



First Financial Group

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“A dynamic economy is one in which human and physical capital are chasing new opportunities, not holding onto lost causes.”

- Arnold Kling

5 Minutes on the Couch + 10 Minutes in the Library = A Plan for the Information Age

Want to put your mind at ease about the current financial turmoil? Here are two perspectives that may help you get out of today’s funk and on to better things.

5 Minutes on the Couch: Letting Go of Present-Event Bias



Here is a brief excerpt from renowned investor Warren Buffett, in his Chairman’s Comments section of the Berkshire-Hathaway 2008 annual report, released February 27, 2009, assessing the economic events of the past year:

“By the fourth quarter, the credit crisis, coupled with tumbling home and stock prices, had produced a paralyzing fear that engulfed the country. A free fall in business activity ensued, accelerating at a pace that I have never before witnessed. The U.S. – and much of the world – became trapped in a vicious negative-feedback cycle. Fear led to business contraction, and that in turn led to even greater fear.”

A “vicious negative-feedback cycle.” Doesn’t that seem to describe all the economic news these days? Bad news causes fear, which leads to more bad news. As Paul Sullivan writes in a February 6, 2009 article in the *New York Times*, (“It’s Not Just the Money, It’s the Mind-Set”),

“Above all, people’s psyches are being wracked by what behavioral economists call **present-event bias**. This is the belief that what is happening now will always be. The same thing

happens in bull markets — values always seem to be rising until they don’t — but it is clearly more painful when wealth is being destroyed.”

Logically, we all know present-event bias isn’t reality – we know that things, both good and bad, will not stay the same forever. But when you’re in the midst of a trend, it can be difficult to see beyond the prevailing sentiments of the moment. In both good times and bad, there is the danger of allowing the faulty premises of present-event biases to guide our attitudes and economic decisions. When we do, the long-term outcomes are not usually favorable.

In fact, many of the issues at the heart of the current economic crisis have been, to some extent, the result of present-event bias. Because of present-event bias...

- Both mortgage lenders and homebuyers felt they could afford the risk of no-money-down, interest-only loans. After all, “real estate *always* goes up.”
- Many stockmarket investors were lulled by the mantra “over time, the market *always* goes up.”
- A union job for a major manufacturer was the gold standard in blue-collar employment, because “General Motors is *always* going to be there.”
- When politicians began government-sponsored pay-as-you-go social security programs, they were sure that there would *always* be enough workers to bear the cost of providing benefits for the retirees. After all, said German Chancellor Konrad Adenauer in 1957, “People will always have children.” (Unfortunately for government planners, many developed nations now have fertility rates well below replacement levels!)

If you recognize that making decisions based on present-event bias isn’t productive, what’s a better alternative? Well, for starters, apply Stein’s Law.

Herbert Stein was an economics professor and

Financial Literacy Question
Answer on page 6

Here’s a quick quiz on a basic financial concept. Do you know the answer?

According to the Urban Institute, what percentage of American workers do not retire on their own timetable, but rather are forced into retirement due to layoffs, illnesses or injuries?

- a. 19 percent b. 26 percent c. 37 percent d. 43 percent**

government advisor to presidents Nixon and Ford (and also the father of entertainer/commentator Ben Stein). He put forward a simple statement about economic trends **“If something can’t go on forever, it will stop.”** Put another way, present-event status will end when something can’t be continued. If banks can’t expand their lending because there aren’t reliable borrowers, they will stop lending. If people can’t afford over-priced housing, they will stop buying. When big corporations can’t be profitable in a competitive marketplace, they will cease to exist. And if there aren’t enough workers to pay the cost of Social Security, it will go broke.

In hindsight, it’s relatively easy to apply Stein’s Law to explain how and why past events changed from boom to bust. But can you use the same logic in a forward-thinking manner, to determine how and why the bust will end and prosperity will return? If you break free from the group psychology that creates present-event bias and take a broader view of history, some possibilities emerge.

10 Minutes in the Library: Going Post-Industrial in the Information Society

More than 30 years ago, some historians, economists and sociologists began questioning whether the current economic realities could continue, and if not, what would happen when they stopped.

In 1973, Daniel Bell analyzed the contrasts between the industrialized economies of the USSR and the United States in *The Coming of Post-Industrial Society*. Bell not only saw the centrally-controlled collectivist Soviet model as unsustainable, but also correctly predicted the attributes of a post-industrial U.S. economy: globally interconnected financial systems; international trade imbalances; and the decline of the manufacturing sector.



Peter Drucker, in his 1989 book, *The New Realities*, highlighted what he saw to be the major cultural shifts in the 20th century. In 1900, farming was the still largest part of every nation’s economy, even though the Industrial Revolution had begun 100 years earlier. By the end of World War II, manufacturing had completely supplanted farming. This was the culmination of economic change in the twentieth century, and was the basis for America’s supreme position in world affairs. But Drucker also saw a “post-industrial” world coming, where manufacturing would be less prominent.

At that time, “post-industrial” was a vague term used by economists in that it told what was passing, but didn’t identify what was coming in its place. Since the mid-1990s, a consensus phrase arose for the coming new economic era: **The Information Age.**

James Davidson and Lord William Rees-Mogg authored several books on the seismic economic changes

they felt were likely to occur in the coming decades. In their 1997 book, *The Sovereign Individual*, Davidson and Rees-Mogg stated that from its earliest beginnings until now, there had been only three basic stages of economic life in human history:

- (1) hunting-and-gathering societies;
- (2) agricultural societies; and
- (3) industrial societies.

“Now, looming over the horizon, is something entirely new, the fourth stage of social organization: **information societies.**”

With the microprocessor and the Internet as the technological drivers of this new economic age, the forward-thinking commentators saw several trends arising from the emergence of these new technologies.

There would be a transition from goods production to the provision of services. This didn’t mean manufacturing would cease, only that fewer people would be employed in manufacturing. (This mirrors the changes that occurred in farming over the previous century. Today, less than 1% of Americans list farming as an occupation, yet the general wealth of the farming sector has not deteriorated. These few farmers produce much more food than their predecessors of the previous century, and both individual farmers as well as the broad population are better off today.)

With the move away from manufacturing as a core economic activity in developed countries, the importance of blue-collar, manual work (e.g., assembly-line manufacturing) would decline, with much of the lesser-skilled work outsourced. Professional and technical work (lawyers, computer programmers, etc.) would come to predominate. Although this service emphasis was predicted to impact a wide range of sectors, health, education, research, and government services are seen as the most decisive for an Information society.

This “Information Age” perspective isn’t new. Remember, a number of economic and sociological commentators saw this economic shift coming three decades ago. In various ways they said, “the industrial society cannot go on forever. Things will change.” And while it’s rare for economists to accurately predict the future, it’s not like other people haven’t seen the same things over the past 30 years. The decline in manufacturing jobs, outsourcing, and the increased globalization of companies are not new trends. ***The inevitable conclusion is the industrial society, and many of the economic features that embodied it are quickly fading into the past.***

The economic ramifications for the individual are significant. Some of the mainstays of the industrial economy like lifetime job security, company pensions, and government benefit programs are no longer financial certainties. In varying degrees, change is shaping *new financial realities.*

The Plan For the Politicians & the Individual

When faced with change, there are two fundamental responses: resist it or embrace it. The chosen response often depends on how much one has invested in the existing program, and how much benefit is offered by the newer approach. For those whose livelihoods are connected to the American automobile industry, the change away from manufacturing is threatening. Workers who have paid into Social Security for 40 years don't relish the thought of seeing the benefits diminish or disappear just as they reach retirement. On the other hand, for providers of Internet search engines and on-line content, change probably can't come fast enough.

The Political Response

Since many politicians have decided the economic crisis requires government intervention, they also face this resist-or-embrace dilemma. Because many of their constituents remain heavily invested in the industrial society, many politicians promise to "save" jobs, Social Security, and the American way to capture their vote. As Arnold Kling, an ex-economist for both the Federal Reserve and Freddie Mac, said in his November 12, 2008 commentary on www.econlib.org, "...I can see where a bailout is a winning policy. The threatened industry is organized and visible. The alternative(s)...are diffuse and unseen." But while such an approach makes for good politics, Kling says political intervention may not be the best response to the reality of a changing economic society.



"My guess, however, is that in a post-industrial economy, the necessary adjustments are too subtle and complex...In theory, wise technocrats could help guide workers in declining industries to appropriate re-training and career development. In practice, technocrats are not that wise. But it is much worse than that. Instead of giving the technocrats the mission of making the adjustment process more efficient, politicians will give them the mission of delaying the adjustment process and resisting the signals coming from the market. Thus, the expectation that government should help could have an ironic effect: the more that the public asks government to relieve the distress in labor markets, the longer it may take for labor markets to adjust."

The Individual Response

While it may be possible for select sectors of the American economy to stave off changes that have been three decades in taking shape, it's unlikely that the US economy will recover by reverting to an industrial/manufacturing base. And for those who want to step away from the gloom of a vicious negative-feedback cycle focused on present events, it makes sense to contemplate ways to embrace the financial changes that may coincide with the growing influence of the Information society.

In *The Sovereign Individual*, Davidson and Rees-Mogg suggested several ways in which the Information society will impact individual economics. First, most Information workers will operate as independent contractors; the term "job" will mean "a project" rather than "steady employment with a single employer." Second, employment opportunities will be global, rather than local or regional – even as the worker never leaves home. Third, the new paradigms in employment "will leave individuals far more responsible for themselves than they have been accustomed to being during the industrial period."

From these broad predictions, it is possible to make some fairly specific personal recommendations.

Cash reserves are critical. In the typical Industrial-era career, workers could count on steady paychecks and generous benefits. This economic certainty made it possible to operate on thin margins. Financial surprises could be covered by cash flow, insurance or even borrowing, as the repayments could be spread over time.

But when employment may be intermittent, and regularly changing, the need for a substantial cash cushion becomes much greater. The most stable Information Age workers will be those who have the financial wherewithal to comfortably bridge periods of unemployment (or perhaps time to work on entrepreneurial projects), instead of being forced to take whatever is available.

You must own or control your insurance and retirement benefits. Employer-sponsored group insurance and retirement benefits are fast becoming relics of the Industrial past, both for employees and retirees. 401(k)s instead of pensions and employee co-pays for insurance are part of the trend to decrease an employer's long-term financial commitments. At the pace these employer-sponsored plans are being dismantled, the only people who will have pensions are government employees and Congresspersons.

So...If it's likely that you will be regularly changing employers or working as an independent contractor, you can't count on employer benefits – even stripped-down ones. This is especially true during the periods you are "between jobs."

Given the dynamics listed above, it seems likely that future insurance and retirement developments will move to two extremes – government and individual programs. For those above the poverty line, government plans will offer minimum benefits, with the individual having the choice to add supplementary benefits at his/her discretion. As a result of this universal-individual model, the number of employers offering benefits will likely decline. Anything above the minimum will be the responsibility of the individual.

Since individual coverage (such as life and disability insurance) is often contingent on your health status, it makes sense to secure coverage as early as possible, with

provisions to keep the benefits as long as they will be needed. Likewise, retirement accumulation programs should be portable, and allow for deposits from a variety of sources, not just wages.

(Using this universal-individual model, here's a possible configuration of medical insurance. The rising cry for universal health care can be seen as a direct result of the erosion of Industrial-era employer-paid health insurance, and the increased technological costs of providing sophisticated Information-era medicine. While a government-sponsored plan may provide a base level of coverage for everyone, the likelihood is that individuals will also find it desirable to purchase additional coverages matched to their unique circumstances.)

Change your borrowing habits. The ability to borrow is determined by a lender's assessment of your ability to repay. For a creditor in the Industrial era, a steady job meant regular repayments. In the Information age, lenders may look more at your assets and less at your employment to determine your suitability for a loan. If your unsecured borrowing exceeds your cash reserves, you may be overextended.

Since you may end up working "everywhere", live where you want – and rent until you're sure you're ready to settle down. The real estate cliché about your home being your biggest asset has changed. For many, after the collapse of real estate values, your mortgage is now your biggest liability. In light of the comments above regarding the changing nature of debt, a large mortgage obligation could be an impediment to seizing financial opportunities.

These broad recommendations are not guaranteed to be the perfect prescriptions for your specific circumstances. But they reflect sound financial thinking in any era, and if nothing else, serve to encourage you to reconsider how many previous financial decisions have been shaped by present-event biases. A measured look at history seems to indicate change is coming, and it will favor those who are the best prepared. Those who make financial plans based on how it has "always been" during the Industrial era may find themselves behind the times.

IS YOUR FINANCIAL PROGRAM STRUCTURED TO EMBRACE A NEW ERA, OR IS IT STILL OPERATING ON PRESENT-EVENT BIASES?

The IRA: A Case Study in Present-Event Bias and Government Response

As a way to encourage individuals to save for retirement, the Employee Retirement Income Security Act (ERISA) of 1974 established the first Individual



Retirement Accounts (IRAs), which eventually gave birth to other tax-favored retirement plans such as 403(b)s, 401(k)s, SEPs etc. The basic format for these qualified retirement programs is a tax deduction on deposits and tax-free accumulation; distributions taken in retirement are then taxable as ordinary income.

Over the past three decades, the ongoing logic for participating in qualified retirement plans has been straightforward. Because retirement is projected to be a period of lower income, distributions taken from IRAs or similar accounts will be taxed at a lower rate. Thus, receiving a tax deduction now (against a higher tax rate), and paying tax later (at a lower rate) is a financial advantage. At some time, every proponent of qualified retirement plans has intoned "You should have an IRA because you'll be in a lower tax bracket in retirement."

The financial advantage of IRAs was predicated on several present-event biases. First, that income tax rates would remain the same. Second, that retirement living expenses would be less than while one was working. Over time, both of these variables have changed. Income taxes have both increased and decreased for segments of the population. And retirement expenses, especially medical costs, have dramatically increased. In short, what was thought to be always the same has changed.

In response to these on-going changes, government has continually tweaked the rules, trying to keep IRAs and other qualified retirement accounts beneficial for participants. But often, even the best government responses are a step slow.

Take for example the recently implemented one-year reprieve in required minimum distributions (RMDs). In order to capture some of the tax eventually due on IRAs, previous IRA regulations required individuals over age 70½ to make mandatory minimum withdrawals from retirement accounts each year. But in December 2008, lawmakers suspended this provision for 2009, hoping to give investors a chance for their "accounts to rebound after a brutal year in the markets," according to a February 11, 2009 *Wall Street Journal* article ("New IRA Law Bewilders Investors"). Instead of being forced to sell investments to take their RMD, account holders will be able to sit tight and wait for a possible recovery of their account values.

However, retirees still had to take their RMD for 2008 or face a stiff penalty from the IRS. Thus, in a year when major US stock indexes had declines of 30% or more, account holders still had to sell out at low prices to meet the RMD requirement. In other words, a one-year suspension of RMDs might have been more beneficial *last year* instead of this one.

In addition, the one-year RMD suspension has created both aggravation and confusion for account holders. Financial institutions holding IRA funds are scrambling to establish procedures for contacting RMD recipients (some are contacting only those receiving

monthly checks, others not planning any contact until April, 2009, and still others are automatically suspending payments). Company administrators of 401(k)s are trying to determine if they first must amend their plan documents. In addition to the unresolved detail, there is uncertainty as to whether the reprieve will be extended for 2010.

Because IRA policy is often present-event driven, more changes – and more uncertainty – seem likely in the future. (Although assuming that government will “always” be a step behind might be a present-event bias as well. Maybe one day, the politicians will get it right in advance.)

Long-Term Care Insurance Continues to Change – Is Now the Time to Buy?



Historically, the current generation is the first to fully realize the social and financial impact of increased longevity. In the “old days,” when elderly people got sick, they often died. Today, because of medical advances, sickness and infirmity are typically not fatal. Instead, the result may be a diminished capacity to execute some of the activities of daily living*. Thus, the expanding need for various long-term care services.

The financial cost of a long-term care situation can be devastating to family finances. This is especially true for a surviving spouse, since the need for long-term care is most likely something that will occur in retirement, making it unlikely one can recover the financial cost by working. This situation is precisely the type that is best addressed by insurance, where one can limit their individual financial exposure by spreading the risk amongst a large group of people.

*Activities of daily living include: bathing, continence, dressing, eating, toileting, transferring in/out of bed or wheelchair.

Brief History of Long-Term Care Insurance

Long term care insurance (LTCI) is a relatively new insurance product. The earliest policies, introduced in the 1970's, covered only nursing home care, and were designed to be compatible with Medicare. In the 1980s, a newer generation of LTCI policies recognized the need for “at home” care and “adult day” care as well.

The changes in features and benefits, along with increasing longevity rates due to new medical technologies affected the pricing as well. Still, insurance underwriters couldn't predict how much health care costs would rise over the next 20 years and how much longer Americans would live. Only recently have these early policies started to result in claims, and some analysts believe insurers may have underestimated their

exposure. As a result, long-term care insurance continues to change.

Current Trends in LTCI

In the January 5, 2008 issue of the *National Underwriter*, an insurance trade publication, Vivian P. Gallo, a long-term care specialist from Hartsdale, NY, notes some trends for LTCI in 2009 and beyond.

- **Gradual tightening of underwriting criteria.** The goal of any insurance company is to accurately assess the risks. In long-term care insurance, this will mean more face-to-face interviews at younger ages, and making a family's medical history a routine part of the underwriting and eligibility assessment. According to Gallo, this will result in fewer people being eligible for LTCI coverage.
- **Rate increases.** Some LTCI policies have provisions that allow for rate increases at specified times in the future, should claim history indicate the need. Gallo reports these increases, mostly on older contracts, have ranged between 2% and 24%.
- **Additional government incentives and employer programs.** To encourage consumers to obtain the coverage, both state and federal governments have considered additional tax credits for qualifying policies. In addition, insurance carriers are looking at new versions of employer-sponsored group coverage, which can offer simplified underwriting.
- **Limited benefit periods.** Some versions of LTCI provided unlimited benefits. But as Gallo notes, it is “apparent that the unlimited liability created by the lifetime benefit option is far too unpredictable to be reliably priced.” The move to defined benefit amounts should mitigate against the need for premium increases.
- **Hybrid policies.** For consumers, the purchase of LTCI presents several financial dilemmas. The public's perception of long-term care, according to William Kelly, another LTCI specialist, is “when you need LTC, it is too expensive, and when it is inexpensive, you are too young and seemingly decades away from needing it.” Additionally, the premiums represent a significant potential lost opportunity cost if there's never a reason for a claim.

As a result, some insurers are finding ways to blend either annuity or life insurance components to LTCI coverage. If not used for long-term care expenses, the policyholder may “recoup” the premiums as either a life insurance benefit, or an annuity accumulation/payment.

Taking Action Today

While the format of long-term care insurance continues to evolve, the need to address the financial issues remains unchanged. Consumers, particularly older

ones, cannot just “wait for the dust to settle,” then decide on what type of insurance to buy, as they run the risk of being ineligible because of stricter underwriting standards.

Given the current landscape, the following suggestions merit consideration.

- **Secure some coverage now while you still qualify.** If, in the near future, LTCI is expected to become harder to get and more expensive, a prudent response is to attempt to secure some coverage now. It may not be a deluxe plan, but some coverage at the current price is better than no coverage (because of your health) and/or higher premiums.
- **If it is financially feasible, purchase coverage that can be paid-up after a certain period.** Some LTCI carriers offer plans that require premium payments for a specific number of years (a typical arrangement is 10 years). This approach gives policy owners both a fixed cost and a secure benefit. Of course, the premiums for this policy feature are higher on an annual basis than policies based on a lifetime of premium payments. But choosing a paid-up feature effectively eliminates any future financial surprises in your coverage.
- **If you cannot make the cost of long-term care insurance fit your budget, at least make sure you have a life insurance program designed to last your entire lifetime.** Here’s an excerpt from the State of New York’s long-term care information web page (<http://www.ins.state.ny.us/lntmcare.htm>) in the section titled “How else can I pay for long-term care services?”

A life insurance policy may offer the opportunity for a loan or withdrawal of the cash value. In addition, a person who is terminally ill may arrange for an accelerated cash lump sum death benefit from his life insurance company or for a cash lump sum (called a viatical settlement) from an outside firm. (Note: not all life insurance companies offer an accelerated death benefit option). These cash lump sum benefits are paid in lieu of the policy’s death benefit.

(Note: Because the greatest likelihood of needing long-term care services is at the end of one’s life, any life insurance program must be structured to be in-force at the end of one’s life. **Term life insurance does not work.**)

There may be several solutions to your long-term care challenges. But even with some uncertainty in the insurance marketplace, doing nothing is not a suitable response. The sooner long-term care registers in your financial consciousness the better.

FINANCIAL LITERACY QUESTION

According to the Urban Institute, what percentage of American workers do not retire on their own timetable, but rather are forced into retirement due to layoffs, illnesses or injuries?

- a. 19 % b. 26% c. 37% d. 43%

Answer: c. For more than one in three Americans, their satisfaction in retirement could be strongly affected by their ability to respond to unexpected financial developments. In other words, they need to have a good Plan B, besides an ideal Plan A.

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