



July 2009 Hot Topics

New Reports on Social Security and Medicare May Change America's Sense of Entitlement

An entitlement crisis has been looming on the horizon for several years. Unfortunately, according to the latest reports from the trustees of the Social Security and Medicare trust funds, a spike in unemployment has helped to hasten the insolvency of these programs'.

In the 2009 annual reports on the health of the entitlement programs, the government revised its projections of the dates when the trust funds will eventually run out of money.

These reports are the latest signals that the federal entitlement system is in trouble. It raises the very real possibility that these government programs may not be able to make as significant a contribution to your retirement income or provide affordable health care.

Social Insecurity

Between December 2007 and April 2009, 5.7 million Americans lost their jobs.¹ Fewer workers means the government is collecting less in payroll taxes, which support Social Security and Medicare. These taxes equal 15.3% of an employee's total wages, a burden that is divided equally between the employer and the employee.²

The 2009 trustee report projects that the Social Security trust fund will be exhausted by 2037, a revision that knocks four years off the previous estimate.³ Furthermore, the program is projected to sink into a cash-flow shortfall by 2016, one year earlier than previously expected.⁴ A part of the program that subsidizes disabled Americans is scheduled to run out of money by 2020.⁵ This all amounts to the sharpest erosion of the Social Security system since the mid-1990s.⁶

¹ U.S. Bureau of Labor Statistics, 2009

² *Los Angeles Times*, May 13, 2009

³ Social Security Administration, 2009

⁴ Social Security Administration, 2009

⁵ *The Washington Post*, May 13, 2009

⁶ *The Washington Post*, May 13, 2009

Moreover, as a result of low inflation rates, it is estimated that Social Security beneficiaries will not receive annual cost-of-living increases for the next two years.⁷

"Medican't"

Even more troubling than the fate of Social Security may be the dire straits facing Medicare, the primary health insurance program for people aged 65 and older. Even prior to the financial downturn, the "Medicare problem" was characterized by David Walker, former Comptroller General of the United States, as "five times greater than the Social Security problem."⁸ The Medicare problem has only been exacerbated by the recent economic downturn.

The Hospital Insurance Trust Fund, which is already operating in a deficit, is scheduled to completely run out of money in 2017.⁹ The trustee report suggests that, even in the short term, the program will "require substantial changes to program income and/or expenditures."¹⁰

Trust funds responsible for Medicare Part B (doctor visits) and Part D (prescription drugs) are scheduled to remain solvent for the foreseeable future because of legislation that automatically provides funding for both programs. As a result, however, 25% of Part B enrollees may face large premium increases over the next several years.¹¹

Too Optimistic?

By some accounts, the projections made by the trustees may be understating the problem. For example, these estimates are based on the expectation that the economy will recover by late 2009 and that revenue will increase soon thereafter, before falling into deficits in 2016. If an economic recovery is late in coming, these estimates could prove too generous. Also, the Medicare

⁷ *The Wall Street Journal*, May 13, 2009

⁸ "60 Minutes," July 8, 2007

⁹ Social Security Administration, 2009

¹⁰ Social Security Administration, 2009

¹¹ Social Security Administration, 2009

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report assumes a 21% cut in payments to doctors working for Medicare, as dictated by law. But Congress has cancelled that reduction for the past several years.¹²

Population Problems

In addition to the complications caused by the current economic crisis, part of the insolvency problem facing these entitlement programs is demographic. As more baby boomers enter retirement and begin to collect benefits, the cost of these programs is expected to rise. In 2008, Social Security benefits amounted to 4.4% of gross domestic product (GDP). By 2034, they will account for 6.2%.¹³ Medicare's annual costs represented 3.2% of GDP in 2008, but they are estimated to surpass Social Security in 2028 and reach 11.4% of GDP by 2083.¹⁴

The trustee's reports confirm that these popular entitlement programs are in serious need of reform. Although most people agree that major changes are needed to fix the problems facing Social Security and Medicare, there is a partisan divide. As with most political issues, both sides of the aisle paint drastically different pictures of what an entitlement makeover might look like.

According to a recent survey, 64% of retirees say Social Security is their single largest source of retirement income, and for 32%, Social Security provides more than 90% of their incomes.¹⁵ Considering the uncertain future of Social Security and Medicare, a carefully considered financial strategy may help you prepare to meet more of the funding demands of retirement on your own.

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Life Lessons

One third of US adults have no life insurance, according to recent research.¹⁶ That may not actually be a big deal. Not everyone needs life insurance.

What's truly alarming is a finding that most people who already have life insurance may not have enough coverage to help prevent the financial hardships that many families face when a major breadwinner dies unexpectedly.¹⁷

¹² Social Security Administration, 2009

¹³ Social Security Administration, 2009

¹⁴ Social Security Administration, 2009

¹⁵ Social Security Administration, 2009

¹⁶ LIMRA International, 2008

¹⁷ Life and Health Insurance Foundation for Education, 2008

The uninsured families are probably aware that they lack coverage. It's the underinsured families who run the risk of finding out too late that they didn't have enough insurance.

Most adults only have group coverage through an employer.¹⁸ Although life insurance is a valuable employee benefit, the risk here is that you could be lulled into believing that having some life insurance is the same as having the appropriate life insurance coverage for your situation.

This life insurance primer may help you understand why and how to obtain life insurance coverage that suits your family's needs.

How Much Coverage Do You Need?

Experts recommend a variety of methods to estimate how much life insurance your family might need. But the best method might be a good old-fashioned gut check. Ask yourself some tough questions about how much money the family would need if a breadwinner in the family suddenly died:

- How much money would the surviving spouse need to pay the mortgage and avoid having to sell the family home and move to a smaller residence?
- How would the surviving spouse care for the children if he or she needed to work?
- How will the kids pay for college?
- How will the surviving spouse's retirement program be affected? Will he or she be able to continue setting aside enough money to fund a comfortable retirement?

Once you have the appropriate coverage in place, it's wise to review your policy (or policies) on a regular basis. Here are some of the things you will want to review:

- Have there been changes in the family that would affect the level of coverage?
- Has the mortgage payment gone up (or down)?
- Has the wage earner's salary increased significantly since the policy was purchased? Has the family's need for income increased since the policy was purchased?

¹⁸ LIMRA International, 2008

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- How has inflation reduced the spending power of the death benefit from a policy that may have been purchased several years ago?
- Are the primary and secondary beneficiaries properly designated on the policy?

What Type of Policy Do You Need?

Most life insurance policies fall into one of two categories. *Term* life insurance is a temporary policy that remains in force for a set number of years. If the policy expires before you do, your heirs receive nothing upon your death. This type of policy does not accumulate cash value, and the insurance company keeps all premiums you paid during the term.

Term insurance is a popular choice for young families because it can offer a substantial death benefit at a fairly reasonable cost. However, term policies become more expensive as the insured ages and may eventually become costly to renew.

Cash-value life insurance, also called *permanent* insurance, typically remains in force throughout your lifetime, as long as premiums are kept current. When you buy a permanent life insurance policy and begin paying the premiums, the policy has the potential to accumulate cash value on a tax-deferred basis. Eventually, you may be able to withdraw any cash value up to your cost basis in the policy, which is the amount of premiums paid, without incurring any income tax liability.

When your cost basis has been withdrawn, you may be able to borrow against the death benefit. Because loans are usually not considered to be income, you typically will not incur any income tax liability. However, the amount of any outstanding loans plus any interest will be deducted from the death benefit after the insured has died.

Permanent insurance may seem like the easy choice, but it is usually more expensive than term insurance. This type of policy is popular among people who expect to owe estate taxes or want to leave a legacy for their heirs and/or a charitable cause. A permanent life insurance policy is also appropriate for people who are attracted to the idea of potential access to the accumulated cash value during their lifetimes for retirement income, college funding, or other major financial goals.

Will Your Family Have To Pay Taxes on the Life Insurance Benefits?

Your beneficiaries will not owe income taxes on the death benefit from your life insurance policy. But if you own your life insurance policy anytime during the three years prior to your death, the death benefit will be considered part of your estate and could contribute to a potential estate tax liability.

If you don't believe your estate will be subject to estate taxes, here are two possibilities that you should consider:

- A large death benefit could raise the value of your estate high enough to trigger estate taxes.
- Don't discount the possibility that your estate could grow large enough during your lifetime to trigger estate taxes upon your death.

By setting up a properly structured irrevocable life insurance trust to own your life insurance policy, the death benefit will not be considered part of your estate. You fund the trust by making "present interest gifts" of cash each year to the trust, which uses the money to pay the premiums. The use of trusts involves a complex web of tax rules and regulations. You should consider the counsel of an experienced estate planning professional before implementing such strategies. Purchasing the appropriate type of policy and amount of coverage involves many factors, some more complex than others. Please call if you would like to review the role that life insurance can play in your financial situation.

The cost and availability of life insurance depend on age, health, and the type and amount of insurance purchased. Before implementing a strategy involving life insurance, it would be prudent to make sure that you are insurable. As with most financial decisions, there are expenses associated with the purchase of life insurance. Policies commonly have mortality and expense charges. In addition, if a policy is surrendered prematurely, there may be surrender charges and income tax implications.

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The Positives of Negative Correlation

Strategy Looks for Investments with Offsetting Risks

All individuals, organizations, industries, and even national economies are subject to routine setbacks, ranging from minor inconveniences to major catastrophes. The recent performance of the U.S. economy, the largest economy in world history, is a good reminder that even something that may sometimes seem miraculous and invincible is subject to downtrends, cyclical or otherwise.

An investment portfolio is likewise not immune to setbacks. In fact, setbacks are so likely to occur that the best defense may be to expect some losses and to employ a method to help reduce any damage.

Up vs. Down

Different types of investments are subject to different types of risk. For example, on days when you hear that stock prices fell, it would not be unusual to hear about a rally in the bond market. This tends to occur when investors decide to shift away from stocks because the risks facing debt instruments might be more palatable.

However, a strategy of identifying investments that face offsetting risks is much more complex than simply spreading your money among stocks and bonds. Such a strategy would involve first identifying *correlations* between different investments.

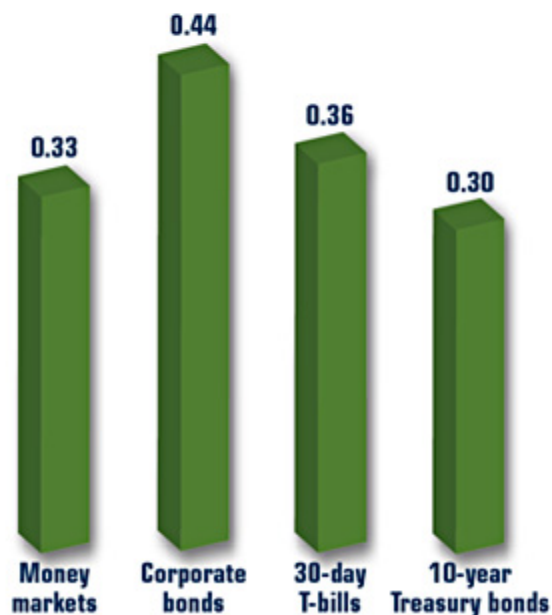
In the financial world, correlation is a measurement of how two securities perform in relation to each other. Securities that are negatively correlated will have prices that tend to move in opposite directions. Securities that are positively correlated will have prices that move in the same direction.

By examining the historical relationship between the performance of two different investments, it's possible to compute a correlation coefficient, which measures the degree of correlation (see chart). A correlation of +1 means the investments have a perfectly positive correlation and will perform identically. A correlation of –1 means they have a perfectly negative correlation and will always move in the opposite directions. A correlation of zero means that the two investments are not correlated; the relationship between them is random.

Assets that have relationships that can be correlated might be found in different industries, sectors, or asset classes. Few asset groups are perfectly negatively correlated, but your portfolio may still be able to benefit from the correlation principle.

Little in Common?

This chart shows the correlation coefficient between certain types of assets and the S&P 500 Composite index (total return) over the past 25 years.



Source: Thomson Reuters, 2009, for the period 12/31/1983 to 12/31/2008. Money markets are represented by the 30-day Money Market Index. Corporate bonds are represented by the Citigroup Corporate Bond Composite Index. T-bills are represented by the U.S. 30-Day Treasury Bills Index. Treasury bonds are represented by the Treasury Bond 10-Year Yield. Treasuries are backed by the full faith and credit of the U.S. government as to the timely payment of principal and interest. The performance of an unmanaged index is not indicative of the performance of any particular investment. Individuals cannot invest directly in an index. Past performance is no guarantee of future results. The principal value of stocks and bonds may fluctuate with market conditions. When sold, stocks and bonds may be worth more or less than their original cost. Investments seeking to achieve higher yields also involve a higher degree of risk.

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