CREATIVE
Wealth Maximization Strategies

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The Paradox of Thrift

Is Individual Saving Bad for the Economy?

Over the past decade, in the midst of several recent financial "crises" (such as the dot-com stock market bubble, rising fuel prices, increased entitlement costs for the Baby Boomers, and the sub-prime mortgage debacle), economic experts have always checked the pulse of the American consumer to see if these "problems" were really cause for concern.

The consensus conclusion: As long as Americans keep spending, everything will eventually be okay. It doesn't matter if the personal savings rate goes negative. It doesn't matter if they have to borrow more – on their credit cards, against their homes, etc. As long Americans keep spending, the economy will keep lurching along, surviving in spite of Wall Street missteps, higher taxes and foreclosures.

Of course, at some point, some American spenders come to grips with the long-term consequences of too much spending and too little saving. They see the increase in their monthly debt service, and the lack of growth in their nest eggs or retirement accounts, and say,

"If I keep doing this, it's going to ruin me. It's time to tighten my belt, time to stop spending so much and to start saving a little more."

Indeed, this may be the moment of reckoning for many Americans. As a January 12/13, 2008 edition of the *Wall Street Journal* reports, there are "fresh signs that consumer spending is slowing." The article notes that retailers, auto makers, and even high-end jewelers like Tiffany's have all registered declining sales. Falling house prices, higher fuel costs, and increased credit card balances add up to one conclusion: "…some consumers need to cut back."

At this moment, a group of very well-educated financial experts rush in screaming,

"No, no, you fools! Now is not the time to save! If too many people start saving, our financial problems will actually get worse!"

Huh?

The Paradox of Thrift

John Maynard Keynes (1883-1946) was a 20th-century British economist whose thoughts on finances have had a major impact on modern economic and political theory, as well as the financial policies of governments. Among his noteworthy ideas, Keynes was one of the first economists to make a significant distinction between the economics of large groups (such as nations) and the economics of individuals. This distinction is often described as macroeconomics versus microeconomics.

John Maynard Keynes, was a British economist whose ideas, called Keynesian economics, had a major impact on modern economic and political theory as well as on many governments' fiscal policies. He advocated interventionist government policy, by which the government would use fiscal and monetary measures to mitigate the adverse effects of economic recessions, depressions and booms. He is one of the fathers of modern theoretical macroeconomics.

In Keynes' estimation, what's good for the individual is not always good for the larger group. One of the areas where this conflict of interest occurred was in the matter of saving. In a nutshell, this was Keynes' perspective:

If people decide to save more money, they won't spend as much.

If they don't spend as much, then sales will decline.

If sales decline, then production will drop.

If production drops, employers will lay off workers.

If workers are laid off, they have no money.

Thus, according to Keynes model, "a decrease in spending leads to a decrease in employment, which leads to a further decrease in spending, which leads to a further decrease in employment, which leads to a further decrease in spending, and so on." (*The Paradox of Thrift: RIP* by Clifford F. Thies, Cato Journal, vol. 16, no. 1.) Unless central banks or governments intervene, this downward economic spiral could lead to financial recessions, depressions and panics. *All because too many people started saving too much money.*

Keynes felt that in order for an economy to be healthy on a macro level, saving had to be balanced by spending. To maintain this macroeconomic state of equilibrium, Keynes concluded that governments and financial

institutions had to intervene by controlling the money supply, changing interest rates, etc. So…

Should you stop saving so much and start spending more?

If Keynes' theories are right, there are still good reasons to save – and save more. If Keynes' theories are wrong (and there are strong arguments in academic circles that they are), there are even better reasons to save.

The Farmer with the good crop in a bad year

Even if the Paradox of Thrift is true, some individuals are still saving. And in ways great and small, savers have distinct economic advantages over those who aren't saving. Over a lifetime, savers may actually be able to spend *more* because they can buy things without paying as much interest. Savers are better equipped to weather economic downturns. Savers have the opportunity to retire earlier, and live on more than a government pension.

Given the choice between saving and spending, spending is the path of least resistance, especially when financial institutions make it easy to borrow. Saving requires self-discipline, which means there will always be fewer people saving than spending. But being part of the saving minority is better. As Rob McTeer mentioned in a July 17, 2007 *Wall Street Journal* opinion piece, the best situation for a farmer would be to have "a good crop in a bad year. Then he could look for a popular restaurant that isn't crowded." Savers are farmers that have good crops in bad years.

> Savers have distinct economic advantages over those who aren't saving.

Saving is really "good spending"

For Keynes, money that was saved had disappeared from circulation, as if it were stuffed in a mattress or buried in the back yard. But most savers don't keep their savings under their pillow or in a coffee can. Rather, their savings are deposited in banks or invested in other financial vehicles to generate additional earnings. And in a way, these savings are "spent" by the institutions and businesses that receive the deposits.

Banks use their depositors' monies to make loans. The loans allow businesses and individuals to spend, either to create more value or consume more stuff. (Issuers of stocks and bonds do the same thing with the capital they receive from investors.) When more people save, there's more money to lend, and usually when there's more of something, the price goes down – even the price of borrowing. All other factors being equal, more saving might lead to more and cheaper spending.

Saving is the catalyst for innovation and value creation. Without the financial assistance from savers and investors, new technologies remain "neat ideas." Instead, everyone can enjoy high-speed Internet on their cell phone. This is what some academics call a "classical" perspective on economics, and might also be considered a parallel Paradox of Thrift: The greater the savings, the greater the growth of the economy, and the easier it is for everyone to afford more.

A Reality Check

Killing Sacred Cows is a book by Garrett Gunderson about commonly-held but destructive financial misconceptions. When evaluating a financial "myth," one of the tests Gunderson uses to determine its veracity is whether or not the principle can be applied to any other aspect of life besides finance. In regard to Keynes' Paradox of Thrift, are there other areas of life where society as a whole would be damaged by too much individual self-discipline?

For example, if too many people exercised and maintained a healthy lifestyle, would it be bad for the nation, or would the country be better off with a "balance" of healthy and unhealthy people?

What if too many people obeyed the speed limit? Using Keynes' logic, fewer high-speed accidents would perhaps mean less business for auto body shops, and fewer emergency room employees. If so, could this imbalance lead to a downward spiral toward extinction for auto body repair shops and diminished emergency room care?

In most areas of life, we favor self-disciplined behavior. We value self-control, both in individuals and in society. Granted, when taken to extremes it's possible for self-disciplined behavior to be unhealthy (think anorexia). But with a national savings rate that hovers near zero, does anyone think Americans are at risk of saving too much?

Henry David Thoreau (1817-1862) famously noted that "the mass of men live lives of quiet desperation." He could have been talking about the American consumer and his/her financial standing. Living paycheck to paycheck, perhaps keeping up with payments, but debt always rising. On the outside, everything is serene, but there's an uneasiness lurking below the surface, knowing that one bad break could topple their financial house of (credit) cards.

No matter whose financial perspective is accurate, you still want to be a saver. And now more than ever. Individual saving is good for your individual economy.

Are you maximizing your saving opportunities? Have you had your team of financial professionals review your debt and spending habits? Economic hard times for the masses can be times of great opportunity for those who are prepared. Make sure you are the farmer with the good crop in a bad year.

THE SAVINGS INDICATOR

If you've read the articles in this month's newsletter, you probably understand there's a fundamental tension between two basic financial decisions: saving and spending.

While you can't simply save your way to wealth (the money has to be multiplied through sound financial strategies), you certainly can't spend your way to prosperity – even if you borrow. Saving is a foundational habit and a "quantum-leap" activity that lays the groundwork for wealth opportunities.

John McCormack is a businessman who made a fortune by building a chain of hair salons. One of his success strategies was to "force" his franchise managers to save money as part of the terms of their employment. In his book, *"Self-made in America"*, McCormack details his reasons for compelling them to save.

"I believe that the extent to which we save and handle our money can be looked upon as the indicator of how serious we are – or are not – about our lives. It says a lot about our optimism and how we as a people view the future.

In fact, a society that doesn't save is basically a society that doesn't believe it has any future – so why not get it all now? Live for the day, eat, drink and be merry so to speak, for tomorrow we shall die.

That would be fine if we all died tomorrow, but the fact is that most of us don't. We have to wake up with the results of our bacchanalian appetites: overweight, hung over, anything but merry, and deeply in debt.

Untold millions of Americans who appear outwardly prosperous and happy, are, in fact, technically bankrupt (they cannot afford to pay the interest payments on their debt) and, consequently, inwardly miserable.

But when you put aside a portion of your income on a regular basis, two things mysteriously happen.

First, you don't miss the money you're saving. Somehow you manage to get along just as well, continue to pay your bills on time, and feel better about yourself because you are building up a "rainy-day" fund that gives you an increased sense of security.

Second, people with money in reserve seem to attract more money from outside sources. It's the "rich get richer" syndrome, and it's true. While this appears mysterious, I believe the phenomenon takes place simply because people with security, i.e., money in savings, are more confident and have a healthier mind-set than those who are living on the edge, and that naturally attracts other people, such as investors and deal-doers, to them. In any event the benefits and rewards of regular savings far outweigh the sum total of dollars that accumulate in the bank."

Is saving in your future?

"Money is an exact index to a man's true character."
- Richard Halverson

OUTSIDE-THE-BOX DESPERATION MOVES

There's no doubt that many segments of America are experiencing the ripple effects from a slumping economy. For some, the financial consequences are uncomfortable – less disposable income, no overseas travel, smaller birthday parties. For others, the challenges are much greater, like how to keep the house or avoid bankruptcy. Here's a quick look at some responses to these financial pressures.

Item #1: Using a Reverse Mortgage to Stop Foreclosure

Reverse mortgages are touted as a way for elderly retirees to create additional income by borrowing against the equity in their homes without having to take on another payment. Instead, the amount borrowed by the homeowner is due only when the home is sold, or the borrower dies. Since the terms of a reverse mortgage are based in part on the age of the borrower (the older the borrower, the more favorable the deal), a reverse mortgage can be a profitable strategy for supplementing one's retirement lifestyle.

But a December 26, 2007 *Wall Street Journal* article turned up another use for reverse mortgages: Staving off foreclosures for senior citizens, especially those whipsawed by declining or fixed incomes and rising payments from adjustable rate mortgages. The strategy, used by an increasing number of legal-aid advocates, isn't suitable for everyone. But in the right circumstances, it can be a financial life-saver.

A typical scenario: A senior couple with significant home equity needs cash. Attracted to the favorable terms of an adjustable-rate mortgage (low initial interest rate, minimum payment options), they take on a new mortgage, one they can theoretically afford. Over the next few years, interest rates increase and so do monthly payments. Perhaps because of health issues, increased living costs, or decreased income, the seniors find themselves unable to meet the mortgage obligation, and facing foreclosure.

Even though they cannot meet their monthly mortgage obligation, the couple still has substantial equity in their home. With the assistance of a reverse-mortgage expert, the couple uses the remaining equity to negotiate a settlement on the existing mortgage. While they receive no cash out from this arrangement, the settlement eliminates the monthly mortgage payment, and keeps them in their home.

Item #2: Senior work-off program to pay property taxes

Rising property taxes and a fixed income are a combination that can challenge many senior citizen home-owners. Consider Audrey Davison of Greenburgh, New York.

As reported in a December 25, 2007 *Associated Press* story, Ms. Davison is a 76-year-old retired homeowner living alone on the $620 she receives each month in Social Security. A resident of Greenburgh for the past 43 years, Ms. Davison faces an annual financial challenge: paying her property taxes, which are currently $12,000 a year. (Greenburgh's homeowner property taxes are the third-highest in the nation.)

Davison has already taken out a reverse mortgage (see above article) to pay some bills, but must confront reality: Unable to afford the property taxes, she may be forced to sell her home. Unless she goes to work for the town – at $7.00/hr.

Modeled after similar programs already in place in Colorado, Massachusetts, South Carolina and elsewhere, Greenburgh is considering a "tax work-off" program for seniors to help them pay their property tax bills. In this particular circumstance, Town Supervisor Paul Feiner is proposing that Greenburgh seniors could serve as part-time receptionists, or perhaps help with landscaping around city property. "It's not like we're going to see grandma driving the snowplow," says Feiner. Because his proposal would have wages earned tax-free and credited directly to the property tax bill, approval of the New York state legislature is required, but Feiner hopes to have a pilot program in place by next year. "People shouldn't have to sell their house, move away to a place with less taxes, leave behind their family and friends," says Feiner.

A quick calculation: For Ms. Davison to work off the entire $12,000 at $7.00/hr., she would have to work over 1,700 hours in a year. That's roughly 34 hours a week (assuming the town would give her two weeks off for vacation), which isn't exactly a part-time job for a 76-year-old.

Item #3: Your personal $170,000 mortgage, courtesy the U.S. government

David Walker is the United States Comptroller General. The comptroller's position is often referred to as "the nation's official accountant," and Walker has served in this capacity for the past 15 years. So when he evaluates the government's financial picture, and says the numbersare "all big, and they're all bad," you'd think

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people would listen – especially people in Washington, D.C.

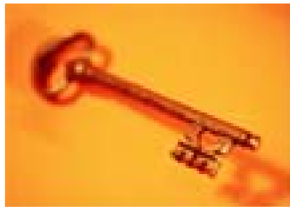
But Walker says he's stopped telling the *politicians* (as he told a CBS News reporter in March 2007, it's the "dirty little secret everyone in Washington knows"), and is trying to speak directly with the American public. He is speaking to civic groups, university forums, and newspaper editorial boards. He's been a headline story for both CBS News and CNN.

To give the issue some perspective, Walker explains the national deficit as the equivalent of a $440,000 mortgage for every American household (except there's no house to back it up, just the future earnings of American taxpayers). Broken down another way, the deficit is equivalent to $170,000 ***per person***.

But beyond the current cost of the country's deficit, the bigger problems are the future obligations of Social Security and Medicare, which Walker characterizes as a "fiscal cancer," because the longer government waits to solve the problem, the more likely it will eventually be unsolvable. Unchanged, these programs "could bankrupt America."

Walker's analysis is accepted by most members of Congress, by the Federal Reserve, by conservative and liberal think-tanks. So why not do something about it?

Senator Kent Conrad of South Dakota, chairman of the Senate Budget Committee, offered CBS News this frank assessment: "Because it's always easier not to. 'Cause it's always easier to defer, to kick the can down the road to avoid making choices. You know, you get in trouble in politics when you make choices."



Some outside-the-box comments:

- The strategy of constantly borrowing to solve financial challenges ultimately exacts a steep cost, because eventually the bill has to be paid. If today's borrowing doesn't result in tomorrow's saving, there's trouble at the end of the line.

- It is also amazing to realize that the productivity of the United States economy can currently afford the costs of its governmental borrowing. It's no wonder some commentators believe the United States government can still climb out of this financial abyss if the economy improves and tax revenues increase.

- Finally, how could anyone read the last three items and not pay greater attention to their own financial situation? It should be pretty clear that no one is going to do your financial program for you. It should also be clear that left unattended, most financial situations get worse, not better.

LARRY KING'S FIRST-PERSON EXPERIENCE WITH SOLI

Here's the opening paragraph from a November 27, 2007 article by Anita Hoslin that appeared in the *Washington Post*:

> ***"The deal the broker discussed with his well-heeled client seemed like a good idea: Buy a $10 million life insurance policy, and if the client wanted to raise some cash, the broker could sell the policy to an investor for a tidy profit.***
>
> ***So the client took advantage of the offer. The broker resold the $10 million policy later that year, yielding a $550,000 windfall for the client. The investors who bought the policy, who remain unidentified, took over payment of the premiums and became the new beneficiaries. The client followed up that transaction by selling a second $5 million policy on his life, earning $850,000. Another unknown investor became the beneficiary."***

An interesting transaction, made all the more interesting because the "well-heeled client" was CNN talk show host Larry King. The details of this situation were brought to light in October, 2007, because King filed a lawsuit claiming he was not adequately apprised of both the tax and future insurability issues that resulted from these transactions. The insurance broker who sold Mr. King the $10 million policy and brokered the sale of the two policies to investors insists that Mr. King understood the transaction, and that his firm "expressly told Larry King's advisors that Larry King was better off keeping the new insurance rather than selling."

The King case is a classic example of an innovative and controversial idea sometimes referred to as stranger-owned life insurance (SOLI): an outside party offers the insured individual an immediate lump-sum payment to become the owner and beneficiary of their life insurance policy.

This type of transaction has legitimate and beneficial uses – the sale of life insurance policies to third parties came into favor in the 1980s as a way for AIDS patients to get cash from their policies before they died – but it also creates some unusual incentives and consequences.

First, as mentioned in the overview of the King lawsuit, the amount of life insurance individuals can obtain is limited by how insurance companies assess one's human life value. It might be a multiple of income, or a measure of assets, but all insurers use some formula to determine the maximum amount of coverage they will offer. **If insurance companies are willing to insure Larry King's life for $20 million, and $15 million of that amount is owned by strangers, that means there's only $5 million that he can own himself and have pass to his designated beneficiaries.**

Second, the unidentified private investors may have an incentive for Mr. King to die sooner rather than later. After all, the sooner Mr. King dies, the sooner they receive the insurance benefit, and the sooner they stop paying premiums. As Joseph Belth, editor of Insurance Forum said in the Post article, "If somebody owns several million dollars of insurance on my life who I don't know…it would make me a little nervous to know someone had an interest in having me dead quick."

Third, the rise of investor-owned life insurance could skew the cost of all life insurance. Actuarial assumptions used to price life insurance include factoring in the reality that the vast majority of life insurance policies will not result in a death claim. According to Doug Head, executive director of the Life Insurance Settlement association, at least 85% of life insurance policies lapse or are dropped without companies ever having made any payout. But if more policies are owned by investors seeking a "return" on their premiums, the increase in benefit payments could force insurance companies to increase their rates.

Consumer advocates, insurance companies, and legislators all agree there is value in this secondary market for life insurance policies. The challenge is making sure the transactions are ethical and legal, as well as clarifying the tax consequences. To that end, several professional associations, state insurance commissions and consumer groups are working to present legislation, regulatory standards and disclosure rules that will help consumers better understand the possible financial value of their life insurance.

Getting past the legal wrangling in this case, there's a really provocative story: According to court information, the sale of these two policies took place in 2004 when King was 70 years old. From those two transactions, he received $1.35 million. Not knowing how much Mr. King spent on premiums, it still seems reasonable to conclude that this was a profitable transaction for Mr. King, especially since one policy was sold almost as soon as it was issued.

But what did Mr. King *do* to earn the $1.35 million? He did no work. He didn't perform a service. All he did was sell his insurability. Talk about creating value out of nothing!

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