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SURVIVING AND THRIVING DURING CREATIVE DESTRUCTION

Short-term & Long-term financial responses to the current "crisis"

The consensus of the mainstream financial media is that times are tough, things are bad, and the future is bleak. And the adjective that most often precedes this pessimistic perspective? "Unprecedented."

That's one way to look at it. But it's not the only way.

Financial crises are not new. Since the United States was established, its people have experienced at least 17 Panics, Crises, Recessions and Depressions (see list, page 2). And while it may take some time, things get better; historically, every downturn has ended with a recovery. And often what arises out of the crisis is better than what was before. In fact, economists have a name for this process of crisis and recovery. They call it *creative destruction*.

Creative Destruction

Creative destruction is a term coined by Joseph Schumpeter in his 1942 treatise titled "Capitalism, Socialism and Democracy" as a way to describe how new businesses and technologies replace older, less efficient ones. It was Schumpeter's observation that the "process of creative destruction is the essential fact about capitalism."

When old technologies and business models are diminished because of creative destruction, there can be significant economic distress for portions of the population. Carriage makers lost their livelihoods when Henry Ford began mass-producing Model Ts. Main-frame computer companies were made irrelevant by Microsoft, Intel and the personal computer. And in a what-goes-around-comes-around irony, the American auto companies may shortly find themselves victims of creative destruction. For those directly affected by these realities, the impact can be financially brutal.

But for the economy as a whole, creative destruction is usually beneficial because it allows resources to be transferred out of older, less efficient industries and into newer, more efficient ones which produce improved and/or less expensive goods and services. If understood and managed properly, creative destruction can be a catalyst to more productivity, higher incomes and better standards of living.

When the prevailing psychological environment is pessimistic, it's easy to forget that what's being experienced right now is nothing new. With this understanding of crises and creative destruction, individuals should be focused on how to ride out the tough times and be prepared for the opportunities that inevitably follow. Many of the details will depend on your unique circumstances, but there are some financial fundamentals that apply. **The key is acting on what has proven to be productive, rather than worrying about what might happen if you do nothing.**

Financial Literacy Question

(See page 6 for the answer.)

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

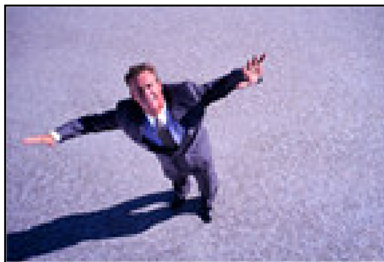
For Americans born in 1950, what is the average annual rate of return they can expect, in terms of retirement income, from their Social Security payments?

a. 36.5% **b. 15.3%** **c. 2.2%** **d. -.1%**

> **Is there anything of which it may be said, "See, this is new?"**
> **It has already been in ancient times before us.**
>
> ***Ecclesiastes 1:10***

1. Manage your debt.

Convinced (or deluded) that their homes and stock portfolios would continue to appreciate, a lot of Americans stopped saving and kept spending; for the past two years, the country's savings rate has been negative.* But the housing market turned sour in 2007 and the stock market plummeted in 2008. In this current financial environment, the biggest challenge for many Americans is finding a way to continue paying for the debt they have accumulated – and finding a way to stop adding more debt to the pile.



The easiest way to manage debt is not to have any. While that comment might sound smart-alecky, this was a prevailing point of view for many Americans that came out of the Great Depression. With the possible exception of a mortgage, many individuals either paid cash or did without. From a personal finance standpoint, living debt-free certainly has advantages, and many households would benefit from making it a financial priority to be debt-free. If your spending is out of control, it may be time to cut up the credit cards or have an intervention to get things under control.

*Bureau of Economic Analysis, U.S. Dept of Commerce report (Nov. 2008, released Dec. 24, 2008), Personal Income and Outlays.

BRIEF HISTORY OF ECONOMIC DISTRESS IN THE UNITED STATES.

Event	Duration
Panic of 1797	3 yrs.
Depression of 1807	7 yrs.
Panic of 1819	5 yrs.
Panic of 1837	6 yrs.
Panic of 1857	3 yrs.
Panic of 1873	6 yrs.
Panic of 1893	3 yrs.
Panic of 1907	1 yr.
Post WW I Recession	3 yrs.
Great Depression	10 yrs.
Recession of 1953	1 yr.
Recession of 1957	1 yr.
Oil Crisis of 1973	2 yrs.
Early 1980s Recession	2 yrs.
Early 1990s Recession	1 yr.
Dot-com Bubble	2 yrs.
Crisis of 2007	?

Practically speaking, most people challenged by debt can't simply sell their house, or tap into savings to pay things off and start over. And they might not be able to stop borrowing either, at least in the short term. (If you don't have the cash for a car, living without one might severely restrict your employment opportunities.) But people who don't find ways to manage their debt will have a tough time surviving the downturn – and are less likely to participate in the recovery that follows.

What is manageable debt? Two Rules

Debt is manageable when the cost to service it doesn't impact your ability to save consistently and substantially. If your income is $10,000 a month, you pay all your monthly obligations, and find it easy to save $2,000 each month, you could make a strong argument that your debt is manageable. On the other hand, if your mortgage, home equity line, auto loan and credit card payments make it impossible to save, your debt is managing you.

From another perspective, debt is manageable if whatever you owe is less than what you own. If your total outstanding debt is $300,000 including your mortgage, and your total assets are $3 million, your debt is probably manageable – provided you could liquidate some of your assets to pay the debt.

And this is where it gets tricky. Illiquid assets count on a balance sheet, but many times turning them into cash would cause major financial disruption. You could sell your business to clear your debt, but then what will you do to earn money in the future? You could sell your home (probably at a discount), but where will you live? Thus, a better way to define manageable debt is if your liquid assets are greater than what you owe.

Should you refinance? Two Reasons

From a debt management perspective, there are two objectives to refinancing. One is to secure a lower interest rate. The other is to lower your monthly payments. Particularly if you have good credit, now might be an opportune time to refinance some of your debt.

While lending standards have tightened, interest rates are historically low, particularly for home mortgages. Credit card companies are still looking for good customers – the ones that have a balance, but pay their bills – so it may be beneficial to transfer balances to a new institution.

Even if you can handle your current monthly payments, there may be value in extending your debt over a longer period of time, especially if the lower payments would help you save money. Changing from a 15-year mortgage to 30 years might seem counter-intuitive if the goal is to reduce debt. But consider the

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possible advantages: A lower monthly payment will be easier to handle. If the difference is saved, you are building a reserve to cushion against unexpected future challenges – thus keeping you from borrowing more or going broke. If not needed, the reserve can be applied against the outstanding balance to pay off the mortgage early.

Should you consider borrowing more? Two Scenarios

Even though the primary focus of debt management for most individuals is debt reduction, there may be reasons to borrow more, depending on your personal circumstances and the reason for doing it.

If borrowing will allow you to acquire income-producing assets, it may be worth taking on the debt. Typical scenarios might be borrowing to acquire income-producing real estate, or ownership of a business. But it also might be student loans to pay for higher education if the end result will be greater earnings potential. Every situation must be evaluated in light of your individual circumstances, but if the anticipated return will exceed the cost of borrowing, there is merit in the idea.

Sometimes the cost of borrowing someone else's money is less than the return you're earning on your own money. If you have liquid assets delivering a 7% annual return, and can borrow at 5%, the math says borrowing is to your advantage. The only caveat: Don't borrow to gratify consumption desires. Borrowing to buy an automobile when you have the cash? Okay. Borrowing for a weekend gambling spree in Las Vegas? Not okay. Wrestle with your own conscience and deal with the rationalization. The basic principle is "borrow to acquire assets, and don't borrow for amusement or lifestyle 'upgrades.'"

- **IS YOUR DEBT MANAGEABLE?**
- **SHOULD YOU CONSIDER REFINANCING?**
- **ARE THERE GOOD REASONS TO BORROW MORE?**
- **WHO CAN HELP YOU WITH THESE DECISIONS?**

2. Build Cash Reserves

When the economy was rolling and markets were booming, out-sized returns led to overconfidence. People got used to operating on skinny financial margins because they found they could spend more, save less, and still come out ahead. Substantial cash reserves were viewed as unnecessary or foolish. ***Oops.***

Building cash reserves may not have the sex appeal of some other accumulation strategies, but building and maintaining a financial cushion is an essential component for responding to times of creative destruction. Cash reserves help you ride out the storm and give you resources for new opportunities that will follow.

What Constitutes Cash Reserves?

Cash reserves don't have to be kept in a shoebox or deposited to a bank savings account earning 1% interest – there are other choices. But those other options should include the *features* of a shoebox or a bank.

First, the money should be **liquid** – i.e., accessible without penalty from either the institution or the IRS. Surrender charges and tax costs can be a deterrent to taking the money, and you don't want to be torn between taking the money and taking a hit.

In most situations, liquidity doesn't mean you must have instant access, like you might at a bank. Receiving funds within five business days is usually soon enough. In fact, a short waiting period might keep you from acting impulsively. The key is the right to liquidate some or all of the account on demand.

Second, the value should be **stable**, and preferably guaranteed. You want some assurance that $5,000 in the account today will be worth $5,000 (or more) tomorrow, next week, next month, next year. This insistence on stability and guarantees can seem foolish when others brag of earning double-digit returns in some non-secure financial product. But a lot of those braggarts have seen their financial safety net unravel as 15% annual returns have been wiped out by 40 and 50% losses over the past two years.

Traditionally, life insurance cash values have served very well as long-term cash reserves. Once a whole life policy has been in place for four or five years, the cash value accumulation can be substantial – and the interest and guarantees are usually competitive with other conservative alternatives.

How Much Should You Be Saving?

How soon do you want to achieve financial stability? Obviously, the more you save, the faster your cash reserves will pile up. But saving more also usually means learning how to spend less as well. In other

words, not only do you have more in reserve, but it costs less to maintain your lifestyle.

Just for your own reference, ask some dedicated savers about the percentage of earnings they allocate to saving. Don't be surprised if the numbers start around 15-20% – and some will be over 50%.

One of the ripple effects of the recent decline in stock market values has been the hue and cry from financial experts that the biggest retirement challenge for most Americans is getting them to save enough money. Where some planning programs might have calculated a successful retirement could be achieved by regularly saving 10% of income and regularly earning 10% on the savings, the numbers have changed. Now, saving 20% is the "new 10%" – this is the minimum amount that must be saved – because a 5% annual return has become the other "new 10%."

But regardless of what's going on in the larger economy, you can't go wrong by saving substantial portions of your earnings.

When Should You Use Your Cash Reserves?

When you have to, and when you can acquire more assets.

One of the casualties of the current creative destruction is lifetime employment security. Nobody graduates from high school or college and settles into a 40-year career with one employer. Fewer employers offer pensions, and many employees won't stay long enough to be vested anyway. In some cases, there isn't even severance pay. All this means a greater likelihood of income interruptions – there are going to be periods ***before retirement*** when you are going to need savings to pay the bills – with no resources except what you've accumulated on your own.

Of course, even in this new employment environment, things may go well. If that's the case, consistent saving could result in a significant cash reserve. If so, this "extra" accumulation may be turned to new financial opportunities – without jeopardizing your financial stability. It's hard to say what those opportunities might be, but as John McCormack noted in his book *Self-Made in America,* "people with money in reserve seem to attract more money from outside sources."

One caution: If you accumulate large cash reserves, prepare to make some decisions about when you should spend the money on personal pleasures – vacations, shopping trips, etc. Money is a medium of exchange, and only reveals its value when it is used to buy something. Saving money for emergencies and opportunities is prudent and productive; hoarding money isn't. Sometimes there is great value in spending the money, indulging yourself or someone else. After all, you can't take it with you. But the best spending usually comes from a plan – i.e., "when we have $20,000 accumulated, we can feel free to spend $2,000."

It might seem odd to think about making spending rules in the middle of a financial crisis, but remember: there's a recovery following a crisis. And if you've been diligent about building your cash reserves, there's going to be opportunities, both to prosper and enjoy it.

- **HOW LARGE ARE YOUR CASH RESERVES?**
- **ARE THEY LIQUID AND SAFE?**
- **SHOULD YOU FIND WAYS TO SAVE MORE?**
- **WHO CAN HELP YOU WITH THESE DECISIONS?**

3. Get Your Own Insurance – and Don't Cut Corners

Having employers provide health insurance was a business practice that arose out of government restrictions on wage increases during World War II. Employers couldn't increase pay to attract new or better employees, but the government allowed a tax advantage for insurance benefits if they were paid by the employer. This was the beginning of employee benefits, and they have represented a significant financial perk for many Americans. A chart from the December 13, 2008 *Lansing State Journal,* showed the average wage for a U.S. autoworker today is $29/hr. When additional, non-wage benefits are added, the number grows to $79/hr.

As mentioned in the previous section, the concept of lifetime employment is part of the past for most people – it has been "creatively destroyed." It's the same with the benefits associated with lifetime employment. Defined-benefit pensions, group health plans, short- and long-term disability coverage, and term life insurance equal to a multiple of your salary are no longer the norm. Even if you're still getting a weekly paycheck or monthly salary, you must think like you are self-employed. That means you will be responsible for providing your own "employee benefits."

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What's the big deal about insurance?

You might not think maintaining an insurance program is a fundamental action for surviving creative destruction. But individuals are most vulnerable to financial disaster during times of economic upheaval. If you're already living on the financial edge because a spouse has lost a job, it doesn't take much for an accident or some other unexpected event to push you over. Insurance is all about minimizing those risks. In order to thrive in the coming recovery, you must first survive, and insurance is a financial survival tool.

But there's another factor: When other people have less insurance, *your* personal financial risk increases. Think of it this way:

Suppose there are 1,000 homeowners in a community. They all face a risk of fire. Statistically, actuaries know that one home will be damaged by fire each year, and the damages will typically be $5,000. Setting aside the administrative costs and other business issues, a simple insurance plan might call for each homeowner to pay $5 a year in insurance to cover the anticipated loss. But what if 400 homeowners decide not to participate in the insurance plan? Now the premium for the 600 participants in the plan must be adjusted. Instead of $5/yr., the premium is $8.33/yr. In real life, the cost of the uninsured is factored into all insurance. Here's a real-life example:

A December 17, 2008 *Wall Street Journal* article reported a significant increase in lapsed auto insurance since the beginning of the financial crisis (nationally, it is estimated that nearly one in six drivers is uninsured – in some states, the ratio is one in four).

One of the ways to protect against being damaged by an uninsured driver who can't pay for damages he/she might incur is to add Uninsured-Underinsured Motorist protection to your policy. This protection means that you can receive money for medical bills, lost wages and other damages even if the other driver has no insurance. This feature adds approximately 7 to 9% to the cost of ***your*** coverage (about 20 states already require drivers to have this feature).

But if you don't have Uninsured-Underinsured coverage in your auto coverage, what happens when you are involved in an accident with an uninsured driver? The *WSJ* article notes "you may have to sue to recover costs, and many uninsured motorists have few assets." You will shell out more money for legal fees, and be less likely to receive any compensation.

Why the emphasis on not cutting corners?

As recent events illustrate, the best-laid plans sometimes fail – and the losses can be much worse than anticipated. **The reason for insurance is to protect against situations that are worse than anticipated**. An insurance program that is based on "perfect-world" scenarios isn't really insurance.

For the last 30 years, many mainstream financial experts have endorsed a buy-term-invest-the-difference approach to life insurance. The BTID strategy calls for purchasing low-cost term life insurance, usually for a period of 20 years, as opposed to paying the higher premiums associated with permanent life insurance such as whole life. To replace the cash value component of whole life insurance, the difference between the premiums is invested in an alternate savings vehicle (the typical recommendation is mutual funds). In theory, the alternate savings vehicle will deliver a larger accumulation than the cash value in a whole life policy. The theory is that this return will be so much larger, that life insurance will no longer be needed.

Can you see the perfect-world mentality driving this strategy? In turbulent times, here's how BTID can unravel:

The good thing about term life insurance is the relatively low cost to acquire the coverage. The bad thing is the high cost of keeping it after the initial term expires. If you reach the end of the term (10 years, 20 years, etc.) and still want life insurance, you will quite likely find the renewal premiums prohibitively expensive. The pricing structure of term life insurance is such that very few people will be able to maintain the coverage. (An oft-cited industry statistic: less than 1% of term insurance policies issued result in the payment of a death claim.)

Suppose you reach the end of the 20-year term period and find the alternative accumulation vehicles have not delivered their anticipated returns. Or suppose the gains have been greatly diminished by losses in the past few years (that could happen, right?). Here's the dilemma: There's not enough money accumulated to replace the life insurance, and you can't afford to keep it.

This doesn't mean you can't do some restructuring of some of your insurance by changing deductibles, elimination periods or other modifications that allow you

to shift some of the risk to your cash reserves instead of the insurance company.

But your insurance choices must reflect your real financial risks, not just the ones you'd like to address. Some people like to dismiss their risk of disability by declaring "Hey, if I'm disabled, I'll find a way to keep working." That's noble and well-intentioned, but when you're disabled, you can't work! You don't get to define what a disability is going to be like, and you don't get to choose which unforeseen events you will encounter.

- **ARE YOU PROPERLY INSURED?**
- **WHO CAN HELP YOU WITH THESE DECISIONS?**

WHO CAN HELP YOU WITH THESE DECISIONS?

If you understand the history of economic downturns and creative destruction, it should be apparent that great opportunities may arise from times such as these. While much of the responsibility for future success lies with the individual, the challenge is easier when like-minded people work together. In your efforts to rise above today's circumstances, don't neglect the assistance of trusted friends, business associates and especially financial professionals.

FINANCIAL LITERACY QUESTION

Here's a quick quiz on a fundamental financial issue. Do you know the answer?

For Americans born in 1950, what is the average annual rate of return they can expect, in terms of retirement income, from their Social Security payments?

a. 36.5%
b. 15.3%
c. 2.2%
d. -.1%

Answer: c. 2.2%

According to statistics provided by the Social Security Administration, an American born in 1877 and retiring in 1942 received an average return of 36.5 % (answer "a") on their contributions to Social Security. When Social Security began, there were 45 workers for every recipient. But as more workers have retired, and life expectancy has increased, this ratio has changed to 3 to 1. These demographic changes have resulted in higher Social Security contributions and lower expected returns from those who hope to receive benefits in the future.

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