

# Financial Insights®

A Creative Personal Finance Report



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## Behavioral Economics

**A**s investors, our goal is to make rational decisions, basing our next steps on solid and accurate estimates and objective data. However, according to a relatively new field called “behavioral economics,” when money is part of the equation, we often make decisions with the wrong reasons in mind: emotion sometimes takes over for common sense.

Some of the common mistakes that investors make, according to the theories include:



- *accepting modest gains and selling successful investments prematurely;*
- *increasing risk by holding on to losing investments for too long; or*
- *accepting more risk than is reasonable or realized because decisions are made based on emotion.*

Two psychologists (Daniel Kahneman from Princeton and Amos Tversky of Stanford University), rather than economists, pioneered the topic of behavioral economics in 1979 with the

## The High Cost of Doing Nothing

The longer you wait, the behinder you get!

The table below shows how various rates of inflation over the years boost the amount of capital you need to achieve the same purchasing power you have today.

Choose a number of years in the future from the column on the left and follow that row across to where it intersects with a hypothetical rate of inflation listed at the top. Rates of inflation have been relatively low in the last decade and a half, but the economy sits on the precipice of even higher inflation. Multiply your anticipated accumulation fund by that factor to see how much more money you'll need to save to achieve the equivalent purchasing power in the future, assuming the inflation rate you select.

For instance, say you want to have \$750,000 (in today's dollars) fifteen years from now and assume an inflation rate of 6 percent. How much more will you need to protect your purchasing power? The multiplier is 2.4, meaning you'll have to accumulate \$1,800,000!

Better get started!

YEARS	3%	4%	5%	6%	7%	8%	9%
<b>10</b>	1.34	1.48	1.63	1.79	1.97	2.16	2.37
<b>15</b>	1.56	1.80	2.08	2.40	2.76	3.17	3.64
<b>20</b>	1.81	2.19	2.65	3.21	3.87	4.66	5.60
<b>25</b>	2.09	2.67	3.39	4.29	5.43	6.85	8.62
<b>30</b>	2.42	3.24	4.32	5.74	7.61	10.06	13.27

Source: The Walsh Group

idea of Prospect Theory, concluding that people tend to settle for the certainty of modest gain and expose themselves to risk of greater loss by waiting for a bad investment to “turn around.” In 1998, research by Terance Odean, published in the *Journal of Finance* analyzed 10,000 accounts at a large brokerage house and found that investors are quick to take gains and slow to recognize losses.

We need not succumb to the vagaries of emotional decision-making, however.

Objective investing might include:

- *making it automatic, adding to investments on a regular basis rather than when the “time seems to be right;”*
- *based on your time horizon, designing an asset allocation model and keeping to it with a view to long-term financial goals; and*
- *diversifying within each asset class as a further defense against investment decisions that might be based on emotional responses.*

## Questions & Answers

**Q.** I have multiple IRA accounts and a 401(k). Since I am required to begin withdrawing money, I know that I can add up all the IRA savings, and then take the Required Minimum Distribution out of one or more accounts. May I also add the 401(k) amount in and take the total from one or another of my retirement accounts?

**A.** No. According to the IRS Internal Revenue Code, Section 26, Volume 5, Sec 1.401(a)(9), you must calculate your Required Minimum Distributions (RMDs) from a 401(k) separately from your IRA RMDs.

**Q.** I have two friends who speak very little English, but want to find out more about Social Security. Any tips?

**A.** Sure. The Social Security Administration indicates that the program is explained in 15 languages by going to their website at [www.socialsecurity.gov/multilanguage/](http://www.socialsecurity.gov/multilanguage/)

**Q.** Any basic investment ideas for retirement during the rest of 2008?

**A.** Yes, four specifically good ideas:

1. If possible, contribute the maximum amount to your tax-deferred retirement plan account. This would be especially important for those whose companies help with matching contributions. Another important reason here is that the contributions may reduce your current taxable income.
2. Contribute as much as you can afford to an IRA. Even in a traditional nondeductible IRA, the tax-deferral benefits are still valuable over time.
3. Save now for larger contributions in the future, should they come through tax law changes and, finally,
4. Consider the creation of a wealth accumulation fund, which, while having no tax advantages, can supplement retirement income sources.

We will accept questions from readers and reprint selected answers in this column. Send your question(s) to us; we'll answer as many as we can.

## Financial Notes Worth Noting

### Seers and Other Forecasting Hoodwinkers

Probably the most blatant of the "experts" that have hoodwinked people (and lined their pocketbooks) is Ravi Batra who wrote *The Great Depression of 1990*. When that didn't pan out, he wrote *The Crash of the Millennium: Surviving the Coming Inflationary Depression* in 1999. Oops.

It seems that the U.S. economic forecasters are neither ashamed nor swayed by making ridiculously large and outrageous mistakes, coming back with more and more ludicrous predictions . . . and people continue to listen to them rant on TV and on the internet.

Bottom line:

- Try to enjoy their entertainment value and try not to listen too hard. They can be scary and sound very sincere.
- Stick to your guns — if your strategies were designed with safety as well as potential growth in mind and are well diversified, it is best to "stay the course."
- Pay little attention to any of the prognosticators and pay attention to people whose business it is to do rigorous research and whose work you respect.

### Increase Your Paycheck Without a Raise

If you usually are "blessed" with a federal tax refund each year, you should consider adjusting your withholding to keep more money in your pocket on payday.

There are many easy withholding calculators on line to help you find out how many exemptions you are entitled to claim — the number of which determines how much tax is withheld from your paycheck.

Then, you need to complete a new Form W-4 (also available in your payroll office or online at <http://www.irs.gov/pub/irs-pdf/fw4.pdf?portlet=3>.

It has instructions and is easy to use.

Revise your W-4 when there is a major life change that could affect how much tax you pay (e.g., divorce, birth or adoption of a child, marriage, a home purchase).

Don't spend your new-found "raise" in one place!

### On Converting A Traditional IRA to a Roth IRA

Under current law, you may not convert a traditional IRA to a Roth IRA if your adjusted gross income is more than \$100,000. In 2010 and forward, however, that restriction is eliminated, so, no matter what your income, you'll be able to convert as much or as little of your traditional IRAs to a Roth as you wish.

Many IRAs, funded with both deductible contributions and tax-deferred earnings, will be taxed at your top income tax rate. If you convert in 2010, you will have the option of paying your taxes over two years.

Income eligibility limits on annual contributions to a Roth IRA — now pegged at \$116,000 for single persons — will remain in effect (and increase in the future, based on inflation). You might consider making nondeductible contributions to a traditional IRA and convert the balance to a Roth IRA in 2010 and beyond. If your traditional IRA is funded entirely with nondeductible contributions, you will owe taxes only on the earnings when you convert to a Roth.

Form **W-4** Employee's Withholding Allowance Certificate  
Department of the Treasury Internal Revenue Service  
OMB No. 1545-0074  
2008  
1 Whether you are entitled to claim a certain number of allowances or exemption from withholding is subject to review by the IRS. Your employer may be required to send a copy of this form to the IRS.

1 Type or print your first name and middle initial. Last name  
2 Your social security number  
3 Home address (number and street or rural route) City or town, state, and ZIP code  
4 If your last name differs from that shown on your social security card, check here. You must call 1-800-772-1213 for a replacement card.  
5 Total number of allowances you are claiming from line H above or from the applicable worksheet on page 2  
6 Additional amount, if any, you want withheld from each paycheck  
7 I claim exemption from withholding for 2008, and I certify that I meet both of the following conditions for exemption:  
• Last year I had a right to a refund of all federal income tax withheld because I had no tax liability and  
• This year I expect a refund of all federal income tax withheld because I expect to have no tax liability.  
If you meet both conditions, write "Exempt" here  
8 Employer's name and address (Employer: Complete lines 8 and 10 only if sending to the IRS.)  
9 Office code (optional)  
10 Employer identification number (EIN)  
For Privacy Act and Paperwork Reduction Act Notice, see page 2. Cat. No. 1022002 Form **W-4** (2008)

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# General Information About Loans for College; Subprime Effects? More Information?

**A**n education loan is a form of financial aid that must be repaid, with interest. Education loans come in three major categories: student loans (e.g., Stafford and Perkins loans), parent loans (e.g., PLUS loans) and private student loans (also called alternative student loans). A fourth type of education loan, the consolidation loan, allows the borrower to lump all of their loans into one loan for simplified payment.

Federal law sets the maximum interest rates and fees that lenders may charge for federally-guaranteed loans. Nothing prevents a lender from charging lower fees. Many lenders offer a variety of student loan discounts to attract borrowers.

Few students can afford to pay for college without some form of education financing. Two-thirds (65.7%) of 4-year undergraduate students graduate with some debt, and the average student loan debt among graduating seniors is \$19,237 (excluding PLUS loans but including Stafford, Perkins, state, college and private loans), according to the most recent National Postsecondary Student Aid Study (NPSAS).

The median is \$17,120. One quarter of undergraduate students borrow

\$24,936 or more, and one tenth borrow \$35,213 or more. For federal student loan debt (excluding PLUS loans), the figures are 62.2% and \$17,036. Average cumulative debt increases by about 3% or approximately \$550 a year. When one includes PLUS loans in the total, the average cumulative debt incurred is \$21,899. Approximately one in ten (10.8%) parents borrow PLUS loans for

their children's college education.

Graduate and professional students borrow even more, with the additional debt for a graduate degree ranging from \$27,000 to \$114,000. Grants, scholarships, work-study and other forms of gift aid just do

not cover the full cost of a college education.

Many students find that they must supplement their sav-

ings with government and private loans. The Federal education loan programs offer lower interest rates and more flexible repayment plans than most consumer loans, making them an attractive way to finance your education. You can also deduct up to \$2,500 in student loan interest even if you don't itemize deductions on your income tax return.

The interest rate on the Stafford Loan for new loans first disbursed after July 1, 2006 is a fixed rate of 6.8%. The same rate applies to the in-school, grace and repay-

ment periods. The interest rate on new PLUS loans first disbursed after July 1, 2006 is a fixed rate of 8.5%.

The interest rates on existing variable rate Stafford and PLUS loans will continue to change annually on July 1, based on the last 91-day T-bill auction in May. The current interest rates on the Stafford loan are 6.62% during the in-school and grace periods and 7.22% during the repayment period. The current interest rate on the PLUS loan is 8.02%. These rates are expected to

decrease significantly on July 1, 2008.

Many financial aid experts are recommending that students who have not yet consolidated their variable rate loans wait until after July 1, 2008 to do so. Interest rates are likely to drop

enough by then to make it worthwhile to wait to consolidate.

Borrowers may be concerned by the possible impact of the

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*Federal loans will remain available, although loan discounts will likely be reduced significantly.*

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subprime credit crisis on the cost and availability of federal and private student loans. Federal loans will remain available, although loan discounts will likely be reduced significantly. A higher minimum balance may be required to consolidate. Private student loans will likely have stricter eligibility restrictions, requiring a higher credit score or a cosigner. There may be increases in the interest rates and fees on private student loans. Lenders will encourage borrowers to make payments of interest while they are in school.

Many student loan providers offer low cost government and private loans with consistently high quality servicing and flexible repayment terms. Many websites offer advice on choosing lenders and tips on identifying the lenders that currently hold or service your loan(s) as well as calculators that can help you better understand your borrowing options. The loan calculators offer estimates of monthly loan payments, estimates of the amount of debt you can afford to repay, an analysis of the cost of capitalizing the interest and tools for comparing loan costs.

Loan forgiveness programs (in which the borrower's loans are paid off in exchange for volunteer work, public service or military service) offer an option for easy repayment. Loan Cancellation and Discharge Forms can be found on the US Department of Education web site.

Source: U.S. Department of Education



## Are You Saving For A Rainy Day?

# Americans Say They're Not Saving Enough

**M**ost Americans say they're not saving as much as they should . . . but they're apparently not worried enough to do much about it.

Three out of every four Americans say they aren't saving enough, according to the telephone survey of 2,413 adults,

conducted earlier this year by the Pew Research Center. What's more, this "savings shortfall" is acknowledged by majorities of rich / poor, male / female, black / white, as well as by most of those



in almost every other key demographic group.

While uneasiness about savings is broadly felt, Americans now save, on average, less than 1% of their incomes, and the savings rate has been in almost continuous decline for more than two decades. Other ways of measuring savings and wealth tell a somewhat less dramatic story, but most experts agree that Americans aren't saving enough.

Even the most privileged Americans say they're not saving enough; nearly seven-in-ten adults who identify themselves as upper or upper-middle class say they aren't saving enough, a belief shared by only slightly larger proportions of middle class (75%) and lower class Americans (82%).

A similar relationship is seen between income levels and savings anxiety. Predictably, the most affluent are the least concerned about the amount they save. But what is striking in the survey is the pervasiveness of the self-acknowledged savings deficit at every income level from the relatively well-to-do to the lowest income stratum.

Fully six-in-ten adults (61%) with family incomes of \$150,000 or more say they aren't saving enough money for the

future. Among those earning between \$100,000 and \$150,000 a year, the proportion soars to 79% and stays roughly at that level among income groups farther down the scale. For example, 78% of those earning \$75,000 to \$100,000 worry they aren't saving enough, as

do 81% of families with incomes between \$50,000 and \$75,000. Even among those with family incomes of less than \$20,000, the proportion stands

at 76%. A somewhat different measure tells the same story. The survey asked respondents which of the following phrases best describes their financial circumstances: living comfortably, have a little extra left over when they pay their expenses; are just breaking even, or are unable to pay their bills. Among those who say they "live comfortably," nearly two-thirds report they should be saving more — a figure that swells to more than eight-in-ten among those one step down who said they were able to pay their bills with a "little left over for extras."

Minorities are somewhat more likely than whites to say they aren't saving enough. Blacks in particular say they should be saving more (84%), compared with whites (74%) or Hispanics (78%) . . . a relationship that persists even after differences in income are taken into account. Even when the focus is sharpened to look at those earning between \$30,000 and \$50,000, the pattern is apparent: blacks are significantly more likely than whites (92% vs. 77%) to worry about saving.

The people in this survey who are doing best, relatively speaking, on the savings shortfall front are senior citizens. Only a narrow majority (54%) of those

ages 65 and older say they aren't saving enough, while more than a third (36%) of seniors say they are saving enough. This may be because they are in a phase of life when it is more normal to consume past savings (or draw on retirement benefits) than to accumulate additional savings. It may also be because seniors generally have lower living expenses than do younger adults.

One other demographic group that does relatively well on this question are college graduates. Three-in-ten (31%) say they save enough, compared with 19% of those with just a high school degree. Some of these college grads, no doubt, took Econ 101.

Source: Pew Research Center

### Not Saving For A Rainy Day

	Saving Enough	Not Saving Enough
	%	%
<b>Total</b>	21	75
<b>Gender</b>		
Male	21	76
Female	21	74
<b>Race/Ethnicity</b>		
White, non-Hisp.	24	74
Black, non-Hisp.	14	84
Hispanic	15	78
<b>Age</b>		
18-29	15	83
30-49	17	81
50-64	24	74
65+	36	54
<b>Income</b>		
LT \$30,000	16	78
\$30-49,999	17	80
\$50-99,999	20	80
\$100,000+	28	71
<b>Education</b>		
LT High School	16	77
High School grad	19	77
Some College	17	81
College grad+	31	68

Some figures may not total 100% due to rounding and "unsure" answers.