Financial In$ight

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Planning for Incapacity… At Any Age

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YOU PROBABLY REALIZE that creating a will is important to ensure that your wishes are followed when you die. But what if you became incapacitated instead? In that case, your will would have no effect. If you are unlucky enough to become incapacitated, you may regret not having prepared in advance.

Your odds of becoming incapacitated in your 40's, 50's or 60's are quite low. But car accidents happen. And healthy people sometimes suffer sudden strokes. Incapacity often strikes out of the blue. While the odds are low, preparing is not difficult.

Here are the four basic steps you should take regardless of your age:

1. **Appoint a healthcare proxy.** This legal document lets you appoint someone (your proxy) to make medical decisions for you if you are unable to do so. They can authorize the start (or end) of medical treatment and can place you in a medical facility or nursing home. Health care proxies are generally very straightforward and can be drawn up by an attorney (or standard versions are available at state government websites.) Keeping this document handy makes sense in the event of a sudden accident or illness. You should give a copy to your primary care physician and request that it becomes a part of your medical record. Also provide a copy to your appointed proxy and always bring one to submit upon admission for any hospital stay. Health care proxies are also known as "power of attorney for healthcare".
2. **Write an advanced directive.** An advanced directive gives your healthcare proxy, and your caregivers, instruction on how you want to be treated if incapacitated. You can clarify your desires regarding end of life decisions, pain medication, invasive diagnostic tests, tube feeding, etc. Standard formats exist but the wording can and should be adjusted to fit your personal wishes. Advanced directives are also know as "living wills."
3. **Sign a durable power of attorney.** This legal document gives authority to someone else to make and implement business and financial decisions on your behalf. Areas of authority may include investment decisions, bill payment, tax return filing, real estate purchase, etc. You can decide how broad or narrow these powers will be. Unless the DPOA has "springing powers" (which means your agent can only act after you become incapacitated), this document's powers become active as soon as it is signed, so you should store this document carefully. It may be best kept in the hands of your attorney. Finally, it is very important that you choose someone who you completely trust to fulfill this role. He/she should be detail-oriented, in good health themselves, have the time and motivation to help you and be well acquainted with your wishes.
4. **Communicate!** If you are responsible for your family's finances, then make sure someone else knows where you store key information they may need to access in the event of your incapacity (i.e. account numbers, passwords/pins, emergency cash, safety deposit box key and number, etc.)

Planning for incapacity is one activity where you hope your efforts will be completely wasted. But if the worst case situation does occur, you will be making life significantly easier for yourself and your family. ■

Make Annual Credit Reports a Priority

Did you know that the more money you have and the better your credit, the more you are a target for identity theft? It's a bit like Willie Sutton's old quote about why he always robbed banks, "Because that's where the money is."

A good credit report is essential for getting good financing rates, insurance rates (insurance companies claim that there is a direct relationship between a consumer's payment history and the number of loss claims they file) and even a good job. The growing opportunities for identity theft also make checking your credit report a priority. The first place identity theft often shows up is in a credit report. Knowing what is on your credit report and getting errors corrected promptly is your best defense against bad credit scoring and identity theft.

Aside from identity theft issues, according to a study released by the National Association of State Public Interest Research Groups (PIRGs), almost 80% of credit reports contain either serious errors or other mistakes of some kind. These errors can result in the appearance that the consumer has "too much" credit available, is overextended or is not a responsible payer.

In 2005, the Fair and Accurate Credit Transactions Act took effect, enabling consumers — by contacting a single phone number or web site — to request their credit reports from the three credit bureaus at no charge once a year. We encourage you to order your free reports now if you have not done so this year and to make a habit of doing so annually.

You can order your free annual credit reports by calling 1-877-322-8228 or by visiting www.annualcreditreport.com. These are the only authorized sources for your free annual credit reports from the three nationwide consumer reporting companies, so don't fall for marketing pitches from other organizations offering to provide you with a free credit report. Those offers typically come with strings attached.

Request your credit reports from all three of the major credit bureaus – TransUnion, Experian and Equifax. They can be requested all at once or you can stagger your requests by calling back every four months to request your next report (you are entitled to one free report per year from each agency).

If there are any inaccuracies on your report, talk with a representative of the credit bureau to find out how to correct the information. Your reports will also list contact information for credit card companies so you can resolve issues directly. If you see unauthorized credit accounts and suspect identity theft, request that the consumer credit reporting companies place a "fraud alert" in your file to let potential creditors know that you may be a victim of identity theft. A fraud alert can make it more difficult for someone to get credit in your name because the credit bureaus will need to contact you in advance for approval. Realize that it also may delay your own ability to obtain credit. ■

Information Found on a Credit Report

- **Personal Information**
  Name, social security number, address and other personal information.
- **Open Account Information**
  Open credit card accounts, credit limits, whether bills are paid on time, balances on the account.
- **Loan Information**
  Mortgages, personal loans, home-equity loans, credit lines and other financings the individual may have outstanding, payment history, account number of the loans and origination date.
- **Collections/Negative Account Histories**
  Whether the individual has any accounts that are in collection and the status of those cases.
- **Judgments/Liens**
  If there is a judgment or an award against a person in a court of law (stemming from a personal suit, small claims matter, etc.) those terms will be included on the report. This section of the credit report will specify the case number, plaintiff and defendant by name, status of the case and resolution.
- **Bankruptcies**
  Bankruptcy information will outline whether it is an individual or a joint bankruptcy, the amount of assets and liabilities the individual has incurred.

Erroneous information should be corrected as quickly as possible. ■

To Request Your Free Annual Credit Reports

Call:
1-877-322-8228

or...Visit:
www.annual creditreport.com

Time and Compounding Are the Investor's Best Friends

When it comes to investing, the most important tool you have is time. A relatively small investment can become a sizable portfolio given time and the impact of compounding.

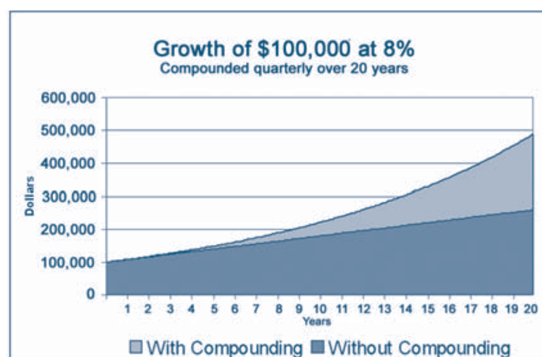
Compounding is the process of earning interest on interest and dividends on dividends, over time. At first your money grows relatively slowly, then with increasing speed as compounding takes effect.

One of the all-time great examples of the impact of compounding is the question…which would be the better compensation plan?

- $100,000 per year with 10% annual increases
- One penny the first month, with your pay doubling with each successive month?

In three years, the individual who chose the $100,000 salary with 10% annual increases would have received $331,000 in compensation. The individual who chose the penny and saw his/her income double each month would have received $687 million dollars. Naturally, that's compounding to an extreme. But the same basic principle holds true at lower rates of appreciation.

Suppose you invested $100,000 for 20 years at 8% annually with earnings paid quarterly. In one scenario, you withdraw your earnings each quarter. In a second, you reinvest those earnings at 8%. Assuming no taxes are paid, in 20 years, the first scenario would have produced $160,000 in earnings and left $100,000 in the account. The second account, which has compounded, would be worth $488,640, a gain of $228,640 due to compounding.



There can be no guarantee that an investment will realize an 8% return over 20 years. All investing has risk and there is always the potential for loss as well as gain.

The sooner you put your savings and investment plan into action, the longer your money goes to work for you. And the longer compounding has to work its math, the more substantial your nest egg can become.

To enhance the power of compounding, you want to minimize the impact of taxes. After all, every dollar you pay in taxes reduces the amount you have to compound. For example, if you had to pay 15% capital gains taxes on your earnings each year, at 8% your account would grow to just $349,000 in 20 years. That's why it's important to invest as much as you can in tax-deferred retirement accounts, or better yet, a Roth IRA where earnings accumulate tax free. Another way to be tax-efficient is to invest using index funds and exchange traded funds.

Understanding the value of time and compounding is one step toward accumulating a healthy retirement fund, but the most important step is to save. Until you set up a plan of steady contributions using an investment approach that works for you, you are letting time and the value it can bring slip away. ■

To Accumulate Wealth, Pay Yourself First

All too often, people put off saving with the idea that it will be easier to set aside money for retirement in a few years when their salaries are higher or perhaps expenses are lower with the offspring off on their own. When later arrives, however, expenses typically have risen to meet income.

The best way to accumulate wealth is to pay yourself first in the form of automatic, regular contributions to your retirement plan or savings account. When your income increases, increase your automatic contribution. Your first priority should be to fully fund tax-deferred accounts, such as your 401(k) or Individual Retirement Accounts. The tax-deferred nature of these accounts gives additional earning power to your investments. If you qualify for a Roth IRA, make certain you maximize contributions to this account as well because earnings can be withdrawn tax-free in retirement.

Long ago, the government figured out the best way to collect taxes was to ensure the government was paid first through payroll withholdings. The same approach works when it comes to funding your retirement. Don't take a chance on spending your income before you have a chance to invest. Pay yourself first. ■

Fat Tails and Probability Statistics

Risk in the financial market is by and large measured by "beta," a measure of the covariance of an asset class with an index. Beta has a number of failings as a measure of risk, one of which is that it considers upward volatility to be as much a negative as downward volatility. But there's another dark side to beta that is too often overlooked; its disregard of fat tails.

DOW JONES INDUSTRIAL AVERAGE: Normal Vs. Fat-Tail Distributions		
Approximate Frequency (Actual Loss is Equal to or Greater Than)		
Probability of Loss	Normal Distribution	Fat Tail "Actual" Distribution
3 %	1 per Year	3 per Year
4%	1 per Decade	1 per Year
5 %	4 per 1,000 Years	5 per Decade
6 %	7 per 100,000 Years	4 per Decade
7 %	1 per Million Years	3 per Decade
		Copyright 2005 Smart Portfolios™

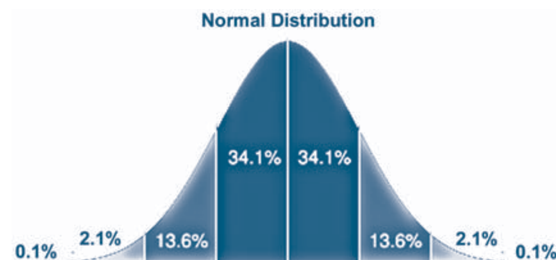
Probability statistics are based on grouping large numbers of variables to determine the likelihood of a specific variable or range of variables occurring. A normal distribution is the well-known bell curve, which is relatively accurate for financial markets most of the time. Given that investment returns follow a normal distribution, you can identify the population average and determine the likelihood of returns varying from that average.

For example, with a normal bell curve distribution, 68.26% of the values will be within one standard deviation away from the mean, about 95.46% of the values are within two standard deviations and about 99.73% will lie within three standard deviations. This is known as the "68-95-99.7 rule." Using beta and historical stock price information, many investment consultants develop portfolios for clients based on the probability of achieving specific returns. But these plans have a flaw that becomes apparent when it's too late. They overlook fat tails.

Fat tails in a probability distribution are those values that fall far to the left or right of the average. Statistically, they have an extremely low probability of occurring, often less than 0.01%. In reality, these extreme outcomes happen much more frequently than statistics would suggest.

Statistically, it was next to impossible for the S&P 500 to fall -22.9% on October 19, 1987. The probability of the S&P 500 losing 4% or greater in a single day is next to nil, yet the S&P 500 has had daily losses of 4% and greater more than 20 times in the last 40 years. The downfall of Long Term Capital Management was directly related to statistically "impossible" moves in the international currency markets.

Fat tails are important to recognize because they remind us that there are no guarantees in investment performance. Putting your portfolio on autopilot on the basis of statistical probabilities does not guarantee that you will arrive at your destination. This is where investment management can add value. ■



The shape of a normal distribution resembles that of a bell, so it is referred to as the "bell curve". Nassim Nicholas Taleb, finance guru and author of Fooled by Randomness, argues that history is dominated not by the predictable but by the highly improbable — disruptive, unforeseeable events that Taleb calls Black Swans. "Before the discovery of Australia, Europeans thought that all swans were white, and it would have been considered completely unreasonable to imagine swans of any other color. The first sighting of a black swan in Australia, where black swans are, in fact, rather common, shattered that notion." The effects of wars, market crashes, and radical technological innovations are magnified precisely because they confound our expectations of the universe as an orderly place.

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