Dr. Dave's Uncommon

Financial Advice

David Shafer, Ph.D.

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Financial

Preface

It's not working. The financial planning model that has been sold to the American public for the last generation has failed. The results are in and it is apparent that a large majority of folks will live longer than their money. What is this model and where did it come from? First, let's tackle the "what is" question. For the last generation the financial advice industry (financial planners, insurance agents, mortgage brokers, bankers, benefit counselor's, etc.) have preached a save and invest strategy. The usual advice is to save as much as possible (usually 10% of income), invest this savings into mutual funds inside tax deferral vehicles, and allow the magic of compound interest and dollar cost averaging turn your 401K/403b/IRA account into a retirement vehicle capable of sustaining you in your non-working years. The second piece of advice is to pay off your debt, including your mortgage, as soon as possible. The theory is that during your non-working years your tax rate will be lower, and you will require less money to live on because you have no debt and no dependants. This strategy is sold aggressively by Wall

Street by appealing to strong emotional hot buttons we all possess. "Buy your piece of American Capitalism by investing in equity based mutual funds and sharing in their prosperity." "You don't really own your house until the debt is paid off." "It is your responsibility to plan for retirement." "Reduce your risk by buying a fully diversified mutual fund." All these ideas create emotional reactions in us. After all, who doesn't want to share in the prosperity of American Capitalism, who doesn't want to take responsibility for their retirement, or who really believes debt is good? I personally bought into all of these emotional appeals at one time in my life.

Perhaps originally these ideas were used because of an honest belief in their veracity. Somewhere along the way these ideas became merely marketing tools for the financial service industry. Because of the success these industries have had, there is little reason for them to change. In fact, the marketing needs now drive the industry. For example, mutual fund managers are paid for the amount of money they attract into the fund instead of performance. The truth is the majorities of sales people for the financial service industry have little in the way of finance background, instead are recruited for their successful sales ability. These sales people are given pre-approved marketing presentations designed to disguise the sales presentation by turning it into a "financial planning" presentation. Now don't get me wrong, there is nothing wrong with using sales presentations, nor using a sales force to market your product. The point is that the marketing of retirement products is more important than the real life results of the strategies recommended. It doesn't matter what industry designed designation is behind the name of the salesperson, because the vast majority use corporate marketing materials and attend sales seminars put on by the financial service industry. These marketing materials and seminars all promote the same two-generation old strategy based on the proven **SALES** success of this strategy. The actual results of the save, invest in mutual funds, and pay off the mortgage strategy is never mentioned because the evidence demonstrates the failure of this strategy.

There is of course another trend that is exasperating the retirement crisis. The defined benefit plans of the last generation are no longer available. After WW II, because of high levels of unionization, defined benefit plans were available to a majority of workers. Whether you were working on the line at a GM automobile plant, working at a coal mine or middle management you probably had a defined benefit plan that would pay you during your retirement years. Now, American corporate philosophy has changed to 401k/403B/IRA plans that leave workers not only open to the whims of the stock market, but also requires them to become experts in understanding financial markets to manage their own retirement funding. Currently, only a small minority of workers has a defined benefit plan, and

even these workers need to worry about their employers canceling those plans and moving to the 401k style plans. Now, more than ever, workers need realistic financial advice and strategies that can give them a chance to not outlive their money.

Since my undergraduate days I have been interested in and followed closely personal finance. Early on, I recognized the need for taking control of one's finances to prepare for future needs. Like many people out there, I assumed the advice from financial planners was evidence based, meaning it was actually proven to work. Several years ago I started to get concerned that even though I was putting a large percentage of my income away for future needs, the numbers were not adding up to a comfortable retirement. Since my professional background as well as my inclination was in the field of research, I started an intense research program to understand why the plan was not working. During this time I found myself called back into the financial services field, where I started my work life. The results of the research certainly surprised me in many ways, but also reinforced some ideas that had been bouncing around in my brain for some time. Knowledge is freedom in many ways. The results from my research combined with my own thinking has freed me from the shackles of what is now considered standard and prudent advice from financial planners and has motivated me to adopt an *evidence based* model.

An evidence based model is based on what the actual results of each strategy tell us about the possibilities of financial success and failure is for those who pursue that strategy. It takes each theory and puts it to the test of real life. There is probably no more studied area than finance, so we are fortunate in having much data to use in an evidence based model for personal finance.

As with offering any advice that runs contrary to accepted practice some time must be spent separating the myths that the accepted way of doing things has engendered. I apologize in advance for the first two chapters, which are highly critical and ultimately depressing. My hope for the reader is that s/he will read beyond the first two chapters to the end of the book and realize that most people have within their grasp the ability to have a comfortable financial future.

The design of retirement strategies needs to take into consideration the different inclinations that people have. Most financial advice is cookie cutter and insists upon individuals bending their normal inclinations to the will of a financial plan. I believe this is one of the reasons that so many fail to successfully manage their money and produce a comfortable retirement. As such, retirement plans should take into consideration where people succeed and where people fail. This is piece and parcel of what I call *evidence based financial advice*. Of course the information on this is available and I will share this with the reader as the book unfolds.

One of my personal pet-peeves is the current idea that retirees only need 60% of their current income in retirement. From a financial planning perspective this seems to indicate many people are planning to fail instead of planning to win. I know it is generated from professional financial planner's need to keep people's hope alive, but in reality it is a classic "avoidance" of the real issue, which is the failure of current financial planning.

Currently, here in Florida the property insurance rates have sky rocketed. Taxes have risen, too. Gasoline keeps going up. Food is on the rise. In short, those living on a fixed income have seen their purchasing power drop significantly. If they had hoped to live on 60% of what their income was when they were working they are finding things a little uncomfortable. Are these times extraordinary? No, typically these items go up. I wonder about those folks who planned to live on 60% of their income. How are they handling it? Unfortunately, I probably know the answer, and it isn't pretty. In order to succeed you need to put into play all the possible income producing assets possible. You need to plan if you are going to win.

There are no guarantees in financial planning or investments. However, given the failure rate of current planning advice, it is obvious that some uncommon advice is not only needed but prudent. I think that using people's strengths, taking into consideration their personality types and designing in strong encouragements for folks to adhere to the plan are required elements of financial planning. Employing the strategies outlined in this book allows folks to reduce both personal risk and market risk in order to markedly increase their chances of having a comfortable retirement. It also forces people to take personal control of their wealth building. In that way, folks overcome their fears by taking ownership of their financial lives. Personal finance is not so difficult that the majority need to cede control to someone else. But it is sufficiently important that everyone should want to learn to control and purposely plan their financial lives. Ultimately, all writing needs an animating idea, an idea to which it owes it existence. Dr. Dave's Uncommon Financial Advice is simply a book based on the idea that there is a way for people to successfully meet their financial retirement needs and live the life they want to live by taking control of their finances from the folks on Wall Street.

Finally, a brief note on what this book is not about. This book is not a comprehensive account of the many financial planning strategies now circulating. It does not counsel you on how to get out of debt, or on the best way to manage consumer debt. It takes no stand on the moral issues surrounding consumerism or credit card debt. It doesn't promise that you will become wealthy, although you will know by the end of the book how wealthy people gained their wealth. The only thing this book asks of you is to allow your mind to digest the ideas before accepting or rejecting them. This is, of course, harder than most people realize since we bring our own emotional baggage with us at all times. As you are about to find out, what most people have done to plan for retirement is not working, so what do you have to lose by opening your mind to new ideas? While attending graduate school I coached a swim team for extra money. One year on the back of our team shirts we had a saying; "If you don't like the position you find yourself in, first change your perspective, then your position will change." This saying was a little heady for young athletes, but totally true. Here's to changing your perspective!

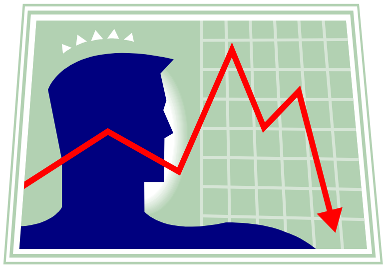
Chapter 1

What is the problem?

The statistics are grim. According to the Congressional Research Service in a report to Congress using 2007 census data, the median (half are above and half are below) value of all retirement accounts for households headed by an individual 55 to 64 years old was $98,000. For all households the median retirement account value was $45,000. Only about half of all households have any type of a retirement account. Astoundingly for households headed by an individual 55 to 64 years old only 64% have any type of retirement plan. Other reports have pointed out that 90% of people at retirement will be dependant on someone else <u>or the government</u> for their income. Additionally, 80% have less than $343,000 in assets including their homes with the median amount being $347,000 for the 55 to 64 age group. Remember this is before the real estate bubble burst and the stock market dropped 60%!

- Median value of retirement funds for households headed by an individual 55-64 years old is $98,000;
- 80% of 55-64 year olds have less than $343,000 in assets; and
- 90% of individuals at retirement will be dependent on government, family, or friends for adequate retirement income.

The largest demographic group in our history (baby boomers), the group that has lived through the best economic times in history, is not only unprepared for retirement, but is in fact



going to be dependant on government programs for the majority of their retirement life. No wonder so many individuals who have recently reached retirement age have remained working!

How did this happen? Well, to hear the retirement industry talk, these baby boomers refused to listen to the prudent voices of financial planners. This is hogwash, and I will show you why. The truth is that the strategies suggested by the financial industry over the last generation failed. And to blame folks for not being able to turn a blind eye to the billions of dollars of product advertising being aimed at them each year is at best disingenuous.

First, let's examine the common advised strategy. A short article by a <u>NY Times</u> best selling financial guru in a 2006 mutual fund magazine will provide a great example to deconstruct. The basic theme of the article is that by cutting our small luxury purchases you can save and invest enough money to become a millionaire. This is of course true, misleading but true. He suggests by investing $10/day over 35 years and getting a 10% return on the investment you would have $1,163,796. Again his math is correct. This sounds simple to do. Just don't buy that expensive cup of coffee each day and voila you are a millionaire. But as they say the devil is in the details.

First, as I am writing this in 2010 saving $300/month seems possible and over $1,000,000 seems like a comfortable nest-egg. But, he suggested one would need to do it for 35 years so let's change our perspective a little. We can all agree that $1.1 million would provide a decent retirement living if we were to retire today. In fact if we lived off the interest only and received 6% (a reasonable expectation for the bond market) it would pay us close to $70,000 per year.

Not bad even considering inflation over the next 17 years we are likely to live. But let's look back those 35 years and see how reasonable it really is.

Median income for 1971 (35 years before the article was published) was $8,965. We know that individuals early in their work lives generally make less than the median salary. So, it is likely if you are 30 years of age and already making the median income you are college educated and have chosen a professional career. However, only about 33% of adults have a college degree now (back then it was less than 20%) so most 30 year olds would be making less than the median salary. We will still use the $8,965 median number, even though we are now talking about a small sliver of the American public who had a college degree 35 years ago. Now we shall take a very conservative estimate on taxes and say this individual with an average salary paid 20% in taxes. That leaves the individual with $7,172 to spend after taxes. This famous financial planner suggests that they could have saved $10/day or $3600 for the year. For the person in 1971 to have saved $10/day they would have had to save about 50% of their after tax income! Well, that changes things a little. For his strategy to work he needs to suggest to the 30 year old client that they need to save 50% of their after tax income. If that client is older and has not started to save money, the percentage needs to be adjusted upwards.

Let's take a quick look at his other assumptions. We know that over 90% of those 35 years and younger are not saving regularly for retirement. In fact, most in this age group if they are saving are trying to save to buy a home. This cohort is a prime target for advertisers. In fact, the television industry will tell you that they are programming to attract the 18-35 age group, because that is the group their clients are trying to reach. A quick look at the TV guide will reaffirm this. These billion dollar companies aren't doing this on a whim. They direct their advertising to this group because it works. This group reacts to the psychology based advertising blitz by spending. But financial advisers suggest that instead of spending the 30 year old needs to save a significant percentage of their after tax retirement **AND** also save for a home. Now the previous paragraph has pointed out that in order to have saved a significant retirement amount workers need to save up to 50% of their income, but in reality advisors suggest 10% savings. Great advice. But if the worker 35 years ago took the 10% figure and made the median income, they would only be investing $895/year, which would obviously generate a much smaller retirement account. To add insult to this assumption, the first 10 years are critical to this strategy to obtain the benefits from compound interest. If you miss a year of savings or even part of a year then the end figure is severely reduced. You can see why average retirement savings is only $98,000 for folks approaching retirement age. What we find is that while corporations are spending billions on getting this cohort to spend, financial advisors are telling them to save 10%. To be truthful they would need to say "save 50% of your income" to build a comfortable nest egg. Who do you think wins out; the corporations or the financial advisor who tells the 30 year old to save? Evidence is that the corporate advertising wins out most of the time.

Another assumption is that each year this hypothetical person will be able to continue the $3,600/year investment. What happens when that person loses a job for a few months? Or, they get sick? Or they have to take care of a sick relative? Or they have extraordinary automobile expenses? Or they want to get married and have to pay for it or part of it themselves? How can the assumed outlay continue unabated when any of the myriad of ordinary life events that happen to us all rears its ugly head? Well, there is no room for ordinary life events in this strategy! What kind of strategy doesn't allow for common events that happen to us all? I will keep using this term *"evidence"* throughout the book to drive home the reality of people's experience, and once again the *evidence* is that retirement funding for even the saver personality is curtailed at many times during one's life to deal with life events.

This financial guru assumes a 10% rate of return is achievable as do most financial planners. Now it is true that the stock market has returned 10% over the last 50 years. However, you can't invest in the stock market. You need to either invest in individual stocks or in equity mutual funds. Either way you have transaction fees. If you could invest in every stock in the stock market, then you have enough money to not worry about retirement. That leaves mutual

funds. There have been many studies done of mutual fund fees, and the results demonstrate that between 2% and 3.5% of the return is eaten up in mutual fund fees and expenses regardless if it is a no-load or a load fund. Let's take 2.5% as a typical cost for buying mutual funds. If the fund mirrored the market and made 10% the net to you would be a 7.5% rate of return. The 7.5% rate of return reduces your total amount after 35 years from over $1.1 million to $735,644. That lowers your expected income from $70,000/year to $44,000/year. Quite a difference when we use realistic numbers. Finally, most financial planners suggest that you invest an increasing amount of your money in the bond market and its lower rate of return as you age. This would of course reduce your rate of return even more. This is the same concept if you look forward instead of backward. A million dollars might seem like enough to retire on now, but if you account for inflation over thirty-five years one million dollars is worth less than $350,000.

At this point you should be beginning to see the reality of why most Americans approach retirement with so little money saved. For the retirement industry to then turn around and place the total blame onto individuals for this failure is disingenuous. It is strategy that is failing as much if not more than any individual failure.

This is not to say that Americans aren't spending too much. One look at the national savings rates tells us that we are a nation of spenders. The following chart demonstrates the falling savings rate.

United States Savings Rate

Time Period	Savings Rate
1960's	11.0%
1970's	8.7
1980's	6.2%
1990's	4.5%
2000's	<2.0%

While the financial planning industry has been preaching saving 10% of one's income, the actual savings rate has dwindled to less than 2%. The lower savings rate has as much to do with the flattening of wages and changing of retirement funding to 401K type vehicles among the middle class as it does with free spending consumerist attitudes. But that hasn't stopped the industry from placing the blame squarely on individuals! As long as the industry can blame the individual it can avoid the spotlight being placed on its financial advice.

From Defined Benefit to 401K Style Plans

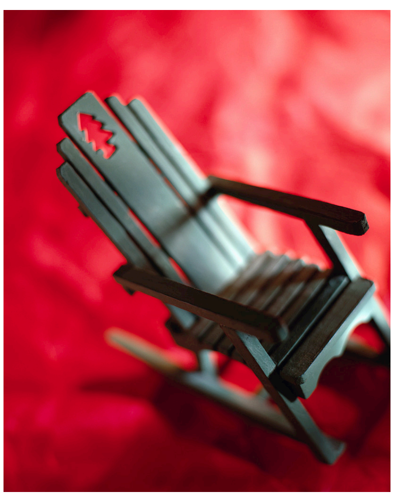
Let's talk a little about the changing face of retirement planning from the corporate perspective. Many large companies have found the legacy costs (fancy word for what they owe workers who spent their lives working for the benefit of the corporation) are holding back the bottom line. Perhaps General Motors is a prime example of this. General Motors claims that each vehicle produced has $2000 in legacy costs added on the wholesale price to pay for current retirees benefits. They are not alone in this issue. In fact, an increasing amount of companies have failed to put aside enough money to cover their retirees' costs. Many have gone bankrupt specifically to shed the legacy costs and turn the pension liabilities over to the government. Once the government takes over, it pays out only a percentage of what was promised.

These retirees can see their defined retirement amount lowered by as much as 50%. The last generation of workers had been promised defined benefits upon retirement, but has found that they received substantially less than was promised. Companies forced to compete with huge legacy costs found themselves at a distinct disadvantage unable to compete unless the defined benefits were curtailed. For new workers, companies put into place a 401K style retirement that they might match up to a certain threshold. This is much more manageable for a business; however it places each individual into a position of managing their own investments or relying on the financial industry for advice.

Instead of guaranteeing an amount of retirement income, an expensive and risky position most private sector companies and increasing amount of public sector bureaucracies are moving to 401K plans that only give a dollar amount invested in the front end. The actual management of the retirement account is left to the workers. These decisions can radically affect the final results or amount of retirement income.

The data is clear that most people are not doing a good job of managing their retirement plans. Now, of course the various financial firms that sell the 401K style plans generally will advise the individual, but the fees for doing this further erode the overall rate of return the worker can get in their retirement plans. Also, these managed plans generally don't have index mutual funds available, only actively managed funds. Actively managed funds, which have a money manager trading stocks to try to get a higher rate of return, have higher expenses and ironically lower rates of returns than the index funds. Index funds, designed to mimic a stock or bond index, generally aren't offered by employer managed 401K programs.

Corporate America makes out well with the defined contribution plans (401K style). Businesses love these plans because their internal business planning can proceed with much more cost certainty and of course these plans are less costly to them. The financial industry makes billions off of managing these plans. A whole new and very large market for Wall Street now exists in the way of individual consumers of retirement plans mostly based on owning stock mutual funds. Works out well for everyone, right?



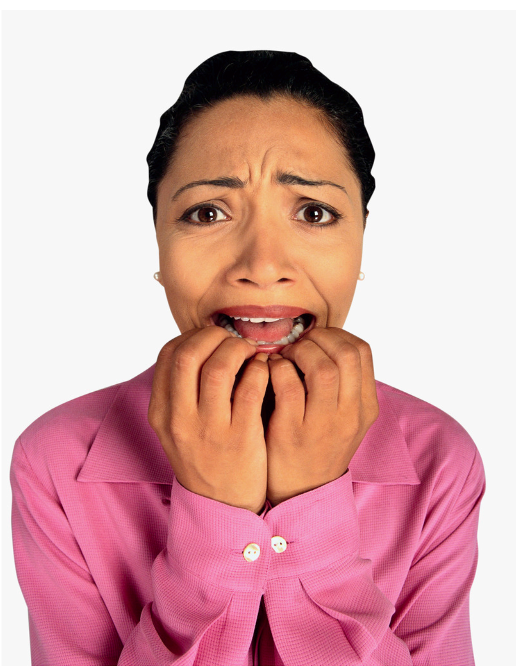
Well actually not. Individuals are left to make critical financial decisions that they have neither background nor inclination to make. Into the information void comes not only multiple magazines aimed at the consumer but several all day, seven day a week, cable TV channels spewing forth more financial propaganda in one day than previously ever existed. Stock pickers, economists, financial gurus are constantly spinning their latest "hot" picks and predictions from these mass media platforms. Curiously, no attempt is made to look back at previous predictions or "hot" picks to give perspective on all this advice. Certainly with all this expert advice at the consumers' fingertips the average consumer must be doing well, right? Well, no they are not and later we will explore the actual results of leaving the financial decisions to the consumer.

Social Security

No discussion on retirement planning can leave out mentioning social security. Originally designed to help widows and disabled, it morphed over the course of the 20th century to include all workers. However, it was never envisioned as becoming the totality of retirement income for individuals. Despite this, almost half of current retirees depend mainly on social security for retirement income. The government designed social security as an insurance program that could help out if individuals suffered a financial catastrophe. And for that purpose it has produced remarkable results. My opinion is that social security has become so depended on by the populace and accepted that the government can never allow it to lapse. What this means to future tax rates should be clear. They won't go down. So, I think it is safe to consider that when you retire there will be social security for you despite what the doomsayers opine. However, this will require increase in tax rates. If you are planning on paying smaller taxes in retirement you might want to rethink this assumption.

Emotions

Probably the biggest failure of the financial services field is their refusal to understand how individual's psychological reactions affect the results of their suggestions. This failure to look at actual results for folks who take their advice on what to invest in has lead to the aforementioned dearth of retirement funds our near retiree's suffer from. The actual studies are all in agreement that people, despite being warned not to, react to down markets by getting out of stocks and mutual funds. Every down year in the market there is a net outflow of money. Additionally, studies indicate that individuals, whether they get advice from professionals or not, under perform the market by 7%-10%. Wow! Think about that for a while. If the market has returned 12% over the last generation, this means that individuals at best



got 5% from the stock market. Not very good considering how much risk people assume by investing in stocks. Much of this is the result of being sold on the risk reduction of stock diversification making it seem there is little down-side risk. It is a fact that negative return years yield outflows from mutual funds. These last few years are no exception. People who have been taught to think of investing as a risk free endeavor are not emotionally prepared for the market downturns, especially when they are close to or are in retirement mode. It is a psychological fact that we fear pain more than we appreciate pleasure. So, in very real terms we are all risk adverse. That is why the financial experts have to downplay market risk in order to sell their wares. So ironically, after they have convinced you to buy those mutual funds because of reduced risk, they then need to change the game for you and attempt to have you forget about the pain of market downturns they never warned you about.

Now, to accomplish this, the financial expert industry has turned to another dubious fix; amateur psychoanalysis! Yes, they are having their clients take tests designed to examine their childhood memories about money in order to get people to stop reacting to market downturns. You think it will work? Well, the bottom line is this system of retirement planning is failing.

FEEs

Fees are a fact of life for consumers in financial products. There is simply no way around them. Actually, fees can be the consumers' friend in many cases. I know there are many consumers out there that simply hate the fact there are fees. They react emotionally to any hint of fees. Many of my friends are just like this. Certainly the financial services industry has not helped by making the transactions so convoluted that fees are hidden or at least not fully transparent. The reaction to fees have made many people make poor decisions while others simply ignore them and end up paying a price for this too.

The great Olympian, Michael Phelps, is obviously an extremely talented swimmer. But the other factor in his success is the fact he has had the same coach for his entire swimming career. This coach has had several swimmers make the Olympic swim team other than Phelps. Bob Bowman has made quite a bit of money based on the success of Phelps and his other Olympic swimmers, some directly from the money made by these swimmers. The swimmers obviously trust their coach and pay "fees" to have him as a coach. We see from this example that fees are not the problem, but bad advice or at least advice divorced from historical data on what works is the real problem. This is the missing link when it comes to building a trusting relationship with a financial advisor.

Of course a trusted advisor must have other qualities too. The first step is to find advisors to do business with that you trust. Trust in a relationship comes from mutual appreciation. The sign of a good advisor is that s/he listens to you first. How else could they figure out what the best strategy is for you if they haven't asked the right questions and then listened to your answers carefully? If they are doing all the talking, then they are trying to sell you something that is most likely not in your best interest. The second thing to look for from any financial advisor is a discussion of the positives and *the negatives* of the suggested strategy. There always are negatives as well as positives. Finally, use your common sense to judge the veracity of what an advisor is telling you. If an advisor is telling you that you can get double digit rates of return on a *risk free* investment, your common sense should click in. All financial services salesmen are taught and given charts to use in their presentations. Most likely these charts represent a best-case scenario. Take all these figures with a grain of salt as they are easily manipulated. Ask the question of yourself, what is the worst case scenario? For any equity investment, for example, it is loss of the entire investment. If your advisor is listening to your needs, giving you both the positives and the negatives, and honestly answers what the worse case possibilities are then you probably have someone you can trust.

Certainly you should take a look at the qualifications of business people who are advising you, but this is more difficult to do than it appears. The financial industry has a whole alphabet of designations that people can put after their name. Some of these designations are simple to attain, while others are more rigorous, but the bottom line is that the industry has designed these courses to produce individuals who advise how the industry wants them to advise. In other words the things taught in these classes are industry approved and for the most part industry designed. The strength of these courses is teaching the technical aspects of various products. What this means is that graduates of these courses are able to identify how these products work, but are not taught to look for real world evidence of the success or failure of any of these products. In my mind, the minimum level of qualification for folks in the financial services industry is a bachelor degree from a recognizable university. In theory, those that have graduated from a university have demonstrated the ability to learn new ideas, test those ideas so as to be able to discern what are facts from what are fictions, and finally communicate those ideas to others. I am certainly not saying that anyone that hasn't graduated can't perform those things, only that a college degree should identify those that can. Further, I think that individuals that have advanced degrees have demonstrated a desire and an ability to refine those skills. Whatever is said about universities there is one clear fact. They constantly test students and force students to compete with each other in order to graduate. The higher one goes in academia the more competitive it gets. Someone with a Master's Degree had to compete with all high school graduates to get into an undergraduate program, compete with all college graduates to get into a Master's program and compete with other similarly situated students to make the grades to graduate. This is the type of person you want on your team.

Why is this so important? Because the world changes constantly. Those that have the aforementioned skills will be able to change and adapt in positive ways. The last thing you want from a financial advisor, whether it is your mortgage planner or your stock broker, is someone who depends on the industry to tell them what to do. They must have the ability to learn new ideas, test them, and be able to differentiate the good ideas from the poor ideas based on real world evidence. When you find these individuals, and there are quite a few out there, they are worth every penny of the fees charged. In fact they are worth hundreds of thousands of dollars more than the actual fees.

Different Business Model?

But perhaps a different model is needed. It doesn't matter how trustworthy a financial advisor is nor whether s/he makes a commission or charges a fee. When it gets down to it, a person is always going to put their interests ahead of yours. There is simply no way around that psychological fact. Perhaps, the critical process needed is education and coaching? As mentioned above most folks are now responsible for their own financial/retirement/wealth planning. Since we are now responsible doesn't it make sense to learn as much about it as possible? Doesn't it make sense to hire someone to teach/coach you in wealth building that isn't selling you any particular financial product? Isn't this the approach Michael Phelps and all other world class athletes take to finding success?

Let us look at the weight loss industry for an example. Would it make sense if weight loss experts told you to simply allow them to do the work? That you didn't need to participate? No, it wouldn't. So instead, they employ a model that requires you to educate yourself on nutrition and education, find a (personal or group) coach, and actively follow the advise by eating differently and exercising. They leave you with a plan that you need to implement and maintain. And if those steps are followed, then the weight loss is successful. This doesn't stop people from writing many books on the subject and designing general weight loss plans for the masses. But these books and general plans fail to achieve the desired long-term weight loss, because a critical part of the plan is the coaching and the individual design.

Doesn't it make sense to take what we know works from weight loss, swimming, and a host of other endeavors, and apply it to wealth building? Doesn't it make sense to design a plan based on what works? And finally, if coaching is so effective, then why not use it for wealth building?

State of Mind

I've noticed a simple thing about those who reach their financial goals versus those that fail in this endeavor. The philosophy that people live by has a profound effect on obtaining goals. To put it more simply, people who learn how to overcome fear, distrust, and yes, greed allowing their intuition to guide them have a much greater degree of success. Admittedly, this is not easy. The media is full of bad news, warnings, and general fear mongering. That is how they sell their wares. The result is that we live in a society fearful of being taken advantage of, of trusting relationships, of even general friendliness.

When I counsel folks I ask a lot of questions. Some start getting uncomfortable as I probe despite having warned them up front why I need to understand their current situation and their needs in order to best advise them. I can literally feel their fear, their distrust coming at me. I know at that point that it is fruitless to continue. So I change my questioning to a more philosophic subject. What is it you want from life? If you had saved $1,000,000 what would you do with your life? What would you buy? Sometimes this simple change of perspective, allows the couple to really open up and start talking about their dreams. This is where we all should be. We should openly talk about our dreams because this is the first step to making them our reality.

When folks' faces become more relaxed, they move closer to whom they are talking to. They grab the hand of their partner. In my case, when I think about my dreams, the world literally seems brighter, more colorful. I take it a step further, imaging myself having reached my goals, imaging how it feels, how it affects those around me, and I even try to conjure up the emotions that I feel upon reaching a goal. This is the state of mind one needs to have to bring about those things you want to happen to you.

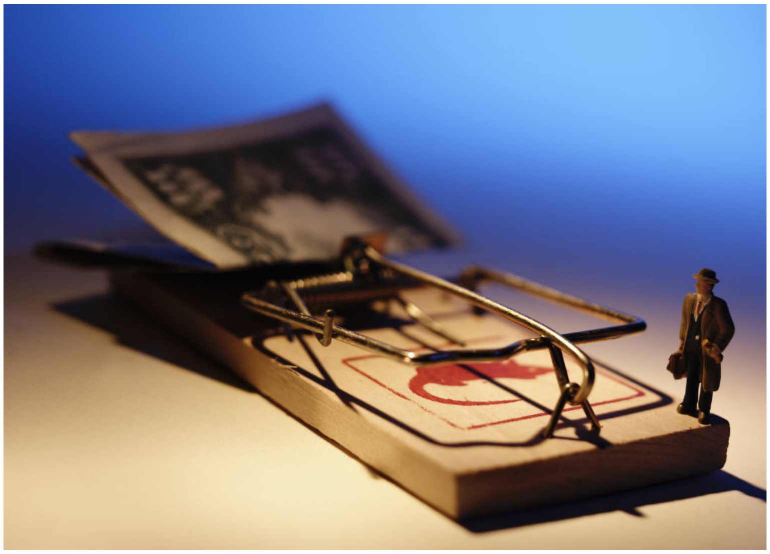
When I talk to successful people, people who have reached goals, they all say the same thing. I imagined it first, and then it happened. My state of mind was critical in achieving success. This philosophical change in me allowed the good things to come to me. In my own life I see this happening, too. There are many books that describe this state of mind in great detail. A list is in the bibliography at the end.

Since I have become aware of this basic philosophical stance, I have noticed the people who have the greatest success with my counsel are those that learn or have learned to actively dream their goals. Those that are fearful, or distrusting of the world rarely become clients, or if they do, they don't follow through with the suggested strategies. My guess, without any data to back it up, is that much of the retirement planning failure is based on the distrusting state-of-mind being produced by our society. Now before we all get together to sing Kum-By-Ya, I am not suggesting that you should trust everybody, only that we should develop the intellectual ability to analyze these situations and use our intuition. Once you gain the confidence from learning about finance, if your gut is telling you that you shouldn't trust someone, believe your gut. If your gut is saying that any strategies (including the ones in this book) are not for you, then trust your intuition. But, you have to have an intellectual framework to be able to analyze any financial strategy and be open to a trusting relationship with people before they can help you. Additionally, you have to be able to openly dream and be willing to put your mind into a state of imagining goals being met in order for you to reach them.

This chapter outlined the current problems and issues with retirement planning as I see it. None of these problems are intractable. They are all solvable for individuals still planning their retirement. The remarkable thing is that the products and strategies for success and retirement have existed for a long time. Unfortunately, the roar of the financial planning crowd has drowned out any honest look at the results of mainstream advice and therefore not forced an inward look for financial strategies that work. The following chapters will outline the strategies that the wealthy folks used to gain their wealth. It will also describe the results of my investigations into current strategies. This is what I call “evidence based” financial planning. In short, what I will suggest is what the evidence tells us has the most likely chance of success. Some of it will be surprising and will turn “common wisdom” on its head. Beyond all the specifics of the strategies and products, I hope that you learn to actively dream and creatively imagine your personal goals. That is perhaps the first and most important step to success.

Chapter 2

Five Common Money Traps



- Liquidity
- 401K/IRA
- Cost of Managed Funds
- Home Equity
- Variability/Rate of Return

Liquidity

Would if surprise you if I told you that what gets people in trouble is not lack of assets, but lack of liquidity? I define liquidity as the ability to turn your assets into cash with the stroke of a pen, click of a mouse, or dialing a telephone, without penalties causing your asset to be devalued. As I write, the mass media has created large amounts of attention to what it calls the foreclosure crisis. The real issue is that people have not created liquid assets to get them through whatever has caused them to lose income. Had they had 6-9 months of liquid assets to get them through the hard times, they would not be having their home foreclosed on at this time. They could have sold the home or solved whatever was causing them to not have the income to pay the mortgage. As it turns out the majority causes of foreclosure are temporary items like job loss or sickness not what the mass media is telling us like variable rate loans.

However there is a small group of homeowners that bought at the peak of inflated prices and now are experiencing being substantially underwater [owe more than the home is worth].

This group is more likely to voluntarily allow their home to lapse into foreclosure. Frankly, this does not bother me because I see this as the result of bad advice from the banks and the real estate industry rather than a moral failing. I will discuss this further in a later chapter.

Lack of liquidity is the common ingredient causing most money woes. But I have a strong philosophical reason to advise folks to maintain maximum liquidity. I like to have control of my money, not have it controlled by someone else or government rules. Now I know, as many financial planners argue, that many people will be better off if you could force them to set aside part of their income for retirement and made it impossible to get at that money except for retirement purposes. This smacks as "financial Stalinism" to me. Like Soviet Russia under Stalin, people are forced into doing things that the authorities think are good for them. I have heard many financial planners, when faced with their clients' failure to have retirement income, simply state they should have listened to me or I told them what to do, but they didn't do it. I have even read some financial planners trying to encourage the government to lock retirement plans completely away from individuals until retirement age! This strikes me as the opposite of what should be done. People should have full access to all their assets without penalties. To lock assets away, for the good of individual's retirement, is ultimately both morally and financially wrong. And to simply wash your hands of clients because you set unrealistic plans for them that didn't account for common life events is morally corrupt at best.

As you read through the rest of the financial traps notice how maintaining reasonable liquidity is one of the most important basis for avoiding these traps. One other note, if you are just starting out and haven't acquired assets like a home or retirement account, you can use these items as guidance on how to build assets.

The 401K/IRA Tax Trap

Already I have pointed out that most people, if they have a retirement plan at work, have a 401K style plan. That is they put money into an investment vehicle that is inside a 401K account. The government has created these accounts and given incentives to put retirement funds inside them. What incentives? The government allows us to decrease the amount of our taxable income by the same amount we put into a 401K/IRA. There are limits to the amount we can put into these accounts (currently $16,500 for 401K, $5,000 for IRA), although few individuals reach these limits. And for those making large salaries there are limits to the tax credit available. The important thing to remember is that for most earners they can offset income with retirement savings and lower their tax payments. Sounds like a great deal, right? Well as they say, it is better than a quick kick in the behind, but let us really look at it from a total tax perspective.

Your Government Planned Retirement

Now I am not one to look a gift horse in the mouth, but I always ask, what is the catch? In this case it is a big one. Inside your 401K your investment should grow significantly. You should be "getting interest on the interest earned" even if it is not technically interest but stock growth that is doing it for you. In other words over time you might have put in $100,000 into the 401K, getting a $100,000 tax deduction. That $100,000 should be worth significantly more over time, say $350,000. When you start to live on the money inside your 401K you have to pay taxes on it. Are you starting to see the trap? You got tax deductions of $100,000, but now have to pay income tax on the $350,000 it has grown to. Most will pass the amount of tax savings they have achieved in taxes paid before they hit their 5th year of retirement. The end result is that they will end up paying several times the amount of taxes to the government by using the 401K/IRA retirement strategy. The following chart demonstrates that it is better to have a Roth 401K than a regular 401K. It is even better to invest outside a tax-deferred vehicle and pay the current capital gains taxes than the regular 401K. For this chart I assume a 25% income tax bracket.

	Taxes Saved	Taxes Paid	Difference
401K	$25,000 ($100,000 X .25)	$87,500 ($350,000 X .25)	$62,500
Regular Investment Account	$0	$52,500 ($350,000 X .15)	$52,500
Roth 401K	$0	$0	$0

Who designed this retirement strategy? The government did. Just so this is clear, the government designed and encourages people to invest in a retirement strategy that will have retirees pay several times the taxes that they think they are saving. Hmmmm! There are some very smart bureaucrats in the government, aren't there? They have employed powerful allies in corporations in pushing this retirement plan. So now we have both the government and corporations strongly encouraging everyone to enter these plans that will produce significant tax revenue throughout their retirement years. The government and the large Wall Street firms have created a product that works well for them; unfortunately it doesn't work well for employees.

Let's talk about some other issues with 401Ks. The IRS has significant rules as to when you can access your money and when you can't. Generally, they will charge a significant penalty if you access it before age 59 ½. There are some exceptions to the penalties, so talk to a CPA if you need to access your 401K prematurely. Of course there is more than just penalties; you must pay income taxes on your money in order to access it. Finally you must start accessing it by age 70 ½ . There is a formula for minimum withdrawals during your retirement years. The government wants to make sure they get that tax revenue! In short, the 401k is designed to make sure the government gets its tax revenue.

My opinion is that it is much better to save/invest as much as you can outside of the 401K/IRA strategies. After all, who should be able to control your money, the government through IRS rules or you? If you save/invest outside of the 401K/IRA strategy you will have to pay taxes. The current capital gain tax rate for investments held longer than one year is 15%. So for households making more than $61,300 the capital gains tax rate would be significantly less than the income tax rate. If you make less, there is a lower rate, but I suggest you contact a CPA for details. The bottom line is that under current tax rules it is better to have passive investment income than earned income.

What about those of you working for companies that match their 401K contribution? First, find out exactly how the match works from your company benefits department. Then only put in the amount that gains the maximum match, not a penny more. After all free money is free money, and the company considers the match part of your earnings so only a fool would turn it down.

Roth IRA/401Ks are much better propositions. These strategies instead of giving you a tax break up front with the inputs, give you breaks as you take it out during retirement years. The Roth 401K is a relatively new product, but gives you much higher limits for putting money into it than the Roth IRA. However, the same rules still apply about getting to your money prior to age 59 ½, there are penalties. Overall, if given a choice always choose the Roth strategy over the alternative.

Cost of Managed Funds

Most companies don't have the expertise to manage 401K plans so they out-source it to financial services companies. This is a very lucrative business. One reason it is so lucrative is that there is significant fees associated with the funds they offer to the employee. Even though there are many investments that can be placed inside the 401K, employees are limited to the offerings of the management company. This usually includes stock mutual funds, bond mutual funds and money market funds. Usually only actively managed stock and bond mutual funds are offered. These actively managed funds have much higher fees included in them than index funds, which attempt to mimic a stock or bond index. Many of these companies also include fees for advice from their company through their representative or a 1-800 telephone number. These fees can cost you up to 4% of your invested funds yearly. It is very difficult and time consuming to find out exactly how much you are being charged in various funds. Lets just say that the published expense ratio is only the tip of the iceberg when if comes to fees on managed funds.

As I have stated before, fees should be evaluated on what you get for them. When you call up your 401K management company to get advice, who do you talk to? Well first off, you usually get someone different every time. If you are lucky you have a representative assigned to your business and it is the same person that you deal with each time. Regardless of whether you are dealing with the same or different person, what is their background? Would it surprise you to know that the majority of them have no finance background? Have they attended college? Some yes, some no. I assume most of the management companies do train their workers. But in what? Sales? Probably. Communications skills? Again, probably. Product knowledge? Yes. Finance? Doubtful. So the bottom line is when you have questions at best you will get answers that serve the management companies interest, not yours. At worse you will get wrong information or be talking to people who have no clue when it comes to understanding personal finance.

But what about the fees paid for the actual money managers? These are the professionals who do the stock trading, company research, stock picking strategies, etc. These expenses are not small as the money managers make extremely large salaries. Common sense would dictate that we want these people to have all the resources possible to be able to pick winning stocks on our behalf. And they do. Money managers are highly educated (most with PhD's, MBA's), they have interned for senior money managers for years, and have access to the best business research available. None of this comes cheap, but we don't want anyone less experienced and trained to invest our money for us. But how well do they do (remember we want/demand evidence based financial planning)? Well, um, ... not well, at least compared to non-managed funds. The truth is that these money managers over time mostly under perform the market. More on this later, but I will let this fact stew in your brain for a little while. The evidence is that money managers under perform the market over time. Now, are you getting your money's worth from those fees?

So now we have learned both that the tax consequences of 401K style retirement plans end up causing us to pay more taxes, and the fees charged are high with questionable results, what else can we illuminate?

Psychology of Risk

Most of the industry standard advice is centered on investing in stock mutual funds. These mutual funds move up and down as the stock market moves up and down. In other words they have much variability. The question is rarely asked if these individuals who invest in mutual funds can withstand this variability. The evidence as mentioned before clearly tells us no. When the market goes down, consumers do what they are trained to do. They shop around for a better product. Or at least try to minimize the perceived damage. Studies of human behavior point out that humans fear loss more than they desire gain. Translated into financial behavior this means when they see their stock mutual funds going down, they get scared and attempt to mitigate the loss by making a change. Studies demonstrate this behavior. Unfortunately, this leads to bad decision making and the rate of return on these retirement funds drops dramatically. Having been sold on obtaining a rate of return of 10%, individuals find themselves actually obtaining less than 5%!

This psychological fact, perhaps, is the most troubling, because other than shaking their fingers and telling people not to behave like this, the financial planning industry ignores that this behavior exists. Working with a coach to help prevent this behavior will dramatically improve a person's financial position. This reason alone is worth the price of a coach.

Back in the good old days, when professionals managed the pension plans, individuals didn't have to manage their own retirement funds. Now, with 401K retirement strategies, they must be responsible for their own funds. Unfortunately, most people don't naturally have the correct psychological makeup for the variability of the stock market. Sometimes the truth hurts, and this is one of those cases. In theory it sounds great, we control our own destiny with our choices. The evidence demonstrates that we don't make good choices when it comes to investing in mutual funds. Let's face the truth. Investing in anything, be it real estate, stocks, bonds, mutual funds or orange juice futures requires a lot of experience, emotional detachment, willingness to make mistakes, and some luck. Shouldn't we be willing to put the time and energy into our financial lives? Yes. But, most investors totally rely on "experts." Have these experts delivered the advertised return and proven that they have your best interest in mind?

The 401K trap is really about five areas of basic finance. Those with finance training will recognize them instantly.

- Taxes
- Costs
- Rate of Return
- Consumer Psychology
- Liquidity

A 401K/IRA traps you into paying much more taxes over the long run. Since taxes paid make up the largest portion of our expenses, they can have a devastating impact on returns. The costs of investing in 401Ks managed by outside financial concerns are high. Obviously, the higher your costs the lower your profits. Finally, the overall rate of return individuals get in their 401K accounts is less than 5%. This is extremely low, the result of poor advice and the reality of normal human behavior. Although 401K/IRA funds are available to individuals who own them, if you don't follow the IRS rules in gaining access there are hefty penalties and taxes connected to that access. This limited access or liquidity can and does hurt individual's financial health.

The government and the large Wall Street firms have created a product that works well for them; unfortunately it doesn't work well for employees. Don't play this game with any more of your money than you have too. Take the company match, but don't put extra dollars into this trap

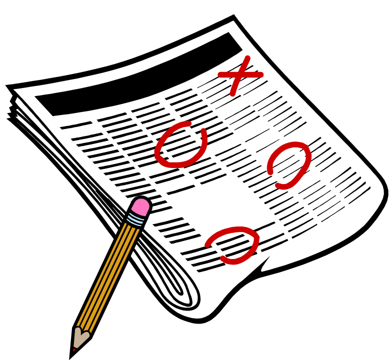
Home Equity

The data on wealth in this country demonstrates that over one third of all individual wealth is held as home equity. Home equity is simply the difference between the market value of a home and the debt on it. So if the market value of a home is $250,000 and you owe $100,000 on it, your home equity is $150,000. Real estate or more specifically, mortgages, have allowed folks to successfully build wealth. Many consider their home as a large savings account and are proud of the amount of home equity they have. Conversely, most people think of mortgages as something that needs to be eliminated at the earliest possible moment. This basic approach, employed by most people, is encouraged by the banks and many financial advisors. There are a variety of strategies employed to accomplish shedding mortgages. Some home owners make one extra payment a year, while others employ the "Canadian Mortgage" strategy of making a half payment every two weeks. Other's use their annual bonuses to pay down principal, while others delve deep into savings when buying a house and put down 40% or more down. Finally, there are the mortgage accelerator plans which use expensive software to help you track your mortgage. Whatever the method employed it is critical to understand why this is a financial blunder most can not afford to make.

Mortgage Risk

First let's talk about mortgage risk. When you buy a home with the use of a mortgage you are sharing risk with the lender. There are two types of risk. First is market risk. Both you and the lender are taking the chance that the home will not depreciate or lower in value beyond the purchase price. Now, we know that over the long run real estate has returned 6.3% annually throughout the country. We also know that for short periods of time all markets fail to make any gain, and in fact, some decrease in value. We also know that certain economic conditions have driven real estate values in certain areas down 20% or more. Houston in the 1980's is a perfect example of this. Or, Michigan in the late 1980's. Now California, Florida, Nevada and Arizona lately have seen double digit drops. Generally, what drives real estate values is jobs.

When unemployment goes sky high in an area, there is no one capable of purchasing homes and others unable to make their mortgage payments. However rank speculation can also do the trick as we now see in Florida. The bottom line is that market risk is real. When you have a mortgage the lender shares that risk with you the owner of the house.



The second type of risk is catastrophic risk. This is mostly events like loss of job, sickness, death of breadwinner, etc. As we have seen over the last decade this can also be hurricane risk, or flood risk, or wild fire risk. Now lenders do their best to guard against these natural disasters by requiring you insure against it. But there is not much they can do to guard against loss of job, sickness or death of the breadwinner. Even by requiring insurance there is risk as we now know after Katrina. When will real estate values come back up in New Orleans? Even getting homes rebuilt after a catastrophe is problematic because of the rapid increase in the price of construction materials.

So in short, there are risks shared by the lender and owner of a home. Most people assume that they are safe from risk when they have paid off their mortgage. This is true with regards to losing a home to foreclosure, but in effect they are getting rid of a partner who shares the risk. Here is what is really happening when people start to pre-pay their mortgage. They are transferring risk from the lender to themselves. That's right. They are taking on more risk during the time they are paying down their mortgage. Here is a little known fact. The more equity you have in your home, the more likely the lender will foreclose on you if you miss three payments. Yes, seems unfair, but the lender is more likely to try to work it out with those folks who have little home equity. From their perspective, the last thing they want to do is to foreclose on a home and not get their money back. So they will work with home owners who have little equity rather than foreclose, while they are unlikely to worry about getting their money back from a home owner with 40% of value in home equity. They could easily sell that home and get back their money.

Since the recent mortgage foreclosure crisis, the government has moved to help some homeowners [and banks] by modifying mortgages. But even this program is reticent to lower principal. So all those homeowners and banks are still on the hook for that lost real estate value. It would seem the rational behavior would be to walk away from homes that are severely underwater and let the lenders take the financial hit, while the owners take the credit score hit. Despite all the moral pandering, this is how the system was designed to work in the first place. But if you have made your home your place of savings by paying down the mortgage then you are left to take the losses alone.

Leaving that aside, let's say you have been making extra payments for years and have paid down much of your mortgage. You get sick and are unable to make your mortgage payments (which have remained the same despite your early pay down). Is the lender going to give you a break because of your pre-payment history? No! Can you refinance? No! You are stuck. The lender is going to foreclose and you will lose that home equity you have been working so hard to build up. If a natural disaster occurs, resulting in property values plummeting and construction costs skyrocketing what happens to your home equity that you worked so hard to build? It evaporates. You have taken on the risk, relieving the lender of its risk. No wonder they are more than happy to take your extra principal payment, or give you a 15 year loan, or take a 30% down payment. The lenders are lowering their risk!

Home Equity Trap

Ironic isn't it? Trying to do the thing that is most responsible and some advisors say most important actually puts you in a worse position. But it doesn't stop there. Here is a question for you to ponder. What is the rate of return of home equity?

The real rate of return on home equity is 0%. That's right. If you use your home as a savings account the return is 0%. This is easy to demonstrate. Let's pretend you and I live next door to each other, in identical homes that are worth $200,000 this year. You have no mortgage on your home, and I have a mortgage for $160,000 on my home. The home market in our area goes up 5% this year. What is your and my home worth? That's right we both have homes worth $210,000 for an unrealized profit of $10,000. All that home equity you have didn't produce a dime for you. Now, since the average person has half their net worth in the form of home equity they have given up the opportunity to earn significant amounts by using their home as a savings account. If you have $100,000 in home equity this opportunity cost is anywhere between $4,000 and $8,000. If you invest this $100,000 in safe investments you can get between 4-8% interest which is $4,000 to $8,000 a year. The average person's income is around $40,000 so this person is giving up the opportunity to increase their income from 10% to 20%. Wow! If you work 250 days a year this represents twenty-five to fifty days of work. Now, there are costs for freeing home equity, but we will talk about that later in another section.

The true realities of paying down a mortgage and keeping home equity in your home should now come into focus. You are increasing your risk. You are incurring opportunity costs. Finally, when you really need to use that home equity, perhaps a job loss or illness, then you can't get at it without selling your home which could take six months in some markets. Does this really seem financially sound?

Variability

This money trap is rarely discussed openly between financial planners and their clients. Variability is simply the historic range of rate of returns for a given investment. Calculated into a single number it is called "beta." Perhaps, if you have a good financial counselor, they will ask questions of you that allows them to judge your risk tolerance and point you into certain directions; investments with low beta's (lower variability). But there is rarely a honest discussion on variability because neither the financial planner nor the client dares to asks the hard questions. What happens if you are in an investment that drops 15%, 20%, 25% or more. Do you sell? Do you blame the advisor and fire him/her? What if your investments lose money several years in a row?

The evidence is clear as I point out consistently, that most people can't psychologically withstand this type of variability. This has been known for years and Wall Street has spent much time and effort dealing with this problem. Before WWII investing in stocks was considered akin to gambling. Only those with money tended to trade in stocks, and it was considered risky. Back in the 1940s one former stock salesman even wrote a rather humorous book called *Where are the customers yachts*? This author pointed out that it seemed to be the Wall Street companies and their top managers that were buying yachts with their profits, not the people who were investing in stocks.

In the 1950's academicians discovered diversification as a way to reduce variability. In short, by owning many companies, you could control the overall rate of return by slicing off the edges. In other words it is not likely, if you own 20 different companies, that all would go out of business. It is equally unlikely that they would all multiply their profits by 100 times. By giving up on the ability to "strike it rich" betting on one company's fortune, you can assure yourself that you would not lose all your money. Further, you could diversify into many different avenues of the economy, protecting yourself against one type of business not doing well. Out of this discovery came the mutual fund industry.

Mutual funds allow you to buy small slices of many businesses, effectively diversifying from the 1st dollar invested. Armies of mutual fund salesmen successfully marched into the hinterlands selling the diversification of mutual funds and downplaying the risk. They were so successful there are probably very few people in the country that do not at least know what a mutual fund is. Indeed, it was a step forward for the individual ownership of stocks. But it did not solve the variability problem, because these mutual funds still have yearly losses (2-4 times a decade), some as large as 80%.

Despite pleadings from financial planners, media, and Wall Street interests, people still behaved as social/psychological research tell us they will. They sold investments that had losses, bought investments based on immediate past performance, or simply decided against investing at all after a bad experience. I believe it was Joe Kennedy who famously shorted the market, making millions, when his shoeshine boy started giving him stock tips. Following the herd, usually leads to poor performance, if not outright losses.

Rate of Return Trap

A big part of the trap is that financial planners don't explain the facts of life to investors. If they pointed out that rates of returns below 12% are not going to enable most people to accumulate enough wealth to have a desirable retirement, then they could start a real conversation about how best to get that rate of return. Of course, then it would limit what the financial planners are really trying to do, which is sell mutual funds or insurance. Instead, they fill their clients heads with "Alice in Wonderland" dreams about being able to create enough wealth with financial products that have failed in that job over the last two generations. They don't have the discussion about how wealthy people have acquired their wealth using the multitude of data we have available on wealthy individuals. They don't tell them the hard truth that how they have arranged their financial life will fail them, unless they change. The truth of this trap, is that it is faulty thinking that has set the trap. You see no one wants to be told what they are doing is wrong, or their thinking is failing to bring about the desired gain, or they will end up poor if they don't change their thinking. But that is exactly what needs to be done. Nicely of course, with a plan to change their course, but it needs to be done by someone willing to look at the real evidence.

Of course, you have to have acquired the finance knowledge to be able to see the difference between the dubious claims and the real evidence. There lies the next trap, you have to learn to do it for yourself first. Too many people think they can simply hire someone that will look out for their money. Well, let me be the first to tell you that you will never be able to hire someone to look out for your interests above their own. The only person that will look out for your interests first is you! Take a good look in the mirror because the person you are looking at is responsible and capable of creating wealth and a happy comfortable retirement. But you have to get away from the scarcity thinking that inhabits your brain. You have to think like an investor or employer, not an employee. You have to recognize the risk of not having enough money for your retirement as real and likely. You have to recognize that average thinking will get you nowhere in this environment.

Sequence of Return Risk

Notice I have put this in large print and red! That is because this is critically important to understand. So what is the sequence of return problem? Probably best to demonstrate this risk.

Two brothers, John and Joe, were approaching retirement. As it turned out they both had $800,000 in funds at retirement to last the rest of their lives. John was 3 year older than Joe and retired in 2000. Joe retired in 2003. They both were very concerned with having their money last and found the research that told them they could safely take out 4% of their original nest egg per year and have a better than 90% chance of not running out of money if they lived to 90. Interestingly, there were some planners that said they could go as high as 8% and not have that problem if they stayed in the stock market. But they were conservative and stayed with the 4% withdrawal rate.

Let's assume both retirees get the return of the S & P 500.

John retires on Jan 1. pulls out $32,000; 4% of $800,000). At the end of 2000 he has $759,552 in his account. He pulls out his $32,000 again and has $641,046 left in his account at the end of the year. For 2002, he pulls out $33,000 [increasing his draw accounting for the inflation] and by the end of the year he has $473,667. For 2003 he pulls out $33,000 again and has $567,051 [market started back up here. In four years his account has gone down 29%.

Now let's look at his brother Joe. Joe is three years younger so he starts his retirement on Jan. 1, 2003 with his $800,000. He pulls out his $32,000 and at the end of the year has $987,494. Again he pulls out his $32,000 and at the end of year 2 of his retirement has $1,059,453. Now he pulls out $33,000 to account for inflation and at the end of year 3 he has $1,076,850. After year 4 he has an account with $1,208,675!

Two brothers, same account size, same strategy, one has over twice as much as the other 4 years into retirement!

That is what sequence of returns is all about. The first few years of retirement are critical and if you pull money out and have significant drawdowns it cripples your future. If you get lucky and have significant upward movements, it allows you to float through troubled times much easier.

Let's finish this example and take them through the beginning of 2009.

John:

2005: Account value $592,155

2006: Account value $ 586,610

2007: Account value [increase withdrawal to $34,000] $639,867

2008: Account value $639,129

2009: Account value $367,011

Nine years and a loss of over half the account.

Brother Joe:

Jan 1 2008: Account value $1,275,031

Jan 1 2009: $753,291

Now who do you bet on having his money last his lifetime?

Do you feel lucky???? Because that is the question following the standard retirement strategies is asking you!!!

Two brothers, three years apart in starting retirement, with entirely different outlooks for their retirement. And worse it is not something anybody can control.

Many investments are sold on the basis of average annual returns. Charts are created, strategies implemented, all based on this simple statistic. But, this statistic is very misleading because the market doesn't work like that. One year the market goes up a little, then maybe up a lot, then it drops a little and every once in a while it drops dramatically. This variance is rarely talked about in practical terms. If the market suffers a major loss close to the time you plan on using the money you have invested, it invalidates your plans. So much in fact, that if you did retire anytime in the last DECADE, your retirement income is radically reduced. You are using your capital instead of allowing it to grow back to that average return. So, in fact, you never reach that "average annual return" that you were led to believe would be YOUR average return. And here is the kicker, historically, you have a better than 80% chance to retire either right after or right before a major market downturn. So, odds are that this will become your reality unless to lower your market presence significantly at least 5 years before you plan to retire. And when you lower your market presence you lower your returns.

So that is what is so insidious about sequence of returns and why you need to understand it now.

Chapter 3

Fear, Risk, and other Scary Propositions

Excuse me for a chapter while I digress. At this point I imagine you have had a reaction to the previous chapters. For some of you it is a negative reaction. Dr. Dave is crazy, you think. Or worse, he is just trying to enrich himself. Others might be less negative, wanting more explanation. Finally, there will be a small group of folks that inherently understand what I am saying, perhaps because they look at their net worth and realize the reality of their situation. Whatever your reaction is at this moment you will benefit from this chapter. We are going to deal with the two most important mathematical concepts in personal finance, regression to the mean and risk. When we have mastered these two concepts we are much more prepared to analyze risk and allay fear. Don't be intimidated, take a deep breath and read on.

Regression to the Mean

Mathematicians for the last 1000 years have advanced theories to analyze risk. For the first half of the 1000 years, time was spent developing ways to account for what is. Then a major transformation occurred. Italian, British, and then French mathematicians set their sights on ways to predict future events. This is called probability theory or as it is commonly known, statistics. There aim was interestingly enough to be able to predict outcomes of games, as many of them were gamblers. The last 500 years haven't changed much as now the financial world is full of individuals trying to predict the movement of stocks for the same reasons. Money is a great motivating force!

There are literally millions of studies designed to predict future stock movements. So far there has been no success. There is no strategy that has shown to predict stock movements. Every single one of them has failed in the long run. Now, there have been many promising strategies that worked for a short time, especially since the designs generally look backwards in direction. But they all fail going forward. Finance theory, based on historical evidence, points out that the market is efficient. In other words the general public can get all the information on a business it needs to make a buy or sell decision, so if a business seems under priced, the whole market will realize this and bid up the price. Now Wall Street types argue vigorously against this fact because what they are selling is the hope of a big score or at least above market returns. This is where the theory of big numbers or regression to the mean comes in.

Now I will spare you the technical details. Here is what this means to you. Given large enough numbers and time all relationships will revert to the mean or average. Let's look at rate of return on mutual funds to demonstrate. Suppose your financial advisor suggests you put some money into a fund that has done very well the last two years. In fact, s/he points out this fund has returned above market rates for the last 5 years. The advisor suggests that the strategy employed and the superior stock picking ability of the fund's manager accounts for this great return. Don't you want to get on board? Should you buy this mutual fund? The reality is most people do fall for this sales pitch. But the answer is no, don't buy it. And the reason is regression to the mean. In the universe of mutual funds the average or mean return is around 7%-8% per year. There is a mathematical certainty that any particular fund over time will return close to that 7-8% figure. What that means is the above average mutual fund this sales person is advising you buy will have to give below market returns at some time in the future to regress to that 7% figure. And in fact research has shown that is what actually happens. Based on prior good performance people buy mutual funds that then give them sub-market performance. And the more they are above average the more they will fall below average. There are several studies pointing out the fact that individuals who own mutual funds see personal returns much lower than mean mutual fund returns. One major study found that individuals rate of return was 2.7% while the mutual funds they were buying and selling returned 7.5% and the market returned over 10%. This propensity to chase past performance is one reason that individual rates of returns for investors are so much lower than the actual mutual funds performance.

Truth be told numbers don't lie, and you can count the major money managers who have beaten the return of the market over 15 years on the fingers of one hand that. Even the legendary Warren Buffett has had several sub-par years lately (Disclosure: I own Mr. Buffett's Berkshire Hathaway stock in my portfolio). The numbers are even worse because of the way the mutual fund market works. When a fund underperforms, it is more likely to be folded into another better performing fund or disbanded altogether because people leave the fund based on its poor performance. In the first chapter I indicated that the marketing strategies are emphasized over sound financial advice and this is a perfect example of this. Pick up any finance magazine and you will see full-page advertisements for funds that have over-performed the market in the near past. Any financial planner or mutual fund sales person would not last in the business by advising people to buy average market performers. They must entice you by pointing out the great returns achieved on funds they suggest. This makes them seem valuable to the consumer and uses that great emotion, greed, to motivate.

The evidence is clear, the more consumers chase high performers, the worse their portfolio returns. It matters little if these are do-it-yourself investors or being led by a financial advisor. The more they trade the worse they do. The only beneficiaries from active trading are Wall Street and its army of sales people. Even the most ethical fee based financial planners suggest yearly "check-ups" where one sells under performers and buys high performers. How else do they account for their fees and commissions?

The Dalbar Studies

Personal finance, specifically the stock and bond markets, have been studied vigorously over the last century by academics laboring in our universities and colleges. Literally, hundreds of thousands of studies have been performed and reported. So it is interesting that the most relevant studies, the one's that report how well individuals actually do when they invest in stocks and stock mutual funds, are not highly reported by the mass media. I suppose they are unlikely to bite the hands that feed them. Wall Street firms, banks and insurance companies spend billions of dollars on advertising with the mass media. Perhaps the signature studies on actual results for individuals investing are done by Dalbar, Inc. The latest study looked at a 20 year period culminating with 2009. What it found was consistent with other similar studies as well as its own previous research. The results might shock you! During that period the market returned 8.2% (S&P 500 Index). But what did individual investors get for a return? 8%? Well, no. 6%? No. 4%? No. The answer is 3.17%!!!!. So the spread from the market to the actual results is 5.03%. Actual investors underperformed the market by over 5%. And those that practiced asset allocation strategies? 2.34%. Why? Because human psychology hasn't changed. We abhor losses more than we love profits. When our mutual funds go down we are hard wired to stop the pain, and we do by selling those losing funds. Sometimes we buy other mutual funds that we think are better, while other times we stay out of the market all together until we feel it's safe to get back in. Either way the evidence is that our actual behavior costs us significantly. Now the scary part of this report is that their analysis demonstrates that mutual fund investors are actually behaving better than they have in the past!

There are other reasons people sell their stock mutual funds that also exasperate this poor performance. Perhaps a job loss or a health issue creates a need for money. So we sell. Or perhaps a happy occasion, a wedding, could cause us to sell. And of course, a divorce creates lots of selling pressure. The truth is, financial planners simply ignore all this evidence and continue to give advice that does not take into consideration how people actually behave. It is my belief you should change your advice to take into consideration actual evidence of human behavior.

Winds of Fate

A few years back I was working for a small company. I loved my job. It was interesting and I was very good at it. I was Director of Research, and the research department was doing quite well for the company. I had designed the research protocol myself, making it one of the most sophisticated methodology in the country. Frankly, I felt bulletproof. Not that I couldn't be replaced, just that why would one replace me after such success. I had set up a meeting with the owner of the company to talk about what I needed to accomplish in order to receive a raise the following year. Instead of that discussion, I got laid off. It came as a complete surprise. There were no previous discussions about my work being sub-standard. It was an unpredictable event.

I have a client who owns a store. He has had it for seven years. Each year it has increased the revenues and profits for the owner. That is until the DOT decided it was closing a bridge. People who lived on the beach easily crossed the bridge to come to his store. However, the DOT decided to rebuild that bridge and close it for six months. That is unheard of. Usually, they will build a temporary bridge while they reconstruct the old one. Here they closed it down totally for six months. No problem my client thought. As soon as the bridge is rebuilt, his revenue will return to its previous amount. That did not happen. Folks got in the habit of going elsewhere and continued their habit. His revenue had dropped by 50%. Now he needed to spend much more money advertising to regain the lost revenue. It was a tough time for my client. Who could have predicted the closing of a bridge for six months?

A friend of mine was in charge of marketing and sales for a small business owned by two brothers. The business was doing very well, growing rapidly, and producing a great income for the owners as well as its employees. Suddenly, one of the owners was diagnosed with a brain tumor. He died six months later. While this person was in the process of dying, his brother, the co-owner of the business, fraudulently sucked all the money out of the business, leaving it bankrupt. My friend went from a six figure income to no income overnight.

The winds of fate blow in many directions. Now I, my client, and my friend have all rebounded from the unpredictable events that dramatically changed our economic lives. However, you can never predict how the winds of fate will blow, just like you can never predict how well the stock market will do or when you will find yourself in financial peril or jobless. What I am suggesting is that your personal financial planning should be able to account for the winds of fate handing you some hard times.

What if everything you thought you knew was wrong?

When would you like to find out about it? Most answer that question with a resounding now! You have now been given the tools to understand how the financial service industry is misleading the public, misleading itself, and generally not giving advice that is **evidence based** when it comes to retirement planning. Let’s do a quick review. There are five important items to remember.

1. Liquidity is critically important. In times of crisis you need to be able to have access to cash. Further, this cash should be accessed without devastating your financial future by triggering severe penalties, taxes, or being forced to take losses;

2. Avoid chasing hot mutual funds. Last year's great performers will turn into next year's poor performer. If you want to own mutual funds, buy index funds. Research has demonstrated that the more one buys and sells the worse the performance is. This goes for the fund managers as well as individual purchasers of mutual funds. Don't believe the rosy predictions Wall Street propagates. They are wrong most of the time;

3. Be honest with yourself about risk. Which risk do you really fear? Is it losses in your investments or not enough money to live on in your retirement years?;

4. The winds of fate will turn against you at some time. Have a financial plan that recognizes this fact; and

5. You don't have to end up with a poor retirement. You have within your means the ability to retire comfortably. Dream it, plan it, and make it happen! This is what the Shafer Wealth Academy is about; helping people build a plan based on evidence of what works and coaching them through the implementation of the plan.

If that is all you take from this book, then it will serve you well. But I hope you read on. In the next few chapters I will spell out the most important financial concepts needed to analyze wealth building and some specific strategies that will help you reduce risk, increase wealth, and turbo-charge your retirement income.

Chapter 4

Paradigm Change: The New Reality

In the previous chapters I have been hard on the financial planning industry. Deservedly so in most cases, but I must point that the advice goes back two generations and two generations ago was a very different environment. Most people had corporate and government pensions that were defined benefit pensions that had cost of living increases built in. The average person only lived for less than 5 years after retirement. Medicine costs were negligible compared to the average budget. So mutual funds, bonds, and annuities were really gravy for those who had social security and a defined benefit pension to live on for that short period of time. The harm done by poor rate of returns was minimized by pensions and lower costs of living.

But now, people are living almost 18 years after retirement, and the majority do not have a defined benefit retirement to lean on. Social Security is in trouble. Can we afford to live off of yesterday's poor advice?

The change happening is not just about retirement but encompasses a whole multitude of areas. The new reality requires a new way of thinking. Evolve or die, metaphorically speaking.

I make it a habit to read extensively about a host of subjects. Currently, there is a major shift in human understanding of subjects ranging from science, spirituality, finance, politics, and social relationships. This paradigm shift is going on right under our noses, mostly unnoticed, and mostly not commented on by the mass media. For those who like to hang out at book stores, you have definitely noticed it. Just walk the aisles of any subject in any bookstore; you will come across titles talking about this amazing change. Want proof of this happening? Up until last year General Motors was insisting that American consumers would never base their car buying decisions on gas mileage. Now, they are marketing their "green" cars. Whether their cars are actually "green" or not is irrelevant to the fact that they are now telling us that American consumers want good gas mileage and lower polluting cars by the way they are marketing. Now this paradigm shift has been in the works for a while, at least since the first hybrid car was introduced, but GM (and many of you) didn't notice this shift until recently.

For the better part of the19th and 20th Centuries citizens of the western world were taught to become consumers. This was a major change from what had existed before; self reliance. No longer do we build our own homes, make our own soap, kill/grow our own food. With the advent of credit, we disconnected our purchases from our cash reserves. Let's not fool ourselves into thinking that credit did not drive the success of our capitalistic system, which we all benefited from. So that evil (according to the bible) of credit did much to benefit our society, but it also played into developing our consumer mindset. This consumer paradigm, or way of thinking, developed two sides; the saver mentality and the purchaser mentality. Now most people think that there is some moral superiority to being a saver rather than a purchaser, but it is really just two sides of the same coin. One side, the saver, is able to put off into the future their consumerism, while the other side, the purchaser is incurring the cost of immediate gratification. No doubt, one is better off in the long run by being a saver over a purchaser, but both labor under a dying way of thinking. The emerging paradigm is the investor/banker paradigm. This paradigm was brought to the attention of millions most recently with the Kiyosaki, *Rich Dad, Poor Dad* series, but it has been emerging for quite a long time. Now there has been some critique on the veracity of Kiyoski's original book, but it is really irrelevant to the message it articulates. The message in this and many other books is one of moving from a consumer paradigm to an investor/banker paradigm. This is important to understand. We are changing our way of thinking as a society whether you personally change or not. Like General Motors, you can deny what is happening for a good amount of time, but eventually you will have to change your way of being to match the new reality. What does this investor/banker way of thinking require of us? Simply we will need to understand our lives and our goals in fundamentally different ways. This can only happen through an educational/emotional process. Let me outline what this process might entail:

Here are some of the mindsets that enable the consumer way of being:

1. The conscious or unconscious belief that money and material wealth is our primary goal;
2. The conscious or unconscious belief that we exist in a zero sum game, that our success is predicated on overcoming someone or something else;
3. The conscious or unconscious belief that material things have intrinsic value;
4. The conscious or unconscious belief that there is a limited supply of wealth that must be competed for; and
5. The conscious or unconscious belief that time and money have a direct relationship.

Compare this to the ideas that animate the investor/banker way of thinking:

1. Happiness for us, our family, and our community, is the primary directive;
2. Success is predicated on positive relationships with others;
3. Only people have intrinsic value;
4. There is unlimited opportunity and prosperity available for all; and

Now the truth is that many of us will deny that we engage in the consumer mindset. But if we really are truthful with ourselves then we will recognize how deeply we are beholden to the consumer way of thinking. Certainly, the investor/banking way of thinking should not be foreign to us. That is because these ideas have been around for a long time, but we only give lip service to them. Our new job is to do the academic/emotional work of engaging these ideas and making them work on an unconscious level, just as the consumer ideas do for us currently.

You might be asking at this point, what this all means to my financial life? First, we need to look at why you need to be concerned about this shift to the investor/banker paradigm. The mortgage industry has suffered from bad press lately. And it deserves the bad press it gets because consumers have been hurt by bad mortgage advice and Wall Street firms have also been hurt by lax underwriting standards. The naked truth is that the mortgage industry labors under the assumptions of the consumer paradigm. Remember, the underlying assumptions from the consumer paradigm are competition for a limited amount of wealth and the need to overcome someone else for limited resources. Hence the lenders set up a system that generally guarantees what is best for them is not best for their customers, neither borrowers nor Wall Street investors. And of course the customers react by not trusting, or even worse, hating the mortgage company so much that they do things that are counter-productive to their wealth building. This is in a nutshell what the consumer paradigm has come to for not just mortgages but for just about everything.

But on the fringes of the mortgage business are folks that have recognized the destruction of this way of doing business and have started to introduce different ways of doing business that break down the destructive cycle. In the finance world I call this the investor/banker paradigm. The change it engenders for both the folks selling financial services and the folks on the consumer side is incredible. But first a little explanation as to how to put the general ideas outlined to work.

There are three intellectual/emotional changes that need to occur:

1. We need to change our understanding of what is financially important from income to net wealth. Let me give you a personal example of how this works. A couple years ago I changed careers. In that particular year I spent more money than I made to the tune of $30,000. Now the old way of thinking is that you should never spend more than you make. There are myriad of advisors out there that ask you to track spending and compare it to how much you make. They insist that if you spend more than what comes in you are on the way to financial ruin. From the consumer paradigm this is a fact. However, for me I didn't care. Why? Because the proper metric to look at is net wealth. Net wealth is the total worth of all your assets minus your debts. In that year my net wealth went up $50,000. Hmm, how could that be? Well, I control some real estate that appreciated. I control some stocks, bonds, and mutual funds that appreciated. So even though my income from work did not cover my expenses, the appreciation of my assets was so

much that it drove my net worth up. Now the interesting thing about net wealth is that you have a great deal of control over it compared to income. Income for most people is controlled by a boss, a company, geographic area, education, career choice, etc. But you can design your assets any way you want to, and this is what creates wealth. From a practical view, you should always know what your net wealth is. This should be a part of your daily regime, calculating net wealth in your head for the day.

2. The mental image of ownership should be replaced by control. You don't own your home, car, truck, etc., the bank does! How many times have you heard that? That is the consumer paradigm speaking loudly. Are you in competition with your mortgage lender over your home? With the bank for your car? Some people think so. The reality is you control your home, your car, or any other item that someone loaned you money in order to purchase. The lender doesn't want it. It is a royal pain for them to get it back. They are in the business of selling money, not in selling distressed homes, or repossessed cars. The truth is that the bankers of the world are your greatest asset, not your enemy (not that they think this way). They make it possible to control assets without having the money to buy them outright. By controlling assets you get the benefit if they appreciate, you get the benefit of using them, and you share the risk of this control with the lenders. Personally, I care less whether I own assets, because I only want to control them so I can benefit from their appreciation and cash flow. Now, here is where the hard emotional work gets done. The consumer paradigm has infused us with fear. We fear losing things that we own, but they are only things. What makes a home? Is it the brick, wood, cement, dry wall, and paint? Or is it the people that live in the home? I believe it is the people that make a home. If a hurricane came and wiped out the structure I live in, I could easily find another one. And it would become my home because my family would be there. My job would be to replace an asset that I controlled. It could be anywhere. Fear of losing **THINGS** we own is what keeps most people from obtaining happiness and security.

3. Victimization and scarcity are the keystones of the consumer paradigm. Currently there is much talk of mortgage companies who victimized consumers by putting them into bad loans.

People are going to lose their homes because of these sub-prime, variable rate, interest-only, or option arm loans. Earlier in the decade it was all those folks who got victimized by financial advisors who had their money in the stock market. Every few years it is a new set of victims. No discussion of why these "victims" knowingly entered into these mortgages. Nor is there any discussion of who and what was really lost. These "victims" are portrayed, somewhat accurately, as passive actors in life. Bad things happen *to them*. They are blown by the winds of society. This can only happen to people working under the consumer paradigm. Those who have moved beyond this are not victims because they understand there is no scarcity. Human beings all have the capacity to act upon things, to control their destiny, to create wealth. There is abundance out there for anyone to obtain. Move beyond victimization and scarcity and you begin to see it, understand it, and make it possible.

How does a banker make money? Well they borrow money from investors who put money into savings accounts and Certificates of Deposit or they borrow money from the government. Then they loan that money out at a higher rate. It is called arbitrage and is the basis for wealth creation for bankers over the last several thousand years. Do banks incur risks? Yes, their main risk is if people don't pay them back what they owe. Periodically, bankers forget about this risk and the result is disastrous. Like in the 1980's with the S & L's lending money to real estate developers who just happen to be their buddies. Or, in the recent past, where banks lent money to people who have a history of not paying their bills led to loan losses. But the bankers do something else; they require collateral in most cases. So, they reduce their risk this way. They really don't like to, but if forced they will foreclose and resell an asset to recoup as much of their money as possible. But here is a key. If bankers don't think they can get their money from the asset, they will work with the borrower to avoid taking a loss. Donald Trump tells the story of owing $100 million dollars and not being able to make his payments. He told a room full of bankers he couldn't pay them back. What did they do? They restructured his loan. Did they take his yacht from him (yacht was his collateral)? No. Now here is the point. It's

good to have a banker as a partner. When they have a large amount of risk in the deal they will become very good partners, willing to work with you to insure that you become successful.

How do investors make money? They buy assets and increase the value of these assets. These assets range from businesses to real estate to bonds. Quite simply they put money to work for them. Successful investors can create extreme wealth by infusing young businesses with capital (money). For example Mitt Romney, once a Republican presidential candidate, and his company Bain Capital turned 57 million dollars into 50 billion dollars. The famous financier JP Morgan put together deals turning his bank into an equity investor creating tremendous wealth.

Now both of these ideas have been around for a long time. Yet, they seemed to be reserved for only a special few. The new emerging paradigm is about extending these ideas to a larger percentage of the people. On top of this is the fact the tax laws benefit business owners and investors.

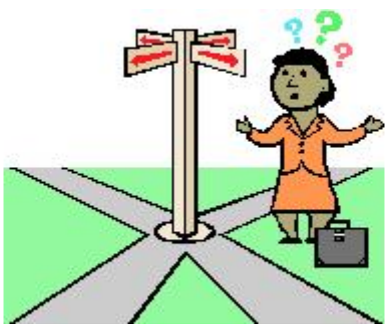
One of the biggest financial hoaxes is that you can achieve financial peace by being a consumer, either a spender or a saver (who saves so they can consume later in retirement). Financial peace can only come from becoming an investor, using the arbitrage method of bankers, and using the power of leverage. Now I know that most people view these ideas as extraordinarily risky. But the financial truth is that they are far less risky than the risk most folks take every day with their finances.

Now you might be thinking that you are an investor because you buy mutual funds inside your 401K. Technically, you are and this is a good thing. But I argue that becoming an investor is more about your state of mind, the way to see the world, than whether you own a microscopic piece of some corporations. In short Wall Street has done a great job convincing us that investing in mutual funds is the way to riches (in order to retire), but behind this veil of propaganda is the reality that the only folks getting rich off of mutual funds is Wall Street. I mean study after study has documented that 98% of mutual funds under perform the market over time (15 years or longer), that stock pickers are routinely beaten by darts thrown at a board (chance), and that you are best off finding a low expense index fund that will mimic the market. In other words the best you can really hope for is average returns. Yet, most people think that they can identify (buy) mutual funds that will turn them into automatic millionaires; or at least that is what the financial gurus are selling these days. The facts tell a different story. Despite having been told to save and invest in mutual funds for two generations, despite having a good amount of folks retiring with a defined benefit retirement plan, despite living through the greatest economic expansion in the history of the world, less than 10% of retirees today are self sufficient. Why? Because they have the mindset of the consumer paradigm. They shop. They get caught up in the minutia of consuming, even to the point of consuming investments/retirement plans.

Those who consume retirement plans are perhaps the saddest of the consumer paradigm, thinking they can save enough from their paychecks to retire wealthy by buying mutual funds. Even the salesmen/financial planners are no longer arguing this is possible. They now tell you that your goal should be to save enough to replace 60%-80% of your current income. But of course they still tell you that you can beat the market with mutual funds, some arguing that you can get a return of 12% or more! Do you remember the Dalbar Inc. studies I discussed in the last chapter? What happens to the wealth prognostications when you put in 4.4% as a rate of return? That 60-80% of your working income turns into 25% or lower of your working income! Are you starting to see how the common retirement strategies sold to you by the financial services industry have failed to solve the retirement income problem?

These strategies sold to you are the opposite of what successful investors do. Investors do not chase yesterday's good investments. They don't panic when their investment dips. Warren Buffet, perhaps the most successful investor ever, sums it up nicely: "You should invest like a Catholic marries-for life." The point that Warren Buffett has made succinctly is that you should do your homework on what you want to invest in, look for true value, and hold on to it for a long time until the fundamentals of the business don't make sense anymore. That is what being an investor is really about. Investors also concentrate their investments not diversify away their chance at a decent rate of return. I will talk about that point latter in the book.

Bankers work a little differently, but ultimately it turns out to be the same viewpoint. Their arbitrage strategy is based on taking money in at a fixed cost and putting it to work at a higher rate than their cost. This works in all interest rate environments because interest rates move in tandem. For example, in the early 1980's bankers were issuing Certificate of Deposits that paid over 14% interest. However, they were charging up to 18% for their residential mortgages. Their commercial mortgages were over 25%. Today you can get a Certificate of Deposit for 2% and a mortgage for 4% so the margin has gone down, but the strategy still applies. The strategy works as long as no malfeasance occurs as when the Savings and Loans lent money to people with no track record of commercial success or when some lenders lent money to individuals with bad credit and/or were lying about their income. As long as you have accounted for the probability of being paid back on a loan the arbitrage strategy will create value and wealth. If you don't believe this, just take a look at any downtown center in the country and note the names on the large buildings. Bet you they include bank names!



Now, the needed paradigm change is a very difficult thing to accomplish. It takes much intellectual and emotional work. You don't accomplish this in a weekend seminar or by reading any single book. For me, it took years of research, reading, thinking and yes mistakes to fully establish my financial viewpoint to the place it is now.

The question for your consideration is, do you want to continue doing what hasn't worked? Or, are you ready to move forward in your understanding of financial principals?

Chapter 5

Wealth Creation: The Forgotten Variable

What the financial services industry has hidden from view, is the forgotten variable called Wealth Creation. The numbers are out there for all to see, no one bothers to talk about them. Why do the self employed have triple the net worth as those who are employees? Why does every study of wealthy individuals demonstrate a large amount of real estate holdings? Why do studies demonstrate the higher the net worth of a family, the lower the percentage of their wealth in mutual funds?

Leverage, Leverage, Leverage

The answer is pretty simple. Every study of wealth creation suggests that the key is using leverage. It is even apparent in the data of wealth among the middle class. The largest amount of wealth is home equity among the middle class. More than stocks, mutual funds, retirement funds, annuities or any other asset. Why, because most people get a mortgage when they buy a home, and that mortgage creates leverage.

So, you want to create wealth? Then you need to understand the importance of leverage. Leverage has gotten a bad name to average investors because it creates risk of loss. I think people sometimes misunderstand what leverage is all about. When thinking about leverage, think about what a lever is. A lever is a tool that allows you to move/lift more weight given an equal amount of force. It gives you what is called "mechanical advantage." When we look at wealth creation, we see that leverage is a requirement for producing wealth.

There are three types of leverage. First is financial leverage. Using real estate as an example, financial leverage is about controlling a large asset with a smaller amount of money. When you buy real estate with 20% down, you control the whole asset. So if you buy a home for $250,000 and put down $50,000, financing the rest, you benefit from the entire $250,000 home. If over the next five years it becomes a $300,000 home and you sell it, then you have made $50,000 by investing $50,000 plus the cost of financing and ownership. In other words, even though your home has only gained 20% in value, since your initial investment was only $50,000 your total rate of return was almost 100% (you still need to account for your financing costs and any other costs incurred). Financial leverage allows you to use "financial advantage" to control a large asset with a substantially smaller cost.

The next type of leverage is labor leverage. This is enjoyed by business owners. Every employee hired by a business owner should produce an excess to their cost (or why hire them?). Say a business owner requires each of his employees to produce an excess $10,000 to the bottom line of his business. The owner can leverage this labor as high as she can add employees that make him more money than it costs her to hire them. When adding an employee doesn't give the owner a net benefit, then the hiring stops. So if he is able to hire 25 folks that meet his $10,000 added value requirement he is able to produce $250,000 in profit by labor leverage.

Finally, is value leverage. A land developer is looking to buy parcels of land. This developer can leverage the value of the undeveloped land when he adds to the value by visioning an end use for this vacant land that the seller hasn’t envisioned and/or does not have the capability to create. Now that end use might be a shopping center, or single family homes, or some other commercial use, but what the developer is doing is leveraging the end use value of the land compared to the current value of the land. The more successful the developer is in this leverage, the more value added he creates, the more profit is obtained.

In order to create real wealth, not just get lucky with speculation, you must use one, two or all three of these leveraging strategies. However, be warned that if you are only using financial leverage for speculating on real estate, stocks, or any other investment, then you have multiplied your risk. I’m not saying speculating with a leveraged investment is always bad, but pointing out that financial leverage needs to be understood fully in the context of the underlying environment.

Why do the average Americans have so much more value in their homes, than their investments? Because they use leverage to purchase their homes but don't leverage their mutual funds or other investments. The truth is that most go through their lives only using leverage to purchase their homes, eliminate the leverage as fast as they can, and are unable to build wealth because of this lack of leverage. People who have brought wealth to their lives all use leverage to accomplish it.

Mortgages: The Misunderstood Wealth Builder

I want to introduce a different way of looking at mortgages. So far, I have mentioned several times that wealthy individuals own much real estate. I have also mentioned that individuals that obtain wealth use leverage in order to obtain the wealth. Add in the fact that most middle class individuals who have a positive net worth have most of their net worth in their homes. The one class of financial products that accomplish this wealth creation is mortgages. Mortgages have created more wealth for the middle class than any other financial instrument, more than stocks, mutual funds, bonds, savings accounts, 401K plans, and IRA's. It is a fact. Yet, most people think of mortgages as a necessary evil at best or more commonly a "rip-off." In reality, you should wake up every morning trying to figure out how to have more mortgages, or at least a bigger mortgage. I know that you are probably at this point thinking that old Dr. Dave has lost it, but I will demonstrate to you the reality of this assertion.

The average American has more than 35% of their total wealth in their homes in the form of home equity. Homes are the great builders of wealth for the middle class. In fact, statistics demonstrate those who don't own their own home, rarely accumulate any wealth at all. Very few could buy homes if they had to pay full price without a loan. A mortgage is the entry cost for home ownership.

The advantage of mortgage debt doesn't stop there. Mortgage debt allows the average person to leverage a large asset. Leverage as we have seen is a simple concept. Simply put, you can control an asset without having to pay for the whole asset up front. For example, if you want to buy a $250,000 house you can write a check for $250,000 or you can write a check for $25,000 and get a loan for the balance. Let's say over the next two years the house appreciates to $275,000 or 10%. If you had written the check for $250,000 you would have made $25,000 on your home/investment from the appreciation. A 10% rate of return. Not bad, but not exceptional. However, if you had written the check for $25,000 and taken the $225,000 loan you would have $59,132 ($34,132 principal and interest payment on the loan at 6.5% + $25,000 down payment) into the deal. Your rate of return would be 42%. Not bad, but it gets better.

The federal government in its wisdom affords the average American with a mortgage interest deduction. This deduction for the person who had a $225,000 mortgage in the previous paragraph would amount to about $7,233 in tax savings for the average person in the 25% tax bracket ($28,933 (interest paid) X .25). More for those in higher tax brackets. So the true rate of return for the person with a mortgage on their $250,000 would be 48%. Pretty good, but we are not done yet.

Most people have at least heard of the miracle of compound interest. The way compound interest works is that money grows exponentially based on earning interest on already earned interest. Let's look at a simple example. Say we invest $100,000 at 7% interest. The following chart demonstrates the miracle of compound interest.

Year	Gain	Total
1 ($100,000 X .07)	$7,000	$107,000
2 ($107,000 X .07)	$7,490	$114,490
3 ($114,490 X .07)	$8,014	$122,504
4 ($122,504 X .07)	$8,575	$131,079
5 ($131,079 X .07)	$9,176	$140,255

In year five your gain is $9,176 compared to $7,000 in year one. You are getting interest on your interest you have earned in year one through four. Over time it can create huge numbers.

So what does this have to do with mortgages? Well, when you pay a mortgage off you are paying a simple interest amount. So every year you are paying a similar amount of interest. Actually, amortizing loans or your typical 30 year loan is front loaded for interest payment so the amount of interest versus principle payment is highest in the first 5 years, but your total amount of interest paid is really the same for each year when you look at the loan in its entirety. If you had a $100,000 loan at 7% you would pay $7,000 in interest for each year of the loan. That is your cost, but it never changes. So if you put the two ideas side by side they would look like this.

Year	Loan Cost	Compound Interest	Difference
1	$7,000	$7,000	$0
2	$7,000	$7,490	$490
3	$7,000	$8,014	$1,014
4	$7,000	$8,575	$1,575
5	$7,000	$9,176	$2,176

This is a critical concept to understand so it bears repeating. Your typical 30 year fixed rate loan charges you a fixed rate of interest that doesn't change. In our example it is $7,000. When you earn interest it is on a compound basis which means each year you earn more than the last year. This simple versus compound interest is officially called arbitrage.

Now, let's put it all together for the previous example of a $250,000 home that the buyer put's down 10% or $25,000 to see why home ownership produces so much wealth. I like to use very conservative numbers, mainly because "pie-in-the-sky" numbers are not needed to demonstrate how wealth is produced by home ownership, but also because I believe in "evidence based" planning. For the purpose of this example I will assume a 6% appreciation on homes and a 7% interest rate. I will also add in additional cost for mortgage insurance for two years since the down payment is less than 20%. I will assume a tax rate of 25% even though most pay higher rates. In my area of Florida the actual rate of appreciation over the last generation is around 7% and currently mortgage rates are less than 6.5%. But I want to demonstrate how this works and not get bogged down in whether my assumptions are too high.

Year	Home Value	Mortgage Balance	Cumulative Cost Cost-Tax Savings	Wealth Created
1	$265,000	$222,714	$39,569	$2,717
2	$280,900	$220,624	$54,138	$6,138
3	$297,754	$217,636	$67,611	$12,507
4	$315,619	$214,818	$81,083	$19,718
5	$334,556	$211,796	$94,556	$28,204

The second column demonstrates the homes appreciating value. The third column is the balance on the mortgage, a conventional 30 year amortizing mortgage. The fourth column is your cost, the principal and interest payments minus your tax savings. Finally, the last column demonstrates your total gain. In five years, this home has created $28,204 worth of wealth for its owners. But, I want you to notice how the wealth creation is accelerating. The first year it only created $2,717 in wealth, but in year five it created $8,486 in wealth. This is the miracle of compound interest as Albert Einstein called it. Just for fun let's look at year ten.

Year	Home Value	Mortgage Balance	Cumulative Cost Cost-Tax Savings	Wealth Created
10	$447,711	$193,078	$161,918	$92,715

In year ten, $92,715 has been created over the total cost. Not bad. Now add this in. If you were not a home owner you would have to put a roof over your head by paying someone else rent. That could easily add up to $150,000 in a ten year period.

That is the mechanism of how leverage, compound interest, and tax deductions allow individuals to build wealth in homes. However, for the purpose of retirement planning there is an even more important point. Having a mortgage performs a psychological miracle on folks.

People who can't or won't save money make sure that they pay their mortgage no matter what else is going on in their life. In other words a mortgage creates compliant savers. It is a forced savings account. Financial planners know that a vast majority of people, even the most motivated savers, fail at some point in saving money. Maybe it is a job loss, a private school for junior, or a new car, but in everyday reality there are times that we aren't able to save.

We have data on mortgage foreclosure rates that tells us that 99% of people make their mortgage payments. That's right Americans have a 99% compliance rate with this mortgage savings program. Even that number is really misleading. We, by and large, are much more compliant than that. Over the last twenty years, until 2006, the foreclosure rate for "prime" mortgages, those with individuals who have a good credit history, has ranged from .4% to 1.3%. For sub-prime borrowers it has ranged from 3.3% to 18%, but these borrowers are sub-prime because they have a history of failing to pay their bills. The vast majority of us pay our bills, and when we look at them, 99.5% make those mortgage payments. This is really the key idea. This is the secret of how mortgages create wealth better than stock/mutual fund investing, bond investing, or even simple savings accounts. Now the foreclosure rate has skyrocketed since 2006. The reasons are well discussed in the mass media. Let's suffice it to say that we are going through unprecedented times. But this too will pass. And with the passing of the new financial services laws, those that attempt to behave recklessly [no liquidity, not enough income to cover loans, etc.] will not find it so easy to get into trouble. We will get back to the time where 99% of us make our mortgage payments.

This is the "evidence" that leads us to successful wealth creation. Take an appreciating asset and combine it with 99% compliance, and you have the first step to wealth creation. This is why I started this section, rather cheekily, telling you that you should start every morning trying to figure out how to have larger and more mortgages. However, in order to put this wealth to work for you and turn it into retirement savings home equity must be managed properly.

Risk

The second and equally important concept to understand is what constitutes risk. Risk is variance. Simply, the more the price a given investment varies from year to year is defined as its risk. Let's look at a single stock for example. The downside risk is that the company can go out of business making your investment worthless. So the downside risk is -100%. Now the upside risk for a stock is great too, let's say 1000%, but it could be even more. The upside is really unlimited, but for our discussion lets limit it to 1000%. Therefore the total variability is 1100%. That is a huge amount of uncertainty or risk. Now we see why some feel the stock market is simply another form of gambling.

However, mathematicians discovered in the 1950's that you could reduce the risk or variability if you own many stocks. This is called diversification. If you own 25 different stocks the odds that all of them will go out of business is so small as to be non-existent. But the odds of these 25 stocks returning 1000% are also non-existent. So we reduce the variability by owning 25 stocks considerably. Let's say the worse you can do is -80% and the best is +200%. Now the overall variability is 280% instead of the previous 1100%. Diversification has reduced the risk considerably. This is the intellectual basis for mutual funds. No longer do you have to gamble on individual stocks. You can buy mutual funds who are diversified enough to reduce variability or risk.

However, not many investors can psychologically deal with the true risks of even mutual funds. Let's take a short look back. In 2000-2001 the NASDAQ index of technology stocks lost 80% of its value. The S&P 500 Index lost 50% of its value. People sold their mutual funds in droves during this time. No wonder, it was beyond anything that they could have conceived or were told was possible. In 2007 the S&P 500 finally got back to its value of 2000. The NASDAQ is still only half of what it was. Could you stand the psychological pressure of these paper losses? What if you needed to use this money during that time period? Or retired? You might never recoup what was lost. We saw the major stock indexes lose 50-60% again in 2008. The same thing happened, people sold their portfolio's and mutual funds after the losses.

If you have an account with a broker chances are you had to sign away your constitutional right to sue the broker. Instead, you are forced into arbitration with three folks making up the panel. One of those folks is going to be an industry representative. There has not been many studies done on the outcome of these arbitrations, but it should not surprise you that the one study that has been done found that the plaintiff lose more than they win. So consumers mostly lose. In fact, this study also demonstrated that the higher the amount in question the more likely the consumer will lose. Now, I am not passing judgment on the veracity of the claims, but only pointing out that the industry would not have gone to all the expense, time and bad publicity pushing people into arbitration if they were not concerned with the ability of their clients to psychologically deal with stock market losses. One way of looking at the results of these arbitrations is that in the majority of cases the losses were the result of routine stock movements, not fraudulent trading or misrepresentation. Regardless of the results of arbitrations, there is ample evidence that consumers in general underestimate how they will react to normal stock market fluctuations.

The truth is that several times a decade mutual funds drop over 20%. It was only 20 years between times that the S&P 500 dropped 50%. So we see big drops aren't unusual for stock funds. Wall Street has sold mutual funds as a way to not have risk or at least avoid most of it. Now the truth is you must assume some risk in order to build wealth. Instead of that message, the message is that mutual funds diversification makes risk disappear. So is it surprising when individuals who are sold on an investment that has little risk, react badly when their funds lose value? Let's compare two financial vehicles rate of returns. You have $1,000 to invest. Which would you choose, Vehicle #1 or #2? Here are the returns for five years:

Financial Vehicle #1	Financial Vehicle #2
25%	5%
8%	5%
-20%	5%
-6%	5%
20%	5%

Most investors would see the large returns for vehicle #1 and choose it. But if you work the math you would have $58 more ($1276 -$1218) if you chose vehicle #2. Yet, vehicle two only gave you very average returns *every year*, while vehicle #1 gave you great returns for three years and negative returns for two. What is going on here? Well first of all negative returns hurt you severely. If I told most people that the first year you lost 10% of your money, but the second year you earned 10% back most would think you were even. But let's do the math. $100 X -10%= $90. So after the first year you have $90. Then the next year you get 10%. $90 X 10%= $9. So you have $99. What happened to the other $1? Well, when you lost the 10% you have to have a 11% return to get back to where you started. That is why losses are so devastating, because it takes time to get back to where you where. Let's look at more dramatic losses. Let's say you lose 50% one year and you make 50% the next. What is the result? You start with $100, after year one you have $50 and after year two you have $75. So you lost $25. When those financial advisors show you those mutual fund charts they don't tell you that, do they? Remember it took seven years for the S&P Index to get back to where it was in 2000! This is why.

By now you must be thinking that I am calling for you to invest in a safe reliable investment like certificate of deposits or savings accounts. But that couldn't be further from the truth. I just want the reader to understand what risk is and how it works. The more you know, the more you can conquer your fear of risk.

The real issue for me is that they have sold mutual funds as a way to not have risk or at least avoid most of it. Wall Street has not prepared investors for the ups and downs of the market. So is it surprising when individuals who are sold on an investment that has little risk, react badly when their funds lose value?

Of course, the ultimate risk avoidance techniques are sold by banks. They point out that their investments (savings, certificates of deposits) are insured by the FDIC against loss (up to $100,000). So they encourage people to avoid all risk and accept a measly rate of return generally between 1% and 6%. Once again in an environment where retirement savings is one part of a three legged stool that includes a defined benefit pension, social security, and savings this might be acceptable. But that environment is no longer what most of us live with. So the question is can you live with getting a no-risk rate of return of less than 6% if this is all the money you are going to have for retirement?

Pay attention to this next statement. You will never create wealth with an unleveraged investment that has a rate of return less than 12%. Let's remember you have to overcome inflation, fees, your own reaction to market variability, and life events that intervene in your wealth building plan.

Remember in Chapter 1 when I talked about the effect of inflation, creating $1 million is not very hard if you have lots of time to do it. But, that $1 million is really only worth $375,000 35 years from now. You see inflation is an insidious force that eats away at your money every single day. Now official statistics indicate that inflation over the last generation is only 2.8%. By now everyone should understand the way the government determines inflation has nothing to do with the actual inflation we all experience. Government inflation statistics have more to do with limiting its obligations than anything else. So many people who have government defined benefit pensions get cost of living increases tied to these statistics that it is imperative that the government understate inflation or drive deficits off the chart.

It should be obvious that this is another reason to build up private wealth. Even if you have one of those great government pensions, over time it will be less and less valuable because of this understated inflation. If you are parking your money into a risk free, low rate of return environment, then you are also losing money as your money fails to grow as fast as real inflation devalues your money.

If you don't leverage your money, then you must get a very high rate of return to create wealth. Looking at the universe of investments, there are only a few investments that have maintained a high rate of return for fifteen years or longer. The bottom line is, it is much easier to find investment returns that will overcome real inflation and create wealth if you use leverage.

Finally, a real discussion of risk has to include the risk of not creating wealth or the risk of being an average wealth creator. The average wealth creator has, in today's dollars, a net worth of well under $300,000 in the 55-64 age group. How long will that last someone? Remember that at least 1/3 of that wealth is in home equity. Now, how long will it last? When one runs out of money what happens then? Work? Yes, for as long as one is physically able. Poverty? Yes, as the cost of medicine and health care overwhelms even those with sufficient pensions. Dependency? Yes, on the government, family, and neighbors. When you put your money into that bank certificate of deposit, this is the risk you are incurring. When you depend on strategies that are generations old, designed to work in a totally different environment, this is the risk you are incurring.

Now, let us compare risks. Is it riskier to use leverage or to risk senior poverty? Is it riskier to learn about investing and put that knowledge to work for you, or remain ignorant and trust some mutual fund manager to make sure you have enough money in your senior days? Would you rather have a paid for home and $150,000 available to produce income, or a $1500 mortgage payment and $800,000 available to produce income? I think that even the casual observer of what is going on at Wall Street now can see that they are not the financial guru's they claim to be!

Now, I truly don't mean to scare anyone, but this is a time for honesty. As Jack Nicholson said, in *A Few Good Men*, **"You Can't Handle the Truth."** That's what financial planners have been telling you all these years. But, I believe at least some of you are ready for the truth. If you really understand what I have been telling you, you also understand that it is imperative to change your behavior in this environment if you want to succeed in having a comfortable retirement. Consider this book a call to action for folks- call to action to change your thinking in order to behave differently. It needs to lead to **you** taking control of your own financial life, taking control back from the "experts"- the financial advisors, the people who are leading you astray. You can handle the truth, if you want to.

Right here is the point where we will begin to explore how you can create the needed wealth no matter what your age or income. Right here is where you make your choice of risks, senior poverty or leverage/high rate of return. Right here is where you need to take a big gulp of air and open your mind to the reality of your financial situation. Right here is where you decide independence or dependence.

Taxes

If you make the choice to accumulate wealth to fund a comfortable retirement, then you have to account for the tax man. If your plan is to have average savings because you can't emotionally handle risk, then you probably won't have an issue with taxes. Poor people simply don't pay much in taxes. That is why most financial planners don't account for taxes paid during your senior years. Their plans won't accumulate much wealth for you, so no tax issues. <u>For those of us who will accumulate wealth, we have to account for taxes because it is the single biggest expenditure of our financial lives.</u>

Whether you think it is fair or not, the fact is there are many legal tax avoidance strategies available to those with money. From the tax reduction from mortgage interest (up to $1M mortgage and real estate taxes that can be deducted not only on a primary home, but also a second home), to the tax advantages of owning a business, there are multiple ways to reduce tax payments. Any true wealth plan needs to take these strategies into consideration.

Take life insurance for example. The amount of people who own permanent, cash value life insurance has dwindled as "financial experts" insist on advising people to only buy term insurance. However, when you look at what the top managers of our largest corporations do, they purchase large cash value life insurance contracts. Why? You can access the cash value without having to pay taxes. The money inside a life insurance contract is usually protected from lawsuits (not divorce proceedings where it is treated as it really is; an asset). There are no limits to the amount of money you can put into a life insurance product, unlike 401ks or IRAs. Ironically, as these experts are telling the masses to buy term life insurance and invest the difference (usually in mutual funds), the top managers of these same companies are doing the exact opposite with their finances.

Real estate investing has some of the greatest tax advantages out there. In fact, real estate investments encompass all the financial rules for building wealth and few of the risks. Financial benefits like depreciation, 1031 exchanges, tax write offs and leverage can be put to use by the average person when investing in real estate. *Real estate investing is very different from real estate speculation that many people unsuccessfully attempted between 2003-2006*

Debt

Debt is universally misunderstood, and nowhere is there more bad information than among financial planners. Many financial planners are trained in accounting, a conservative occupation that can be considered on the opposite spectrum from entrepreneurs. The facts are there is good debt, and there is bad debt. Going into debt for depreciating consumer items is rarely a good idea, although it is not the "end of the world" situation that many make it out to be. In a perfect world you would pay cash for automobiles, boats, flat screen TV's, etc. instead of financing them. I think this is a great goal, although there are other strategies that can accomplish the same outcome of minimizing finance charges. On the other hand, automobiles are so expensive that it is not realistic that people will always be able to pay cash for them. The big problem is credit cards are so easy to obtain, that there is a temptation to live above your means using credit cards. Of course eventually, if you don't increase your cash flow, you end up having to pay for all those items plus finance charges when you couldn't even afford the cash price when you bought them. Here is a simple solution. If you have a burgeoning credit card balance, don't spend more than you have coming in. If you have an issue with this, then you need to make a budget so you know how much you have to spend.

Consumer debt is about ego. Our ego won't let us see the truth of our financial lives. It tells us to buy consumer goods to hide the reality of our lives. It tells us we can obtain satisfaction from owning things. At the Shafer Wealth Academy we build financial plans that don't allow for the ego to lie to us. We insist people track the reality of their financial existence. We teach people to measure progress. We insist people have financial success before they purchase vanity consumer goods.

Now, let us talk about good debt. Debt has been used for centuries to create leverage and/or to enlarge a business. There are not many businesses that become successful without some type of debt or credit line. Even among the middle class, debt, in the form of mortgages, is used to create the lion's share of net worth. Of course, many people know this, but in their brain this information gets confused and emotionally tied into knots. Why else would folks whose only successful investment is their home, spend so much time and energy trying to get rid of the one financial instrument (mortgage) which created wealth for them?

Good debt is loans that allow you to arbitrage the cost of financing into greater wealth creation. Good debt allows you to share the risks. Good debt creates a tax write off. A sensible wealth plan must include good debt.

How the Wealthy Invest

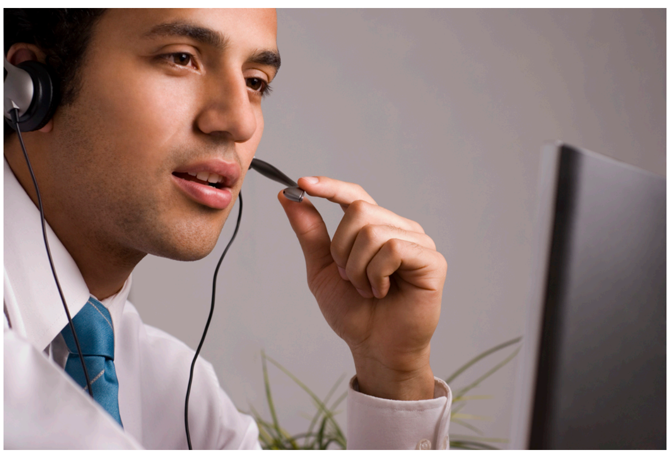
There is much research on this subject. Funny thing, the wealthy do behave differently as the writer F. Scott Fitzgerald noted years ago, especially when it comes to their financial lives. Probably not surprising by now is that the wealthy do exactly the opposite of what the common wisdom advises. They do exactly the opposite of what financial planners suggest the middle class do. If you are thinking that the wealthy probably don't invest in mutual funds, then you are right. If you are thinking that they don't worry about diversification in their stock holdings you are again right. If you are thinking that they are overly concentrated in one particular asset class, then you hit the bull's eye. But, then again, if you had been thinking those thoughts, you would probably be wealthy now.

First, let us define wealthy. There are three generally agreed upon categories; the mass affluent who have a net worth outside of their primary home of $100,000- $999,999, the wealthy who have a net worth outside of their primary home of $1,000,000- $9,999,999, and the super wealthy who have a net worth outside of their primary home above $10,000,000.

Interestingly, the investment strategy is basically the same between the wealthy and the super wealthy, and the higher you go in net worth for the mass affluent the more they look like the other two classes.

So how do they invest? What financial instruments do they use? Well, the truth is they use all sorts of financial instruments, but there are two main strategies which set them apart from those who have less than them.

First, is real estate. The largest category of investments for the wealthy is real estate, and it only gets larger as you go up the wealth ladder. Of course, they all own a primary home, but a second home is also common. As you go up the wealth scale, they own 3,4 or more homes. Along with personal residences the wealthy own much income producing real estate. They own apartment buildings, commercial buildings, duplexes, etc. that produce income and throw off tax benefits. You see the wealthy understand, or have their accountants tell them, that investment real estate has multiple tax advantages. They also understand that well placed real estate can provide multigenerational income streams. There are other smaller categories of real estate owned by the wealthy that include REIT's (real estate investment trusts), especially the REIT's that use leverage, and raw land. Raw land is a much more long term and speculative investment, that generally takes multiple generations to pay off.



The next largest category is businesses. Usually they control or own large blocks of a business that can be best called creative or niche businesses. The wealthy have been able to identify unique ways to satisfy needs. Many times the discovery has come out of an industry that they worked in for years, first as an employee. You see, they understand that owning a business allows them to use all three types of leverage as well as take advantage of the tax advantages granted corporations. So, it is not just the cash flow that comes from selling products or services that produce wealth, but the leverage available to business owners, the tax advantages, and yes the bankruptcy laws that protect their personal finances from business failures.

Interesting isn't it. Think about the risk of being an employee. You are at the whims of not only a world economy, but the whims of the owner of the company, your boss, your co-workers, etc. You can be laid off at any time, even if the business is doing well. This happened to me. One person with power decides you are not needed or you are a threat to them or just doesn't like you, and you get the pink slip. Yet, for some reason most think it is safer to be an employee than a business owner? Actually, it is the opposite. Wealthy people understand this point well.

The wealthy also own some of the traditional investment classes like stocks, bonds, mutual funds. However, it is at much smaller percentages than the non-wealthy. For example, the super wealthy own individual stocks and mutual funds, but the median ownership is around $1,000,000 for individual stocks and $500,000 for mutual funds. Now remember, the super wealthy category starts at $10,000,000. So their stock ownership percentage is very small compared to their overall assets. They own cash value life insurance at about the same percentages as their stock ownership.

Their overall strategies suggest an understanding of the key elements of finance that we talked about earlier; leverage, taxes, risk. They take risks on things they understand, increase the velocity of cash flow by using leverage, and keep their taxes low. It's pretty simple when you understand how it works.

It also tells us the wealthy understand history. The greatest investments, those that last for generations until someone forgets why they were purchased in the first place, are income producing real estate. Imagine if your great grandfather purchased apartment buildings in Manhattan or Miami Beach or Chicago. What would they be worth now? How much income might they be producing for you? The truth is, businesses come and go and our needs change, but we always need a place to live or a place to shop. Quite frankly, I think it is very difficult to build wealth without some type of real estate investment. But, the good news is that anyone can learn how to invest in real estate.

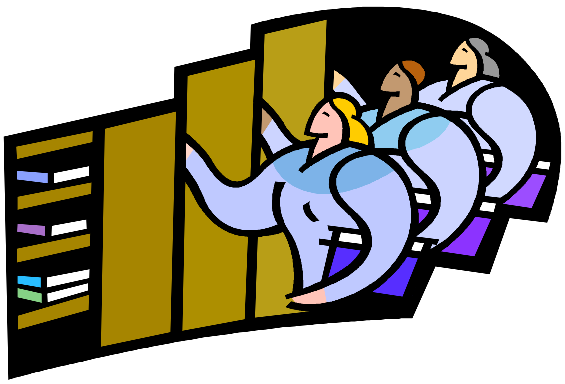
Maybe you are not the landlord type, like me. The thought of having renters calling me all hours of the day and night to have the plumbing fixed is my nightmare. There are many ways to own real estate that don't have that nightmare. And here is the kicker, buying investment real estate is one of the few options readily available to virtually everyone in the middle class. Now there are some rules you need to understand and some reserves you need to have to protect yourself. The bottom line is you can invest like the wealthy if you want to and you don’t have to quit your job to do it. As a matter of fact it would be much better if you didn’t quit your job at first.

Here is the second thing you can do without immediately quitting your job. Start a company. I am not talking about the network marketing opportunities that we all have been pitched. No, the starting costs for your own company have never been lower. With computers and the internet, you can start a company for little up front cash. What kind of company? Every one has some interests or some experiences that can be used to creatively think of a product or service that people need. Start a business, and learn from it. It might not create enough cash flow for you to quit your job, or it might. Either way, you are on your way to independence and mimicking what the wealthy have done to create wealth. Even if you end up a life long employee, the concepts like cash flow, taxation, accounting, and debt management that you learn from owning a business will make you a much more valuable employee. Remember the goal is to join the investor/banker paradigm, so owning your own business even if it is only for a “learning moment” will also make you a much better investor. Don’t be surprised, many people once they get the entrepreneur taste, never go back to being an employee.

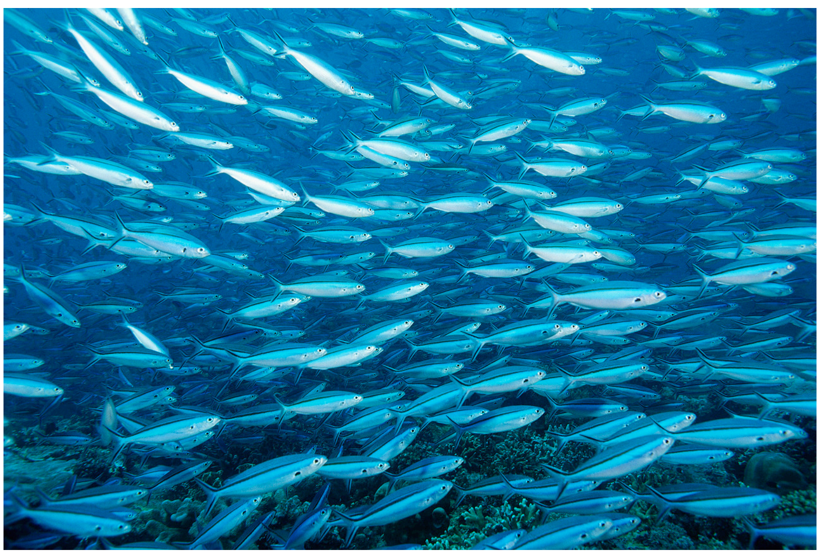
Creating The Herd

What I am suggesting is that you put to work for you the same financial concepts that have created wealth since the beginning of the industrial age. Leverage, managed risk, increased rate of return. But, if it is that simple why don’t more people use this knowledge? First of all it is not taught in schools. But more importantly, there are forces out there that don’t want you to really understand it. These forces are not some secret cabal of mean spirited folks. No, they are the forces of Wall Street and Main Street. They are the people who need, no require, a complacent group who will work well in their businesses and trust others to do what they feel they can’t do. Now, last generation there was a social compact between these business owners/managers and the masses that required both sides to take care of the other in order for mutual prosperity. Hence, the aforementioned defined benefit retirement plans that corporations have now relegated to the trash bin. This social contract is now broken, and you better be prepared for its consequences as there will be consequences for which to plan for!

The purpose of current public school structure is to build the herd. To build obedient citizens with the proper skills to work in the modern bureaucracies we see all around us and accept their limitations with things like investments and financial planning. If you had a hard time with algebra in school, you are more likely to look to an expert to help plan your financial life, even though algebra has little to do with investing as Warren Buffett likes to point out. If you are used to looking at the teacher as the expert, then you have been trained to accept your lack of knowledge and authority figures' expertise. Think about the structure of schools. How they conceive of education; standing in lines, moving from one area to another at exactly the same time, regulated meal times, institutional food that must be made palatable to everyone, and the division of students into those who are "smart" and those who need "help." We know through research that children are ready to learn to read at different times. Some are early readers, as early as 3 years old, while others are late readers, as late as 9 years old. But once they are ready to learn to read, it happens in a very short amount of time (about 16 hours of instruction). So what do schools do, they insist all children need to start reading by a certain age, and if you are not ready then you are labeled "slow," either by the school system itself or by the segregation of children by reading ability (self labeling). Multiply this simple example by hundreds of times, and you have a recipe for creating followers; good soldiers within other institutions.



Let me tell you another finding about those with wealth. They had a variety of different school outcomes. Some, those in high income professional occupations, did well in school. While many others, perhaps the majority, had less positive school outcomes. Some of the wealthiest people in this country dropped out of school. Many others barely graduated. For every medical doctor that acquires wealth there are many more average students who created wealth from a simple idea. In fact, talking about medical doctors, they are on The Millionaire Next Door's list for wealth underachievers along with financial services professionals! In fact, when one looks at the evidence, you could easily make the argument that success in school is not correlated at all with wealth. I know that the mass media likes to point out how much more income those with a college education earn than those without. But, we are talking about wealth here, not income, and they are two different measures. In fact, I would argue that income is a secondary measure, falling far below wealth for adjudicating financial success. And the income result is really talking about how well folks do in bureaucracies. It is not surprising that those who succeed in one bureaucracy, school, also succeed in other bureaucratic environments. After all, as I just pointed out, the real objective of schools is to produce good workers for bureaucracies.



What we do know is to find financial success you have to break away from the herd, ignore all that school training, learn what is important and what isn't in wealth creation, and create a plan that is based on what we know works not on what we know fails. Best of all, the evidence tells us that when one does that, they are happier and obtain lives that allow them more freedom. What a cool thing, making yourself wealthier gives you happiness and freedom.

Chapter 6
Creative Thinking

Creative thinking is required to break out from the herd. Thinking is, of course, what everyone believes they do well, but the truth is something very different. You can judge the quality of thinking from the results. Here are my favorite thoughts on thinking from the author and leadership expert John Maxwell:

Poor thinking produces negative progress
Average thinking produces no progress
Good thinking produces some progress
Great thinking produces great progress

Judging from the results for wealth creation there is a lot of poor and average thinking, a small amount of good thinking, while great thinking is rare. Of course, our schools do their share in creating poor and average thinking, don't they? So, we need to break out from what we have been taught previously. We need to decide to blaze a trail much different than what our neighbors, parents, and friends have decided, and that is hard work.

Again from John Maxwell:

Unsuccessful people focus their thinking on survival
Average people focus their thinking on maintenance
Successful people focus their thinking on progress

Where do you focus your thinking? This is more than an academic question. I believe that how people think is 90% of the issue of people not having enough money to retire comfortably.

I hope you understand by now why, in our current financial environment, you can't depend on average thinking. If you still aren't sure then let us do a quick reminder:

- ❄ Average retirement plans have $98,000 for the 55-64 age group;
- ❄ Over 90% of folks will be dependant on the government or their family for retirement income;
- ❄ Defined benefit retirement plans are rapidly being phased out. For the minority with these plans there is a very real chance of a bankruptcy voiding the plans;
- ❄ Average investor returns from mutual funds have been 3.1% for the last 20 years;
- ❄ Taxes will claim a large part of income for retirees that have even moderate income;
- ❄ The average person will live almost 20 years past retirement age; and
- ❄ Most people are using the wrong financial instruments to obtain wealth.

The key to changing all this is to change your thinking. This can only be done by education and effort. I guess if there is one thing you should take from this book at this point, it is creating enough wealth for a decent retirement is not a hands off affair. You can't leave it up to someone else to do it for you. You must do the hard work of understanding the process, create a true wealth plan, and implement the plan. Of course, the good part is everyone has within their grasp the ability to give themselves wealth. They just have to believe that and start to make it happen by educating themselves. This book is probably the first book that most have read that puts it all out there honestly and forthrightly. So in a sense, if you have made it this far, you have started your path to wealth. But, additionally you must make taking control of your financial life something you enjoy and want to learn how to do well.

Let us look to Albert Einstein, one pretty creative guy, to help us grasp how we need to become creative thinkers. There is much written about Albert Einstein as should be of a man of such great intellect and I want to share with you a little of what I believe we should learn from Einstein. First, let us put to bed that falsehood that he failed in school. He didn't. What he did was rebel against the harsh realities of German schooling (a system we copied for our school model). In fact, if you were to ask about one prominent characteristic of Albert Einstein, it would be his rebellious nature. It led him to hate school orthodoxy and the military mobilization of German society of the time.

Our society has much in common with the Germany he grew up with and rebelled against. So what can we learn from Einstein? Allow me to share some Einstein quotes to animate the discussion:

"Imagination is more important than knowledge"

This is classic Einstein. Not only is it the basis for his thinking, but it was the basis for his dislike of schools. While he was imagining and writing the basics of what would become his great theoretical breakthroughs (at age 16), his teachers were more concerned with him memorizing facts resulting in one of his teachers famous quips, "it doesn't matter what he [Einstein] does, he will never amount to anything." He wore the scars of this educational model for his life. Later he would say:

"Great spirits have always found violent opposition from mediocrities. The latter cannot understand it when a man does not thoughtlessly submit to hereditary prejudices but honestly and courageously uses his intelligence."

He thought the time consuming memorization of facts was the exact opposite of what schools should be doing, the antithesis of his and other intellectuals' way of allowing imagination to engender their thinking.

"Education is what remains after one has forgotten what one has learned in school."

Critics have suggested this next quote points to Einstein's elitist attitude, but I think this is more closely as a result of his problem with schooling and his pacifism. In fact, throughout his life he remarked on the stupidity of "military thinking" and "schooling to memorize."

"Only two things are infinite, the universe and human stupidity, and I'm not sure about the former."

His open rebellion with orthodoxy was laid bare by this quote:

"Common sense is the collection of prejudices acquired by age eighteen."

This quote goes off in my brain every time someone says "common sense" to me! How can we learn from Einstein? Well, it is pretty simple. First, don't waste our time with the trivial. Instead, allow time to use our imagination and to really think hard about the theories we use to run our lives. Next, don't be afraid to break from the herd. Just because everyone thinks one way or behaves in a certain way doesn't mean it is right or even worthwhile. Finally be an intellectual rebel. Don't accept what other folks see as common sense or the truth. Look beyond the surface for the evidence of reality! One final quote that really sinks home for folks who want to create wealth in their lives:

"Sometimes one pays most for the things one gets for nothing."

Think about that quote when you see some talking head on cable TV spewing forth on some investment strategy!

Creative thinking is a must for folks to build wealth in their lives. We can all learn how to think creatively if we want to, although it does take work. Now we all can't be as creative thinking as Mr. Einstein, but the good news is we don't need to be that exceptional. We simply need to be good enough thinkers to break from the herd and turn off all that noise that comes from Wall Street to us via the mass media.

When I created the **Shafer Wealth Academy** I knew the first thing that needed to be accomplished was to change the way people thought and approached retirement planning/investing. As Einstein and others understood, our brains, our way of thinking is what keeps us from reaching our goals. In essence we create our own reality with our way of thinking. That is why I spend much time in the Academy helping people to change their way of thinking first. Then, and only then, do we get to the technical issues of investing.

Chapter 7

Investor v. Speculator

The media pounds us every day with the losses in real estate. A few years ago it was the losses in stocks. What they don't tell us is that these losses are mainly limited to people who were speculators or who listened to others who were speculators. Now I know that there are some who simply wanted to own a home and are now facing foreclosure. But, behind the wanting to own a home was the thought of real estate as an appreciating asset. Speculators think of the possible appreciation without concern for the realities of market fluctuations. Speculators bound into decisions without proper thinking. Hence, individuals without any cash reserves to tide themselves through the tough times bought houses with no down payments and used mortgages that inappropriately created jumps in payments over time. If the only way you could afford a certain house was to get an option arm loan, which hid the real cost for a period of time, then you were speculating that the house would appreciate in value and be easily sold when the payment went beyond your means. If you bought a home with no money down and had no reserves, then you were speculating that the home would appreciate quickly and would be easily sold when you lost your job or had other financial issues. If you bought a stock of a company that had no profits, you were speculating that it would eventually be profitable enough to justify its cost. Speculating is not investing, not by a long shot.

Let me give you a quick example of what investing means when it comes to my favorite middle class investment, real estate. Would it surprise you that you can earn a greater return and build more wealth from purchasing an investment duplex in an area that has growth of 4%, than one that has growth of 7%? Yet, it is true. You don't buy investment real estate based on how much it will appreciate; you buy it for other factors. Now, I am not going to go into the technical details like we do at the academy, but the numbers you look at are capitalization rates (ratio of purchase price to expenses), cash flow (how much money you make every month minus your expenses), and the rental market (what is the likelihood of having it rented and the ability to raise rent over time). These numbers determine the wealth creating ability of a piece of real estate without guessing what the rate of appreciation might be in the future. If you have done your homework and have a piece of property that produces cash for you every month, that you didn't overpay for, that is leveraged, and is appealing to renters, then you have a wealth creating machine that can't be sidelined because of variability in real estate prices. And if you have appropriate amount of reserves to take care of those real estate emergencies that might occur, then you can sleep at night while your wealth creating machine cranks out wealth.

Back in 1996-2000 people made fun of Warren Buffett and his company Berkshire Hathaway because he refused to invest in high tech companies, after he said he didn't really understand how they planned to make money. Warren was "old school" they said, "didn't understand the new realities." He would be left behind like the dinosaurs. Then came 2000, and all those technology stocks crashed, most going out of business. The index of technology stocks (NASDAQ) dropped 80% and still in 2010 remains 50% lower than it was in 2000. Meanwhile Berkshire Hathaway has averaged 18% rate of return over the last 10 years. It is not that Mr. Buffett was right. It is he is a stock investor while the others were stock speculators. You can spend thousands of dollars on fancy software which is supposed to guide you to successful stock investing, but reams of research demonstrates that this is just another high tech form of stock speculating. The Buffett way is to identify strong companies with good management that are attractively priced and buy and hold them, at least until some fundamentals change to make them unattractive. His idea of an ideal hold time for stocks, forever!

For a period of time you could attend a seminar every weekend, in every major city, which would teach you how to invest in real estate, stocks, or some other investment strategies like options or FOREX (currency arbitration). Many people flocked to those seminars. Some of those people armed with the advice gleamed from these seminars became speculators. Most lost money. Some lost more than money like their good credit standing and their homes.

These seminars are built upon a lie, that the average person can easily make money speculating in investments. Speculation is all about luck and being early into a trend. If you weren't early, and by definition if you attended a seminar you weren't, then you either had to be very lucky, or you lost your shirt.

But there is another class of folks who learned to either become an investor themselves or hitched their wagon to someone who was already a successful investor. These people are doing fine. Even more than doing fine, they have put together a wealth building plan that doesn't depend on luck. Perhaps this point is the most important point about being an investor. You've got to have a purposeful plan, as my friend Jeff Brown calls it. So now I ask the reader, do you have a purposeful plan that doesn't require luck to get you to your goal? Are you speculating, which at its core means you hope someone else dumber than you comes along and overpays for your asset? Because that is the riskiest position you can be in!

There is one more characteristic of those who have obtained wealth that I have not discussed. They have a plan. It just didn't happen to them. It was visualized, thought out, planned, and measured. If any part of the plan wasn't performing, it was changed. Can you say that about your wealth building plan? Do you even have a wealth building plan? Speculators hope their investment will grow, while investors plan for it to grow!

Does your wealth map look like this?

When it should look like this:

Are you still **hoping** for a good financial outcome instead of **planning** for it? Are you a speculator? If you are, then congratulations you are in the majority. You are a member of the herd, and you will end up where the herd is going.

Creating the Plan

The basis for any plan has to be an accounting of where you are **right now**. You need to figure out your net worth. That is an easy exercise. First, list all your assets and their approximate values. Now break the list down into two categories. The first category is appreciating assets. Place all your assets that appreciate over time in this category. This should include your home, other real estate, stocks, bonds, mutual funds, savings accounts, etc. The second category is non-appreciating assets. Here you put your cars/trucks, furniture, TV's, personal items, etc. Next create a list of your liabilities/debts. Your mortgage, credit card balances, car loans, etc. Now subtract your liabilities from your assets. This is your net worth.

Don't panic if this is a negative number! Now, subtract your liabilities from your appreciating assets. This is your **working net worth**. This is our most important metric. This is the number that we want to see grow and will determine how well your plan is working.

Next is cash flow. Take a look at your main checking account. What is the average of outlays from it over the last 6 months? Subtract that from your net income. What amount did you owe on your credit cards and/or home equity line six months ago? What amount do you owe now? If you owe more then add this number to your outlays. If you owe less, then subtract it. This tells you what your cash flow looks like. If this is a negative number then you have a budget issue. Common sense tells you not to spend more than you earn. If this is the case, then the plan needs to start with building up your monthly cash/flow.

Finally, write down your goals. Be specific. How much net worth do you want to have at what age. How much passive income do you desire? Whatever it is, you write it down. Now you have the starting point and the ending point.

All plans need contingency planning. In other words, the "what if" questions. What if we lose our job? What if we get sick? What if a dramatic expense occurs? Generally, we contingency plan by creating reserves. Reserves are pools of cash that we can access easily, perhaps by a click of a computer mouse or calling a phone number. Money market funds, savings accounts and cash value life insurance all act as reserve accounts. Equity inside your home is not an acceptable reserve account even if you have an open home equity line of credit. Lines of credit can and do get frozen. Home equity is not liquid enough to be considered a reserve account. Having adequate reserves allows us to sleep well at night.

Another part of contingency planning might be starting your own business. Even if this business creates relatively modest cash flow, it could be a life saver if you get laid off from your main job. This type of thinking is much more progressive than how most people think. Many individuals have found out their part-time business can be ramped up once they dedicate themselves to it full-time. Imagine if you could tap into passive income as well as have a business providing some cash flow during the time it takes you to find a new job! Imagine the peace of mind knowing that you are not totally dependant on a job for your livelihood.

Plan Summary

There are four moving parts of the plan. First is our **working net worth**. This calculation should be done monthly until the day you no longer need to calculate it, but you know it unconsciously. Then an annual calculation will suffice. Next is the cash flow analysis. If your cash flow turns negative then additional income streams must be found. Contingency

planning means maintaining adequate reserves to respond to all possible “Murphy’s Law” items and having a plan on how to increase cash flow when needed. As your net worth increases it might mean that your reserves will also need to increase, although in some plans the opposite will occur. The amount of needed reserves is dependant on your particular plan. Finally, the actual investment vehicles are monitored for performance and whether they still match the plan.

Investment Analysis

The plan is the first thing that separates investors from speculators. The analyzing of investments is the next point of separation. We analyze each investment to make decisions as to how well it fits the needed rate of return, time frame, and risk tolerance. First, we take a look at various investment categories and discuss how well they fit into the plan. We ask what risk must be assumed to connect the investment to the plan, and how to mitigate the risk, and then we look at the risk history of the asset class.

We then come up with either an asset class mixture or a single asset class that fits the plan. Now we turn our attention to the individual investment. Following the advice of the greatest investors like Warren Buffett, we look for investments that we would like to hold for a long period of time. We analyze their long-term ability to produce cash flow or capital appreciation. We ask the obvious macro-economic questions like will the product become obsolete in the future, will competition erode its ability to appreciate or produce cash flow. We do not want to get involved in investments that require us to micro-manage them. That is too time-consuming and ultimately forces folks into emotional decisions. Investors think long-term while speculators think short term!

Again using the wisdom of Warren Buffett, we are not concerned with diversification. Investment concentration is our friend as long as we do our homework. That is why we might choose one asset class to invest in, if it fits our needs.

Now if all this is starting to scare you, don’t let it. As Warren Buffet declared, “if calculus or algebra were required to be a great investor, I'd have to go back to delivering newspapers." The math needed is addition, subtraction, multiplication, division, and ratio's. Beyond that it is the ability to look around you and see what is happening. Finally, the internet now allows for the accumulation of information by everyone, where it was once reserved for only the wealthiest or the most skilled researcher.

When evaluating any investment there are consistent sets of questions to ask. Most of these questions involve simple math equations, which many times others will perform for you (although it is best to be able to do it for yourself). These are time-honored equations that allow you to compare investments in order to make the best decision.

It's a three-step process. First, we start by finding investment strategies that fit into the individualized plan. Next, we ask the big economic questions about the long-term viability of the investments. Finally, we use time-honored financial equations to guide us to the best specific investments. At this point we have identified the proper investments but we need to make sure the other parts of the plan are in place, cash flow and reserves, before we pull the trigger and buy.

The Process

- Assure adequate cash flow, contingency planning, and reserves are in place;
- Identify needed rate of return to reach goals;
- Find investment classes (class) that will give us the needed rate of return;
- Identify particular investments within investment class using time honored financial equations;
- Ask questions about long-term viability of the investments; and
- Take action

You can avert the impending retirement disaster if you want. You can take control of your financial life from Wall Street if you dare. You can create a life based on how you want to live by following the strategies discussed in this book. It is all within your grasp at this point.

I am adding a bibliography at the end of the book for guidance to the many people whose ideas have made this possible. Imagine you throw a rock into the middle of a pond. The ripples head outward, getting larger and larger. The rock is my metaphor for an idea. The ripple effect spreads the idea to all shores. When it reaches the shore, it is not apparent exactly where the ripple originated, only that something did start the ripple. My hope is that this book starts a ripple that takes people to a better life.

Chapter 8
Putting It All Together

You now have waded through all these chapters and have a good feel for my philosophy and the important concepts you should understand about personal investing. Now lets put it all together. Fortunately, you are now armed with the knowledge to appreciate these suggestions. The scope of the book is not to sell you any particular product [even though I do sell one product], but to bring you to a place where you understand the uncommonness of real financial knowledge. This should not be the last book you read on investment strategies, but it should be a launching pad to finding out more. Hence, the following is my thoughts based on what I have outlined in the first seven chapters but is not intended to be a total "how-to" invest in these strategies. There are experts available in each area that can and will teach you how to successfully navigate these strategies.

There are three investments strategies that make sense and one should consider using at least two of them if not all three. They all have these qualities. They take into consideration taxes and are tax efficient. They are able to produce income without also having penalties or severe consequences tag along with that income. They don't rely on "average" rates of returns so are not susceptible to either the flaw of averages or to sequence of return risk.

The first is investment real estate. Recent amateurish investing in real estate has given real estate a bad name. Real estate investing has proven to be the best way to produce wealth historically. By using proven buying metrics, learning your market, and using some common sense you can develop excellent retirement income without relying on property appreciation. And best of all there are some excellent advisors that can guide you. You won't have to pay cash flow out to these advisors until you sell. But beware, there are many more folks who will steer you wrong only looking for the sale. It is beyond the scope of this book to instruct you on the ins and outs of real estate investing but done correctly there is no better investment vehicle. Obviously you are using leverage. But you can also partially offset income from taxes. And you can achieve decent rates of returns without having to depend upon excessive capital appreciation of the property.

At the end of the day, you can with modest investments, end up with substantial rental income that rises with inflation and is partially protected from taxes. No need to sell an asset into a down market. No need to sell at all if the desired income has been achieved. No need to personally manage these properties unless it is something you want to do.

Dividend producing stocks is the second place that I think folks should look for income. If instead of investing in stocks for capital appreciation one would invest in stocks that pay steady increasing dividends for decades they would be much better off in retirement. Currently dividends are taxed at a lower rate than income, so they are tax efficient. And it is easy to figure out how much income you get. Just add up the dividends paid. If the stock market goes down [or up] it doesn't matter because all you care about is the dividend payment. If you choose large companies that have a long history of increasing their dividend [McDonalds or Proctor and Gamble for example] and diversify a little you can design an income stream that will at the very least keep up with inflation if not compound out. There are multiple books and internet sites to help you choose dividend paying companies to own. And with a little monthly homework on your ownership you can make the appropriate changes if a particular company puts their dividend stream at jeopardy. Sequence of return risk is mitigated as you might never sell the stock in these companies, instead live off the dividends. There are many companies that have increased their dividends over 8% a year for extremely long period of time. Some that have increased dividends over 10% a year. Although it is unlikely that you would get a rate of return as high as your real estate investments, it can and should be an excellent return. Choose 5-8 companies and you should be diversified enough, but not too diversified to cost you returns. These large long-standing dividend paying companies don't change over night so the homework and surveillance is kept within the reach of almost any thinking person's abilities.

Finally, permanent life insurance should be owned and structured to maximize its cash value build-up. When structured correctly, the costs are minimized and the internal rates of return are substantial. I prefer and sell equity indexed universal life insurance policies. These policies pay interest tied to a stock index with caps around 15% and never give a negative return. They give good protection against an early death as well as mitigate the sequence of return risk.

And best of all income can be taken from these policies tax-free. Although these policies won't deliver internal rates of returns as high as the first two suggestions, the tax-free aspect makes up for the lower rates of return. They have high liquidity with few limitations to accessing the cash value. Those interested in understanding EIULs should start at my blog at http://shaferfinancial.wordpress.com. The truth is that life insurance has been used by the wealthy and large corporations for several generations to create a stable financial platform. Life Insurance Companies are some of the most stable companies in our history. Internal Revenue Codes have been in place for over a generation that enables the tax-free nature of income from the policies. These policies are products with good internal rates of returns and established taxation decisions backed by financial secure entities.

If one were to use all three of these strategies, they would protect themselves against the common financial maladies most folks experience. They would have income from three different sources [diversified], pay few taxes, and not have to worry about the huge ups and downs of the stock market. Emotionally, they should be prepared to accept the realities of a dynamic economy without panic nor silly mistakes. In short, they would be in control of their own retirement destiny. What more can someone ask for?

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