



Wealth Architecture™ Digest

Often people do not plan because they see only what is, and they do not have a vision of what can be. Something is always possible. We believe that, with vision, the possibilities are almost unlimited.

Lesson from History:

"Every sector went down. I'm not prepared to panic and jump off a building."

-- Richard Haas, San Jose Mercury News, October 20, 1987, page one, in response to the 508 point drop in the DJIA the previous day. The same percentage drop now would be 2,900 points.

American Millionaires:

46% are women
16% live in California
9% live in New York
7% live in Florida
Are most common in Connecticut, where they account for 3.2% of the population

Source: IRS Statistics of Income Bulletin, Winter 2005-2006

Fall 2007

Watch the Numbers

In July the media trumpeted the record highs of the Dow Jones Industrial Average and the S&P 500 Index* (before the recent drop off). By early October there will likely be a great emphasis on the "five-year track records" of various indexes and many money managers. The purpose of this article is to expand the conversation and caution readers to look beyond the simple sound bites that may be used.

It has been the custom to report track records in rolling periods – one-, three-, five-, and ten-year periods. At the end of the current quarter, the five-year track record for the S&P 500 and many other domestic stock indexes will reflect a period from the long-term low in 2002 to a much higher level. In my opinion this moving number can lead to serious misunderstanding as advertisers and media trumpet potentially self-serving conclusions about "performance."

We always need to be aware that published performance numbers *are historical, apply only to the period mentioned, and apply only to the index or fund mentioned.* Recent history has illustrated well the significance of potentially misleading use of historical data. At the end of July,

2006, the 5-year trailing total return for the S&P 500 Index was 5.4% -- about 1% per year. At the end of July, 2007 the trailing five-year return was 59.64%, close to 11% per year compounded (source: standardandpoors.com). The 10-year trailing returns for the period ending July, 2006 was 99.49%, and 52.49% ending July, 2007 (7.1% and 4.3% per year respectively). These are after negative returns in June and July of this year.

How can it be that the five-year annualized returns were up so sharply from 2006 to 2007, while the ten-year were so much lower? The answer is in the time periods. We are almost to the end of the time when the last Bear Market bottomed in late 2002, so those negative results don't affect the numbers, while the major drop from 2000 through late 2002 are fully reflected in the ten-year statistics.

There is no predictive value to this knowledge. The fact that the markets produced returns of X% over a given period does not tell us what might happen next, but opportunistic people may attempt to imply that they add value because they performed well over an arbitrary time period. Food for thought.

*The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. Indexes are unmanaged and cannot be directly invested into. NFP Securities, Inc. does not offer tax or legal advice.

Why Won't Insurers Insure People?

Life and health insurance have been a part of my business since my career began in October, 1969. It has always amazed me how poor a job the insurance companies have done in explaining the basics of how they work to their customers. Unfortunately, as the realities of the medical insurance crisis have continued to set in, insurance companies have become the perceived enemies of the people. While I do not maintain they are the guys on the white horses, I'm not sure they should be considered evil, at least not without understanding what part they play in our society, and in our economy.

I remember from my initial training that insurance contracts are considered "aleatory" contracts. *The Oxford English Dictionary* defines aleatory as "Dependent on the throw of a die; hence, dependent on uncertain contingencies." In other words, insurance contracts are gambling contracts. If a company builds a business around making a profit based on "uncertain contingencies" like when a policyholder will die, or if one will have a major medical claim, the company had better bet right.

One of the advantages that the insurance companies have is an extraordinary database, based on *actual experience* of the claims of tens of millions of people. The data are used to price products in a way that reduces, as much as possible, uncertainty by separating new applicants into rating classes that reflect the probability of claims to be paid in the future. Overall the company is pooling risk (the larger the pool, the more predictable the outcomes) with the goal of having adequate reserves to pay claims, pay expenses, and make a profit.

The insurance industry in the U.S. (at least the life insurance part) grew out of 19th century fraternal organizations that took small deposits from their members, held the money, and paid benefits out to help with members' burial expenses. Over time this concept has expanded to an international industry insuring people for *trillions* of dollars. For a moment, let's focus on this pooled risk and see if it aids understanding.

Take a group of a hundred 35-year-old friends, each of whom would like his family to receive \$1 million **when** he dies. We'll assume all are very healthy. If each person contributes \$1,000 to the pool, in all likelihood there would be no claim paid in the first year, as the probability of death at that age is extremely small. The money could build up, and, along with subsequent years' premium and investment returns, create a reserve for the time when that \$1 million claim would need to be paid. If all goes well, and the premiums go up as the *probability* of death gets greater, enough money should be in the pot to pay claims over time.

But what about if one of the men were just diagnosed with cancer, and had a fairly predictable life expectancy of five years? Should the other ninety-nine people, all of whom are healthy, absorb the inevitable claim for their friend? Most of the early insurance companies were "mutual" insurers, owned by the policyholders, not outsider stockholders. If they accepted *known* adverse risks, all other policyholders would lose. This is a typical example of using known data to screen out those risks that would lead to excess claims. For our group of friends, as well as for an insurance company insuring millions of people, screening out adverse risks (this process is called underwriting) is essential to both fairness and financial survival.

In the underwriting process the companies start with a "standard" classification based on life expectancies for people with "normal" health risks. If an individual has a shorter life expectancy, be it from health issues like smoking, diabetes or hypertension, or from lifestyle risks like sky diving, motorcycle racing, etc., he/she needs to pay more to cover the extra risk. It would be unfair to healthy people with low-risk lifestyles to pay the added expected claims of the higher-risk insured. It would be catastrophic for the insurance companies to not be able to charge extra premiums for excess risk. This applies to medical insurance as well as life insurance.

(Continued on page 3)

(Continued from page 2)

Looking at today's health insurance crisis, insurers can quite accurately predict what level of claims will result from almost every kind of ailment disclosed on an application for coverage. If the company believes it would simply be buying a claim – which could grow – by issuing a policy, it might decline to do so because doing otherwise would negatively impact other policyholders or the stockholders, as either premiums would have to increase, or profits would decrease.

This does not take into consideration the waste or abuse that undoubtedly takes place in many situations. However, making coverage available to all, regardless of medical history (and therefore risk), would un-

doubtedly result in higher premiums to cover the costs of those with adverse risks. To the extent that insurance is issued by private companies rather than the government, it must realize profits or it will cease to remain viable and able to pay claims. This means companies will continue to refuse to insure many people.

I am not making any policy proposal, as I understand this is a very complex area. However, as many people are frustrated and angry at the inexplicable complexity of the process of obtaining medical, life, and other forms of insurance, I thought I'd provide a bit of an overview.

All Income is Not Created Equal

As most of us have recently completed the painful process of paying taxes, I thought it would be interesting to run some simple tax calculations* to illustrate the current trend that favors capital at work versus labor at work. This is not about economic theory or the rich versus the middle class, but rather about those who have made it compared to those still working at it.

For the first example, I assumed two different sets of married taxpayers, both in the top 1% of income earners. As you will see below, the sources of their incomes made for very different results. The first couple has a total income of \$3 million, none of which is derived from employment. They have a huge investment portfolio of stocks and municipal bonds. Two thirds of their income is tax exempt and the remaining one third is subject to federal tax at 15%. Neither is employed, so there are no payroll taxes for Social Security or Medicare. The calculated tax bite would be \$143,630, less than 5% of their total income.

The second couple pays a considerably higher percentage in taxes. The husband is self-employed and his total income of \$500,000 results in \$199,000 in income taxes, **plus** \$24,500 in self-employment tax,

the Social Security and Medicare taxes for the self-employed. This couple pays out 28.7% of their total income in federal taxes, approximately six times the percentage rate of the retired couple with only investment-related income. If the self-employment earnings had been the same \$3 million as the first couple's investment earnings, they would pay over 35% of total income in federal taxes- \$1,090,000!

The problem illustrated by the examples is that it's not about how much you make, but rather how you make it. Obviously, someone earning \$3 million from investments is extraordinarily wealthy, likely with investable assets of \$50 million or more. But this dichotomy of differing tax treatments even applies to those of far less affluence.

When I adjusted income down to more earthly levels, I found the results were even more startling. I first looked at a two-income couple, each earning \$125,000. With \$30,000 of mortgage interest, \$20,000 of property taxes, and \$20,000 of state income taxes for deductions, they paid \$50,400 of federal income tax (including over \$12,000 of Alternative Minimum Tax) and a combined \$16,000 in payroll taxes- a total federal tax outlay of \$66,000.

(Continued on page 4)

(Continued from page 3)

Determined to see how this capital versus labor tax division plays out, I then took the same income, but with all of it coming from investments. With the identical total income and deductions, the second couple paid only \$7,123 of federal tax, with no AMT and no payroll tax. For the couple working for a living the difference is a startling \$59,000- about **800% more** that the couple living from investments. For a married couple the marginal tax rate on earned income and interest income goes to 25% on income over \$61,300, and to 28% on income in excess of \$123,700, almost

double the 15% rate on long term capital gains and qualifying dividends.

While little can be done to reduce taxes on wages or self-employment income, it is important to be aware of the significant difference in the taxation of different kinds of investments, and different entities. Part of our ongoing responsibility at Financial Catalyst Group is to understand the differences and consider them in our recommendations.

*These tax calculations are from very simple assumptions and should not be meant to imply what your taxes may be. You should always contact your own tax adviser for tax advice.

New Addition at Financial Catalyst Group

My name is Kat Wimmer-Lambrech and I would like to take this opportunity to introduce myself to the FCG family. I was born in Washington D.C. to German parents who shared a love of travel, which they instilled in me at a young age. My first trip (to Sydney, Australia) took place when I was only three months old. I had visited six countries, and lived in two, by the time I was five. It is this early introduction to multiple cultures and countries that has compelled me to see as much of the world as possible.

My work life has been similarly diverse. After studying journalism at New York University, I sold real estate in Greenwich Village and worked at a hedge fund on Wall Street. Recently, I spent 13 months in Baghdad, Iraq working in media relations.

It was in Baghdad that I met my husband Mark. Mark comes from the island of Sylt in Germany and shares my love of SCUBA diving and travel. Mark and I moved to California from New Orleans in February, 2007. We love the people and weather here and are excited to call it home.

I am thrilled to be at FCG. I believe that each life experience prepares you for the next one. My position at FCG is a unique opportunity to combine my skills and channel them in a new direction. I am able to use my experience in sales, customer service, finance and media regularly, but in ways in which I have not applied them before. This both challenges and inspires me, which I think is key to a happy and successful career.

FINANCIAL CATALYST GROUP

4030 Moorpark Avenue
Suite 105
San Jose, California 95117

Phone: 408-261-7600

Richard Haas and Judith Puette are Registered Representatives offering securities and Investment Advisory Services through NFP Securities, Inc. a Broker/Dealer, Member FINRA/SIPC and a Federally Registered Investment Advisor. Richard Haas also offers Investment Advisory Services through Financial Catalyst Group, Inc. a Registered Investment Advisor. NFP Securities, Inc., and Financial Catalyst Group are not affiliated. Richard Haas' California Insurance License number is 0391885. Judith Puette's California Insurance License number is 0D56569.

Financial Catalyst Group was founded in 1977 to help successful people articulate their goals, and realize their dreams to protect and preserve their hard-earned wealth. At Financial Catalyst Group we provide unique Wealth Architecture™ services that result in the implementation of value-added plans for the responsible preservation and transfer of wealth through the generations. We specialize in working with successful people to solve probblems and simplify their lives around their wealth. We work closely with these families and their advisors to form a strong, results-oriented team.

The opinions expressed are those of the writer and are subject to change with economic and market conditions. They are not meant as specific investment advice. Market forecasts cannot be guaranteed and may not come to pass.