



NASD Intends To Regulate You

Several years ago NASD changed its mission statement from being the nation's security industry regulatory provider to declaring itself to be "the world's leading private-sector provider of financial regulatory services".

Although there have been public denials from NASD that they don't want to extend their jurisdiction, the current NASD is positioning its image to become the regulator of insurance companies, agents, investment advisors, and others. Perhaps emboldened by the surrender and silence of state insurance departments and insurance carriers when they usurped supervisory authority on index annuity sales, NASD has decided a name change is due to show its enhanced powers

the new Financial Industry Regulatory Authority

In an email to firms on July 12, 2007, NASD Chairman and CEO Mary Schapiro announced the decision not to use the name "Securities Industry Regulatory Authority" for the new regulatory organization formed from the consolidation of NASD and the New York Stock Exchange Member Regulation. The organization is now known as the Financial Industry Regulatory Authority, or FINRA.

Can Seniors Make Wise Decisions?

In the 46 years since the U.S. Senate established the *Special Committee on Aging* there have been many regulations proposed and passed by both Congress and various state legislatures designed to protect senior citizens. Recent attention has focused on how insurance agents interact with seniors, with this attention ranging from banning the use of designations if they contain the "s" word to requiring that insurance transactions with seniors follow more restrictive rules than would be required for other consumer segments.

It should be noted that these senior protection regulations would not offer new protection to consumers with Alzheimer's disease or dementia, or some other condition that may in and of itself make any legal contract voidable – contracts made by adults viewed as legally incompetent are not enforceable. Instead, it appears the legislators are saying that the decision-making capabilities of senior citizens in the insurance and annuity realm are not as good as younger citizens and therefore additional mandated protection is required.

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Cartoon

Illusion of Validity

I was speaking at a function for planners and advisors awhile back and one of the planners afterwards told me that he didn't need to use fixed annuities because he was doing *strategic* asset allocation, and that based on his knowledge and his models that his clients were protected against market risk of loss.

When I heard this I had a flashback to the fall of 1999 when another young stockbroker/planner told me his clients didn't need index annuities because he was using *tactical* asset allocation and thus they were protected against market risk of loss – and based upon what he described his typical client would have lost roughly half of the value of their “tactical” portfolio in the millennium bear market that followed.

The market has risen for four years. At the end of May the S&P 500 finally passed the old high set seven years before. The market exuberance is more tempered than the last time around. However, just as markets have never dropped to zero neither do they keep going constantly up. If you look back over the last 60 years the market has failed to increase a fifth year in a row 90% of the time.

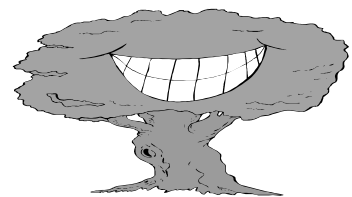
The problem for a lot of investors and advisors is if they've invested in the stock market for the last four years they've been right, and all of this “proof” results in something called an *illusion of validity* wherein we think we will be right in the future because we were right in the past. But, this all overlooks something my first manager told me years ago, which is never confuse brains with a bull market. Unfortunately, there are many people that believe the “new” stock market has two phases – up a little and up a lot.

If the market does what it has always has done in the past it will fall, and then rise again. If you are in for the long term and can emotionally handle the risk, it's usually smart just to ride it out. However, every time a bull market extends its time in the arena it attracts folks and money that probably shouldn't be there because risk of loss is not fully appreciated, and neither these folks nor dollars can truly handle a potential loss.

For these people and this money fixed annuities with a stated or indexed interest rate can often make sense.

Introducing The Green Annuity*

- ◆ Policies printed on recycled paper
- ◆ Insurer portfolio holds only “G” rated bonds (debentures of windmill companies, bio-fuel conglomerates and perpetual motion corporations)
- ◆ Our wholesalers only use public transportation to visit you (remember if they are late for your appointment it is because they are saving the earth)
- ◆ Please forgive our telephone service center agents for sounding out of breath, they are pedaling bike generators to power their computers
- ◆ Building a tax-deferred umbrella to protect the earth from global warming



*not invented by Al Gore

You are not going to die May 7, 2042 (and other misconceptions)

According to a Society of Actuaries study roughly three-quarters of folks surveyed felt they would live until age 80, but roughly the same percentage thought they'd be dead by age 85. I believe the reason for this groupthink, whereby everybody dies in the same five year period, is due to the media talking about life expectancy and the public misunderstanding it.

We keep hearing about our life expectancy being 81.6 years or 83.1 years or such. It appears many people take this to mean that if they are age 48 today that they will die on May 7, 2042 exactly as their lifespan hits age 83.1 years, as if some cosmic actuary pulls the plug on their life cord.

The reality is life expectancy is the point at which half of the people in your particular segment will be dead. This means half will die early – need more life insurance? And half will live longer – that GLWB might be very useful!

A Maturity Date Is Not Life Without Parole

One of the stranger conclusions I once read was that annuities lock up your money for 40 or 50 years, and the reason is the writer confused maturity date with the surrender period. Suppose an age 65 consumer purchased an annuity with a maturity date of age 95 and a 10 year surrender period. The consumer would probably incur a penalty if the annuity was cashed in before age 76. However, there would be no charge for almost every annuity on the market if the consumer cashed in the policy after 10 years. What about the age 95 maturity date? All this means is the consumer must begin to withdraw money from their annuity at age 95. The maturity date is the longest the consumer can force the insurer to keep the money, not the other way around.

The annuityowner may get off the annuity highway at any exit

Fixed annuities have maturity dates that permit the consumer to keep an annuity until age 85, 95, or even 105. However, saying that this locks you in is like saying if you get on Interstate 80 in New York you can't get off until you reach San Francisco.

A fixed annuity is a financial highway, and just like on the Interstate the driver can choose to exit at any time, but they need to be aware of any early tolls.

The PE Ratio Does Not Foretell The Future

How often have you heard some wag say something like “since the average market P/E ratio is much higher than the long-term average this means the stock market will head lower”. Wonderful line, the problem is it's not supported.

The ratio shows how many times higher the price (P) of a stock is when compared with the stock's earning (E). A P/E ratio of 2 means the stock is selling for 2 years worth of earnings and a P/E ratio of 24 means a stock is priced at 24 times earnings. A higher P/E is viewed as a bullish indicator of the company's expected future. A lot of folks say a really high overall market P/E ratio is too bullish and this means the market will go down, and a really low P/E ratio means the market is too bearish so it will go up (maybe it's kind of like reverse psychology).

However, a study published in the *Journal of Portfolio Management* looked at 128 years worth of P/E ratios and concluded “they provide unreliable forecasts of future returns”. They also said “there is no statistically significant relationship between P/E ratios at the beginning of a year and returns during the following year”. There is nothing in the past to support the idea that a high P/E ratio this year means bad stock market returns next year, or a low ratio today means the market will go up tomorrow.

What Everybody Knows

What “everybody knows” in the financial world often is wrong, or at least only part of the story. It is usually a good idea to question everything, especially those facts that “everybody knows” to be true.

Society Of Actuaries; *Key Findings and Issues Longevity: The Underlying Driver of Retirement Risk 2005 Risks and Process of Retirement Survey Report*; July 2006

Fisher, & Statman, (2000); Cognitive biases in market forecasts; *Journal of Portfolio Management*; 27; 73

Can Seniors Make Wise Decisions? (continued from page 1)

Who is a senior citizen? Although the U.S. Senate Committee on Aging describes senior citizens as anyone age 60 or older*, most of the state regulatory acts and proposals seem to define a senior as a citizen age 65 and beyond. The various studies on aging and decision-making I read used “old age” subject groups from as low as age 50 to as high as age 82. Based on my research any attempt to define a “senior citizen” by coming up with a stated age is entirely arbitrary because people age differently. The decision-making capabilities of the average 55 year old appear to be very similar to the average 70 year, and a specific 55 year old may have much worse mental acuity than a specific 85 year old. I use the word “senior” in this article to describe one that is older than middle-aged, and I will leave it to the lawmakers and scientists to decide the magic age at which a citizen become old.

The question this article attempts to address is: Has the decision-making capability of senior citizens, however defined, declined to such an extent that they need to be protected as a separate class?

My research involved a review of over 40 peer-reviewed articles that discussed or tested the effects of aging on decision-making. Unfortunately, the articles revealed conflicting views of the decision-making capabilities of seniors.

Decision-Making Overall

A 1998 study found that seniors made equivalent risk-taking decisions to those of young adults¹. A 2005 article found “older adults’ decision behavior is similar to young adults, contrary to the notion that economic decision making is impaired with age”². On the other hand, a 1999 study said seniors’ decision-making was similar to young adults with frontal-lobe brain damage³. Indeed, a 2000 study said the decline in decision-making ability started at age 50 and steadily increased⁴. Another 2005 study punted by saying although the ventromedial brain sector (which supports reasoning and decision-making), may undergo disproportionate aging in some older persons, the overall empirical evidence is decidedly mixed⁵.

I found everyone agreed that aging negatively impacted mental powers to some extent. After a certain point memory skills slide, and the older you get the more likely you are to rely on mental shortcuts to reach a decision rather than examining the problem anew (if a senior is facing a complicated decision they are more likely to apply the results of a similar previous decision to the new one, rather than decide based solely on the circumstances of the new situation). However, there was disagreement as to whether aging caused the average senior to make worse economic decisions than young adults.

Knowledge & Emotions

Seniors know more than young adults, but perhaps even more importantly, seniors know what they know and don’t know – seniors are much more willing to admit when they don’t know something than young adults². Seniors are also affected more deeply by positive emotions in decision-making.

Several studies said seniors spend more time trying to feel emotionally good and tend to block out negative emotions, and if negative information is received, seniors disproportionately forget it⁶. Although the stereotype of seniors is often the complaining curmudgeon, seniors are more likely to be in a good mood more often than young adults, and seniors work hard to keep themselves in a positive frame of mind⁷. They are more affected by appeals to emotion than logic and react positively when asked to recount life experiences. And although all people are subject to *vividness bias* – whereby we react more to the brightest color, biggest number, loudest noise – seniors are more susceptible to this bias⁶.

There are numerous implications to the annuity world if these findings hold up:

- Showing a picture of a smiling annuity owner of the annuity being pitched should be much more effective than loading up the laptop with pie chart slides. Seniors react to “feel good” messages more strongly than cold facts.

*http://aging.senate.gov/issues/elderfraud/investment_fraud.cfm



- If you are trying to get a senior in a better mood asking the senior to recount some aspect of their past will usually do the trick.
- If you ask seniors whether they understand something they are more likely to tell you yes or no – and mean it – whereas a young adult may try to bluff instead of admitting they don't know. Therefore the agent needs to frequently check how well the senior understands what is being presented.
- Seniors are more attracted to the most vivid data, as opposed to the best data, in making a decision. If the proposed annuity rate is shown in orange and the competitor's rate is shown in light gray the proposed rate should make more of an impact, even if it is lower.
- Carriers and agents need to place additional emphasis on the negative aspects of the annuity offered because seniors tend to ignore negative data and try to forget it. When I read senior complaints about the annuity purchased they often claim they were unaware of the surrender penalties when they bought, even though the senior signed disclosures at time of purchase stating these penalties. Based on the research it is possible that any discussion of surrender penalties by the agent is ignored, and even if the senior understands the consequence of the penalties at purchase that the senior works to forget this negative information. What this may mean is carriers and agents need to spend more time covering surrender penalties with seniors, and perhaps increasing the prominence of the surrender penalties, and any other negative facts, on sales materials and disclosures.

Decision Time

Several studies have found seniors deliberate for less time, look at fewer facts, and tend to replay the same decisions they made earlier in life in similar circumstances⁷. All of this could lead to seniors making bad decisions. However, a recent study has found that when seniors are given more time to study and remember new data that they perform as well as young adults⁸.

The study says if seniors are not pressured and not rushed they tend to make decisions as well as anyone else. In addition, if given the deliberation time needed, seniors do not tend to be more risk-averse or conservative than young adults³.

Conclusion

Do the decision-making capabilities of senior citizens decline as they age? I don't know, the research is contradictory. It does appear that seniors may be manipulated by strongly appealing to their desire for positive emotional balance, and a stronger reliance on vividness in processing information may lead to bad decisions. But it also appears that if seniors are given sufficient time they can overcome these characteristics and make good decisions. More research is needed.

Should seniors be protected as a class? An 85 year old may well be sharper than a 55 year old. Until there is more evidence showing mentally capable seniors need to be treated as a protected class it make more sense to treat all the same.

1 Itiel, Katona & Mungur, (1998); Age Differences in Decision Making: To Take a Risk or Not?; *Gerontology*; 44, 2

2 Kovalchik, Camerer, Plott & Allman, (2005); Aging and decision making; *Journal of Economic Behavior & Organization*; 58; 79-94

3 Denburg, Bechara, Tranel, Hinds & Damasio, (1999); Neuropsychological evidence for why the ability to decide advantageously weakens with advancing age. *Society for Neuroscience Abstracts*; 25, 32

4 Ponds, Rudolf, van Boxtel, Jolles & Jellemer, (2000); Age-related changes in subjective cognitive functioning; *Educational Gerontology*; 26, 1; 67-81

5 Denburg, Tranel, Bechara, (2005); The ability to decide advantageously declines prematurely in some normal older persons. *Neuropsychologia*; 43, Issue 7; 1099-1106

6 Kennedy & Mather, (in press); Aging, affect and decision making; *Do Emotions Help or Hurt Decision Making?* New York, Sage.

7 Carstensen, Pasupathi, Mayr & Nesselroade, (2000); Emotional experience in everyday life; *Journal of Personality and Social Psychology*; 79; 644-655.

8 Spaniol & Bayen, (2005); Aging and Conditional Probability Judgments: A Global Matching Approach; *Psychology and Aging*; 20, 1; 165-181

Returns (Year Ending 31 July)

Range of 1st Year Index Annuity S&P 500 Linked Returns

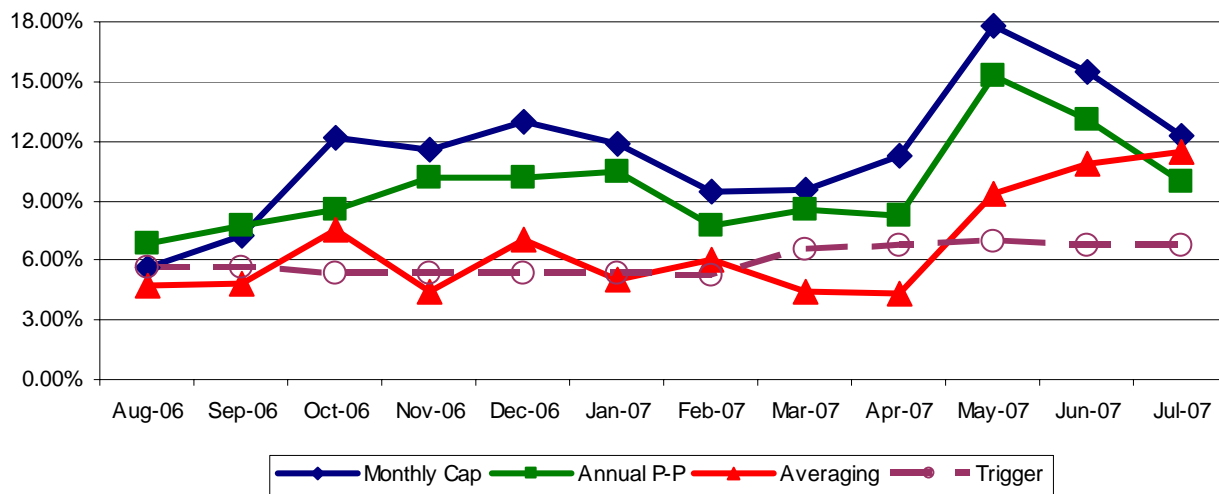
Monthly Cap Gain-Not Loss	8.15% - 12.28%	S&P 500	13.99%
Annual Point-to-Point	4.75% - 10.00%	Dow Jones Industrial Average	18.12%
Trigger Method	4.65% - 6.70%	Russell 2000	10.79%
Monthly Average	7.00% - 11.29%	Nasdaq	21.75%
Daily Average	5.45% - 11.45%	One Year Certificate of Deposit	3.91%

Data Source: Advantage Compendium, bankrate.com No index sponsors or endorses any index product

Index Annuity Returns – The Best & Worst

The charts below show, respectively, the best and worst first year interest credited over the previous 12 months based on rates, caps and spreads in effect at time of purchase for all of the index annuities on the market. Please note, most index annuity carriers group the applications received, so the chart shows what interest “woulda” been if all of the annuities had issued policies at the end of each month.

Highest Index Annuity Interest Credited



Lowest Index Annuity Interest Credited

