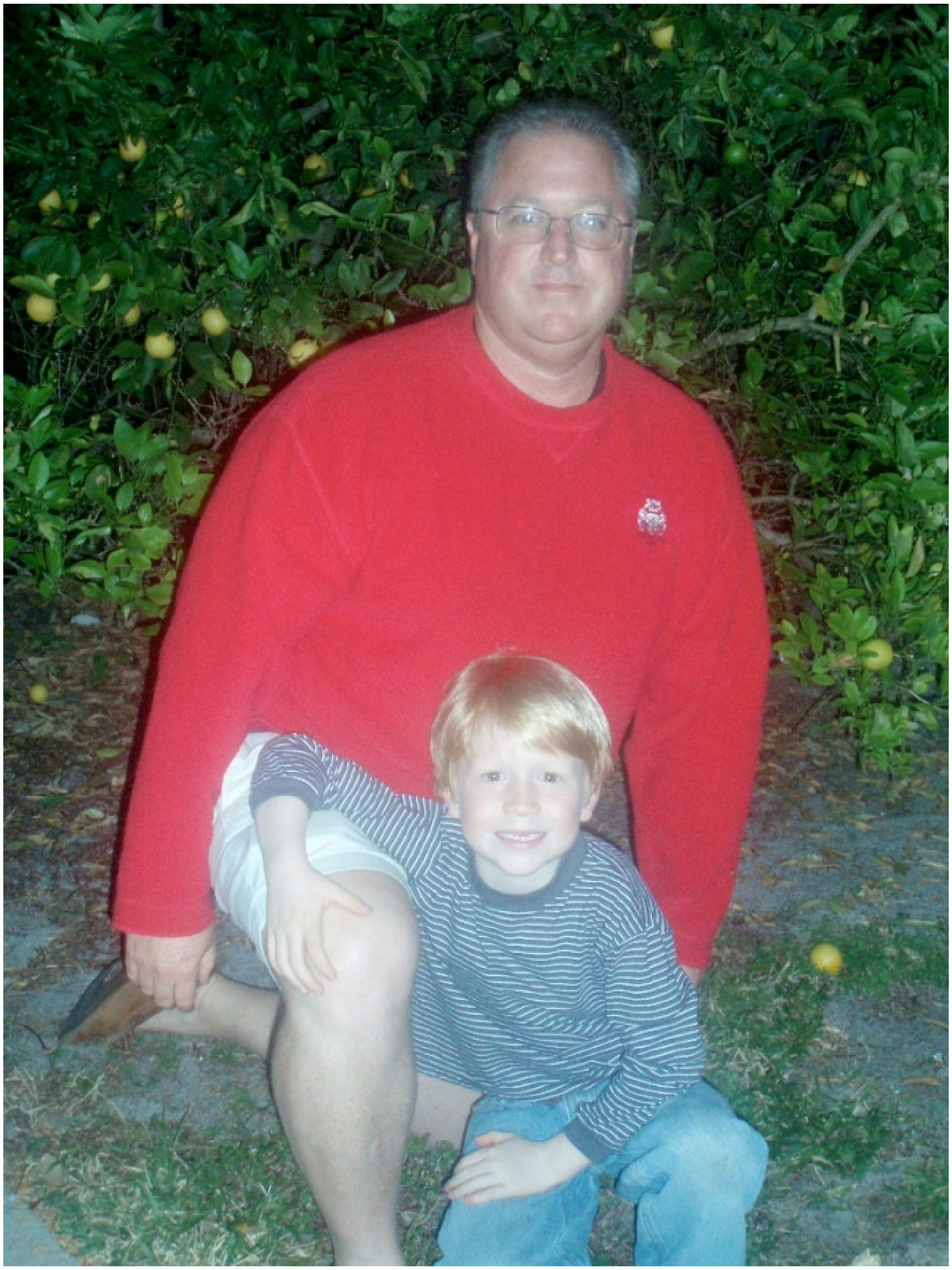
The Best of
Uncommon Financial Wisdom
David Shafer, Ph.D.



Dave and Garrett Shafer in Front of their Key Lime Tree; 2008

Forward

This e-book is a compilation of the most popular posts from my blog, Uncommon Financial Wisdom located at: http://shaferfinancial.wordpress.com. It is offered as a gift to my readers. It has been my pleasure to write a blog for the last year and especially gratifying to have regular readers. I know there is much thirst for financial wisdom, which has reached a critical mass during this last year. It is my hope that the blog and the associated business, Shafer Wealth Academy, will function to help folks build stronger financial lives and gain a greater degree of personal freedom. Here's to a great 2009 and thank you for reading Uncommon Financial Wisdom.

Chapter 1
Wealth, Retirement and the Middle Class

What do the Wealthy Invest In?

The title to this post is a little off in that most times people invest in things in order to get wealthy. Either way you look at it, there is much research on this subject. Funny thing, it is not primarily mutual funds or even individual stocks that make up the portfolios of the wealthy.

First, let's define wealthy. There are three generally agreed upon categories; the mass affluent which has a net worth outside of their primary home of $100,000- $999,999, the wealthy which has a net worth outside of their primary home of $1,000,000- $9,999,999, and the super wealthy which has 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 that have less than them.

First, is real estate. The largest categories of investments for the wealthy are 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 the next largest category of real estate investment. And as you go up the scale they own 3,4 or more homes. Next category is income producing real estate. The wealthy own apartment buildings, commercial buildings, duplexes, etc. that will produce income for multiple generations. REIT's (real estate investment trusts) are favored by the wealthy. Raw land is bought and sat on until the investment blooms.

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 a industry that they worked in for years, first as a employee.

They 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 stock 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 tax laws, so that they legally avoid high outlays to government. It also tells us they 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.

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. But there are many ways to own real estate that don't have that nightmare.

Think about starting a business that fills a niche. Think about investing in real estate. If you can find success in these two areas, then you are likely to join the wealthy or even the super wealthy!

There is none so blind as those who will not see.

Study after study has documented the difference between those that build wealth and the majority that don't is based on attitude and how one thinks. But that fact doesn't change anything for the readers. So you know that in order to build wealth you need to change the way you think. But how? That is the problem that I have been dealing with both personally and professionally for twenty years. It finally clicked for me about 10 years ago, but it took 5 years to fully implement. The results were wonderful and allowed me to build the life I wanted. Part of the implementation was sharing with others what I had done for myself so I created the Shafer Wealth Academy (www.shaferwealthacademy.com). Now it is my privilege to help clients build the mind-set to create wealth in their lives. Frankly, I talk to many people who choose not to become clients and that is frustrating to me. Why, I wonder? They are obviously in need of help as they are uniformly not wealthy.

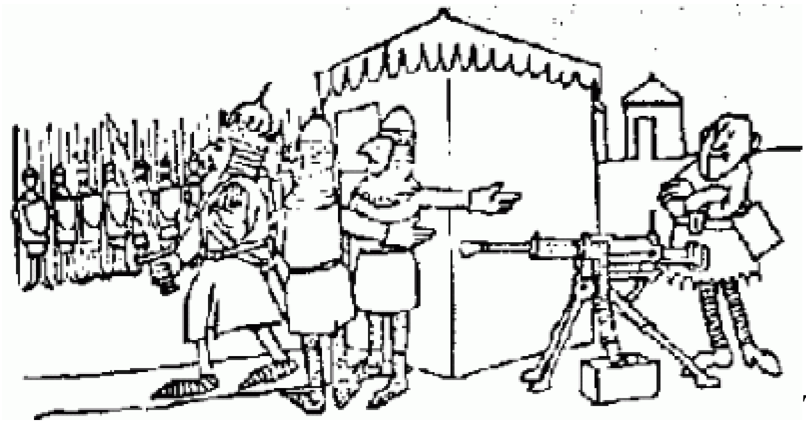
I have come to believe it is that word "security." It is ironic that in an environment where the majority of folks are constantly in danger of losing a job, losing a home, retiring poor, losing money in investments, etc. that they consider the way they are currently living a safe and secure environment, something to cling to, but that is the way it is. I guess I have to be the bearer of bad news and tell people that the security they feel because they get that paycheck every month or because they throw a little money at a mutual fund every month or they are paying off their mortgage every month is not security but blindness. The only security in our current economic environment is the security of being able to be independent; to not need an employer, to not need a financial planner, to not need any financial expert, to not be dependent on anyone else for your livelihood. Once you have THAT feeling, you are truly secure. Once you are secure you might choose to work for someone else, or you might choose to work with a financial expert, but that is a choice not a requirement for you. Now I use a particular kind of "shock therapy" to help people get to that point, called net worth analysis. If you figure out your current net worth and working net worth you get the real picture of where you are financially. That to most people is a shock.

We have been taught the way to react to that reality is to become more frugal. There are a multitude of folks out there that will tell you by getting out of debt, becoming more frugal, etc. you will solve your financial issues. But does that make sense? After all you haven't really changed anything other than impoverished yourself more by cutting your spending on things. Does that make you feel more secure? Does that change the way you think? Does that make you feel better about your life?

The truth is it is better to not be in credit card debt, to not spend more than you make. But I fail to see how this fact makes you feel better, more secure. No, it's just saving so you can spend later in life when you are no longer economically valuable enough to anyone that would pay you to work. And the results of this thinking, most of the time, ends up with folks who are dependent on the government.

Are we starting to see the theme? That security folks feel is really dependency. Just as a child eventually gets thrown out of their parents home and has to make it on their own, folks need to step up and throw off their security blankets. That is what we teach at the Shafer Wealth Academy. How to, step by step, throw off that security blanket and become financially independent. And that is why many folks don't join. That security blanket feels so good! There is an old proverb that sums it up: There is none so blind as those who will not see!

Are you Fighting the Retirement Wars with Last Century's Tools?



Thanks to Todd Carpenter at Lenderama for this blast from the past. It's called Gun Sale and the caption goes something like this: Salesman, I don't have time for a salesman, I got a war to fight!

I remember this cartoon from years ago and it made me chuckle then as well as now.

Are you fighting the finance wars with outmoded equipment? Simply put do you think Mutual Funds or Certificates of Deposits or Annuities are going to get you to a comfortable retirement? If you do then you are like this King going off to war with a sword instead of a gun. Many people are so busy fighting the battle of life to take the time to really look at the equipment they use. They assume the equipment of the last century is good enough for them to use in this century. But we all know the defined benefit plans of the last century are mostly gone except for government workers. Mutual funds were designed to complement those defined benefit plans, not to be the only retirement vehicle. 401K's were designed as an additional way to get compensation into the hands of upper level management, not to be the only retirement vehicle. Yet, these financial vehicles are now being sold as the way to retirement riches. They aren't and the proof is out there as I have pointed out many times. Either you learn to become more entrepreneurial or you risk a very rocky retirement. Either you learn to produce real wealth or you leave your financial fortunes to Wall Street. And if you think that Wall Street has your best interest at heart, then there is no helping you! Folks don't go to the retirement war with last century's tools

How do I Best set up my Children for a Financially Sound Future?

This question has been proposed to me by several clients. So I decided to spend a little time discussing this important topic for parents.

First, is education of course. As soon as they start understanding the concept of money, you should introduce the theory of saving. Create a savings account for them at a early age. When they get to an appropriate age then let them handle the details. Games like CASH FLOW can help too. But beyond early education there are some realities that need to be dealt with. So I want to concentrate on strategies parents can employ to deal with the reality of young adults psychological makeup. Now, you are always going to have some children that from an early age are financially astute. However, these kids are the minority. The reality is, despite being correctly raised, most will spend their teens and twenties behaving with other priorities. Part of this is the result of the slow maturation of a human brain where neurons that are actually created in the early teens are not wholly linked up to the rest of the brain until the twenties. Environmental influences encourage reckless behavior that coincides with this lack of a fully mature brain.

So, although education is important, it will likely not take hold until later in life for most. Combine this with the fact that most young adults make moderate salaries, including college educated ones, and you see why the evidence points out to the age of 40 where concerns for retirement and their financial future really emerge.

So, I have developed two strategies that parents with some disposable income can employ to really give their children a great start.

But first the rules:

1. First, make sure you have a reasonable plan for acquiring wealth in place. The best thing you can do for your children is not be a drain on their finances during your senior days.

2. Second, don't listen to those "experts" who think you should fund a tax deferred investment for your kids. This makes little sense, the amount of

time young adults have to retirement will assure a huge tax bill coming due when they take the money out of the 401K/IRA/Annuity. Since they make moderate incomes, their current taxation is not the problem.

3. Finally, help them in their twenties and thirties (or even earlier if you can afford it), when they are least likely to help themselves or be able to help themselves.

4. Set up the following accounts with the thought that you want to keep them from having full access at least to age 25. Talk to a good lawyer to help you figure out how to do this!

So here is a plan for a $12,000/year budget, but you can change the amounts for any budget:

Set up a money market or savings account for the child or young adult. Every month put automatically a deposit of $500 into the account. Do this for at least 10 years.

Have the adult open a brokerage account or you open one under the child's name. Whenever there is enough money in the savings account buy one share of Berkshire Hathaway B's (current cost $4400).

Buy a Equity Indexed Universal Life Insurance Policy for the child. Fund it with $500/month for at least 10 years. Make sure to have it set up to minimize the insurance face value under IRS codes. You will need to have a fixed amount of time you plan on making premiums to set this up right.

So let's take a look into the future. Let's say you made a 15 year commitment to your child's financial future, starting at his 20th birthday and going to he is 35 years old. Now, Berkshire Hathaway has returned over 21% for the last 43 years and over 18% for the last 10 years, but lets be conservative and use 15% for the next 15 years. For the EIUL I use a ultra conservative 6.5% rate of return and use the 15 year commitment.

When he is 35 years old he will have a brokerage account worth around $335,000. His cash value (I used a male for this example) would be $104,000 with a face value of $760,195.

Now remember this is about the age where we find adults starting to take their future finances seriously. But let's say he does nothing else but maintain these two accounts. What does it look like at age 65? Well his brokerage account is worth about $29,000,000. Yes, that's right. And his insurance account is worth $711,000. Now, remember the brokerage account number is very speculative assuming that 15% rate of return for 45 years. But I just wanted to give some perspective to this. I don't really believe that Berkshire Hathaway can continue its return for 45 years, but I do believe if can for the next 15 years.

Now you might be asking why fund an insurance account when the money will create so much more wealth in Berkshire Hathaway. Two reasons, one we don't want any temptation to spend from that brokerage account, so we have the cash value inside the EIUL that can be accessed for things like a down payment for a home/investment property or a wedding, or a temporary job loss, etc. Remember it can be accessed tax free. Learning to borrow and pay back from your insurance cash value is a valuable lesson as well as a cheap way to borrow. Secondly, a sound financial strategy for dealing with wealth are these EIUL's which he will already have experience with.

So there it is. An easy way to set up your children for an abundant future! Dial the numbers up or down as your budget allows, but stick to it for at least 10 years and your children will have a living legacy, then give away your money at death to your favorite charity!

Retirement Strategies Redux: Old School Versus My Way.

Mary and Joe are typical folks, they have about twenty years to retirement with two kids fast approaching needing money to attend college. Joe has been fortunate and has had the same job for over 15 years, while Mary works part-time for a local business and still does the majority of taking care of the kids. They have accumulated around $100,000 in a 401K and owe $100,000 on a home that is worth $300,000 by aggressively paying off the mortgage and owning the home for 15 years. Their emergency fund is meager at $8,000. They know they need to figure out a way to get more money for retirement, but frankly, are at a loss how. They make an appointment with John, the financial planner. Mary pulls up in a 7 year old Honda minivan and waits for her husband. Joe running a few minutes late pulls up in a 4 year old Chrysler 300. Joe parks next to a new Lexus and admires it as they go into the office. John meets them at the door and acknowledges Joe looking at the Lexus and mentions he has just leased it a few weeks ago. Joe is impressed.

John, takes all their information and runs the numbers. He looks them in the eye and delivers the bad news. At their present rate they will not have enough to retire on. They need to do something now! Mary and Joe are a little embarrassed about their situation, but they thought they were doing the right thing, paying off their mortgage and putting 8% of Joe's salary into the 401K. Frankly, Mary knows because the wives talk about this, that they are better off than most of their friends. So she is a little peeved at John's rather cavalier attitude toward their retirement savings. Then John throws in the kicker. He can help them achieve success. He starts to talk about asset allocation mentioning that they have all their money in one mutual fund. He pulls out a prospectus that is for an international mutual fund that returned 28% last year. Joe is impresses as he knows his fund returned a meager 3% last year. Then Joe pulls out another prospectus for a Precious Metals Mutual Fund that returned 85% last year. Joe is fully impressed now. John suggests he take control of the $100,000 in the 401K to manage it. He tells the couple to keep up the good work paying off the mortgage, but they need to put away more, much more if they want to retire comfortably. John also suggests they need some life insurance so he suggests a $250,000 10 year term insurance which he says is dirt cheap now. Joe and Mary look at each other with the same thought. They are already pretty thrifty, but there goes the one night a week they eat out together and maybe Mary could work more hours after all the kids are old enough that they don't need Mary to be there when they get home from school. But, if that is what they need to do, then they will figure it out.

On the way home Joe is sold but Mary has some doubt about John. She remembers reading "The Millionaire Next Door" in her book club a few years back, so she is not impressed with John's car. Her intuition also tells her that the returns that he showed them for those two funds were a little high, they must be risky she thought. She thinks they should talk to someone else.

Can you spot the mistakes?

1. The assumption that leasing a nice car means that you know what you are doing financially is incorrect and probably the exact opposite.

2. Mutual funds as a class under perform the market and specialized mutual funds have even more variability which means that those two mutual funds will probably under perform for many years to come to make up for their amazing performance last year.

3. They use little leverage on their finances and are decreasing it by paying off their mortgage.

4. The majority of their net worth is home equity which gets a 0% rate of return.

5. Suggesting to a frugal couple that they need to be more frugal is like throwing gasoline onto a fire. They drive older cars, eat out only once a week and work 1 1/2 jobs between them while caring for two kids. Life shouldn't be this onerous for this couple.

My Way:

Move their 401K money to a discount brokerage account and buy $100,000 of Berkshire Hathaway B's. Warren Buffett's company returns 21% over 43 years and 18% over the last 10 years.

Re-finance their home with a $250,000 mortgage now available at 5.75%. This gives them $150,000 cash.

Take $25,000 and purchase a $200,000 duplex in Dallas, Texas that is cash flow positive (See my Friend Jeff www.bawldguy.com for details)

Purchase a $450,000 equity index life insurance contract. Fund it with $25,000 year for five payments.

Reduce the 401K amount to the 3% company match to cover the extra expense of the larger mortgage.

Place the $100,000 left over into a money market fund or high paying savings account to act as an emergency fund and reserve fund for the real estate.

As each year goes by make the $25,000 life insurance premium payment.

Taxable income goes down as the mortgage interest goes up substantially and the real estate investment throws off tax advantages.

Let's look down the road five years. The real estate investment has a cash flow of +$3,000, +$3,000, +$4,000, +$5,000, +$6,000 as rent could be increased. This $21,000 is held as reserves for deferred maintenance and is not counted for assets. College aid was applied for the kids and this amount was not counted!

The insurance contract has a cash surrender value of $110,000 since the front loaded fee's have been paid. But this works as the couple's emergency fund available to them with no tax consequences. The big positive is that this is not counted toward income or assets for college aid. So they have moved over $100,000 off the college aid books allowing the kids to qualify for more aid.

The Brokerage 401K is worth $228,776 with Warren Buffett continuing the 18% he got the last decade.

The duplex is worth $250,000 getting slightly less than 5% return. They have around $80,000 in equity.

Their home is worth $380,000 getting the same 5% return. They have over $150,000 is equity.

Their taxes have gone down due to the mortgage interest deduction and the investment real estate.

Their passive income from the real estate is $500/month.

Their kids received large amounts of student aid for college.

They have a emergency fund/reserves over $130,000 so they sleep well at night.

The costs to do this was $5,000 for the refinance, $5,000 to buy the duplex, $12 to buy the stock, and the commission and fee's for the insurance contract.

There are no ongoing fee's (other than the insurance contract) payable to a financial planner.

No reduction in life style needed. In fact as the couples net worth rose, they started to take a nice vacation once a year and Mary will stop working as soon as the kids are out of college.

Old School V. My Way: You make the choice!

PS I used conservative numbers all the way through my way!

PSS As usual this should not be construed as financial advice with respect to any particular stock or any general investment advice that might come under the auspice of the SEC. It is only the ramblings of a derelect and a individual that does not have a license to issue stock or mutual fund or real estate advice. Please see an "expert" for all tax issues.

Saving for Retirement.

If there is one place that there is much misinformation, it is in how much you need to save for retirement. The mutual fund industry has spent much time and effort to propagandize to folks why they can accomplish this using mutual funds. The truth is much different. Now there is one caveat before I go into the numbers. If you are fortunate to have a defined benefit pension, then you can make it work by putting monthly money aside into a mutual fund inside a IRA/401K wrapper. Even better if you also qualify for social security. But, if you really want to accumulate enough to have a comfortable retirement then pay attention. If you don't have a defined benefit pension, then it is critical that you understand the following.

Mutual funds have been sold as a safe/low risk investment. And that is truthful. But the rule of finance is that the lower the risk the lower the potential rate of return. Now we know that individuals that purchase mutual funds average 2.5%-4.5% rate of return. But for the point of this exercise let's assume a 8% rate of return (the average mutual fund return).

Now here is my rule of thumb. In order to build enough wealth to have a comfortable retirement you must get 15% rate of return from you investments. Let me show you why.

Let's say you put away $300/month until your retirement in 25 years. Let's also assume you never fail to put this money away. If you get a 8% return on investment, you would have $285,308 after those 25 years. This can produce $22,800 of taxable income per year assuming that same 8%. Not bad. That puts you in the top quarter of net worth for folks in the United States. However, you haven't accounted for inflation. Taking official inflation statistics, which I believe seriously understates inflation, that $285,308 has the buying power of $142,654 or $11,400 year. But that is on day one of retirement. The average person will live another 20-25 years. So by the time you die that $285,308 will only have $71,327 of buying power or $5,700/year.

Now let's run the numbers with 15%. Same deal, $300/month for 25 years. Now you have $973,059 and using 8% of it each year you would have

$77,844/year. But the buying power would only be $38,922 when you retire and $19,461 at likely death.

Now that is more like it! But you say how can I get 15% without risk? You can't. But you can get 15% assuming less but a different type of risk than you have with mutual funds.

First, can you spot the risk of investing in mutual funds? Well it is the very real risk of running out of money before you die. In fact, 90% of retired folks are financially dependant on the government or family/friends before they die. Remember mutual funds have been sold to the public for 2 generations and that strategy has been pushed for just as long. So that risk is extremely high.

Here is the less risky way.

1. Find a stock that has returned over 15% for over 40 years.

2. Use leverage. If you leverage an investment three to one you only have to have that asset return 5% to get that 15% return.

For regular readers you now should know the answers. There is only one stock that has returned over 15% for 40+ years. Berkshire Hathaway. In fact it has returned over 21% for 43 years. Over 18% for the last 10 years. I put my bet on Warren Buffett the driving force behind Berkshire Hathaway.

Finally, investment real estate, properly structured in growth areas have historically returned over 6%. You can leverage this with mortgages. And you get all the tax advantages of real estate.

Your choice on the risk. Bet on two things that have proven to give superior returns over the last two generations, or bet on mutual funds which have proven to given inferior returns over the last two generations.

***** As always, this post in only the musings of a clearly deranged individual that happens to be good at math. He has no license to sell securities nor real estate and any advice should be considered for amusement purposes, not expert advice that ones gets from a licensed individual.****

Is it really simple to get rich?

One of the interesting phenomenon's in the finance world is the ability of Wall Street to get people to hold two opposing but simultaneous opinions. Over the years Wall Street has engendered many articles and even books that tell us that it is simple to get rich. Simply invest monthly into mutual funds and "whala" you are rich. Of course they supply their sales people with charts and statistics that demonstrate this simple fact to you. Then with a sleight of hand they take that simple away from you and tell you to get a "professional" to advice you. So simple you need a stock/mutual fund salesperson to advice you so you stay out of trouble? So simple that they need to tell you all about their money manager's pedigree? So simple that they tell you to get a "check up" annually so changes can be made? Hmmmm…..is there something in your brain telling you that maybe it isn't that simple? Can you look around and see all those folks who became rich because of mutual funds? Is there any study of rich folks who document their wealth as a result of investing in mutual funds monthly?

There is an interesting chart in the back of "The Millionaire Next Door," which documents their study of folks by occupation that are overachievers and underachievers when it comes to building wealth. In other words, have they built more wealth than expected given their income or less? Financial Services Professionals come in as less. Are they not taking their own advice? Or are they? Maybe they are spending too much on trying to impress their clients and not enough on investing? But, the bottom line is if they were so "expert" in investing surely they would do better than the average folks in building wealth, wouldn't they?

I have documented the results many times before. I have pointed out the faulty assumptions before. I have strongly suggested, if you are concerned about your retirement, that you not only take a look at my website www.shaferwealthacademy.com but you fill in the contact information so we can have a discussion about wealth building. Is your brain telling you it is not so simple as Wall Street has propagandized? Are you willing to admit that you might need a little help? Are you going to continue to do what Wall Street wants you to do? Or are you ready to take control of your destiny? Because it really is more complicated than putting a few hundred dollars a month into a mutual fund!

What Einstein Can Teach Us?

There is much written about Albert Einstein as should be of a man of such great intellect. But I want to share with you a little of what I believe we should learn from Einstein. First, of course let's put to bed that falsehood that he failed in school. He didn't. But 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 AE 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 school 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. And 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!

And 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."

Chapter Two
Investing

Mutual Funds; Good or Bad Investment?

I will keep this simple. I have posted often about my thoughts on mutual funds as an investment. Here are the latest datum from Dalbar Inc. on the actual rate of return folks get from mutual funds. I will put three columns together, actual returns from investors who invest in mutual funds, actual returns from the S&P Index and actual returns from Berkshire Hathaway. Then I will post as a comparison the what if you invested $10,000 question that equity prospectus usually have. This is a much more accurate comparison because negative returns hurt, and cause you to have to get a greater return to make up for the negative.

	Actual Mutual Fund Return	S&P Index	Berkshire Hathaway
20 years	4.48%	11.81%	19.77%
10 years	5.66%	5.91%	12.7%

$10,000 invested in Berkshire Hathaway Jan 1, 1988= $315,381 Dec. 31, 2007

$10,000 invested in the S&P 500 Index including dividends with no expenses (an impossibility) on Jan 1, 1988= $93,423 on Dec. 31, 2007

I can't do it for actual mutual fund returns because I don't have year to year data.

So there it is in stark black and white. $315k actual number, versus $93K pretend, no expenses, number. Actual rate of return over the last 20 years of 4.48%, which is 7.33% below the index and 15.29% below Berkshire Hathaway. You make the decision. Are mutual funds a good investment, or are they merely a hedge against inflation?

Once again this is only the ravings of a person who can do math. Shafer Financial does not have a license to sell equities (stocks), nor does the SEC consider him an "expert" who can give advice on particular stocks

Why do you hate mutual funds so much?

Yep, you guessed it, I get this question a lot. In fact, sitting on my porch with some neighbors espousing the philosophy of the Shafer Wealth Academy, I got it asked in a much nicer way. So I thought I would answer it directly for the readers.

There are three reasons:

1. Diversification sucks. There I have said it. There is an open secret in the investment world that diversification is for suckers or at least for folks that will never capture wealth. You see, mutual funds were invented as a marketing strategy. After academic finance disclosed you could reduce risk (variance) by diversification, astute Wall Street companies knew they could market this to average folks. Previous to mutual funds and the idea of diversification the average person felt that investing in the stock market was akin to gambling and shied away from it. But those folks in Wall Street knew a good marketing opportunity when they see one and ran with it. Diversification reduces the variance to a point where the likely outcome is single digit returns. Single digit returns are fine if all you want to do is beat inflation, but it will never create wealth. What started as propaganda aimed at getting average folks to own stock has turned into common advice that is demonstrably wrong. Every wealthy person from Warren Buffett to Donald Trump, when being honest, tells us that concentration is the way to go. Diversification before we obtain wealth is a fear based Strategy. People think by diversifying, when things go badly, they can hang on to some of their wealth. Unfortunately, diversification is a block to building wealth, so they are protecting themselves from a loss that means nothing. Since fear keeps most folks from building wealth, when they hear diversification can protect them, they jump at it. It's a perfect fit for a fear based environment. Not that fear is a totally wrong emotion to have for the middle class. After all this is a group that is experiencing the economic changes most acutely.

2. Mutual funds are retail products so there is an extra hand (middlemen) between you and your investments. Even the lowest cost mutual fund

company has employees that must be paid, buildings that must be leased or bought and profit that is made. Where does all this money come from? Yes, your returns. See how this all blends together. In order to get diversification you need to buy mutual funds, which not only creates a profit center between you and your investment but also implicitly requires you to look toward others for financial advice.

3. The army of mutual fund sales people have no idea how to get wealthy because they aren't. Their participation in this propaganda machine, no matter what the initials after their name are, tells you they don't. The data is clear how people acquire wealth and/or financial independence and it is not by owning mutual funds. Anyone that gives you that advice is wrong and ignoring the evidence.

A few words on why mutual funds are so popular. I'm sure the denizens of Wall Street never imagined the success of mutual funds when they first designed them. As it turns out they were ideally suited for the psychology of the middle class. The middle class, especially during the last two decades of the 20th century, were looking for security. Remember, previous to 1980, layoffs were non-existent, defined benefit pensions were what most people had, and retirement for most was usually less than 10 years before death. Security for the middle class was the name of the game. The economic insecurity of the early part of the century eventually got turned on its head, but this was just a temporary reprieve. Education beget a good job, which brought economic security. Enter an investment strategy called mutual funds, which offered as its main selling point security (even though this was false, it matters only what people perceptions were). In other words, mutual funds fit right in to the way people thought about and approached their financial life.

Then the stability of the middle class was turned on its head in short order. Layoffs became common place not only for industrial workers, but for middle management and technical workers. Aerospace engineers became perhaps the first middle class victims of this change in the 1980's. The government along with Wall Street stepped in and created IRAs and 401Ks ostensibly to encourage retirement savings, but also to pump up their respective cash flows. We are just now starting to see the results of this unholy trilogy (Wall Street, Government, Security Seeking Workers). The noise has reached a crescendo about the lack of retirement funds for the current generation of retirees. Yet, few question the strategy that brought us to this point??? And of course, the latest dependency; home equity. If you were depending on your home equity to fund your retirement, the bubble has now burst.

So there in a nutshell is why I rail against mutual funds. It is an outdated investment strategy for the world we live in now. Never was honestly sold. And absent financial education as to the realities of the current economic climate, causes and will cause much financial pain at the exact time (retirement) that folks can least afford it.

Betting against Warren Buffett?

I am always surprised at the amount of people who bet against Warren Buffett. If you don't know who he is, let me tell you. He is the world's richest man, made his money by managing a company called Berkshire Hathaway, which is a holding company for his investments. He owns large amounts of stock in companies as well as outright owns over 60 companies. Over the last 43 years the company he manages has returned over 21% annually for a total return of 400,863%. That's right a total return of 400,863%. But people have always taken pot shots at Warren. In 1998-1999, the voices got very loud because he wasn't taken in by the technology stock bubble. People said he was old school, didn't understand the new rules of investing, etc. Then the tech bubble burst. Now, it is he is to old, he has lost his touch etc. For the last 10 years he has averaged over 18% return! Here is the last 10 years return:

1998 ………………………………………………. 48.3%

1999 ………………………………………………. .5%

2000 ………………………………………………. 6.5%

2001 ………………………………………………. (6.2)%

2002 ………………………………………………. 10.0%

2003 ………………………………………………. 21.0%

2004 ………………………………………………. 10.5%

2005 ………………………………………………. 6.4%

2006 ………………………………………………. 18.4%

2007 ………………………………………………. 11.0%

His company is publicly traded so you can buy his stock. He doesn't pay dividends so there is no tax consequences of owning his stock, no dividends nor capital gains until you sell, so it really doesn't matter if you own it inside or outside a tax deferred vehicle. Look at the return you are getting for the last 10 years on your mutual fund. How does it compare versus Warren? So why are you betting against Mr. Buffett?

****As usual this is only the ranting of a clearly deranged man who doesn't have a license to issue stock advice. Clearly, don't take anything he says seriously as this blog is only for amusement purposes. Talk to a "professional" for any tax and investment advice.*******

Leverage, Leverage, Leverage!

So, you want to create wealth. Then you need to understand the importance of leverage. Now 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 actual 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 he can. 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 land to develop. 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. 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. That is not to say that, speculating is bad, but only 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 folks go through their lives only using leverage to purchase their homes, and are unable to build wealth because of this lack of leverage. And people who have brought wealth to their lives all use leverage to accomplish it.

Analyzing Real Estate: The Basics.

Ok, so the mass media is pummeling real estate every day with more bad news. All you need to know about real estate is that it is in trouble, right? Well, no! Today I will go over real estate as an investment. Regular readers know that wealthy people have their largest chunk of their net worth in real estate. They also know I love real estate as an investment for the middle class because of the leverage one can use. Suffice it to say that the data is conclusive when it comes to investing in real estate. It is a great investment as long as it is done correctly.

First let talk about types of real estate investment.

1. Your Primary Residence. There is debate as to whether this should be considered, but I think since the data indicates that most people have significant savings in the form of home equity it should be included. First let me say this, if your home is the only form of savings you have, you are in big trouble. You should be considering equity management practices, which I have posted about before. Now owning your primary residence is a good idea is most cases, although there are some exceptions. My advice is buy close to your work, within walking distance if possible, buy small, use equity management strategies, and realize real estate is a long term investment. The point is to minimize your cost of living so you have more money to invest. If you spend all you have for housing, then you have created a situation where you are house poor and investment poor. With the cost of gas, living close to work can save you hundreds of dollars a month, which can be put to use acquiring assets.

2. Real Estate Investment Trusts. There are three types of REIT's.

1. Equity REITS, the most common type of REIT, invest in or own real estate and make money for investors from the rents they collect;

2. Mortgage REITS lend money to owners and developers or invest in financial instruments secured by mortgages on real estate; and

3. Hybrid REITS are a combination of equity and mortgage REITS.

Some REITS use leverage and some do not. I only invest in leveraged REITS. REITS are traded on various stock markets making them easy to buy and sell. They have their own accounting regulations that require them to pay out the rent they collect. Speak to an accountant for an in-depth discussion of REIT accounting. You have dividends paid out each year, which can be reinvested. The value of the underlying real estate backs up the investment and the rents along with the real estate value determine what the market prices of their shares are in the long run. Because they are so liquid, they are subject to the whims of investors on a daily basis. The REIT I own currently pays a dividend of 12% on my costs. Over the last 10 years REITs have outperformed all other classes of stocks. Positives include liquidity, someone else managing the properties, some leverage applied, access to larger properties than one would normally have, and potential for double digit returns. Negatives include daily price fluctuations, limited leverage, and the passive nature of the investment. Since I am a big believer in long term real estate investing, I keep a good percentage of my assets in REITs.

3. Owning investment real estate outright. Perhaps the best way to take advantage of the various tax and leverage pluses of real estate is to buy real estate and rent it out. This can range from single family homes to duplexes to apartment complexes to commercial property. I can think of no better way to have a comfortable retirement than this strategy. Beware, this is not the place for amateurs going it alone after attending some seminar. You need an experienced hand to help you. I suggest talking to Bawld Guy first, if this is your intention. Just click on the Brown & Brown link to the right!

The matrix for investment real estate is very different than the one for buying a personal residence. Here are some basic considerations:

CAP Rate: Net Operating Income/ Purchase Price. This is a great tool for comparing properties. Net Operating Income is the total of all rents received minus maintenance expenses, vacancy expense, taxes, insurance, repairs, management fees. Cap rates are usually in the single digits. The higher the better. But this is only one metric to look at.

Cash Flow: Add up the total of all expenses plus the mortgage cost for the year and divide by 12. Compare this number to the total monthly rents collected X .8 to account for vacancies. If this number is positive it is said to cash flow. Never get in a situation where there is a negative cash flow.

Leverage: How much money do you have to put down in order to have the property cash flow. Generally the less you have to put down the better it is because you are using leverage.

Return on Investment: Cash Flow + Appreciation/Down Payment. If you put down $20,000 on a property that cash flows $2000/year and appreciated $4000 then you have a return on investment of 30%.

Market Demand: First, what is the market demand for rental properties in the specific area you are thinking about buying? Does this area of a net inflow of population? Can they afford the rents you are asking? How does the rent you are asking compare to other rental properties? Are you trying to rent a one-bedroom apt. in an area dominated by families who are looking for multiple bedrooms? What is your target renter? etc.   Now, how about appreciation in the area? Is this an area where there was an extreme bubble? Net inflow of population? Area trends? Affordability factor? Jobs in the area? This is where an experienced hand really comes in handy!

Management: Are you going to manage it yourself? This is not recommended because it limits your investment to areas close to where you live now. How much will it cost you? 6% seems to be a good number to aim for.

Location: Can be anywhere the analysis leads you to. Most likely not going to be in your backyard!

Once again don't let this intimidate you, hire an experienced investment real estate person to guide you. Remember, only a small minority of real estate folks specialize in investment RE! Use only them.

Positives: Tax deductions, Leverage, Accessible to most of the middle class. Negatives: not liquid, requires active participation, high learning curve (can be offset by using Bawld Guy!).

4. Private placement investments. Many groups form LLCs to invest in real estate. Also land developers are always looking for capital. If you can hook up with good experienced people, then you can get outsized returns. Usually, this only happens after you have been an active investor for a while and meet people in the industry. This is not a place to start investing. But to experienced real estate investors it is a place that can be very fruitful. Positives: Outsized returns, limited time required (half way between active and passive investing), leverage. Negative: Higher risk, high level associations needed.

5. Second Homes. Generally not a great investment, but if leveraged can get double digit returns if price appreciates 4%/year. If you rent it out part of the year, you can get some cash flow, but generally they are cash flow negative. Being totally dependent on price appreciation is not the best place to be, but can work out in the long run. I put this under life style investing. Instead of driving that Lexus, which will depreciate, own a Toyota and buy a second home. You will get more pleasure out of it and will make money in the long run with it.

6. Raw Land. Extremely speculative and long term. Think in terms of your children and grandchildren. Don't expect to ever see the money in your life time. If you do, then lucky you!

Hope this helps folks.

****This is only the ramblings of the village idiot, who does not have a license to sell real estate or securities. Go to a professional for real estate advice. Go to an accountant for accounting advice with regards to real estate ownership. Go to a stock broker/financial planner if you want to hear what Wall Street thinks about any individual security. Once again this blog and this post are for amusement purposes only and does not represent any offer to sale or buy real estate or securities or offer any advice as to what the reader should do. Do your own independent research as I have done before making any financial decisions.*****

Buffett; Concentrate Your Investments, Not Diversify.

Regular readers know I don't like mutual funds for several reasons. But, the #1 reason is that they diversify away the opportunities for great rates of returns. Warren Buffett and Charlie Munger (Buffett's right hand man) agree we me. They ask the question, Once you have identified companies that you believe are fundamentally sound, of good value, and look strong going forward, why buy the twentieth best on your list? Buy as much as you can of your top five or ten! Buffett believes that if you have an opportunity to buy into a wonderful company, with great management at a good price, then load up as much as you can! Buffett's teacher, Benjamin Graham also did the same making the majority of his fortune in GEICO Insurance holdings! The data on wealthy people demonstrates the same strategy with highly concentrated investments in businesses (sometimes the result of founding the business, sometimes being one of the largest outside shareholders).

If you know that you are going to concentrate on a few companies, it encourages you to focus hard and make unemotional decisions! Psychologically it does the opposite of what passive investing in mutual funds does. What if all those Microsoft millionaires sold their Microsoft stock as soon as they were vested? They would be unhappy campers now!!!! The examples are endless of people becoming wealthy by concentrating their investments!

Step 1 in Analyzing Stocks; Look at the Facts.

*****Remember the following is only the ramblings of the town fool who does not have a license to sell securities or give advice on what securities to purchase. This post as well as this blog is for entertainment purposes only and represents the collective foolishness of the the writer only. Do not follow his advice unless you perform your own independent research and come to the same conclusions. Listen to the licensed experts as well as cable TV if you want the collective wisdom of Wall Street.******

I am going to show you how I analyze investments starting with stocks. Here is a comparison between the S & P 500 Stock Index and Berkshire Hathaway for the last 10 years. Remember you can invest in BRKbs for only a small one time ($12 fee), while even the cheapest index fund will cost you .5% a year.

There is a fact in stock ownership that gets overlooked. That is profitable companies tend to stay profitable as long as some fundamental change in the environment doesn't happen. This is Warren Buffett's key point. So anytime you are looking at making an investment, then you need to create a chart like this that goes back at least 10 years. If you are in mutual funds then substitute your actual mutual fund with the stock index I picked. Key is this is how I start out. Since I think that Berkshire Hathaway is the gold standard, I always compare to it as to well as the S & P 500 stock index.

Now remember this is not how financial planners work, so if you have a financial planner you can direct him/her to do the charting in this manner for you.

This is the chart for a real estate investment trust that invests in health care facilities. About five years ago I did a chart and found it outperformed the S&P 500 by a wide margin as it does now.

Remember this is the first step I go through. If it hasn't outperformed the S & P 500 for the last 10 years I drop the idea. If it doesn't perform as well as Berkshire Hathaway and is a equity stock, then I don't buy it unless I put it in the highly speculative category and decide I can afford to throw money at it to lose. If it passes the ten year performance test, then I move on to step two.

Step 2 is a mind game. Does this company make things that people will use ongoing? Are there technological inventions coming down the pike that might make these things obsolete. Think of General Motors. Are people going to buy SUV's (majority of profits came from SUV's) ongoing? Are there technological advances that might make GM cars obsolete? Finally, are they a forward looking company? In other words do they make decisions based on the right now, or how the world might look in the future? And finally, what is the long term trajectory of its earnings. Don't even go there if is doesn't have any earnings; I made this mistake once in the late 1990's! Remember, the only thing that matters is earnings, everything else is speculative!

Step 3 is a look at the financials. What is the history of profits? How much debt? What is the P/E ratio? Return on Equity? Dividend history? Cash flow? How much cash is on hand? Management History? Take a look at what the professionals say about the company.

Finally, Step 4. If it passes the first two steps and step three looks promising, then apply some patience. All stocks go up and down. Wait until the stock takes a dip and then buy. This is another Buffett speciality. He identifies stocks and companies he likes, and then waits until the price drops to his point, then he pounces!

Now I keep my stock portfolio concentrated. This is another Buffett idea. But having said that, since most is in Berkshire Hathaway which owns outright over 60 companies and owns stock in another 30 or so it by itself is diversified. The only way to get double digit returns, in my opinion, is to be concentrated. And the only way the numbers work for the middle class to build wealth is to get double digit returns. So for me the risk that I end up with little money in retirement is what I am worried about. My wealth plan requires me to invest this way in order to make a comfortable retirement.

Chapter 3
Life Insurance

To Build Wealth Avoid the Herd!

Rarely, does the herd move in the right direction. Or put another way if you want to end up at a place that is different from the masses then you have to do things differently. When it comes to wealth building, believe me you want to end up in a different place than the average person. I have used this figure before but it is the figure that really started me thinking outside the box on wealth building.

The median net worth for folks in the 55-64 age group is $248,700. And that is from the latest report issued about the year 2004. Median total in retirement accounts: $83,000. This is likely to have dropped since the majority of net worth is held as home equity and much of the country has seen real estate value drops over the last 18 months. Also note that this age group has the largest net worth and retirement account amounts of any age group.

So when I suggest to folks they should look outside the box for building wealth it is because of these numbers. You really don't want to end up with the herd.

There are two financial strategies that almost all middle class folks can use if they are willing to separate from the herd. There is a third if folks really want to increase their chances, but it takes a major life changing decision. Interestingly, the herd denigrates these strategies as too risky. Yet, the herd is headed toward these above figures. So I question the herd's judgment of risk.

Prepare yourself to doubt my words since the financial propaganda out there about these ideas is intense. If you are willing to open your mind to the possibility, then read on. If not ride with the herd!

Strategy #1

Cash Value Life Insurance. Yep, that's right the same vehicle which everyone says is too expensive or buy term and invest the difference, or as one financial advisor puts it, is no investment. Actually, as it turns out it is a vehicle favored by the wealthy for its ability to legally avoid taxation. And there lies its power. In fact, after the IRS saw how effective a tax avoidance vehicle it is, it put into the tax code rules regarding the limits of cash that can be put into this financial product. So if fact, the IRS was codifying into law the tax benefits of this financial product. Now would the IRS have bothered to worry about a vehicle that was not an effective place for the wealthy to put their money? Of course not! Would the wealthy put their money into a vehicle that was not earning more for them after tax than other vehicles? Of course not! Is this a product just for the wealthy? No, the middle class can put it to use too.

Here is how. You load the cash value life insurance contract with as much cash as is legally allowed for the face value of the insurance. This excess cash is credited with gains dependant on the arrangement made in advance. There are several different types of arrangements, fixed interest rate, fixed indexed, and variable. Variable universal life insurance allows you to invest in the stock market. This is of course the riskiest strategy because the stock market goes down as well as up. Fixed offers a annual rate of interest determined each year by how well the insurance company has done with their portfolio. Fixed contracts also have minimum guarantees. The fixed index product has minimum guarantees, but allows you to share in the gains of a stock index like the S&P 500. Now if there wasn't an investment segment, like some financial advisors say, then how could there be these investment options? The answer is of course there is an investment portion, the amount of excess premium you pay goes into an investment account. Now you have the life insurance portion go along for the ride to get the tax advantage. The contracts allow for you to access the cash value of the accounts by way of "loans." Many contracts allow you to have wash loans which costs you exactly what you earn. So you can access your cash with "loans" and these "loans" are not taxed. So in essence you have money earning interest, becoming exponentially larger as time go on, and you get to it tax free. No wonder the wealthy love cash value life insurance. And you should too. Couple of caveats, one you must keep the insurance in force to maintain its tax free status and not all life insurance sales people know how to set these up correctly so make sure you are dealing with someone that does. Finally, if your estate with the insurance is going to be larger than $2 million, look into putting the insurance into a life insurance trust to avoid estate taxes.

Personally, I have one contract now in the fixed index strategy tied to the S&P 500 on myself. I soon will have that fully funded and will start one on my wife. Meanwhile if something bad would happen to me, I am assured my family will have the financial means to go on, although as my wealth continues to grow that has become less of a need, just a bonus. As far as rate of return, I am satisfied with it so far, and feel comfortable with the strategy for the future.

Equity Indexed Universal Life Insurance

When BawldGuy asked me to blog on equity indexed universal life insurance (EIUL), I thought no problem, since I had been blogging on it for a couple of years on both my site and others. Then he asked me to look at the archives from Bloodhound to see his previous posts and I knew I had to write something a little different. In order to make sense of EIUL contracts you really need to understand the misinformation that underlie the arguments being put out by folks in books, the mass media and blogs on both sides of the issue. You need to be clear on what your wealth creation plan is and what it isn't. So bear with me for a few paragraphs as I burn down the straw-men arguments before we get into the mechanics of EIULs.

Usually these discussions surround a common theme, EIULs versus mutual funds inside a tax deferred wrapper (401K, IRA). First let's talk about mutual funds. Mutual funds were designed to reduce risk or as financial experts describe it variance. They were a boom to Wall Street as mutual funds induced many folks to invest in stocks, something they were not inclined to do in the past. They have been around for 2 generations so we have plenty of data to tell us accurately how people do investing in mutual funds.

We have plenty of studies of wealthy folks too; many specifically designed to find out how they became wealthy and what wealthy folks invest in. What they tell us is very clear. The higher the net wealth, the smaller percentage of wealth is in mutual funds. Or to be more exact, the super wealthy (net worth in excess of $10M), have less than 5% of their wealth in mutual funds (mostly bond mutual funds), the wealthy (net worth $1M to $10M) has only a slightly higher percentage of wealth in mutual funds, and the mass affluent ($100,000 to $1M) has close to 30% of their wealth in mutual funds (second in percentage only to home equity). And if you look at this class closer you see a curve that continues the trend with the higher the net worth ($500,000-$1M) looking more like the wealthy and those under $500,000 in net worth having the highest percentage of their wealth in mutual funds.

So it is very clear that those that invest primarily in mutual funds are planning to be in the $100,000-$500,000 net worth category. Now there are some real reasons for this and they can be summed up quickly:

1. The rate of return people get from their mutual funds is meager. Study after study has pointed out that individuals' rate of return from mutual funds on average ranges from 7-10% **BELOW** market returns (Dalbar, Inc. Vanguard, etc.). Average fees range from 2-4% of value for mutual funds. Employer managed 401K's have the highest fees sometimes as high as 6%;
2. People don't consistently put money into mutual funds as they are instructed to, because life intervenes and the money is used to cover expenses; and
3. The experts advising folks on mutual fund investments actually cause folks to have a lower rate of return than if they did it themselves.

The bottom line is that when your advisor or the mass media you are listening to tells you to invest in mutual funds they are putting you on a plan to have low six figures in net worth in today's dollars. One can reasonable assert that investing in mutual funds will not make you wealthy, only keep you from being poor.

Tax deferral programs (401K, IRAs) were designed by the government for two reasons. One was to encourage folks to save money. It should be noted that it was never thought to be the only retirement vehicle, but an adjunct to defined benefit pensions and social security. The second reason is to increase tax revenues. By giving a tax break as you put the money in and taxing it as you take it out, even getting a meager rate of return will assure greater tax revenue. It is pretty simple to understand. From these meager beginnings 401K/IRAs have become the only retirement vehicle most people have outside of social security.

Those that oppose the use of EIULs accurately state that most people upon retirement have a decrease in income, and tend to move down a tax bracket. And they also accurately point out that the advantages of EIUL's goes up as your retirement tax bracket goes up. So for those who plan to have a drop in income and/or a drop in tax bracket EIULs might not be advantageous.

By now you are probably wondering why I am talking about mutual funds and 401Ks instead of the topic at hand, EIULs. I am trying to bring some clarity into the readers' thinking in order to break down certain categories in your mind. Categories created by folks surrounding investing, retirement, wealth. Frankly, most people are on a snipe hunt when it comes to creating wealth through mutual funds. They are looking at the amount of fees charged, or which mutual fund returns slightly better than others last year, or speculation on how much their 401K's will be worth somewhere in the future. Frankly, all that stuff doesn't matter. It only appears to be important because of the categories you have created and put mutual funds/401Ks into; retirement funds or wealth creation. Truly, mutual funds don't belong in those categories; they really belong in the asset protection category or more specifically the asset transfer category. I know that is a hard pill to swallow, but if you really look at information I have given you, and really think about it, you will understand why. You really are just moving some of today's income into tomorrow's income hoping to account for inflation.

Now let's talk about the EIUL. It is a life insurance contract. Life insurance is designed to solve two problems. The first is to protect against the loss of income in the case of death of an income producer. The second is asset protection from the tax man. Life insurance like mutual funds will not make you rich.

So let's burn down those straw men right now. Neither mutual funds nor life insurance have demonstrated the ability to make their owners wealthy. Anytime a mutual fund salesman/financial planner/CPA tells you that the rate of return from mutual funds is 8, 10 or 12% they are not being entirely truthful. (Don't respond with your own fantastic returns from mutual funds, it simply doesn't matter in this argument). Planning to live on less money in retirement than in your working life is planning to fail, no question about it. And not planning to have enough assets to have to protect them from the tax man is not what I call a real wealth plan.

Now it's time to put the pedal to the metal. Everyone who is planning to have a net worth less than $500,000, please raise your hand. Everyone who is planning to have a big drop in income when you retire, please raise your hand. Everyone who has no dependants or who plans to not have dependants and/or who plans to not have any assets to protect, please raise your hand. O.K., all those with your hands raised, EIUL is not for you.

Now, for the rest of you, here is how it works. Permanent life insurance has two sides, an insurance side and a cash value side. The cash value side either earns a fixed amount of interest or in the case of a variable universal life can be invested in the stock market. Equity indexed universal life insurance is of the fixed interest type, although your interest credited is connected to a stock index. EIULs have a floor in which the interest credited can't go below and a ceiling in which the upside is capped. So you know each year the cash value of your life insurance will go up between those two figures, say 2% and 12%. So each year, you look at how much the benchmark index (usually the S & P 500) goes up or down and you know how much your cash value will appreciate. Now here is the key provision. You can access your cash value through policy loans. The loans costs are generally no more than the interest credited (companies have different plans so make sure you understand how your company treats loans). When you take out a loan against your policy there are no tax implications as long as it was set up correctly initially. You are under no provision to ever pay back the loan. Now previous to 1982 you could load these contracts with as much cash as you wanted. Many of the wealthy loaded up their contracts with massive amounts of cash, enough to get the attention of the IRS. The IRS subsequently put limits on how you fund the cash value and how much insurance you need to go along with the cash. So the strategy is now codified into tax law. Follow their guidelines and you have no tax problems.

Properly structuring these life insurance contracts now means minimizing the face value of life insurance, which maximizes the cash value. The cash value increases in value depending upon the index, but never goes negative. By maximizing the cash value the cost of insurance stays low. The contracts I sell have a rider on them that precludes the owners from taking out so much cash that the insurance is not covered, keeping these contracts from lapsing and a taxable event occurring. Surrender fees generally stop at year 10 to 15, but the point is once you fund the contract to keep it for life, so surrender fees are really meaningless. Expenses and commissions are front loaded, so it takes about 10 years for these contracts to really start performing. That means if you are in your 60's this strategy probably doesn't make sense for you.

Anytime during the contract you can access your cash value with a policy loan tax free. Some people use them for retirement income, while others use it as a bank, purchasing automobiles and paying the policy back instead of occurring interest by getting a bank loan. They can also be used as a reserve account for emergency funding. This liquidity and flexibility is what makes them so attractive to folks like me and BawldGuy. What rate of return can one expect? Well, I run them with 6.5%, but the historical amount (using data back to 1950 and plugging in that historical figure is 7.5%). I like to be a little on the conservative side. Once again, the point is to transfer assets so as to protect them from the tax man, not create wealth. Look, the bottom line is an unleveraged investment must get a rate of return well over 12% to really build wealth; neither mutual funds nor EIULs are likely to get that high of a return!

So what is the bottom line? You use real estate investments to create the wealth. Leverage, depreciation, 1031 exchanges, etc. all do the wealth creating. Then you protect those assets against the tax man by using EIULs. And if something bad happens to you, your family is protected.

When you take away all the "straw men" arguments it all gets clear. Protect or not protect assets? Protect or not protect dependants? Accept a moderate rate of return for these benefits?

You choose?

Why EIULs Might Outperform Mutual Funds

Several months ago I posted on equity indexed universal life insurance products (EIUL) versus mutual funds on this and at Bawld Guy's real estate investment blog. There are always critics of this product that want to compare fees between the products. No doubt, EIULs have fees, many times more fees than low expense mutual funds like Vanguard. But, these folks miss the point. It is all about the strategies employed. Now, is a good time to talk how the basic strategy makes a difference. EIULs have guaranteed rate of return, usually 2%. They also have ceilings, like my favorite EIUL has a 30%/ two year ceiling. But more importantly, they never go negative. In other words any year the underlying index is negative, your EIULs cash value remains the same. Let's look how this factor can benefit you in down years like this year.

If you had $300,000 in a mutual fund at the peak of the market in April, and it got the S & P 500 market return (remember this is impossible since even Vanguard mutual funds have expenses and fees) it would be worth somewhere around $168,000 today. If you had cash value of of $285,000 (lets pretend the extra fees and the cost of insurance cost you $15,000) in a EIUL, it would be worth $285,000 today. You would need a 79% rate of return to get back to your $300,000 in your mutual fund. You need to get a 70% rate of return to catch up with the EIUL! That's right, a EIUL never gives a negative return. Looking at the historic rates of return, I doubt you will ever catch up with a EIUL, fees and all! Remember, we have a bear market, on average every 6 1/3 years that averages a 31% decline. We average 2-4 down years every decade! My EIUL has a two year 30% ceiling, so you would need to outperform that by more than 70% and still overcome other future down years!

Wall Street has been very astute at reacting to every challenge to its mutual fund industry. It has adeptly allowed people to focus attention on fees instead of the actual results of mutual funds. Now, as people panic and pull their money out, it has a built in blame factor to further hide the failure of the mutual fund strategy from folks. Already, they have cranked up the propaganda machine blaming individuals for the poor performance of their retirement vehicles!

Those of us who have EIULs are not afraid to look at our statements as they come in the mail, can you say the same!

Life Insurance; Who owns it and why?

Last week I spoke about my dislike of mutual funds as folks primary investment. This week I am talking about Life Insurance. Now let me be clear, like mutual funds, life insurance will not make you wealthy. However, it will provide a hedge against inflation and will protect you from the tax man.

Interestingly, most of the mass media "financial experts" tell people to buy term insurance and invest the difference, while some tell you how bad insurance is as an investment. Well, as usual, their advice runs contrary to what the wealthy actually do.

First off, as a financial product permanent life insurance is one of the few that has performed as it is advertised, with the exception of variable universal life insurance. So right off the bat, I am telling you to not buy that product. You see life insurance is not an investment, at least not the way some people try to sell it. Variable life insurance allows you to invest your cash value in mutual funds (any bells going off for you?). But the inherent costs of the product as well as the ability for folks to try to "time" the stock market makes it an inferior product in my opinion. But for variable universal life, permanent life insurance is a great product.

First, what it allows you to do.

1. Create a pool of money that YOU own and can be accessed without penalty (as long as you don't end the contract), and without tax issues for whatever reason you want without government interference;

2. Create a pool of money that your heirs can receive tax free (with the exception of the inheritance tax);

3. Create a pool of money that has guaranteed principal and minimum guaranteed rate of returns;

4. Create a pool of money that is protected from lawsuits (except divorce);

5. Protect your family from loss of your income if you die prematurely; and

6. Create a pool of money that can sustain you in your retirement years.

This money is protected by the insurance company you write the contract with. Life insurance companies rarely fail, unlike banks which fail by the thousands every decade or so.

Perhaps the most telling point is to look at what corporate executives use for their compensation packages. Here is a very small slice of companies that pay for life insurance as a form of compensation for their top executives:

American Express/Anheuser-Busch/Bank of America/Dow Chemical/Fannie Mae/General Electric/Johnson & Johnson/Harley Davidson/Pfizer/PNC Bank/SunTrust Bank/ TD BankNorth/Wachovia/Verizon/Lockheed Martin

The king is apparently William Ryan of TD BankNorth whose annual premium of $1,260,000 is paid for by the corporation.

Interestingly, banks along with purchasing life insurance on their key executives also buy what is called "Bank Owned Life Insurance." They own a tremendous amount of life insurance because it is considered "TIER ONE" capital, which is there to protect the bank in times of adversity. Other Tier One capital includes cash, gold, funds borrowed from the federal goverment and the federal reserve. Just so we understand, banks buy cash value life insurance for safety and as a reserve requirement. How much? Over 110 BILLION dollars of it. Corporations also own quite a bit of it.

So financially astute executives own it, banks own it, corporations own it, why do the so called experts tell you not to own it? Even some of the corporations that own a lot of it (GE), have their employees giving out advice not to own permanent life insurance!! Are you ready to throw out all those financial advice books into the nearest trash can yet? You should!

Here is the final story I would like to tell you. It might make your blood boil as it tells the story of how a corporate criminal kept millions away from those that he harmed. Remember Enron and its main man Kenneth Lay? About 10 years before his death, Enron purchased a $11.9M life insurance policy for him. In bankruptcy the trustees was able to collect the $1.25 M in premiums from his estate. Of course that left over $10M for his family. That came in handy as the rest of his estate was valued at $0. So after his death his wife collected over $10M that was paid for by Enron and no one could sue to get that money.

Chapter 4
Paradigm Shift

Paradigm Shift I

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, to social relationships. This paradigm shift is going on right under our noses, mostly unnoticed, and mostly uncommented on by the mass media. For those that 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. http://www.youtube.com/watch?v=luopS-xmQYI

I have decided to spend some blog time talking about the paradigm shift going on in the finance world. This is the first of a series of posts to address this issue. 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 did 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. Now, 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 directive;

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

5. Time and money have only indirect relationships.

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. The investor/banking way of thinking should not sound foreign to us. That is because these ideas have been around for a long time, but we only give lip service to them. Our 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.

Paradigm Shift II

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. But 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 the limited resources. Hence the lenders' set up a system that generally guarantees what is best for them is not best for their customers. 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 in my first post 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 folks 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. I will take that kind of year any day over a year that my income and expenses were evenly matched, yet my net wealth stayed the same. Now the funny 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 it is 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 or variable rate or 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 to and fro. This can only happen to folks working under the consumer paradigm. Folks who have move beyond this are not victims because they understand there is no scarcity. Human beings all have the capacity to act upon things, to control our 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.

Paradigm Shift III

How does a banker make money? Well they borrow money from folks 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 now, lending money to people who have a history of not paying their bills. 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. 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, Republican presidential candidate, and his company Bain Capital which turned 57 million dollars into 50 billion dollars. The famous financier JP Morgan, along with being a banker also 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. But the new emerging paradigm is about extending these ideas to a larger percentage of the people. Now on top of this is the fact the tax laws privilege 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 99% 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 a generation, 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 folks retiring 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.

These folks who consume investments 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! Here is another fact that should shock you. Study after study has indicated that consumers of mutual funds' total rate of return is approximately 10% below what the market returns! Why? Because folks think like consumers, selling their mutual funds to change to the hottest funds of yesterday, cashing in their 401K's to bid them over in times of trouble, and moving out of the market after a large drop in value.

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.

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. Now in all interest rate environments this works 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 for their residential mortgages up to 18%. Their commercial mortgages were over 25%. Now you can get at Certificate of Deposit for 5% and a mortgage for 6% 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 folks with no track record of commercial success or when some lenders lent money to individuals with bad credit. But as long as you have accounted for the ability to be 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 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 pull 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
Risk

Investment Risk I

I divide investment risk into four areas, strategic risk, systemic risk, emotional risk, and longevity risk. Today we will talk about strategic risk.

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Strategic risk is a variable that often gets left
out of the discussion. It is the risk that your
strategy will not give you the needed returns to
reach your goal.
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It easiest to understand by using specific examples. Let us begin by saying you have built a wealth plan that requires you to get a 10% rate of return from your investments in order to reach your goals. Now you look at the world of investments and you note that the stock market has returned 10% since WWII, real estate has returned 6%, and bonds 6%. So you figure equities is where you want to be. However, what are the chances you can get this rate of return? That is the risk. Since, you can't buy the whole stock market you settle for a broad based indexed mutual fund. However, all mutual funds have expenses. Now we know that the average mutual fund has returned around 7.5% over the last 35 years. Not bad, but we can't find a single mutual fund that has returned that high over that long of time period, and certainly we can't find one that has returned 10%. So that forces us to trade mutual funds searching for funds that are doing well while our existing one is not in order to try to pump up the return. But research has shown that active trading, on average, lowers our rate of return. So for this investment we see there is a large amount of strategic risk.

Lets look at real estate. On the face of it a 6% return will not get us anywhere close to our 10% requirement. But, we can safely use leverage with real estate. Lets say we purchase our re investment with a 80% Loan to Value mortgage, so we are leveraged 4 to 1. Now there are huge swaths of the country where putting 20% down will give you a positive cash flow, but lets be conservative and say our expenses equal our costs for this real estate. For the time being lets not count our depreciation, real estate taxes, and mortgage interest, tax savings. And lets say we allow our loan to value to go to 50% before we put that equity to use again so we have a two to one average leverage over the long run. With a two to one leverage situation for every 1% appreciation we get 3% rate of return. So if over the long run we get the historic average (6%) our rate of return will actually be 18%; well more than we need to reach our goal. Now what is the strategic risk with real estate? If the long term real estate return is only 4% (33% less than the historic average) we still make our goal with some to spare. Would we say that our strategic risk is exponentially less than with mutual funds? I would! Comparing odds, what are you chances of getting 25% more than the historic average for mutual funds compared with getting 33% less than the historic average with real estate? And remember we set aside the tax advantages for real estate, and did not count any positive cash flow that would likely accumulate!

Here is another quick example. The historic average over the last 40 years of an average mutual fund (can't really find a mutual fund that has been around that long with the same money manager) is 7.5%. The historic average for Berkshire Hathaway over that same time period is 21%. What are the odds of that Berkshire Hathaway going forward produces returns 1/3 as high as its 43 year history?

Note that financial planners never talk about the strategic risk of any given investment. Nor do they build plans that give you any idea of what the needed rate of return will be to obtain goals. Now you know why.

Investment Risk II

Following up on our discussion of strategic risk yesterday, we will discuss systemic risk today.

Systemic risk makes up the majority of what most investment folks consider risk. Very simply it is variance. It is the total margin, both positive and negative, of the possible rates of return. For a stock the possible negative is -100% or total loss of all capital and the possible positive is infinity. A stock can go up as high as its cash flow allows it. In more practical terms the total possible can be thought to be +500,000% (Berkshire Hathaway has gone up 400,863% in the last 43 years). So we can reasonably say that any stock has a variance of 500,100% (500,000% + 100%)!

Now we see why mathematicians think that any single stock is tremendously risky! Now as a way to deal with this risk, most investment professionals suggest diversification. What diversification does is truncate the possible rates of returns. For example, if you own 20 stocks it is highly unlikely that all 20 will go out of business. It is also highly unlikely that all twenty will return anywhere near what Berkshire Hathaway did. So we can say with a good degree of certainty that the negative possibilities decrease from -100% to -80% and the positive possibilities from +500,000% to +10,000% (The S & P 500 Index went up 6,840% in the same 43 year time period). So diversification decreases the possible variation of rate of returns from 500,100% to 10,080%. Quite a difference and why mathematicians were so impressed with diversification!

Now, I want you to look at the numbers again. The risk is uneven or skewed. The upside has much more potential than the downside. With diversification you really bring the upside potential down, but only reduce the downside potential by a little.

Warren Buffett does not believe in diversification as a strategy to reduce risk because of this skewed situation. He thinks one can pick companies that have good management, good cash flow, business plans that make sense, products or services that aren't going out of style, and product or name recognition that creates a protective moat around the business. He has demonstrated he can pick good companies. There are many others that do the same thing, just not in a publicly owned company.

The key take-away from this post is to understand that systemic risk equals variance and that it is skewed toward positive results. Your fear of loss of all your money (as opposed to 80% of your money) is costing you much upside potential! My point isn't to tell you not to diversify, but only to illuminate what it is costing you. Knowledge is king!

This 10 year chart of Berkshire Hathaway versus the S & P 500 Index I believe illustrates what I have been saying. Note, the much tighter range for the S & P than Berkshire. Berkshire has a much higher systemic risk (variance) than the diversified index! However, the payoff for assuming this risk is in upside movement!

Risk III

I have had several "financial planners" who have told me in discussion that they don't suggest certain strategies because their clients wouldn't be able to sleep at night. Although I don't agree with the logic, there are certainly people who forego activities because of the "good night sleep" factor.

Emotional risk is pursuing strategies that so unsettle one as to keep them from behaving rationally. For example, every time the stock market goes down significantly, many people sell their mutual funds/stocks because they fear more loss. Other people fear debt so much as to pay down their mortgages or put large down payments on their houses feeling like there is less risk in this strategy. Or others never consider strategies or self-employment because of an emotional attachment to a weekly paycheck or consistent earned interest.

I argue that emotions can be overcome with rational planning. If you have a specific plan, employ it consistently, and track its progress then one can overcome the negative emotions, fear, with a positive emotion, comfort. But here is the sticky part. If your plan is only to overcome a negative emotion, like getting rid of debt or risk, then you will never get to that comfort part because as soon as you succeed, you will have another fear supplant the current fear and start the cycle over again.

For example, if you eliminated the risk of equities from your life, and had your money in a bank CD or savings account, the current bank failure scare would ratchet up your fear again and cause you to pull your money from banks. Or if you were using your home as a savings account, paying down your mortgage, the current real estate market would again ratchet up your fear and probably cause you to lose sleep or even worse cause you to sell your home in a poor market.

The alternative is to build a plan that history has proven to work. Put your emotional energy into the implementation of the plan, and allow for the long term financial winds to push you past the finish line!

Of course having a wealth coach to help build your financial plan and walk you through the implementation process might help too. ☺

Risk IV

Among the assumptions we make in our lives, is how long we are going to live. I am not going into whether one should be pessimistic or optimistic about getting old, but will say that this risk is often not thought about except of course when those pesky life insurance sales people are banging on your door.

Longevity risk is the repercussions of living to short a life to create assets for one's family or the risk of living too long for one's accumulated assets. Both, have drastic repercussions, but have very different risks. A 35 year old male has a super low .16% chance of dying. Even at 50 the chance is only .56%. While there is a greater than 90% chance of someone outliving their money. This skewed risk pattern requires real clear thinking about personal finance. Clear thinking that most insurance agents and financial planners fail at!

Not until age 59 does the chance of dying move about 1%, it goes above 2% at 67, 3% at 71, and then starts up a steep slope breaking 10% at age 84. Now you know one of the reasons term life insurance is so cheap! The other is that people tend to drop the insurance after a couple of years. The life insurance company rarely (less than 1%) pays out on their term policies. Yet, life insurance agents and financial planners are always pushing term life insurance.

But the real and present danger for folks is the other side of the coin. The likelihood of running out of money before you die. We have record numbers of people having to work well into their 70's; not because they are bored, but because they have to in order to have a place to put their head down at night or buy gas or buy food! This risk is real and present danger that anyone can see around them, yet not really dealt with by most people!

Regular readers of this blog, recognize I talk about this risk all the time. In fact it might even be my primary directive to help people understand this risk and guide them to a wealth building plan that will eliminate it!

Risk; The Final Words

In the investment world, like life in general, you can never avoid risk. Instead of trying to avoid the unavoidable, the point is to embrace and manage risk. The best way to do that is to build a plan and stick to the plan until something fundamentally changes. Its funny, people have made money trading in stocks, have made money by buying and holding stocks, and by investing in fixed income securities, investing in real estate, but they all say the same thing; I constructed a plan and stuck to it!

What that should tell us is that you need to build a plan that has staying power. If you are investing in real estate and have to flip a property in a short period of time because of negative cash flow, then you are asking for problems. If you are investing in stocks and emotionally not prepared for down trends, haven't plan for them, then you are again asking for problems. There are ways to invest in stocks that doesn't depend on stocks going up all the time and there are ways to invest in real estate that doesn't depend on large amounts of capital appreciation. That is what I am talking about when I say manage risk and embrace it.

The bottom line is ***active*** investors have a plan for all market situations, while passive investors don't. ***Active*** investors have a plan built on historic evidence, while passive investors don't. ***Active investors have accounted for all contingencies while passive investors haven't thought about them.***

At the **Shafer Wealth Academy** (*www.shaferfinancial.com*) we think about what history tells us will happen and we plan for it. You don't fear what you already are prepared for!

Chapter 6
Miscellaneous

John D. Rockefeller, Debt, and Wealth Creation

The **Shafer Wealth Academy** (www.shaferfinancial.com) is dedicated to teaching people about how wealth is created and making an independent life. We can learn from the success of others. It is really unfortunate that so much is not taught in schools about wealth creation and the financial world. John D. Rockefeller was the wealthiest man in the history of the world even more wealthy in his time than Warren Buffett and Bill Gates are now. He was known as an exacting, very conservative, man whose first job was a bookkeeper. To him the business world was an exacting world where numbers spoke volumes and everything else was secondary. He spent his last 40 years of his life in retirement and is known as one of the greatest philanthropist ever. His Standard Oil company was demonized by the press and broken up as a monopoly by the politicians.

But how did this bookkeeper, who grew up relatively modestly, become wealthy? His first company was a partnership with two older gentleman (he was 20) that was in the commodity business. He felt his partners were purely speculators and wildly unpredictable. He was the sober one, that constantly reviewed the books and made decisions based on pure rational thought and the numbers. Where did the division appear between the partners and John D.? In the 1860's, during the Civil War, Rockefeller borrowed $100,000 from the banks to expand his oil refinery business. The partners, these wild speculators, were aghast. Now, $100,000 was a lot of money back then and the companies profits were less than $17,000 at the time, so we can see that there was some reason for their concern. But to the not yet 25 year old Rockefeller, this was what the numbers told him. He believed the oil business was here to stay and he wanted to be a big player in it. So for him, borrowing this amount was not a risk, but a necessity. His main concern was that the bankers would look at his partners and decide they were too great a risk. So Rockefeller used this schism to jettison the partners and buy the company for himself. The bankers trusted the sober, meticulous, Rockefeller and had no problem lending him more money as the numbers told Rockefeller to do. Later in life, after he was already the richest man in the world, he would eschew the banks and borrowing money, but that was more about his personal issues with bankers like JP Morgan, and his lack of a need for more capital than anything else.

Borrowing allows one to create leverage. It is why most people are able to create wealth through their homes. And it is why most people fail to create wealth elsewhere. Understanding the numbers and what they tell you is not as hard as most people would have you believe. The Shafer Wealth Academy will teach you how.

Now, there are many people out there that will tell you debt is bad and should be avoided at all costs. No doubt credit card debt to buy consumer goods is not the best thing to do; John D. would be flabbergasted at such outlandish consumerism! But, debt to take advantage of business opportunities is a different animal. Financial leverage, building business leverage, and leverage to create value is one of the basis for creating wealth. When evaluating investments the first thing one should look at is the leverage created. If no leverage is created, then the returns can only be miniscule. It is the law of money.

I wonder if all those financial planner folks who advise their clients and write books about avoiding debt, really understand that they are making sure their clients will not become wealthy? I assume they are more concerned with not getting sued than in helping their clients create wealth. At the least they are participating in what many workers for Wall Street companies describe is their goal; Turn your clients wealth into your wealth! Warren Buffett describes Wall Street as a place where people drive their Rolls-Royce to Wall Street and turn their money over to people who ride the subway to work!

Learn about wealth. Learn about Leverage. Don't turn your money over to Wall Street. Sage advice from those that have created wealth.

401K Condo????

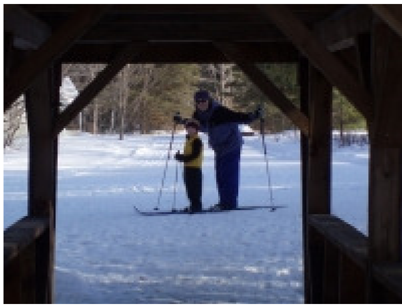
One of the best decisions we ever made was to purchase a condo in the white mountains of New Hampshire. We made the decision quickly when an opportunity came up. I think it was a critical decision made because our thinking on wealth building had changed due to much reading and personal evaluation. At the time it was not clear that our wealth building had been transformed for the positive or that we would be traveling a very different personal road that what we had been traveling. But it set the seed of our personal wealth creation transformation.

In his excellent book Missed Fortune 101, Doug Andrews calls the purchase of a second home a 401K condo. He thinks that owning a second home and paying the expenses/mortgage is a better retirement plan than spending the same amount inside a 401K. I think he is probably right on his math and strategy advice. Further he states that his 401K condo is a place for creation of memories that a 401K can't duplicate. I can attest to the absolute correctness of this.

The memories that our condo has created for us makes us wealthy in ways that simply can't be counted. It is a part of what can be described as "true wealth." But it goes even further than simply memories and real estate investments. In short the condo made us feel wealthy, even before it started to add to our net worth. And that feeling I believe has led to even more wealth coming into our lives.

My wife comes from a large family and many in that family have come and stayed at the condo. Some of our friends have done the same. My sister-in-law lives around the corner and she has many of her relatives and friends stay there. We have become friends with other's that own there. The ripples continue to go beyond any direct benefits that can be counted.

So for any of you that are thinking about purchasing a second home and are trying to come to grips with the numbers, understand that the numbers are only a small part of the story. Don't let people, events, or things cause you to hesitate.

Option Arm Loans: Good or Bad Product?

West Coast Banks like World Savings, Washington Mutual, Countrywide, and others have originated and propagated option arm mortgages. In short a option arm is a short term variable rate loan that recalculates the rate frequently based on the "COFI Index." This index represents the rate depositors are paid for savings accounts in the 11th District. Most of these loans are sold with a lower "teaser" rate that is only good for a short period of time. In addition to the variable nature of the loan, 4 payment options are given. These usually range from negative amortization payment to a 15 year amortized payment. Most people that have this loan choose to pay the negative amortization amount. This means that every time they make a payment their loan amount is increasing. Popular in California, the underwriters allowed folks to qualify for these loans using the teaser rates. In short, you could buy a more expensive home using this loan than the other types of loans.

The people selling these loans usually advertised the payment rate and kept the actual interest rate from the consumer as long into the process as they could. There is a reason for this. Because these loans are considered higher risk loans, they had a higher underlying interest rate. This "premium" was anywhere from 1% to 3%. Now in order to make these loans seem less expensive than they were, and to add to the profit mortgage originators made, almost all option arm's were sold with a 3 year pre-pay penalty.

One final comment on these loans. When the loan value went up to 110% of the original value the negative amortization payment rate drops off and your required payment moves to an amortizing payment rate.

Now here is what is happening to folks with these loans. They have seen their loan amount go up, their real estate value go down, and their payment rate go up. If they tried to get out of these loans they were hit with the triple whammy. Pre-payment penalties of 6 months interest, little or no equity left, and debt to income ratio's that are too high for conforming loan standards.

In short, they are stuck in a very expensive product that has a much higher interest rate than they could have qualified for at the time of their loan.

I have never sold an option arm loan. I think they are too dangerous for most folks and too expensive to consider. You make the decision for yourself what you think of these loans. If you want one there are many folks who will sell you one, just not me.

True Wealth

On the eve of my rollout of the Shafer Wealth Academy, I thought I would put some thoughts on my blog about what "True Wealth" is about.

First, I need to digress a little. For years I worked as someone's employee. Sometimes this relationship was good, and sometimes it wasn't, but the real issue was that I wasn't particularly happy. For me it was loss of control of my life. My last job, when a client wanted us to work for them, it usually meant travel and overnight stay, many times on short notice. When our son arrived, this situation became a source of unhappiness.

When circumstances dictated a job change, I came to believe that being someone's employee was not where I wanted to be, so I started Shafer Financial. Since that decision it has been both emotionally and financially up and down, but the bottom line is that I am a happier person because I have control over my time. When my dad died, I was able to grieve and deal with closing down someone's life without having to worry about a boss's expectations. When there was a school function for my son, I went. When my wife needed me I was there. I am able to prioritize what is important to me.

That is the core of what "True Wealth" is about. I believe in order for people to have more control over their lives they must start with their financial life. Once control over one's financial life is established, it works its way outward to all other parts of their lives; their personal relationships, their health, intellectual, and spiritual lives.

In my mind, creating true wealth is dependant on the confidence and security that comes with seeing your net worth increasing year after year. And that is dependant on getting one's mind around a new way of thinking. Unfortunately, developing a new way of thinking (a new paradigm) is not as simple as reading a book or two or going to a weekend seminar. For me it took several years of reading, thinking, and introspection to start to see that change. Had I had a mentor to help me through this process, I believe it would have happened more purposefully, and ultimately been a quicker process.

The actual techniques used to build net worth are individualistic, and that is also a new concept for many people. Warren Buffet, perhaps the greatest investor ever, Donald Trump, Robert Kiyosaki, all uniformly think that the "save and invest in mutual funds" thought pattern is not likely to create wealth, nor in my opinion create the security needed to be able to move successfully into new paradigm thinking.

The aim is to move our way of thinking into a place that can see opportunity when it comes by, act on it without fear, and end up in a place of control over our lives.

Hope, everyone has a happy holiday season. My family and I will leave for our condo in New Hampshire soon. There is already good snow up there. You should see the smile on my son's face, when told of this. He loves to ski and snowboard.

Thanks for reading "The Best of Uncommon Financial Wisdom." I hope it has stimulated your thinking about personal finance. My new web site will soon be up at www.shaferfinancial.com. I have added a new component to the Shafer Wealth Academy. Now you can gain access to my thinking and have a personal wealth coach on a monthly basis. For $150/month you can hire a personal wealth coach to help you transform your life. There is no long-term commitment requirement, enabling you to experience having a wealth coach for a small fee. This is billed on a month-to-month basis allowing you to determine whether you want to continue the relationship or end the relationship each month. Frankly, I can't imagine a better deal. Simply contact me through the blog or at shaferfinancial.com or shaferwealthacademy.com to determine if there is space available and if you are a candidate for wealth coaching.