

CREATIVE

Wealth Maximization Strategies

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DOES YOUR INCOME HAVE “HIGH BETA”?

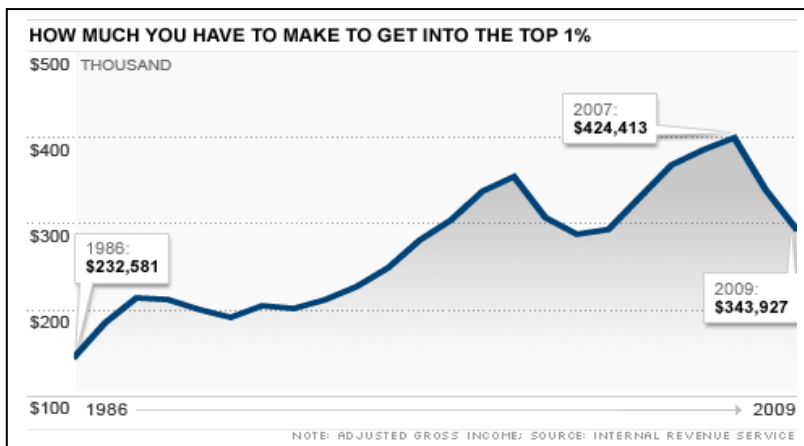
(And if it does, what are you going to do about it?)

Recently, the paradigm for a lot of financial discussions has been making distinctions between the 1 percent of Americans who earn the highest annual incomes and the other 99%. In some conversations, the 1 percent has been characterized as the “millionaires and billionaires,” with examples of huge salaries and additional compensation that are almost beyond comprehension, particularly when compared to the average American’s take-home pay.

While these off-the-charts examples of annual income may seem outlandish and far out of proportion to the value of the products they produce or services they provide, this type of anecdotal information distorts the real picture of the top 1 percent that some call “the rich.”

In a *CNNMoney* column by Tami Luhby published on October 20, 2011 (“Who are the 1 Percent?”), the annual adjusted gross income threshold for qualification in the top 1 percent is not a million dollars. It’s not even \$500,000. According to the most current statistics from the Internal Revenue Service, anyone who earned more than \$343,927 in 2009 was part of the top 1 percent. And while this number represents a significant annual income, the 1 percent threshold has actually declined 19% in the past two years. (see Fig. 1). In fact, you might say the rich are not getting richer.

Fig. 1



If you make a visual comparison between the income graph in Fig. 1 and a graph of the performance of the S & P 500 stock index over the same time period, there are some interesting similarities. (See Fig. 2). And these similarities have led some financial commentators to interesting conclusions, not only about the income of the “1 Percenters,” but everyone else as well.

Fig. 2



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Understanding Beta

Financial analysts use a variety of mathematical metrics to evaluate the performance of individual stocks and indexes. One of these terms of evaluation is “beta,” the measure of a stock’s volatility in relation to a broader benchmark, usually an index. By definition, the benchmark index or market has a beta of 1.0, and individual stocks are ranked according to how much they deviate from the benchmark. A stock that swings more than the market over time has a beta above 1.0. If a stock moves less than the market, the stock's beta is less than 1.0. Thus, if a stock has a beta of 2.0, it means its performance tends to be twice as volatile as the benchmark; if the index goes up 5%, the stock will increase 10%. The same proportional difference will also magnify losses – a 5% drop in an index would predictably result in a 10% loss for the high beta stock. Historically, high beta stocks are riskier but provide a potential for higher returns; low beta stocks pose less risk but also offer lower returns.

High Beta Incomes of the “1-Percenter”

Robert Frank is a senior writer for the *Wall Street Journal* and author of an upcoming book titled “The High Beta Rich.” In an October 22, 2011, *WSJ* article adapted from his book, Frank reports some interesting findings about America’s high-income 1-Percenters:

The American rich, who used to be the most stable slice of the personal economy, are now the most volatile, with escalating booms and busts.

During the past three recessions, the top 1% of earners (those making \$380,000 or more in 2008) experienced the largest income shocks in percentage terms of any income group in the U.S., according to research from economists Jonathan A. Parker and Annette Vissing-Jorgensen at Northwestern University. When the economy grows, their incomes grow up to three times faster than the rest of the country’s. When the economy falls, their incomes fall two or three times as much.

From statistical analysis, Frank says the beta for the top 1 percent of income earners was .72 for the 35-year period from 1947-1982, meaning their incomes moved generally in line with the overall economy, but with slightly less ups and downs. However, in the succeeding 25 years (1982-2007), the beta for these 1 Percenters has “soared more than three-fold, meaning the incomes of today’s rich have higher betas than many of the riskiest gambling stocks.”

Why the sudden change in beta for the 1-Percenters? Frank says research from several sources points to a range of possibilities: technology and globalization (making businesses and industries more sensitive to changes in demand and economic conditions), rising debt levels (having less ability to withstand income changes), increased consumer consumption (resulting in lower saving levels), and greater “financialization,” which means high beta income and wealth is tied to the stock market, either in the form of compensation (such as stock options) or assets (shares of stock). This explains why the graph of the 1-Percenters’ income looks very much like the graph for the stock market.

But whatever the cause, Frank sees the income volatility

of 1 Percenters as having a significant trickle-down effect on everyone else:

As go the high beta rich, so goes America. Their hyper-cycles will become our own, as the consumer economy, financial markets and tax revenues experience more rapid and extreme spikes and crashes.

Is Your Income “High Beta”?

Even if your annual adjusted gross income doesn’t quite reach the 1 percent level, the issues of income beta are relevant. For example, how much has your household’s income increased or decreased in the past few years? Have there been significant income fluctuations due to a job loss, reduced work hours, or diminished bonuses? How has this affected your ability to maintain your lifestyle, or stay on track with your long-term financial objectives, such as retirement, saving for college, buying a vacation property, or leaving a financial legacy?

If your income history is showing the same volatility as a high beta stock, it might also alter your long-term financial priorities. Much of the conventional retirement accumulation model is built on steady, predictable employment, i.e., you can afford regular contributions to a qualified retirement account because you have the expectation that your regular employment will provide enough to meet today’s living expenses. But what if you’re not sure about the source or amount of next year’s income?

This uncertainty might compel you to consider building larger cash reserves, or wonder what you could do if you lost employer-sponsored insurance benefits. And if your future income seems less stable, perhaps it seems prudent to pursue less aggressive investment strategies, because how bad would it be to lose income and accumulation value at the same time?

One of the underlying observations of Frank’s reporting is how much income fluctuation affects other aspects of individual, corporate and governmental finances. When incomes were stable, lenders were more liberal in their approval standards, and consumers felt more confident about buying, even if they had to borrow. Businesses could invest in new facilities and hire more workers, knowing people could afford their products and services. And municipalities could budget for infrastructure improvements and community services, knowing the tax base could support these items. But high beta fluctuations of income cause major disruptions in the ability to systematically plan for your financial future.

If an assessment of your personal income situation finds you with a high beta, now is the perfect time to reassess both your financial strategies and your ability to carry them out. Income uncertainty doesn’t mean you can’t reach your objectives, but it may require you to take a different approach.

IF YOUR INCOME IS “HIGH BETA,” WHY NOT FIND SOME WAYS TO OFFSET THAT VOLATILITY IN OTHER PARTS OF YOUR FINANCIAL LIFE? A CONSULTATION WITH YOUR FINANCIAL PROFESSIONALS COULD UNCOVER EXCELLENT STRATEGIES TO BALANCE YOUR “HIGH BETAS”.



HINDSIGHT SHOWS: Three Days Have Mattered Most *(But which three?)*

Math never lies, but sometimes you wonder what it says. Consider the following statistics, compiled by BTN Research:

Stat #1: - The S&P 500 is down 1.1% (total return) YTD through Friday 10/14/11. If you were out of the market for the **3 worst trading days** of 2011, your **YTD gain** is +16.5%.

Stat #2: - The S&P 500 is down 1.1% (total return) YTD through Friday 10/14/11. If you were out of the market for the **3 best trading days** of 2011, your **YTD loss** falls to 12.7%.

This data is the “80-20 Rule” *on steroids*. Instead of 80% of the results coming from 20% of the activity, the ratio is more like 98.5% to 1.5%. During the time frame mentioned, the stocks that comprise the S&P 500 index have been trading approximately 200 days. As an investor, if you had been prescient enough to determine which three of those days were the worst days to be invested, your portfolio could be significantly fatter right now – and you’d probably have your own TV show on MSNBC.

This stock market analysis appears to simultaneously support two diametrically opposed views of investing: market timing and buy-and-hold. On one hand, the data shows that, over time, a small number of days have an outsized impact on investment results. Having the framework or insight to determine which days are “special” could mean incredible profitability (or the avoidance of large losses). When viewed through the prism of “what could have been,” developing a model for market timing – stepping in and out of the market to maximize profits – seems a worthy pursuit.

On the other hand, this information also points to the difficulty in achieving the potential profits that are hypothetically possible with market timing. If avoiding three bad days would cause a significant increase in profitability, the downside is almost as great from missing the three good days. Since the future is unknown, any decision to get out of the market could be made on the very day when being in the market would be most beneficial. When just three days of staying invested would have cleared away almost 9 months of losses, how bad would it be to miss those three days? The buy-and-hold paradigm proposes that staying invested

ensures you will always hit the good days, and there will be enough of them to overcome the bad ones. Historically, this approach has also been validated by the data. Over long holding periods, say 10 years or more, most stock indexes have shown positive gains that equaled or exceeded many other accumulation options.

But the efficacy of buy-and-hold is being challenged by two factors: the long-term results from the past decade (2001-2011) have not been as good, and increased volatility has made investors more skittish about riding out the bumps. An October 18, 2011, *Wall Street Journal* article by Tom Lauricella and Gregory Zuckerman reported that the Dow Industrial Average stock index rose or fell more than 1% in 14 of the past 19 trading days. These are significant swings, ones that have spooked many investors into stepping out of the market completely. Fewer investors in the stock market lead to fewer trades among shareholders, which also tends to exacerbate the fluctuations.

When the long-term trends aren’t favorable, and the short-term fluctuations are dramatic, many investors have decided they don’t have the stomach for the game – whether they use a timing approach or buy-and-hold. An October 21, 2011, Associated Press article noted that in four of the past five months, investors “scarred by volatility” have liquidated more than \$20 billion from stock mutual funds.

But “playing it safe” may also have an opportunity cost – the potential gains that investors will miss by leaving the market. The AP article notes that the S&P 500 has produced losses in “only four out of 76 different 10-year periods since 1926.”

DO YOU HAVE A CLEARLY DEFINED STRATEGY FOR HANDLING MARKET VOLATILITY?

RETIREMENT INCOME INSURANCE: How to Make the Key Factor More Than Just a Guess

“What’s my number? – That is, how much do I need to retire?”

These are pressing questions for individuals whose major financial objective is saving for retirement. And no matter how complex and sophisticated the process used to answer these questions, every retirement projection has at its core a calculation of Present Value. Interestingly, most of the time, the critical factor in the generation of a Present Value calculation is nothing more than a guess.

Present Value

Present Value (PV) is defined as “the amount of cash today that is equivalent in value to a payment, or to a stream of payments, to be received in the future.” If most people kept their retirement savings in a mattress, calculating Present Value would be easy. For example, if a person wanted to be assured of receiving \$1,000 a month for 35 years (i.e. 420 months), the amount of cash needed today to be present in the mattress would be \$420,000.

But very few individuals will put their money in a mattress; instead they will place the unused principal in a financial vehicle with the intention of earning a return – through interest, dividends, capital gains, etc. – which can be added to the accumulation. And this is where PV becomes a guessing game; how do you choose a rate of return that will reflect the future performance of your savings?

The projected rate of return – the present value factor – is the one component of a PV calculation that impacts everything else. Higher PV factors result in lower PV calculations, and vice versa. Using numbers from BTN Research, here is an example of a Present Value Retirement Calculation, the type that might be part of a moderately sophisticated retirement plan.

Suppose an individual wants to determine the lump sum amount required to fund a 30-year stream of retirement distributions. The annual income will begin at \$100,000, and to maintain purchasing power, the income will increase 2.5% each year to keep pace with the historical rate of inflation. What's the PV number? It depends...

- If the assumed annual rate of return is **5%** for each of these 30 years, the amount needed is **\$2.21 million**.
- If the assumed annual rate of return is **6%** for each of these 30 years, the amount needed is **\$1.96 million**.
- If the assumed annual rate of return is **7%** for each of these 30 years, the amount needed is **\$1.75 million**.

A fair number of financial experts would probably consider present value factors between 5-7% to be “reasonable” expectations; based on historical rates of return, these numbers aren't outrageous projections that require risky investments to pay off. But note the Present Value amount required with a 5% projection is 26 percent greater than the PV with a 7% projection. That's quite a difference. So which number should you choose? You can't know for sure.

When the assumed rate of return on your retirement accumulation is just a guess, there is a ripple effect of uncertainty. First, since the present value factor is speculation, you really don't know your “number.” And even if you feel confident about your projections, there's the issue of how to handle deviations from your projection that might occur in the future. Because if the earnings from your retirement accounts under-perform the target rate of return at any time during retirement, you are facing either a reduction in annual income or the prospect of running out of money.

But what if you could make your present value factor a guarantee instead of a guess?

A Present Value Factor with Guarantees

One of the practical challenges for individuals approaching retirement is identifying financial products that can deliver a reliable and consistent income over an extended period. There are some debt instruments that promise regular payments over longer time periods, but for the past hundred years, the principal long-term retirement income products

have been annuities.

With an annuity, an individual gives an insurance company a lump sum in exchange for a guaranteed stream of payments. These payments can be guaranteed for specified periods of time, including periods that last as long as the annuity holder is alive. The present value factor used by the insurance company will depend on the type of payment the prospective annuity buyer is seeking, but the key element is this: the insurance company has now assumed the risk of making sure the payments are made. For the individual, the guesswork and uncertainty of the PV calculation has been eliminated.

“Okay, I like the idea of guaranteed retirement income, but...”

In August and September of 2011, Synovate Research conducted a retirement survey of 1,000 non-retired Americans. When asked which factors related to creating a more secure retirement, 86 percent of the respondents chose “having a guaranteed stream of income in retirement.” In the press release accompanying the survey results, Allianz Life Insurance Company, the sponsor of the survey, noted:

Especially in an environment where equity markets – and therefore 401(k) balances – can swing wildly within a week or a day, it is not surprising to see Americans expressing far more interest in the need for guaranteed retirement income versus the balance of their retirement account.

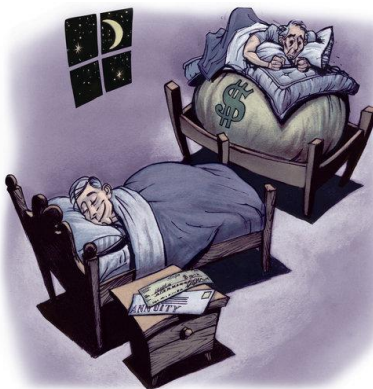


Illustration from the New York Times.

But even though almost 9 out of 10 Americans want retirement security, the press release also acknowledged this reality:

Although the idea of a guaranteed stream of income continues to resonate with Americans, most pre-retirees don't own annuities or are apprehensive about adding one to their retirement plan.

Economists call this the “annuity puzzle” – even though they want the features of an annuity, most Americans don't buy them. Why? According to Richard Thaler, a prominent financial behaviorist and author of “Nudge,” the problem is how annuities are “framed,” i.e., how they are presented. Even though annuities are a form of insurance, “most people seem to consider buying an annuity as a *gamble*, in which one has to live a certain number of years just to break even.” Writing in a June 4, 2011, *New York Times* column (“The Annuity Puzzle”), Thaler enumerates several advantages that annuities have over other retirement alternatives:

- Using standard assumptions, economic studies (going back to the 1960s) have repeatedly shown that buyers of annuities are assured more annual income for the rest of their lives, compared with people who self-manage their portfolios. One reason is that those who buy annuities and die early end up subsidizing those who die later.
- Annuities provide clear information about when to retire. An annuity quote translates a lump sum into a monthly

income, allowing individuals to determine whether they have accumulated enough to stop working.

- Not having an annuity (specifically fixed immediate annuities, not variable annuities) adds layers of complexity to people's financial lives. Retirees who choose not to annuitize must acquire the knowledge and assume the risk of investment managers, making allocation decisions and calculating the optimal drawdown rate over time. And since most of their decisions will be based on guesses/assumptions, Thaler's research shows that many retirees actually tend to underspend in retirement.

When it comes to providing income security in retirement, Gary Bhojwani, Allianz president and CEO declares: "the simple fact is that annuities are the only retirement income products that pool risk, and thereby can guarantee that all annuity owners will have income for the rest of their lives, regardless of how long they live."

If you want security in retirement, it is prudent and logical to consider the income insurance that only annuities can provide.

DOES YOUR RETIREMENT PROGRAM INCLUDE AN ANNUITY?



“DELEVERAGING” VS. SAVING

With the economic turmoil of the past few years still roiling their personal finances, many American households have made a focused effort to “deleverage,” that is, to pay down their debt balances. And while the average American consumer may have given lip service to reducing their indebtedness in the past, this time it appears they are serious about it. The Federal Reserve reported that revolving credit debt for Americans (mostly in the form of unpaid credit card balances) was at its lowest level since 2004. The Fed also determined that total household debt dropped 8.6% since 2008.

Because consumer spending is also down, it seems that most of the accelerated debt payments are primarily because people are reducing or eliminating purchases, and instead

applying those unspent dollars as additional payments on their credit cards, loans and mortgages. But some financial commentators are also touting the idea of redirecting funds previously allocated to long-term savings toward paying off debt. Their logic is as follows:

With the volatility of the stock market and diminished real estate values, paying off debt is a good “investment,” with a rate of return equivalent to earning the interest rate charged. In other words, paying off a credit card balance which charges 12% interest is akin to earning 12% - guaranteed.

Mathematically, this is an enticing perspective. It's simple to picture, simple to calculate. But a closer look at some of the other issues involved (instead of just the simple parts) should prompt most people to think twice before they divert too much of their savings to increased debt reduction.

Paying down debt is not the same as saving.

Sometimes financial commentators confuse the two ideas, or view them as interchangeable. They are not. When you save, you accumulate money under your control. You can decide where to put it, when to take it, what to use it for. When you repay debt, you reduce the control the creditors have over you. But just because the creditors control you less, doesn't mean **you** have more financial control.

If all your earnings were put toward debt reduction, and you had no savings and no capital, how would you be able to take advantage of a financial opportunity? Either you couldn't, or you would go back to your creditors — you'd run up the credit card to its limit, or see the bank for another loan. When you must rely on borrowing to participate in a financial opportunity, the ultimate decision-making power (control) lies with the lender, not you. Paying off debt is not saving.

Debt is really about control.

When you owe a creditor, the creditor exercises a measure of financial control over you until the loan is satisfied. As long as there is a lien, they can lean on you. Paying the debt faster (such as making extra principal payments) without paying the balance in full, does not decrease the creditor's immediate control over a portion of your finances. Even with extra principal paid, you still have an obligation to make next month's payment. The lender's control is not removed until the loan is completely repaid.

In fact, you could argue that making additional periodic payments on debt obligations actually gives *greater* immediate control to the lender. Not only do you still have another monthly payment coming, but the additional debt repayment means more of your “discretionary” dollars are also in the lender's hands.

From a control perspective, a better approach to reducing debt could be to systematically fund an account for the purpose of accumulating enough to make a single balance-clearing payment. Rather than sending an extra \$500 on the credit card balance, the “controlled alternative” is to deposit that same amount into another savings vehicle, while continuing to make the regular minimum monthly payment. When the savings account equals the remaining balance, you would pay the balance off.

Some may be quick to point out that the interest earned in

the savings account will most likely not be equal to the rate of interest charged by the lender, thus arguing that you “lose money” by not paying the additional amount to the credit card account. That’s probably true, and saving in an outside account might take a few months longer to fully pay off the obligation. But the key financial issue here is control, not rate of return. Keeping the money under your control gives you greater current financial security and opportunity than if you send those dollars to a creditor.

Integrating Deleveraging and Saving

Under almost all circumstances, paying off debt is a good thing, and so is saving. Being debt-free gives you financial freedom, savings allows for financial opportunity. And the two actions are not mutually exclusive – you can pay off debt *and* save at the same time. Furthermore, you may find a financial advantage in integrating the two activities by saving in a format that can eventually reduce or eliminate debt.

IF YOU ARE INTERESTED IN WAYS TO COMBINE SAVING AND DELEVERAGING IN YOUR FINANCIAL PROGRAMS, NOW MIGHT THIS BE THE BEST TIME TO EXPLORE NEW IDEAS OR ADJUST YOUR CURRENT PLANS.



THE “GOOD OLD DAYS”?

By some measures, the past four years have been the worst economically since the Great Depression of the 1930s. But while today’s financial difficulties are real, there are some positives. For example...

According to statistics from Freddie Mac, the average interest rate on a **30-year fixed rate mortgage** was 18.45% in **October 1981** (i.e., 30 years ago). The average interest rate on a **30-year fixed rate mortgage** last week on **Thursday, 10/13/11**, was 4.12%. The former mortgage rate would produce a \$1,544 monthly “principal and interest” payment on a 30-year fixed rate mortgage for \$100,000 while the latter would cost just \$484 per month.

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