# Aren’t you a*maze*d?

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Tidbits to help you through the financial labyrinth

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**1,** It has been talked about for a long time, but now it is happening: A few insurance companies have raised their critical illness (CI) insurance premiums by about 15 to 20 %, and the rest will follow suit very soon. At the same time, the new versions offer even more covered conditions and various novel features as well. Even after the premium increase, buying this kind of protection is a very prudent thing, and we should be happy that in Canada (unlike anywhere else) it is still available with fully guaranteed premiums.

I underline here two features that are somewhat new, or at least not emphasized enough on my webpages about CI. The first is that once someone has made a decision to buy a CI policy, adding a Return of Premium Rider (ROP) is not a luxury, but a smart investment. I know it sounds dubious at first, and can remind people of salesmanship again. However, there are hard numbers to show that my claim is true. For a healthy 42 years old non-smoker male, I did detailed calculations to show the annual return on the money he pays for this rider on a specific CI policy that would protect him until age 75. Let’s look at three scenarios: (a) he gets struck with cancer, heart attack, or some other covered conditions and the policy pays the contracted benefit. In this case, the policy pays the contracted lump sum, and the annual return on the money is some astronomical number in the first few years, of course, but even toward the end of the insured period it remains a decent 4.93%, as opposed to the 6.08% that

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would occur if he goes without the ROP. (b) He dies before age 75 without first getting a CI benefit (because the cause of death is not a covered condition, or because he doesn't survive the prescribed survival period). In this case, all the money he paid for the policy (with or without ROP) is paid back. There is no gain on the money in this case, of course. On the contrary, there is a notional negative return, or opportunity cost deriving from the fact that he could have invested his money in some investment instead of parking it in a CI policy for the sake of some piece of mind from the knowledge that a critical illness will not ruin him financially. (c) Let's have a look now at the most likely scenario, namely, that he will live without any critical illness until the age of 75. In this case, he will get a nice lump sum then, tax-free. The annual return (on the moneys paid for the ROP) that this sum represents is 8.66%. If you know any 33 year investment with guaranteed after-tax annual return of 8.66%, then you should not buy an ROP, … but otherwise it just makes sense. It's important to add that with this particular policy I scrutinized, the client can surrender the whole policy after 18 years and still be entitled for the return of the premium. I don't think it's basically a good idea from a risk management point of view, however, it might happen. If it does, the annual after-tax return on the cost of the ROP is even higher. (12.96% after 18 years, … then it slowly goes down to the already mentioned 8.66% by the time he reaches age 75.) With the recent changes the choice of various ROPs became wider.

The other interesting development is that there are now two companies that offer CI insurance specifically for insuring mortgages. These are all the more important since many people make the mistake of lightheartedly signing up for poor quality and expensive life and/or CI insurance when they sign their mortgage contracts. One of these special new CI policies combines basic CI coverage with an emphasis on critical conditions resulting from accidents, making it more affordable for more people.

**2,** There are developments in the field of long term care insurance as well. One policy was withdrawn for the market, another was introduced, and a third that is available from brokers has been revamped. In addition, more policies are in the planning stage, reflecting the recognition of the increasing need for this kind of protection. The currently available policies are more affordable (especially if buying is not left to old age), and have a range of features to choose from, according to preferences and financial means. In addition to the pure financial benefit (that is cash), they offer various support services as well (including the invaluable Best Doctors service) for the family of insured people who get into trouble. The common criteria that triggers the insurance claim is the need for help, either at home or in a care-providing facility, in carrying out normal activities of daily living, due to some physical or mental infirmity. An important novelty is that care provided by family members of the needy insured are not necessarily excluded anymore, except in situations when they live in the same household.

**3,** Many people make serious mistakes in the way they handle their debts, including mortgages. Often, they overstretch, believing that current extra-low levels of interest rates will always be available; they don't shop around for best rates; they sign unsatisfactory and expensive insurance policies with the mortgage; they don't do everything possible to pay the mortgage off as soon as possible; and they don't take the trouble arranging their finances so that they can get a tax receipt against the interest portion of their regular mortgage payments. Tens and hundreds of thousand of dollars are wasted over the years in too many cases, basically just because people don't take the trouble of searching for and learning about the best ways. Maybe somewhat less in Canada, but certainly in the US, there is a scary phenomenon of unprecedented indebtedness, and it's just a matter of time when the housing bubble will burst. Interest rates and inflation will go up, perhaps dramatically and briskly, and many home owners will be in big trouble, partly because of this kind of negligence.
A related article in The New York Times a few days ago reported that credit card payment problems are more and more frequent. It's only 40 % of credit card owners who pay their cards fully every month; the typical household has eight cards with $7,500 on them. Consumers are in debt up to their eyeball; still the buying binge is going on. If all hell breaks loose there, will not we be affected, … and don't we have the same kind of problems in this country as well? I guess we do.

**4,** Another sign of widespread negligence and close-mindedness is the fact that huge amounts of money are kept in GICs, even though historical evidence indicates that if one considers the effects of taxation and inflation, the real return on GICs is hovering around not much above 0 %. One way of achieving better returns than the ones available in GICs is by relying on annuities. If combined with insurance and charitable giving, one can achieve significantly (in many cases by 50-60 %) higher retirement income, while at the same time keeping estate values intact (or perhaps even increased), and/or supporting worthwhile organizations or causes of own choice. Being cautious and risk averse, especially at an advanced age and these days, is a natural and wise thing; however, giving up the search for better solutions (in this example: higher annual real returns) is not. Annuities can be great, but they are not the financial panacea either, of course. The healthy middle ground is to apply the principle of diversification among the income producing investment categories as well.

**5,** According to most reports and analysts, the North American economy and markets are on the mend. Despite of dire warnings by some credible sources about the state of the American economy and dollar, the tectonic changes in the world economy, the increasingly more frequent and serious developments in the environment and around some natural resources, and inevitable consequences of demographics, the majority of opinion leaders and money managers are quite bullish again. Yes, once again, they might be right … for a while. Stephen S. Roach, chief economist for Morgan Stanley pointed it out in the Nov 26 issue of The New York Times that the weakening of the US dollar is an inevitable and basically good thing, provided the central banks of the world can manage this decline so that it would be gradual and predictable. America absorbs now about 80% of the world's surplus savings, and the situation is untenable. He wrote: "This is a dangerous arrangement. The day could come when foreign investors demand better terms for financing America's spending spree (and savings shortfall). That is the day the dollar will collapse, interest rates will soar and the stock market will plunge. In such a crisis, a United States recession would be a near certainty. And the rest of an America-centric world would be quick to follow." What is the real chance for the successful management of rearranging all those factors (exchange rates, savings rates, trade balances, etc.) in our fragile and divided world? To me, it seems low. Though there are even unusual initiatives to achieve changes in the US government's fiscal and monetary policies (undeniably a key factor but not the only one in this complicated game), like the recently recreated civic Sound Dollar Committee, they may turn out to be just desperate attempts, as futile as many international events that achieved nothing in the necessary and perhaps successful coordination. Maybe the genie is already out of the bottle.

**6,** Have you heard the latest news about Management Expense Ratios (MERs) on Canadian mutual funds? Unfortunately, most people do not pay attention to it, but Fidelity announced a decrease of MERs on their funds, and a few other companies are already pondering whether they should do the same. I think it is related to the general outlook indicated above, even though the relationship is not direct, of course. In other words, much of the outward bullishness is a pretense, I think, … the way as it has happened before. I find it quite impressive and rare when a fund manager has the guts to go against the current, and stay the course even if it means low rates of return on the short term. Notwithstanding knowledge, experience, and access to up-to-date information, in a way, it's really uplifting to witness how much is dependent simply on the human character of experts and professionals. One of my favourite money managers wrote this in March 2004: "Mr./Ms. Advisor, you are the **"doctor"**. Make sure your "patients" get the treatment they ***need***, not what they think they ***want***. As for myself, **I am not in a popularity contest.** Those of you who have followed my statements and actions know that I march to the beat of a different drummer. I will do what is necessary, even if it is unpopular, because it is right. The father of security analysis, Benjamin Graham said, **"You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right…Have the courage of your knowledge and experience."** Right now our knowledge and experience is saying that the US stock market is now in dangerous ground." (italics and bolds in original)

**7,** A few months ago, consumers got another good news, probably even more widely (and just as undeservedly) disregarded than the news about MER decrease. In this case, the change is an increase, … that of guarantees by CompCorp, the insurance industry's non-profit organization for ensuring that clients be protected against loss of policy benefits in the event of the insolvency of their insurance company. The previous fixed limits ($200,000 for death benefits, $2,000 for monthly income benefits, $60,000 for health income benefits) have been expanded, so that if the promised benefit was more than these limits then 85% of the promised benefit (but not less than these amounts) will be paid. The limit of the guarantee on savings benefits (cash values, accumulated values) remained $60,000 per insurance-covered person per insurance company. This is the same extent of guarantee that The Canada Deposit Insurance Corporation offers for consumers of non-insurance financial institutions (banks, mortgage companies, trusts) on their eligible deposits, in case the institution fails, … again, per depositor, per institution. To be eligible, the deposit should be in Canadian dollar, payable in Canada, and term deposits must be repayable no later than five years after the date of deposit. Investors should be aware that there is no this kind of guarantee for mutual funds of any kind.

**8,** Socially responsible investing (SRI) has by now become an increasingly more accepted way of aligning personal values with decisions on where and how they invest their savings, for many people. The noise about the alleged likely lower performance of green, ethical, renewable energy, sustainable development, etc. funds that are included in the broad SRI category has subsumed after studies and respectably long series of decent annual returns made it non-defendable. Another kind of reservation against SRI funds however, this time by people I call on my relevant webpage 'purists' got significant reinforcement recently.
Pauld Hawken, author of "The Ecology of Commerce: a declaration of sustainability" and "Natural Capitalism: creating the next industrial revolution", cooperating with others in and outside the Natural Capital Institute, published a remarkable study in October of SRI funds worldwide. The title and subtitle are quite descriptive: "Socially Responsible Investing: How the SRI industry has failed to respond to people who want to invest with conscience and what can be done to change it". Based on an ambitious survey and analysis of all the investment funds in the world that identify themselves as SRI funds, they prepared this 35 page report (available at http://www.naturalcapital.org/intro.html), and also a searchable on-line database, to be followed by one more study in which they promise to identify a list of the "best" public and private companies, based on much more strict criteria than what are used by SRI money managers. The current study can be seen perhaps as unrealistically ambitious or utopian in its demand for much higher standards

or suggested disregard of using general non-SRI indexes as benchmarks to compare performance to, or there can be arguments that that the authors belittle some real merits and achievements, still, basically it's criticism certainly cannot be swept away.

They claim that the SRI mutual fund industry has no standards, no definitions, and no regulations other than financial regulations. "Anyone can join; anyone can call a fund an SRI fund. Over ninety percent of Fortune 500 companies are included in SRI mutual fund portfolios." Based on their findings, they accuse that the SRI industry "misleads investors", and they come up with some recommendations to improve the situation. They challenge the notion that SRI funds play an important role in changing corporate practices, and raise at least the possibility that they may end up instead "serving as marketing tools used to appease investor sentiments and greenwash corporations."

These are the summaries of their ten main findings, verbatim:

1. The cumulative investment portfolio of the combined SRI mutual funds is virtually no different than the combined portfolio of conventional mutual funds.
2. The screening methodologies and expectations employed by most SRI mutual funds allow practically any publicly-held corporation to be considered as an SRI portfolio company.
3. Fund names and literature can be deceptive, not reflecting the actual investment strategy of the managers.
4. SRI fund advertising caters to people's desires to improve the world by avoiding bad actors in the corporate world, but it can be misleading and oftentimes has little correlation to portfolio holdings.
5. There is lack of transparency and accountability in screening and portfolio selection.
6. The ability for investors to do market basket comparisons of different funds is difficult if not impossible.
7. There is a strong bias towards companies that aggressively pursue globalization of brands, products and regulations.
8. The environmental screens used by portfolio managers are loose and do little to help the environment.
9. The language used to describe SRI mutual funds, including the term "SRI" itself, is vague and indiscriminate and leads to misperception and distortion of investor goals.
10. Although shareholder activism is cited as a reason to invest in SRI mutual funds, few SRI mutual funds engage in shareholder advocacy or sponsor activist shareholder resolutions.

They elaborate on these five recommendations:

1. Change screening criteria
2. Improve and modify fund language descriptions, … and they come up with some specific suggestions
3. Moderate investor expectations
4. Become transparent and specific with respect to how companies are chosen
5. Maintain constant online disclosure of portfolios with full commentary on why a company has been selected or deleted.

In a powerful closing paragraph, while acknowledging a few funds by name that make real contribution to corporate reform and accountability, they call for the reform of the SRI industry: "To put it plainly, if the SRI industry were a corporation, it wouldn't qualify in a rigorously screened portfolio. Either the industry has to reform in toto (or rename itself), or that portion of the industry that wants to maintain credibility must break off from the pretenders and create an association with real standards, enforceability, and transparency."

Understandably, the report immediately stirred up debates, and probably hurt some undeservedly. Still, all in all, I think, it is very good that it was published. Where there is deception, weak transparency, and unaccountability, it has to be challenged, and painful truths are better to be faced than hidden. There are certain positions though that could be debated, I think, … and hopefully there will be ensuing exchange of views that leads to improvements. What seems to be the most exciting and problematic, but fundamental issue is the authors' suggestion that SRI funds should not be measured by the yardstick generally applied in the financial industry. "The obsessive drive to compare SRI funds with conventional funds should cease. The difference in yield is largely irrelevant. What is relevant is what a company does, how it does it, and then, and only then, is yield relevant. Investing is both a quality issue and a timing issue. If a stock is overbought, it doesn't matter how wonderful the company is, this is commonsense portfolio analysis. But using standard stock indices as measures of SRI performance betrays the mission of the industry. We don't know what a socially responsible rate of return is because no real socially responsible portfolio has been put together and tracked over a significant time."

I would like to know how people think about these issues, … so please send me your opinion if you don't mind.

**9,** I intended to entice readers to John Allen Paulo's book (published in 1988, then again in 2001), "Innumeracy: Mathematical illiteracy and its consequences". I'm running out of space here, so please just believe me: it you read it, you will likely learn a lot from it, and in an enjoyable way.

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