is liquid. If the homeowner needed to liquidate, it is possible that realtor fees and other transaction costs could affect the net amount received (example: if the house sold for \$350,000, a 7% realtor's fee would be \$24,500).

Two factors give home ownership a boost as a viable financial strategy. One is leverage, the other is the tax deductibility of mortgage interest. In our example a \$60,000 down payment secures a \$300,000 asset. Even if the rate of growth in value for real estate is less than other financial alternatives, the growth is applied to a larger asset – i.e., a 3% annual growth rate on a \$300,000 home (\$9,000) is more than twice the 6% rate of return on \$60,000 deposited in some accumulation account, which would equal \$3,600.

On the flip side, the lack of liquidity and potential market risk inherent in real estate holdings could make renting a more appropriate financial decision. And realistically, most homeowners don't bank the tax savings from the deductible interest. So while the tax benefit is real, it usually won't show up as a tangible asset.

Also, the focus of this discussion has been primarily financial. Homeownership delivers psychological benefits and anxieties (“*Is that the plumbing acting up?*”), which impact your quality of life, but can't necessarily be quantified in mathematical terms. But from a financial perspective, this exercise should give you a feeling for the incidental factors that might make renting or buying the more desirable option.

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